COMMENTS IN RESPONSE TO NOTICE 2000-29

These comments (these “Comments”) are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the Section of Taxation of the American Bar Association.

These Comments were prepared by individual members of the following three Committees of the ABA Section of Taxation: Partnerships, Real Estate, and Employee Benefits. The principal draftpersons of this report are Paul Carman and Kevin Thomason, with substantial contributions by Stephan Bachelder, Sheldon Banoff, Steven Breitstone, Adam M. Cohen, Terry Cuff, David Culpepper, Allan Donn, Chuck Fassler, Glenn Ferencz, Barbara Freedman, Steven Frost, Leigh Griffith, Kristen Hazel, Elizabeth Bergin Hess, Anthony Ilardi, Robert Keatinge, Victor Keen, William Klein, Paul Lion, Scott Ludwig, Angela Macropoulos, John Maxfield, Christopher McLoon, Todd Molz, Payson Peabody, Steven Schneider, Walter Schwidetzky, Barbara Spudis-Demarigny, and Thomas Yearout. The Comments were reviewed by Adam Handler of the Section’s Committee on Government Submissions and by Stanley Blend, Council Director for the Committees on Partnerships and Real Estate.

Although members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact person: Steven Frost
Telephone (312) 845-3760
Fax (312) 701-2361

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EXECUTIVE SUMMARY

The recent rise in the popularity of the use of options, convertible debt, and preferred partnership interests convertible to “common” partnership interests both in the employee compensation area (“Service Options”) and when issued or deemed issued for consideration other than services rendered to the partnership (“Investment Options”) has highlighted the absence of certainty regarding the appropriate treatment of the grant, lapse, repurchase, sale and exercise of such items, especially when compared to the relative certainty of the treatment of the grant, lapse, repurchase, sale and exercise of options to obtain, and debt convertible into, shares of corporate stock. In Notice 2000-29\(^1\) (the “Notice”), the Internal Revenue Service (the “Service”) and the Department of Treasury (“Treasury”) requested public comment on “the tax consequences to the recipient of the partnership interest as well as to the partnership upon the exercise of a partnership option or conversion of a debt or preferred interest in that partnership.” These Comments and recommendations were prepared in response to the request contained in the Notice.

A summary of our Comments and recommendations is as follows:

1. Although neither the entity nor the aggregate theory is mandated by statute, regulations, rulings or case law, we believe that policy analysis and case law support the application of the entity theory to an analysis of the tax consequences of the issuance, lapse, repurchase, sale and exercise of partnership options.

2. To the extent not otherwise mandated by existing law and policy, we believe that it is desirable to parallel the treatment of corporate options in the treatment of partnership options. We believe this is desirable not only from a general simplification perspective, but also from the perspective of aiding the orderly administration of a tax system based upon the reasonable predictability of commercial transactions. The tax impact of the distinctions between entities is beyond the understanding of the ordinary business person, so distinctions in treatment that are not inherent in the nature of partnerships as flow-through entities only serve to create traps for the unwary and inadequately advised.

3. The partnership, the historic partners and the optionee should not recognize income on the issuance or exercise of an Investment Option.

4. Administrative guidance should be issued on whether the optionee recognizes income if the optionee uses appreciated property to pay the option premium.

5. Section 1234(a)\(^2\) should apply to the purchaser of an option.

6. The partnership, the historic partners and the optionee should not recognize income on the issuance or exercise of a Service Option other than the income and deduction consequences that would occur under Section 83.

\(^1\) 2000-23 I.R.B. 1241 (June 5, 2000).

\(^2\) All references herein to “Sections” are to sections of, and to the “Code” are to, the Internal Revenue Code of 1986, as amended.
7. To the extent an adjustment to the capital accounts is necessary to reflect the economic agreement between the partnership and the optionee, such an adjustment should occur at the time of exercise. The treatment of such an adjustment should be that it would be nontaxable to the partnership, the historic partners and the optionee if the adjustment is made to reflect the economic consequences to the parties, whether to reflect the agreement of the parties or to reflect adjustments necessary to take into account consequences under Section 83. Administrative guidance may be necessary to clarify that the Treasury Regulations (herein “Regulations”) promulgated under Section 83 are intended to apply to Service Options issued by partnerships. Administrative guidance should be promulgated to clarify that adjustments to capital accounts under Regulations Section 1.704-1(b)(2)(iv)(f) and/or Regulations Section 1.704-1(b)(2)(iv)(q) should not by themselves be taxable events because they either reflect (i) the economic realities already taxed under Section 83 or (ii) the economics already reflected in the arms’ length option premium and exercise price as described in these Comments.³

8. A majority of the Options Group believes that administrative guidance should be issued to clarify that the Service will not treat an exchange of options as a taxable event if an option is exchanged as result of a merger of an issuing partnership into another partnership or conversion of an issuing partnership into another form of entity that is treated by Subchapter K as a partnership. A portion of the Options Group believes that the law is not certain enough to make a recommendation.

9. A majority of the Options Group believes that administrative guidance should be issued to clarify that the Service will not treat an exchange of options in the context of the incorporation of a partnership as a taxable event if the new optionor corporation acquires substantially all the assets of the original optionor and takes a carryover basis in such assets. A portion of the Options Group believes that the law is not certain enough to make a recommendation.

SPECIFIC COMMENTS IN RESPONSE TO NOTICE 2000-29

1. THE GENESIS OF THE ISSUE.

1.1. Increased Use of LLC’s and Partnerships. In recent years, many factors have motivated business owners to utilize unincorporated business organizations taxed as partnerships (herein collectively referred to as “partnerships”). Such factors include (i) the flexibility available to partnerships in allocating income and expenses, as well as cash flow, to different owners at different times during the life of the entity, (ii) the avoidance of the federal corporate income tax without being forced to grapple with the rigid requirements of Subchapter S, (iii) the preferential treatment accorded partnerships, and sometimes LLC’s, under applicable state tax laws, and (iv) the relative ease with which partnerships can be converted to corporations, as compared with the converse.

³ It may be appropriate to tax the optionee on the transfer of appreciated property in payment of the option premium or upon receipt of the option in satisfaction of an obligation.
1.2. The Business Need for Options. For many years options (including warrants) to acquire equity in corporations have been utilized for a variety of business reasons, including incentivizing key employees, paying vendors with “non-cash” property, and motivating investors and lenders to advance needed funds.

1.3. Treatment of Non-Qualified Stock Options is Clear. The tax treatment of non-qualified corporate stock options is well settled. If such options are issued to a grantee for services rendered by such grantee to the corporate issuer, Section 83 and the Regulations promulgated thereunder provide rules for the timing and amount of the income recognition to the grantee and the deduction to the corporate issuer. Section 1032 generally provides the treatment for the corporate issuer of options on the issuance and exercise of options other than in regard to the compensation deduction controlled by Section 83. Except as provided in Section 108(e), the corporation is not taxed on the issuance of its stock.\(^4\)

1.4. Treatment of Partnership Options is Not Clear. Although there are a growing number of articles on the topic,\(^5\) the treatment of the issuance and exercise of options under Subchapter K presents a wide range of questions for which there are no clear answers provided by the Code or Regulations. Whether considering options issued to key employees, warrants issued in connection with loans to a partnership, debt issuances that contain some feature of convertibility to equity of the partnership, or preferred classes of partnership interests that are convertible in some fashion to a more “common” interest in the partnership, no clear authoritative guidance exists regarding how the issuing partnership, the historic partners of such partnership, and the option holder, lender or preferred partner are to report the tax consequences of the issuance, sale, lapse and exercise of such options. Simple analogies to the treatment given similar options in the corporate context fail to address the “capital account maintenance” issues and partnership allocations of income, deduction, gain and loss. Lack of authority on the proper adjustments to capital accounts and the tax consequences of such adjustments have left taxpayers relying upon the adviser’s intuition as to the “best” treatment.

2. TREASURY/IRS REQUEST FOR COMMENTS—NOTICE 2000-29. In the Notice, the Service and Treasury requested “comments on the tax consequences to the recipient of the partnership interest as well as to the partnership upon the exercise of a partnership option or conversion of a debt or preferred interest in that partnership.”

3. RESPONSE. The LLC Task Force of the Tax Section of the American Bar Association (the “Task Force”) has coordinated the efforts to prepare these Comments. The Task Force is comprised of members of various Committees of the Tax Section of the American Bar Association, with a heavy involvement by members of the Partnerships, Real Estate and Employee Benefits Committees. As of May 2001, the Task Force became a Subcommittee of the Partnerships Committee of the ABA Tax Section, but it will be referred to herein as the “Task Force”. In mid-2000, the Task Force decided to take on the project (the “Options

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\(^{4}\) See, I.R.C. § 1032.

\(^{5}\) See, attached Bibliography.
Project”) of preparing a response to the request for comments contained in the Notice. At that time, the Chair of the Task Force asked for volunteers to work on the Options Project, and to date approximately 30 members of the Tax Section (the “Options Group”) have volunteered. Because of the need to address compensatory, as well as non-compensatory, options, several members of the Employee Benefits Committee of the Tax Section of the ABA have been involved in the Options Project.

4. DEFINITIONS, ASSUMPTIONS, ISSUES AND ANALYTICAL APPROACH.

4.1. Classifying Options. The Options Group determined that the classic compensatory/noncompensatory distinction between the types of options that could be issued by a partnership did not describe all of the relevant types of such options. With the general focus of the professional community being on compensatory options, options issued for services, a tendency had developed to think of all other options in the same way. However, that understanding was too narrow in that it assumes that the same rules would apply to all types of noncompensatory options. Therefore, the Options Group has analyzed the federal income tax treatment of two general types of options: the Investment Option and the Service Option, but acknowledges the existences of a variety of types of options.

(a) The Investment Option. An “Investment Option” is an option to acquire a partnership interest in a partnership (P1) granted by P1 to an investor (I) in consideration of the payment by I to P1 of cash or other property.

(b) The Service Option. A “Service Option” is an option to acquire a partnership interest in a partnership (P2) which is granted by P2 to a service provider (S) in consideration of the performance of services by S for P2.6

Examples utilizing this terminology will be presented throughout these Comments.

4.2. Assumptions. Unless otherwise stated, in preparing the examples and throughout these Comments the following assumptions have been made:

(a) The grantee of the options is not a partner of the partnership at the time of the grant of the option and does not obtain any other partnership equity unless and until such grantee exercises such option.7

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6 Other types of options include a rent option and a debt option. A “rent option” is an option to acquire a partnership interest in a partnership (P3) granted by P3 to L in consideration of the use by P3 of property (tangible or intangible, real or personal) of L. Examples would be (i) the use by P3 of L’s office space in exchange for an option to purchase an interest in P3, (ii) the use by P3 of L’s patent in exchange for such an option, (iii) the use by P3 of L’s equipment in exchange for such an option, and (iv) the use by P3 of L’s money in exchange for such an option. Generally, options issued in respect of the payment of obligations would be treated as Investment Options because of the investment unit provisions in the original issue discount rules. See, Treas. Reg. § 1.1273-2(h); TAM 200043013 (June 30, 2000).

7 This assumption has been made because of a concern that treatment under I.R.C. § 707 may differ in timing, and potentially in amount, from treatment under I.R.C. § 83. It has also been noted that although the statutory
(b) With regard to any Service Options, such options do not have a readily ascertainable fair market value within the meaning of Section 83.

(c) The option terms are such that the option would not be deemed to be substantially certain to be exercised utilizing the analysis set forth by the Service in Revenue Ruling 82-150 or as the issue is interpreted by the applicable case law.

(d) Until specifically added to the analysis, special statutory, regulatory or judicial alterations to the normal rules of income realization and recognition and the timing of deductions, e.g., Section 83 with regard to Service Options will be ignored, the intention being to first identify the fundamental rules governing the taxation of partnership options, then to add such existing statutory, regulatory and common law overlays to such analysis, and finally to identify open or troublesome issues and recommend solutions.

(e) All of the partners, optionees and assignees of options are unrelated to each other.

(f) Each option grant is made at arm’s-length.

(g) Each partnership has a partnership agreement that provides that taxable gain, loss, income and deductions are shared in a manner that satisfies Section 704(b) and (c) requirements.

(h) Except where expressly so stated, when valuing the partnership interests in the following discussion and the examples, when necessary to compute the fair market value of a partnership interest, no discounts for marketability or lack of control are taken into account. Thus, the fair market value of each partnership interest is equal to its ratable share of the net fair market values of the assets of the partnership.

(i) All of the options are for interests in partnership capital and profits, and not merely for interests in partnership profits.  

(j) With regard to each Investment Option, no consideration is given for the option other than the specified option premium of cash or other property.

language of I.R.C. § 83 would apply to payments by a partnership to a partner, the language of the Regulations would not literally apply.

8 1982-2 C. B. 110.

9 The combination of Revenue Procedure 93-27, 1993-2 C.B. 343 and Revenue Procedure 2001-43, 2001-34 I.R.B. 191 (August 3, 2001) greatly simplified the treatment of a recipient of a profits interest in a partnership (See discussion of the two Revenue Procedures in attached Appendix B). However, it seems unlikely under current law that an option would be granted in respect of an interest that would still be a profits interest at the time of the exercise – although the Options Group is aware that documents attempting to accomplish this result have been drafted by some tax practitioners.
(k) Sections 707(a)(2)(B), 731, 751 and 752 do not apply.

(l) In each example, the partnership is the grantor of the option.

4.3. Issues to be Addressed. Although the Notice requested comments on the tax consequences only to the recipient of the partnership interest as well as to the partnership upon the exercise of a partnership option or conversion of a debt or preferred interest in that partnership, we believe that useful input on those issues cannot be provided without also addressing the issues arising upon the issuance, lapse, repurchase and transfer of partnership options. These Comments address all of such issues so as to present an integrated approach to the entire area of options for partnership interests.

These Comments address the issues related to the tax exchange of options potentially resulting from the modification or exchange of the options, the merger of the issuing partnership into another partnership and the incorporation of a the issuing partnership. Although the issues presented by these sections are substantially similar in many respects, three different subgroups of the Options Group addressed these issues. These Comments leave the differing approaches of the subgroups intact, illustrating the differences of opinions in the area. However, the conclusions of the subgroups are substantially the same.

These Comments do not address preferred interests convertible into “common” partnership interests. Similarly, these Comments do not analyze options that are embedded in and inseparable from debt instruments.

4.4. Analytical Approaches.

(a) Desire to Approximate Corporate Treatment. We believe that where possible and appropriate it would be preferable that the tax treatment of the grant, lapse, repurchase, sale and exercise of options for partnership interests be consistent with that of options for corporate stock. Both for the purpose of simplifying the administration of tax in general and for the purpose of promoting the voluntary compliance system by making the results of transactions reasonably predictable so that, except where some overriding policy concern would dictate a contrary result, similarly situated taxpayers should be treated similarly.

Although current Sections 721 and 1032 have certain differences in language, there is no policy basis for the distinction. Section 1032 as originally added to the Code by the 1954 Act provided:

No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

Section 721(a), which has remained substantively unchanged since the enactment of the Internal Revenue Code of 1954, reads as follows:
No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for a partnership interest.

The regulations originally proposed under Section 1032 were limited to the literal language of the Code section and covered only exchanges of stock for money or property, causing income recognition to a corporation on the issuance of its own stock in consideration for services. As adopted, Regulations Section 1.1032-1(a) provides that:

A transfer by a corporation of shares of its own stock (including treasury stock) as compensation for services is considered, for purposes of section 1032(a), as a disposition by the corporation of such shares for money or other property.

The amended Regulations Section effectively adopted a cash-out cash-in approach for the treatment of issuing stock in exchange for services.

In contrast, the Regulations under Section 721 currently provide:

To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply.

Thus, the Service has by Regulation interpreted nearly identical statutory language with diametrically opposed results. Corporations are protected from a recognition of income on the issuance of stock in payment of services by a deemed circular flow of cash which the Service has supported by its regulatory authority. Partnerships (or the partners), on the other hand, arguably are subject to income recognition on the issuance of their own interests in exchange for services.

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10 Prop. Treas. Reg. § 1.1032-1(a) (1956). Such treatment would parallel the treatment that is arguably required under the second sentence of current Treas. Reg. § 1.721-1(b).

11 The expansion of the statutory language by Treas. Reg. § 1.1032-1(a) applies only to the satisfaction of compensation obligations with stock. Both the Code section and the Regulations are silent on the satisfaction of other obligations with stock. Section 108(e)(2) would exclude from income discharge of indebtedness to the extent the payment of the liability would have given rise to a deduction. Section 108(e)(8) treats the satisfaction of a corporate debt with stock of the corporation as being satisfied with cash equal to the fair market value of the stock for the purposes of determining income from discharge of indebtedness. However, neither provision of Section 108 deals with the potential gain to the corporation on the satisfaction of an obligation with its own stock.

12 Treas. Reg. § 1.721-1(b). Arguments have been made that the quoted language only causes gain recognition to the recipient partner. However, in the absence of the application of the Section 721, it is unclear what authority protect the partnership or the historic partners from income recognition.
under the current regulations\textsuperscript{13} because the partnership is paying compensation with a partnership interest in which the partnership has a zero basis.

To the extent possible, these Comments attempt to treat partnership options similarly to stock options. In applying this principle, we have first assumed that the issuance of a capital interest in a partnership would be treated similarly to the issuance of stock in a corporation. Such a result may require the promulgation of administrative guidance, but the Regulations under Section 1032 demonstrate that such guidance is within the authority of the Treasury.

It has also been occasionally argued that, even if a capital interest in a partnership were exempt from taxation by the application of a cash-out cash-in approach similar to that under the Section 1032 Regulations, an option is separate property with a zero basis in respect of which Section 1032 provides statutory protection from income recognition, but Section 721 does not. Such an argument does not take into consideration the historical development of Section 1032.

In 1984, Section 1032 was amended to add the following sentence:

\begin{quote}
No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock).
\end{quote}

Prior to the addition of the second sentence of Section 1032(a), the issuing corporation’s treatment of an option in respect of its own stock was described in Revenue Ruling 72-198\textsuperscript{14}. Citing Revenue Ruling 57-40, Revenue Ruling 72-198 concluded that the issuer’s treatment is deferred until exercise. At exercise, the issuer did not recognize income under the authority of the first sentence of Section 1032(a), which is parallel to the existing language of Section 721. Thus, just as the Service promulgated Revenue Ruling 72-198 interpreting the statutory language of Section 1032 that was then parallel to Section 721 as supporting nonrecognition to the issuing entity on the issuance of options, it would be within the authority of the Service to similarly interpret Section 721. In other words, it is proper to interpret Section 721 as providing that a partnership issuer’s treatment is deferred until exercise of the option, and, at exercise, the issuer does not recognize income, since that is how Revenue Ruling 72-198 interpreted language under former Section 1032 that was substantially identical to the current language of Section 721.

Although Section 1032 now does have a second sentence that addresses income on the lapse or acquisition of an option and Section 721 does not, the two Sections were originally substantively identical with the statutory changes being made to codify Treasury interpretation rather than expressing a legislative desire for differing treatment.

In addition, in 2000, the Service promulgated final Regulations under Section 1032 extending the non-recognition treatment of Section 1032 to the issuance of stock in situations in

\textsuperscript{13} The satisfaction of an obligation to pay compensation with appreciated property is taxable to the payor. See, \textit{U.S. v. Davis}, 370 U.S. 65 (1962). See, also, Willis at ¶ 4.05.

which a subsidiary entity exchanges stock of the parent for money or other property.¹⁵ The Regulations provide that the transaction is treated as if the subsidiary purchases the stock of the parent in exchange for cash contributed to the subsidiary by the issuing corporation.¹⁶ Thus, in respect of corporations, the Service has recently affirmed the use of a cash-out cash-in method, which is discussed in greater detail below, even in situations not expressly addressed by the language of Section 1032.

(b) Use of General Option Principles. We believe that where possible the general rules found in the existing Code, Regulations and case law concerning the taxation of options should control the tax treatment of the grant, lapse, repurchase, sale and exercise of options for partnership interests.¹⁷

(c) Entity vs. Aggregate Theories. Much of the discussion surrounding the issues raised in the Notice has centered on which of the major theories of partnership taxation – the entity theory, in which a partnership is viewed as a separate entity from the partners,¹⁸ or the aggregate theory, in which a partnership is viewed as an aggregation of partners and the assets and trade or business of the partnership is treated as directly owned by the partners without considering the partnership as a separate entity ¹⁹ – should control the treatment of partnership options. The analytical approach found in these discussions seems to be that one or the other theory should dominate in each area of the Subchapter K arena, and once the superior theory is determined it would guide the treatment of whatever specific issue is being examined.

Because so much attention has been devoted to this debate, we undertook an analysis of such theories.²⁰ The conclusions of our analysis are that (i) neither theory has been determined

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¹⁵ Treas. Reg. § 1.1032-3.


¹⁷ Prior to the addition of the second sentence of Section 1032, general option principles were viewed as sufficient to determine the treatment of a corporation issuing options. The issuing corporation’s treatment of an option in respect of its own stock was governed by Rev. Rul. 72-198, 1972-1 C.B. 223, obsoleted by Rev. Rul. 86-9, 1986-1 C.B. 290.


¹⁹ Youngwood, p. 39. A relatively pure application of the aggregate theory is illustrated by the decision in Benjamin v. Hoey, 139 F.2d 945 (1st Cir. 1944). In Benjamin v. Hoey, the court considered whether the income of a partner in a brokerage firm included his proportionate share of the commission he, individually, paid to the firm. The court held that to the extent of the partner’s interest in the partnership, the partner was dealing with himself and did not create income. This approach was specifically rejected under almost identical facts in Heggestad v. Commissioner, 91 T.C. 778 (1988), under the authority of I.R.C. § 707.

²⁰ Our analysis is attached as Appendix A to these Comments.
by the courts, ruled administratively by the Service or overwhelmingly adopted by commentators to be the theory applicable in all situations arising under Subchapter K,21 (ii) to the extent that any trend has developed, the entity theory appears to be dominant, and (iii) both theories have been utilized – by the Government, the taxpayers and the commentators – to support whatever was ultimately deemed to be the appropriate policy result. Thus, it appears that the more productive approach to solving this and other Subchapter K debates is to determine the appropriate policy applicable to a particular transaction or set of facts, and then ensure that the results can be supported by the applicable theory.

Because, as stated above, we generally believe that the tax treatment of the issuance of options by partnerships should parallel the tax treatment of the issuance of options by corporations, we have generally applied the entity theory in these Comments.

4.6. Structure of these Comments. In these Comments, we will first address the issues arising upon the issuance, lapse, repurchase, sale and exercise of Investment Options and Service Options. We will proceed through the lifecycle of each type of option, setting forth the appropriate treatment to the various taxpayers involved, including the recommended capital account adjustments. Where such treatment is well settled, we will so state. Where the treatment is not well settled, we will also point that out, refer the reader to an extended discussion of the open issue provided later in these Comments, and state our conclusion as to what the treatment should be. Finally, where administrative action appears necessary or helpful in order to clarify and settle open issues, we will suggest the preferred action.

5. INVESTMENT OPTIONS.

5.1. Grant of an Investment Option. Although the issuance of a capital interest in a partnership is covered under Section 721, currently neither the Code nor the Regulations under Section 721 directly address the treatment of the issuance of an option. Consistent with our analytical approaches discussed above, we have attempted to treat the issuance of an Investment Option in a manner similar to an option issued by a corporation. In other words, we have applied general option treatment to defer the consequences of the issuance until exercise.

To illustrate the issues arising with regard to Investment Options, we will begin with a simple, although not necessarily realistic, example:

Example 5.1. On January 1, 2001, A and B form an entity (P1) that is treated as a partnership for federal income tax purposes and each contributes $100 to it. On that same date, P1 purchases a tract of unimproved real property (R) for $200 to hold for investment. On February 1, 2001, at a time when R still has a fair market value of $200 and P1 has no other asset or liability, I purchases from P1, for a cash premium of $10, an option to purchase a one-third partnership interest in P1 for $90.22 The option may be exercised at any time during the ensuing

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21 See, e.g., the discussion of the two theories in Rev. Rul. 75-62, 1975-1 C.B. 188.

22 This example assumes the option has an independent value of $10.
10 years and is non-transferable except with the consent of P1. The amount paid to P1 by I upon the purchase of the option will be held as cash for the duration of the term of P1. On March 1, 2002, at a time when R still has a fair market value of $200 and P1 has no other assets or liabilities other than the $10 paid by I for his option, I exercises the option by paying $90 to P1. On April 1, 2003, P1 sells R for $200, the amount of P1’s tax basis in R, recognizing neither gain nor loss, and distributes in a final liquidating distribution the $300 it then holds, $100 each to A, B and I.

(i) Consequences to Grantee. The purchaser of the Investment Option, I, recognizes no income upon the grant of the option.23


(iii) Capital Account Adjustments. The premium received upon the issuance of an Investment Option should be credited to a “Deferred Account” (herein so called) and not otherwise currently taken in consideration in the capital accounts.35


24 1958-1 C.B. 279.


27 1965-1 C.B. 365.

28 1966-1 C.B. 149.

29 1967-1 C.B. 195.

30 1968-1 C.B. 363.


33 1978-1 C.B. 265.


5.2. Exercise of Investment Option.

(a) **Introduction.** At the time of exercise, both the amount of the option premium plus the exercise price should be treated as a capital contribution pursuant to Section 721. Neither the issuing partnership nor its partners should recognize income upon exercise of an Investment Option, subject to the potential application of Sections 707(a)(2)(B), 731, 751 and 752.

The capital accounts of the partners, including the exercising optionee’s capital account, should be adjusted immediately following the exercise to reflect the economic arrangement as reflected by the option and the partnership agreement. This adjustment should be made irrespective of whether at the time of exercise there is sufficient unbooked appreciation in the partnership’s assets to balance the partners’ capital accounts. This could be accomplished by way of a revenue ruling clarifying the application of Regulations Section 1.704-1(b)(2)(iv)(q). Section 704(c) principles should apply to resulting book-tax differences.

(b) **Discussion of the Recommended Approach.**

(i) **Entity Approach; Apply Section 721.** We recommend that the entity approach be applied with respect to the treatment of Investment Options and that guidance be issued to clarify that the exercise of an Investment Option not be taxable to the partnership, the historic partners or the optionee pursuant to Section 721 and well-established option principles, regardless of whether the transaction results in a capital shift between partners. The tax-free treatment of the exercise of an Investment Option is consistent with the tax treatment on exercise of the holder of Investment Options in other contexts (e.g., both in the context of an Investment Option to acquire the optionor corporation’s stock and in the context of an Investment Option to acquire other property such as real estate). Under this approach, both the option premium and the exercise price would be treated as a capital contribution pursuant to Section 721 at the time of exercise, giving the option holder a basis in the optioned property equal to the basis in the option (i.e., the option premium) plus the exercise price. The optioned property’s holding period in the hands of the exercising option holder begins at exercise, without any tacking of the option holding period.

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36 For example, a partnership ("P1") which has previously issued an option which is in the money, sells all of its assets on December 31, 2002, for cash and the option holder exercises the option on January 1, 2003, then P1 will not have sufficient unbooked appreciation in its assets to reflect the exercising optionee's (new partner's) capital account immediately after the exercise. Accordingly, to reflect the economics of the exercised option we believe that the adjustment necessary to reflect the economics of the option exercise should be made pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(q).


39 See, Rev. Rul. 84-121, 1984-2 C.B. 168. There is some authority that would suggest that the use of appreciated property to pay the option premium results in immediate gain recognition to the optionee. See, Rev. Rul. 72-198, 1972-1 C.B. 223, obsoleted by Rev. Rul. 86-9, 1986-1 C.B. 290. It is difficult to reconcile these
From a tax basis perspective, the partnership’s receipt of the option premium results in an inside-outside basis disparity until the option either is exercised, is sold, is repurchased or lapses. The partnership will have basis in the cash or other property received for the option premium, yet there is no corresponding outside basis, because under well established principles applicable to options the tax treatment of the option premium is held in abeyance until the option either lapses or is exercised. It does not seem appropriate to treat the option premium as a liability for purposes of Section 752, pending the exercise or lapse of the option, because the option premium is not a liability as the term is generally used in the Code. The inside-outside basis disparity should be eliminated upon exercise or lapse. Accordingly, the temporary inside-outside basis disparity does not appear to present significant problems for the partnership or its partners.

Under general option principles, any post-grant appreciation inherent in the property transferred to the optionee upon exercise of an Investment Option is not taxable. This principle is illustrated in the following example:

**Example 5.2A.** On January 1, 2001, individual M purchases a tract of unimproved real property (R) to hold for investment for $200. On February 1, 2002, at a time when R still has a fair market value of $200, I purchases for a cash premium of $20 an option from M to purchase R for $200. Such option may be exercised at any time during the ensuing ten years. On March 1, 2003, at a time when R has appreciated in value to $500, I exercises the option.

Tax consequences of exercise:

- M recognizes $20 of gain ($20 + $200 - $200), even though M is transferring property worth $500 with a basis of $200.

- I recognizes no income or gain and takes R with a basis of $220, even though it received property worth $500 for $220 total consideration paid.

In the case of an Investment Option to acquire a partnership interest, it would be inconsistent with general option principles to treat the in-the-money portion of the property (i.e., the partnership interest) transferred to the exercising optionee as a taxable transaction. The authorities with the general rule that the tax consequences of both parties are held in abeyance under an open transaction theory. See, generally, the Option Rulings.

40 See, I.R.C. § 1223(6) in the context of options to acquire corporate stock.


43 This approach is consistent with Rev. Rul. 78-182 regarding the treatment of an option premium by the writer/seller of a “call” option on stock. See, also, Simon Friedman, “Partnership Securities,” 1 Fla. Tax Rev. 521, 528 (1992).
treatment would place holders of Investment Options to acquire partnership interests in a
dramatically different (worse) tax posture than holders of Investment Options to acquire other
property (including other property that is identical to the property owned by the optionor-
partnership).

With respect to the pre-grant appreciation, such amount should not be taxable in the
partnership context (subject to the application of any overriding Code sections). In contrast to
the sale of an option on property held by an individual (in which case the optionor liquidates his
or her investment on the exercise of the option), in the partnership context the other partners are
not liquidating their investment. Instead, the result of the exercise of the option is that the
optionee has made a capital contribution to the partnership. Any pre-grant appreciation and
option premium are still at the risk of the partnership’s business and may never be realized by the
partners. This is consistent with the principle that the pre-admission gain is not taxed to the
historic partnership upon the admission of a new partner for cash or upon the contribution of
appreciated property to a new partnership where one partner contributes cash and the other
contributes appreciated property.

Section 721 itself provides sufficient support for tax-free treatment upon exercise. Section 721 states: “No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.” Hence, the plain language of Section 721 seems to mandate nonrecognition treatment for the exercising optionee, the historic partners and the partnership with respect to both the pre-grant appreciation and the post-grant appreciation in the partnership’s assets.\(^4\)

Regulations Section 1.721-1(b)(1) provides that Section 721 does not apply “[t]o the
extent that any of the partners gives up any part of his right to be repaid his contributions (as
distinguished from a share in partnership profits) in favor of another partner as compensation for
services (or in satisfaction of an obligation).” (emphasis added). Since the Investment Option is
by definition not issued as compensation for services, the only question is whether the
partnership interest transferred to the optionee upon exercise of an Investment Option is “in
satisfaction of an obligation.” Although contractually the option imposes an obligation on the
optionor partnership to issue a partnership interest upon payment of the exercise price (and
otherwise comply with the terms of the option), it does not appear that the term “obligation”
should have such an expansive definition in this case. Otherwise, the term “obligation” would

\(^4\) It might be argued that the recommended approach is inconsistent with *Lehman v. Commissioner*, 19 T.C. 659 (1953). In *Lehman*, the taxpayers (husband and wife) were partners with others in a limited partnership in which the husband was the only general partner. The partnership agreement provided that when the other partners earned or received partnership profits of $50,000, taxpayers would each receive a $5,000 credit to their capital accounts. The Tax Court held that the taxpayers each recognized $5,000 ordinary income upon the transfer of $5,000 to their capital accounts from the other partners’ capital accounts. The Tax Court’s decision in *Lehman* does not appear to be relevant to the exercise of an Investment Option, because unlike the facts in *Lehman*, I.R.C. § 721 is invoked by virtue of the exercising optionee’s contribution to the partnership of the option premium and the exercise price. *Lehman* is further distinguishable because it did not involve the exercise of an option, and consequently, the well-established option principles that tax neither the optionor nor the optionee on the portion of the value of the optioned property that is in-the-money were not applicable in *Lehman*.
appear to cause appreciated property transferred by a partner to a partnership pursuant to the partnership agreement or a contribution agreement to similarly fall outside of Section 721.

The application of the aggregate theory would ignore Section 721 and the historic partners would apparently recognize gain or loss upon exercise to the extent that the amount of the option premium plus the exercise price exceeded (or was less than) the partnership’s basis in the portion of its assets deemed sold to the optionee. The application of Section 721 to the option premium and the exercise price is appropriate in any event because it is within the ambit of Section 721. Further, there is no apparent policy reason why Section 721 should not be applied.

However, when appreciated property is used to pay the option premium, the application of the open transaction doctrine has practical problems. The partnership needs to know when it receives the property whether it is taking the property with a stepped up basis under Section 1012 (consistent with a lapse of the option) or a carry over basis (consistent with Section 721 treatment of an exercise of the option). Carryover basis treatment seems problematic because the principles of Section 704(c) cannot apply if the optionee is not yet a partner. Although inconsistent with the general theory, it may be preferable to simply treat the transfer of appreciated property as payment for an option premium as a taxable disposition of such property at the time of transfer. Such treatment would enable the partnership to know that it should take a Section 1012 basis. Such a rule would raise the issue of whether the partnership would also have gain on the sale of the option. However, we believe that under general option principles the partnership’s tax treatment upon receipt of the appreciated property should be held open until the option is either exercised, repurchased or lapses.

Whether the optionee recognizes gain on the transfer of appreciated property to pay an option premium or the partnership takes the property with a carryover basis, a clear rule should be established so that taxpayers may plan their transactions with confidence in the tax consequences.

A cash-out cash-in approach similar to that employed in Regulations Section 1.1032-3(b) may seem appealing for determining the tax consequences to the partnership and the optionee on the exercise of an Investment Option. However, this approach, the details of which are discussed below, is not appropriately applied in this context. In view of well-established federal tax law principles that apply to the exercise of Investment Options generally, there is no need to treat the optionee as constructively receiving and re-transferring cash equal to the excess of the fair market value of the partnership interest over the exercise price on exercise. Such a need exists only where, as in the case of Service Options, the transfer of property with respect to which

45 Under the aggregate theory, each partner is deemed to own an undivided interest in each asset and is deemed to be selling a portion of his or her undivided interest when a new partner buys in. If the aggregate theory should control in this instance, the need for the disguised sale rules would be diminished as each admission would constitute a deemed sale by each person who is a partner. Aggregate gain and loss would be recognized and then the normal distribution rules would apply with respect to those who received the cash or property.

46 See, discussion of Service Options, infra, in Section 6 of these Comments and Paragraph 4.5, supra.
income is realized occurs on exercise of the option.\textsuperscript{47} With respect to Investment Options, the tax significant transfer of property occurs when the option is granted because, unlike a Service Option, an Investment Option is itself property.\textsuperscript{48}

In summary, it appears that an entity approach is appropriate for Investment Options. However, the cash-out cash-in treatment provided in Section 1032 does not appear to be appropriate for Investment Options, because Investment Options are themselves treated as property for tax purposes and, under well established principles, the optionee is not treated as receiving and re-transferring cash equal to the spread upon exercise.\textsuperscript{49}

(ii) Capital Accounting. We recommend the following approach to capital accounting for Investment Options.

(a) Prior to lapse or exercise, record the option premium in a Deferred Account on the liability/equity side of the balance sheet.

(b) Except for changes in the amount of the option premium, do not increase or decrease the Deferred Account until the option is exercised.

(c) If before exercise of one or more outstanding options, additional partnership interests are issued to new or existing partners (other than by way of option exercise) or a partner’s interest is redeemed, the historic partners’ capital accounts should be adjusted pursuant to Regulations Sections 1.704-1(b)(2)(iv)(f) and 1.704-1(b)(2)(iv)(q).\textsuperscript{50} We recommend that such adjustments be reflected only in the partners’ capital accounts (and not the Deferred Account or from an option premium). Such adjustments and asset revaluations, as a rule of convenience, generally would be determined with reference to the amount of cash and fair market value of other property contributed to, or distributed by, the partnership in connection with the event giving rise to such adjustment. As discussed below, this approach to capital account adjustments will generally cause the partners’ capital accounts to be adjusted to an amount equal to their share of the net assets of the partnership after taking into account the portion of the partnership’s net asset value that is economically attributable to the outstanding

\textsuperscript{47} Treas. Reg. §§ 1.83-3(a) and 1.83-7(a).


\textsuperscript{50} Although Treas. Reg. §1.704-1(b)(2)(iv)(f) is permissive, Treas. Reg. §1.704-1(b)(2)(iv)(q) is mandatory. Since such adjustment seems to fall within the purview of Treas. Reg. §1.704-1(b)(2)(iv)(q) and since it is necessary to accurately reflect the underlying economic arrangement of the partners, we believe that this adjustment should be mandatory. Administrative guidance should be promulgated to clarify that adjustments to capital accounts under Treas. Reg. §1.704-1(b)(2)(iv)(f) and/or Treas. Reg. §1.704-1(b)(2)(iv)(q) should not by themselves be taxable events because they reflect either (i) the economic realities already taxed under I.R.C. §83 or (ii) the economics already reflected in the arms’ length option premium and exercise price as described in these Comments.
options.\textsuperscript{51} Thus, the partner’s booked-up capital accounts will, consistent with economic reality, not reflect previously unreported gain that is economically attributable to outstanding options. The results of this approach are illustrated below in \textit{Example 5.2B}.

(d) Upon exercise of an option, the resulting capital account adjustments would be made to reflect the net asset value of the partnership’s assets, excluding the option premium and any of such net asset value that is economically attributable to any remaining unexercised options.\textsuperscript{52}

This treatment is consistent with both of the following principles applied to Investment Options in other contexts: (x) the optionor is, for tax purposes, treated as the owner of the optioned property until the property is transferred to the optionee pursuant to the exercise of the option; and (y) neither the optionor nor the optionee is taxed on the transfer of the post-grant appreciation.

At first glance, the recommended approach to capital account adjustments for partnerships with options that remain outstanding might seem to deviate from the mandate of Regulations Section 1.704-1(b)(2)(iv)(f)(1) that “[t]he adjustments are based on the fair market value of partnership property (taking 7701(g) into account) on the date of adjustment.” However, we believe that this approach does comport with a fair reading of this Regulation, because such approach will generally adjust a partner’s capital account to an amount equal to such partner’s share of partnership net value \textit{after taking into account the net asset value, if any, that is economically attributable to the optionee}. In contrast, if the partners’ capital accounts are booked to the net fair market value of the partnership’s assets without reduction for net asset value attributable to outstanding options, such capital accounts often will be inflated. Accordingly, adjusting the capital accounts in the recommended manner appears to be in keeping with the requirement of Regulations Section 1.704-1(b)(2)(iv)(f) that such adjustments be \textit{based on} the fair market value of the partnership property. Further, as provided in Regulations Section 1.704-1(b)(2)(iv)(q), adjusting the capital accounts in this manner:

“(1) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership’s balance sheet, as computed for book purposes,

(2) is consistent with the underlying economic arrangement of the partners, and

(3) is based, wherever practicable, on Federal tax accounting principles.”

\textsuperscript{51} Ignoring for this purpose any minority, marketability or other discounts associated with the new partner’s partnership interest (and listed as assumptions in Section 4.2 above), but taking into account the likelihood that an optionee will exercise an at-the-money or in-the-money option upon notice of the anticipated liquidation of the partnership.

\textsuperscript{52} As will be seen in the analysis of \textit{Example 5.2B}, this adjustment is needed to place the capital account of a person exercising an option in the same place as a person acquiring the identical interest for fair market value of such interest by a capital contribution at the time of exercise.
We considered the alternative of requiring that the Deferred Account maintained with respect to outstanding options reflect not only the option premium (as recommended above), but also the optionee’s contingent share of partnership net asset value. We ultimately dismissed such approach as being unnecessary and administratively burdensome.

The recommended approach is illustrated in Example 5.2B and Example 5.2C as follows:

**Example 5.2B.** On January 1, 2001, A and B form a partnership (P1) by each contributing $100 to the capital thereof. On that same date, P1 purchases to hold for investment a tract of unimproved real property (R) for $200. On February 1, 2001, at a time when R still has a fair market value of $200 and P1 has no other asset or liability, I purchases from P1, for a cash premium of $20, an option to purchase a one-third partnership interest in P1 for $100. Such option may be exercised at any time during the ensuing 10 years and is non-transferable except with the consent of P1. The amount paid to P1 by I upon the purchase of the option will be held in cash for the duration of the term of P1. On March 1, 2002, at a time when R has increased in value to $360, C obtains a one-third interest in the capital and profits of P1 by contributing $160 to its capital. On March 15, 2001, when R is still worth $360 and P1 still holds I’s $20 premium and C’s $160 capital contribution, I exercises its option (the terms of which have self-adjusted such that I now obtains a one-fourth interest in P1’s capital and profits upon exercise) by paying P1 $100. On April 1, 2003, P1 sells R for $360 and distributes in a final liquidating distribution the $640 ($360+20+160+100) it then holds, $160 apiece to A, B, C and I.

**Analysis of Example 5.2B:**

On January 1, 2001, the capitalization of P1 causes A and B to each have a capital account equal to their capital contribution (balancing the land booked at its cost of $200).

On February 1, 2001, I is issued an option and pays a premium of $20. This creates a Deferred Account on the equity/liability side of the balance sheet to be established at $20 (balancing the cash booked at $20).

On March 1, 2002, C is admitted as a partner and his capital contribution is credited to his capital account. If capital accounts are booked up on admission of C as a partner, A’s and B’s capital accounts are booked-up pursuant to Regulations Sections 1.704-1(b)(2)(iv)(f) and (q). As capital account adjustments are required to be based on the fair market value of P1’s property, as a rule of convenience, capital account adjustments occasioned by the admission of a new partner (other than upon exercise of an in-the-money option) are typically determined with reference to the capital contribution of the new partner.

We recommend that upon the issuance of C’s partnership interest, P1 should be permitted to determine the revaluation of its assets and the corresponding adjustment to the partners’ capital accounts with reference to the $160 capital contribution by C in exchange for a one-third

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interest in partnership profits and capital. Under this approach, the capital accounts of A and B will each be adjusted to $160, thereby accounting for their one-third share of the appreciation in P1’s assets, and R should be revalued to $320 thereby accounting for the appreciation economically attributable to the partners. Note that the total value of the partnership is $540, one-third of which is $180. But it would be inappropriate to adjust the capital accounts to $180 as a portion of the appreciation is economically owned by I. We believe this approach both comports with economic reality (by not over-inflating the partners’ capital accounts), and complies with the mandate of Regulations Section 1.704-1(b)(2)(iv)(f)(1) that such revaluation be “based on the fair market value of the partnership property” (emphasis added). Determining the capital account adjustment with reference to C’s $160 capital contribution in exchange for a one-third interest in P1 causes the capital account of each of A, B and C (i.e. the historic partners and the new partner) to reflect only that portion of the fair market value of P1’s assets that is economically attributable to their interests.54 This method also is much easier for taxpayers to administer because upon admission of a partner occasioned other than by exercise of an option, it simply requires that the capital account adjustment be determined with reference to the purchase price of the new partner’s (C’s) interest (a number that is both known and determined through arms-length negotiations), rather than through the uncertain and often administratively burdensome process of trying to determine the total net fair market value of the partnership’s (P1’s) assets.

On March 15, 2002, I exercises its option. I has paid a total of $120 to P1. Ordinarily, I’s capital account balance following a contribution of $120 would be $120. As discussed above under accounting for Investment Options at Section 5.2(b)(ii), I’s capital account is increased by $40 to reflect I’s share of the net assets of the partnership to $160 and the value of R is increased by $40 to $360, its current fair value.

The book capital account entries under this approach with respect to Example 5.2B are illustrated as follows:

54 Pursuant to their arms-length negotiation of the $160 purchase price for C’s one-third interest in P1, both P1 and C typically will determine the fair market value of A’s and B’s resulting one-third interests in the partnership (i.e., the same $160) taking into account the value, if any, of I’s option. This is so because in deciding how much she is willing to pay for an interest in the partnership, C will (or at least should) take into account the existence and economic significance of any outstanding options. Hence, so long as the parties are dealing at arms-length, it seems most logical to determine the asset revaluation and corresponding adjustment to P1’s capital accounts with reference to the $160 purchase price paid by C for a one-third interest because such valuation is consistent with the economic fair market value of C’s and the historic partners’ (A’s and B’s) interests.
Example 5.2B
Book Balance Sheet

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash</th>
<th>Land</th>
<th>TOTAL</th>
<th>Capital Accounts + Deferred Account</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/2001</td>
<td>0</td>
<td>200</td>
<td>200</td>
<td>A 100</td>
<td>200</td>
</tr>
<tr>
<td>1/1/2001</td>
<td></td>
<td></td>
<td></td>
<td>B 100</td>
<td></td>
</tr>
<tr>
<td>1/1/2001</td>
<td></td>
<td></td>
<td></td>
<td>C ---</td>
<td>---</td>
</tr>
<tr>
<td>1/1/2001</td>
<td></td>
<td></td>
<td></td>
<td>I ---</td>
<td>200</td>
</tr>
<tr>
<td>2/1/2001</td>
<td>20</td>
<td>200</td>
<td>220</td>
<td>A 100</td>
<td></td>
</tr>
<tr>
<td>2/1/2001</td>
<td></td>
<td></td>
<td></td>
<td>B 100</td>
<td></td>
</tr>
<tr>
<td>2/1/2001</td>
<td></td>
<td></td>
<td></td>
<td>C ---</td>
<td>20</td>
</tr>
<tr>
<td>2/1/2001</td>
<td></td>
<td></td>
<td></td>
<td>I 220</td>
<td></td>
</tr>
<tr>
<td>3/1/2002</td>
<td>180</td>
<td>320</td>
<td>500</td>
<td>A 160</td>
<td></td>
</tr>
<tr>
<td>3/1/2002</td>
<td></td>
<td></td>
<td></td>
<td>B 160</td>
<td></td>
</tr>
<tr>
<td>3/1/2002</td>
<td></td>
<td></td>
<td></td>
<td>C 160</td>
<td>500</td>
</tr>
<tr>
<td>3/1/2002</td>
<td></td>
<td></td>
<td></td>
<td>I 20</td>
<td></td>
</tr>
<tr>
<td>3/15/2002</td>
<td>280</td>
<td>360</td>
<td>640</td>
<td>A 160</td>
<td></td>
</tr>
<tr>
<td>3/15/2002</td>
<td></td>
<td></td>
<td></td>
<td>B 160</td>
<td></td>
</tr>
<tr>
<td>3/15/2002</td>
<td></td>
<td></td>
<td></td>
<td>C 160</td>
<td>640</td>
</tr>
<tr>
<td>3/15/2002</td>
<td></td>
<td></td>
<td></td>
<td>I 160</td>
<td></td>
</tr>
</tbody>
</table>

Example 5.2C. On January 1, 2001, A and B form a partnership (P1) by each contributing $100 to the capital thereof. On that same date, P1 purchases to hold for investment a tract of unimproved real property R for $200. On March 1, 2002, at a time when R still has a fair market value of $200 and P1 has no other asset or liability, I purchases from P1, for a cash premium of $10, an option to purchase a one-third partnership interest in P1 for $75. Such option may be exercised at any time during the ensuing six months and is non-transferable except with consent of P1. On April 1, 2002, when the value of the land is still $200, I exercises its option by paying P1 $75.

Recommended Treatment: Immediately after I exercises the option on April 1, 2002, the capital accounts of A, B and I are adjusted to reflect the fair market value of P1’s assets. It is not appropriate in the context of the exercise of an option to employ the rule of convenience that the capital account book-up be determined with reference to the amount contributed by the exercising partner ($85) because in the context of an option exercise, the sum of the exercise price and option premium (i.e., the amount deemed paid by the exercising optionee for its partnership interest) generally bears little or no relation to the fair market value of such partnership interest or the partnership assets at the date of exercise. Accordingly, in the case of the exercise of an option, the book-up should be determined with reference to the net fair market value of the partnership’s assets. Regulations Sections 1.704-1(b)(2)(iv)(f) and 1.704-1(b)(2)(iv)(q). No gain or loss is recognized by A, B or I upon either the issuance to, or exercise of the option by P1.
The application of this approach is illustrated as follows:

*Example 5.2C*

Book Balance Sheet

<table>
<thead>
<tr>
<th>Date</th>
<th>Assets</th>
<th>TOTAL</th>
<th>Capital Accounts + Deferred Account</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash</td>
<td>Land</td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>1/1/2001</td>
<td>0</td>
<td>200</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>3/1/2002</td>
<td>10</td>
<td>200</td>
<td>210</td>
<td>100</td>
</tr>
<tr>
<td>4/1/2002</td>
<td>85</td>
<td>200</td>
<td>285</td>
<td>95</td>
</tr>
</tbody>
</table>

**Analysis of Example 5.2C:**

Although from a capital accounting standpoint the option appears to be “in-the-money” at the date it is issued, the option should not be deemed exercised at the time it is issued because it is not substantially certain that it will be exercised.\(^{55}\) Section 721 should govern the exercise of the option and, therefore, none of P1, A, B nor I should recognize income upon I’s exercise, irrespective of the apparent shift of partnership capital from A and B to I upon exercise (i.e., I’s resulting capital account of $95 is $10 in excess of the amount paid for the partnership interest by way of the $10 option premium and $75 exercise price, and A’s and B’s capital accounts are each reduced by $5). This result is consistent with general bargain purchase principles where, as in this example, the parties negotiate a purchase price pursuant to arms-length dealings, no services are involved, and no other consideration is given for the subject property.\(^{56}\)

(iii) Section 704(c) Principles. In any of the allocation scenarios described above, Section 704(c) principles should be applied to the resulting book-tax differences.

6. **SERVICE OPTIONS.**

6.1. Grant of a Capital Interest in a Partnership.\(^{57}\) As discussed in Paragraph 4.4. above, we have generally attempted to apply the same treatment to the issuance of partnership options as are provided for stock options. In approaching this analysis we generally also have assumed that the issuance of a capital interest in a partnership should be treated similarly to the issuance of stock. The current Regulations under Section 1032 and Section 721 arguably provide for differing treatment on the issuance of a capital interest in a partnership and stock when the interests are being issued for services. As to the issuance of the option itself (as

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\(^{55}\) See, Rev. Rul. 82-150, 1982-2 C.B. 110.

\(^{56}\) See, *Palmer v. Commissioner*, 302 U.S. 63 (1937). ("…one does not subject himself to income tax by the mere purchase of property, even if at less than its true value, and that taxable gain does not accrue to him before he sells or otherwise disposes of it."); See, also, *Pellar v. Commissioner*, 25 T.C. 299 (1955).

\(^{57}\) The treatment of the grant of a profits interests is discussed in attached Appendix B.
opposed to the issuance of a capital interest in the partnership), parallel treatment for partnership options and stock options could best be obtained by applying the existing rules under Regulations Section 1.83-7.

Regulations Section 1.721-1(b)(1) provides, in pertinent part, that:

[t]o the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), Section 721 does not apply. The value of an interest in partnership capital transferred to a partner as compensation for services constitutes income to the partner under Section 61. The amount of such income is the fair market value of the interest in the transferred capital, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee’s future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner’s right to withdraw or otherwise dispose of such interest.

With the non-recognition provisions of Section 721 being made inapplicable to transfers of partnership interests for services (at least as it relates to the income recognition to the service provider), Section 83 establishes timing rules for compensation income and deduction arising from transfers of property in connection with the performance of services where the property is subject to a substantial risk of forfeiture and is nontransferable.58

We considered the tax consequences of the issuance, lapse, sale and exercise of Service Options under the aggregate and entity theories. There is a potential partnership level gain on the exercise of a Service Option under either theory. Under the aggregate theory, the partners are each deemed to sell a portion of his or her interest in partnership assets resulting in gain to existing partners. Under the entity theory, the partnership could be deemed to be transferring zero-basis property (i.e., the partnership interest itself) to satisfy an obligation and may realize gain59 on the transfer that would equal or exceed the gain realized under the aggregate theory.

58 The statutory language of I.R.C. § 83 is broad enough to include the issuance of Service Options by partnerships. However, it could be argued that Treas. Reg. § 1.721-1(b)(1) provides for the timing and amount of income. Similarly, it could be argued that I.R.C. § 707 and the Regulations thereunder should govern the timing and amount of income from Service Options. The lack of certainty is increased by the absence of a reference to partners in Treas. Reg. § 1.83-7.

59 If the second sentence of Treas. Reg. § 1.721-1(b)(1) is interpreted to apply generally to any grant of a capital interest rather than literally to apply only to a partner giving up a right to be repaid a capital contribution. Although these Comments generally recommend that nonrecognition treatment be allowed to the grant and exercise of a Service Option, under the current regulations, if they were applied literally, the existing
However, applying the cash-out cash-in method of Regulations Section 1.1032-1(a)\textsuperscript{60} to the exercise of a Service Option in conjunction with the entity theory would cause the historic partners to be protected from income recognition to the extent of the value of the services under Section 721 regardless of whether the entity or aggregate theory were used.

\textbf{Example 6.1.} On January 1, 2001, A and B form an entity (P2) that is treated as a partnership for federal income tax purposes by each contributing $100 to the capital thereof. On that same date, P2 purchases to hold for investment a tract of unimproved real property (R) for $200. Simultaneously, S provides services to P2 in exchange for an option to acquire a one-third interest in the capital and profits of P2 for $90. The option may be exercised at any time during the ensuing 10 years and is not transferable except with the consent of P2. The option has no readily ascertainable fair market value.

(i) \textbf{Consequences to Grantee.} Regulations Section 1.83-7 provides that in the case of an option given in exchange for services, Section 83(a) does not apply on the grant of the option unless the option has a readily ascertainable fair market value. Accordingly, since in the example the option does not have a readily ascertainable fair market value, there is no income to S upon its issuance.\textsuperscript{61}

If the option later becomes heavily “in the money” and its exercise a virtual certainty,\textsuperscript{62} the answer normally would not change. In order for an option to have a readily ascertainable value, it must be either publicly traded, or, among other requirements (i) be transferable, (ii) be immediately exercisable, and (iii) not be subject to a restriction or condition that has a significant effect on value.\textsuperscript{63} In the case of a Service Option these conditions will almost never be met.

(ii) \textbf{Consequences to Partnership/Historic Partners.} Since Section 83(a) does not apply to the grant of the option, there is no deduction to P2 or to A and B on the grant of the option either. Nor is there a gain or loss recognition event.

(iii) \textbf{Capital Account Adjustments.} There is no capital account adjustment at the time the option is granted since S has not yet become a partner. No amount need be credited to a Deferred Account since the optionee does not pay an option premium in cash or other property.

\begin{tabular}{l}
partners could have gain recognition in those situations where appreciated property was contributed to the partnership and the value of the services provided by the service partner are not capitalized. \\
\end{tabular}

\textsuperscript{60} \textit{See}, discussion of the history of Section 1032 supra at Paragraph 4.5(a) of these Comments.

\textsuperscript{61} We assume that Treas. Reg. \textsection 1.83-7 is not limited to options on corporate stock, although administrative clarification of this point would be helpful.

\textsuperscript{62} Assuming the optionee was not deemed to be a partner at the time of grant.

\textsuperscript{63} Treas. Reg. \textsection 1.83-7(b)(2).
6.2. Exercise of Service Option. Assuming that Section 83 treatment is first applied to the issuance of the option, the exercise of a Service Option brings to focus the contrast between the Regulations under Section 721 and Section 1032. As mentioned in Paragraph 4.4 above, applying the current Regulations under Section 721 to exclude the issuance of a capital interest in a partnership in respect of services entirely from Section 721 could arguably result in income not only to the optionee, but also to the partnership or the historic partners. Consistent with the analytical approaches discussed above, we have recommended that the treatment of the exercise of partnership options be conformed to the treatment of the exercise of stock options.

Example 6.2. Same facts as Example 6.1, except that S does not exercise the option until March 1, 2002, at which time R has appreciated in value to $600.

The tax consequences will vary depending upon the assumptions made.

Assumptions 6.2(a): Assume that the services provided by S do not add any value to R. Further assume that S does not take advantage of any minority or illiquidity discounts in valuing his partnership interest and, in consequence, his interest is valued at $230 (i.e., $690/3). On April 1, 2003, P2 sells R for $600 and distributes in a final liquidating distribution the $690 it then holds, $230 to A, B and S.

Analysis 6.2(a):

(i) Consequences to Option Holder: Under Section 83(a), upon the exercise of the option, S would report $140 of income, being the excess of the value of the P2 partnership interest ($230) over the option exercise price ($90). S would have a basis equal to the exercise price of the option plus the amount included by him in income, or $230.

In order to reflect the economics, S’s capital account immediately after the exercise of the option should also be $230 if capital accounts are booked up at the time of the contribution. We believe that the so-called cash-out cash-in approach should be utilized to obtain this result. Under this approach, P2 would be considered to have paid cash compensation to S in an amount equal to $140, which would then be deemed to have contributed to P2 in addition to the $90 actually contributed. This is necessary because the capital account maintenance rules of Regulations Section 1.704-1(b)(2)(iv) do not contain a provision permitting a capital account to be increased by virtue of a contribution of services, but rather cover only the contribution of money and the fair market value of property. This would be consistent with the approach taken in Regulations Section 1.1032-3(b)(1) in which a circular flow of cash is used to avoid a zero basis problem in connection with the use by subsidiaries of their parent’s stock to pay compensation to employees of the subsidiary. It is also consistent with the approach taken in Regulations Section 1.1032-1(a) which deals with a transfer by a corporation of shares of its own stock as compensation for services rendered to such issuing corporation.64

64 See, Paragraph 4.5, supra.
(ii) Consequences to Partnership: Historic Partners. As indicated above, in the case of the exercise of an Investment Option, Section 721 provides authority for tax-free treatment to the partnership, the historic partners and the exercising partner. However, Section 721 is inapplicable in the case of the exercise of a Service Option with respect to the value of the interest acquired in excess of the exercise price. Section 721 does not explicitly provide for the tax treatment to the optionee, the partnership or the historic partners on the exercise of a Service Option beyond the fact that the provision is inapplicable. Regulations Section 1.721-1(b)(1) specifically provides that to the extent that the historic partners give up their right to be repaid their contributions as compensation for services, there is a taxable event to the services provider measured by the value of the interest so transferred. While the Regulations under Section 721 could be read to imply that such transfer also gives rise to a taxable event to the partnership and/or the historic partners, they do not specifically so provide.

Viewing the partnership as an aggregate of its partners in the case of the exercise of a Service Option would produce the following tax consequence to the partnership and the historic partners: The partnership would be treated as having transferred a proportionate part of each partnership asset to the historic partners (to the extent of the service provider’s interest) at the time of exercise of the Service Option, followed by the transfer of that undivided interest by the historic partners to the service provider in exchange for services, following which the service provider recontributes those assets to the partnership. The historic partners would recognize income or loss with respect to this “disposition” of each asset and would obtain a corresponding basis adjustment in such assets (by means of the service provider having a fair market value basis in the assets deemed recontributed to the partnership).

Viewing the partnership as an entity, on the other hand, no property of the partnership would be deemed transferred, but instead the partnership would be treated as having issued an interest in itself in exchange for services. Unless Section 721 or other authority can be read as providing for a result comparable to Section 1032, the partnership could be deemed in receipt of income equal to the difference between its basis in the partnership interest issued (i.e., zero) and the value of the interest at the time of issuance to the service provider.

In our view, neither of the above approaches results in an appropriate result as a policy matter or is required under current law. Thus, while the holder of the Service Option is and should recognize income on exercise (and the partnership and the historic partners recognize a corresponding compensation deduction where appropriate), the partnership and the historic partners should not otherwise be taxable.

Historically, large partnerships have not been used to operate businesses other than professional partnerships. Because the issuance of stock as compensation was commonplace, the Regulations under Section 1032 were promulgated to provide that such a transaction is a nontaxable event despite the fact that Section 1032 is silent on this issue. It is not surprising that a similar change was not made to the Regulations under Section 721 because that was not an issue anyone considered.

The Regulations under Section 721 were promulgated prior to the enactment of Section 83 and, if read literally, could be viewed as creating a special regime for Subchapter K,
notwithstanding that the language of Section 83 would appear to encompass the issuance of partnership interests for services.

If a new partner enters a partnership by contributing cash, the use of a pure aggregate theory would indicate that the historic partners should be subject to tax because they have a decreased interest in the historic assets, and an increased interest in the cash contributed. Section 721 clearly indicates this is not to be the case. From a policy standpoint, it seems less appropriate to tax the historic partners when their interest has become less monetized than in the case of a cash contribution because their interest has not been “cashed-out”.

A useful construct in reaching this policy oriented result is the cash-out cash-in approach, under which the service provider is treated as having received as compensation an amount of cash equal to the value of the interest received in excess of the option premium and having retransferred the cash (in addition to any actual cash, if any, required to exercise the option) to the partnership. Under this approach, the service provider is taxed in an appropriate fashion, the deduction is appropriately accounted for, but otherwise the transaction does not constitute a taxable event to the partnership or the historic partners because Section 721 would then apply.

Consistent with the analysis set forth above and in Paragraph 4.4 above, as a policy matter there should not be any recognition of gain or loss by P2 or A and B as a result of this transaction. Applying the entity approach, P2 has issued a capital interest to S. If the cash-out cash-in approach is utilized to explain the treatment of the issuance of an interest in exchange for services, then Section 721 by its terms would apply since S would be deemed to have made a cash capital contribution. Thus, the use of the cash-out cash-in approach results in capital accounts properly reflecting the economic arrangement among the parties consistent with the existing capital account maintenance regulations, while also providing a statutory basis for nonrecognition of income by P2 and A and B which, as a policy matter, is the correct result.

In connection with the admission of S, P2 would book-up the value of R to $600 in accordance with Regulations Section 1.704-1(b)(2)(iv)(f). The $400 excess of the value of R over the book value of R would be allocated $200 to each of A and B resulting in A and B having $300 capital accounts. The compensation deduction of $140 to which P2 is entitled pursuant to Section 83(h) would be allocated one-half ($70) to each of A and B, reducing their capital accounts to $230 each.65

Assumptions 6.2(b): Utilize the same assumption as in Assumptions 6.2(a), except that S obtains an appraisal that supports valuing his interest in P2 at $160.

65 A bookup is appropriate under these circumstances even if the property contributed by the optionee is de minimis notwithstanding the apparent limitations in Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5). We suggest that the limitation of the circumstances giving rise to a permissible bookup should be reconsidered in general not just on account of the issue presented here, but also because it creates uncertainty on the issuance of “profits interests” under Rev. Proc. 93-27, 1993-2 C.B. 343.
Analysis 6.2(b):

In accordance with Section 83(a), P2 would report $70 of income, being the excess of the value of the P2 partnership interest ($160) over the option price ($90). S would have a basis equal to the exercise price of the option plus the amount included by him in income, or $160.

In order to reflect the economics, S’s capital account should be $230. The use of the cash-out cash-in approach does not achieve all of the required adjustments necessary to S’s capital account. Under the cash-out cash-in approach, P2 would be considered to have paid cash compensation to S in an amount equal to $70, which S would then be deemed to have contributed to P2 in addition to the $90 actually contributed. This results in S having a capital account of $160. In order to reflect the economic deal among the parties, an adjustment needs to be made under Regulations Section 1.704-1(b)(2)(iv)(q) to increase S’s capital account by $70. In effect, S has received $230 in capital with a market value of $160.

(i) Consequences to Partnership/Historic Partners: In connection with the admission of S, P2 would book-up the value of R to $600 in accordance with Regulations Section 1.704-1(b)(2)(iv)(f) resulting in A and B having $300 capital accounts. The compensation deduction of $70 to which P2 is entitled pursuant to Section 83(h) would be allocated one-half ($35) to each of A and B, reducing their capital accounts to $265 each. To reflect the $70 adjustment made to S’s capital account under Regulations Section 1.704-1(b)(2)(iv)(q), each of A and B’s capital accounts would be reduced by $35. This results in all of the partners having capital accounts of $230, reflecting their economic deal. The amount of the Section 83(h) deduction, however, is limited to $70.

There should not be any tax gain recognition to P2 or A and B.

Assumptions 6.2(c): Utilize the same assumptions as in Assumption 6.2(a), except that (i) some of the services rendered by S add $100 to the value of R and are capitalized into the basis thereof, (ii) the balance of the services rendered by S add no value to R and are fully deductible by P2 and (iii) on April 1, 2003, P2 sells R for $600 and distributes in a final liquidating distribution the $690 it then holds, $230 apiece to A, B and S.

(i) Consequences to Option Holder: Under Section 83(a), S would report $140 of income, being the excess of the value of the P2 partnership interest ($230) over the option price ($90). S would have a basis equal to the exercise price of the option plus the amount included by him in income, or $230. Utilizing the cash-out cash-in approach, S would be deemed to have made cash capital contributions of $230 ($90 plus $140) and would have a $230 capital account.

(ii) Consequences to Partnership/Historic Partners: In connection with the admission of S, P2 would book-up the value of R to $600. The $300 excess of the value of R over the book basis of R ($200 plus $100) would be allocated $150 to each of A and B, resulting in A and B having $250 capital accounts. The compensation deduction of $40 ($140 less $100 capitalized to value of R) to which P2 is entitled pursuant to Section 83(h) would be allocated one-half ($20) to each of A and B, reducing their capital accounts to $230. This results in the capital accounts of all the partners being equal, reflecting their economic deal.
7. **LAPSE OR DISPOSITION OF OPTIONS.**

7.1. The Treatment of the Optionee who Sells an Investment Option. This portion of our Comments concerns the tax consequences that apply (or should apply) to the optionee and, where applicable, the partnership, when an Investment Option lapses or is sold. For the sake of clarity, we first discuss the consequences that apply (or should apply) when an Investment Option is sold.

The character of the optionee’s gain or loss on the sale of an Investment Option is determined under Section 1234(a). Section 1234(a) provides that the character of the optionee’s gain or loss on the sale or exchange of an Investment Option is determined with reference to the character of the underlying asset in the optionee’s hands.\(^{66}\)

The character of the property underlying an Investment Option can be characterized in more than one way, mostly depending upon whether one applies the entity theory or the aggregate theory. If one applies an entity theory, then one must conclude that the underlying property is the partnership interest.\(^{67}\) Under this theory, the underlying interest is a capital asset.\(^{68}\) On the other hand, if one applies an aggregate theory, then the underlying property should consist of proportionate shares of the partnership’s property.\(^{69}\) Under the aggregate theory, some of the underlying property may be capital assets, while others may be other than capital assets.

The correct answer probably lies between these two absolutes. Congress, the courts, and the Service have generally applied a qualified entity approach to sales and exchanges of partnership interests. While varying in the degree to which they qualify the entity approach, authorities universally agree that a partnership interest in a “going concern” partnership is a capital asset.\(^{70}\) Authorities differ, however, in applying the aggregate theory to sales of partnership interests. Prior to the enactment of Section 751, courts tended to eschew any application of the aggregate theory in connection with the sale of a partnership interest. With the enactment of Section 751, Congress established the rule that the aggregate theory will apply to

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\(^{66}\) Section 1234, the provision pursuant to which the character of gain or loss from the lapse or disposition of option is determined does not apply to Service Options (i.e., options to which Treas. Reg. § 1.83-7 applies). Treas. Reg. § 1.1234-1(c).

\(^{67}\) See, Appendix A.

\(^{68}\) G.C.M. 26379, 1950-1 C.B. 58; Robert D. Fraser v. Commissioner, 64 T.C. 41, 50 n.4 (1975), acq. (AOD July 18, 1975); U.S. v. Shapiro, 178 F.2d 459 (8th Cir. 459) (“[t]he sale of an interest in a partnership is the sale of a capital asset, regardless of the nature of the partnership properties”); in the context of Subchapter K, see, Section 741.

\(^{69}\) For a more detailed discussion of the aggregate and entity theories of partnership taxation, see Appendix A.

\(^{70}\) See, footnote 67 supra.
each sale of a partnership interest to the extent the interest relates to assets producing certain ordinary income. In spite of this, we conclude that, for purposes of Section 1234, a partnership interest should be treated as a capital asset, even if the partnership has assets producing income that is not capital gain. The following discussion provides the foundation for our conclusion.

(a) Pre-1954 Case Law. Before 1954, courts generally elected against using the aggregate theory in connection with sales or exchanges of partnership interests. Courts also generally rejected a pure entity theory of partnership taxation. Instead, courts generally applied a qualified entity theory to determine the character of income realized on sales or exchanges of partnership interests. For example, courts have applied the assignment of income doctrine to sales of interests in service partnerships with substantial accounts receivable. Courts have also used the collapsible partnership rules to look-through sales of interests in partnerships that have completed their partnership business.

There are two important points to make with respect to courts’ treatment of transactions structured as partnership interest sales applying pre-1954 Code Federal tax law. First, to the extent the transaction was truly the sale of an interest in a “going concern” partnership, courts respected the form of the transaction and treated the seller as selling a capital asset. Second, courts did not use an aggregate approach to thwart taxpayer attempts at assigning income or selling assets under the guise of a partnership interest sale. Rather the courts applied “substance over form” analyses, treating the taxpayer as assigning an income right, or selling assets, as the case may be. These points are material to our analyses, and we will refer to them again later in our discussion.

(b) Enactment of Section 751 and Related Legislative History. Subchapter K of the original 1954 Code reflects Congressional intent to apply the entity theory for many partnership

71 See, Tax Management Portfolio 720-1st - Property Transactions - Section 751 Property, paragraph II.A. (citing Commissioner v. Smith, 173 F.2d 470 (5th Cir. 1949), cert. denied, 338 U.S. 818 (1949); Garling Estate v. Commissioner, 6 T.C.M. 879 (1947), aff’d, 170 F.2d 73 (9th Cir. 1948) (per curiam); Commissioner v. Shapiro, 125 F.2d 532 (6th Cir. 1942); McClellan v. Commissioner, 117 F.2d 988 (2d Cir. 1941) (per curiam); and Humphrey v. Commissioner, 32 B.T.A. 280 (1935), nonacq., XIV-2 C.B. 34). See also MCKEE, at ¶ 16.01[1].

72 See, Tunnell v. U.S., 259 F.2d 916 (3d Cir. 1958); B. Howard Spicker, 26 T.C. 91 (1956).

73 See, Haggard v. Wood, 298 F.2d 24 (9th Cir. 1961).

74 See, McKee at ¶ 16.01; Tax Management Portfolio 720-1st - Property Transactions - Section 751 Property, paragraph II.A. See, also, United States v. Shapiro, 178 F.2d 459 (8th Cir. 1949); Long v. Commissioner, 173 F.2d (5th Cir. 1949) cert. denied, 338 U.S. 818 (1949); Commissioner v. Smith, 173 F.2d 470 (5th Cir. 1949), cert. denied, 338 U.S. 818 (1949); Garling Estate v. Commissioner., 6 T.C.M. 879 (1947), aff’d, 170 F.2d 73 (9th Cir. 1948) (per curiam); Commissioner v. Shapiro, 125 F.2d 532 (6th Cir. 1942); McClellan v. Commissioner, 117 F.2d 988 (2d Cir. 1941) (per curiam); Humphrey v. Commissioner, 32 B.T.A. 280 (1935), nonacq., XIV-2 C.B. 34); G.C.M. 26379, 1950-1 C.B. 58.

75 See, e.g., U.S. v. Snow, 223 F.2d 103 (9th Cir. 1955); Thorneley v. Commissioner, 147 F.2d 416 (5th Cir. 1945); Haggard v. Wood, 298 F.2d 24 (9th Cir. 1961); Trousdale v. Commissioner, 219 F.2d 563 (9th Cir. 1955).
tax purposes. However, such provisions were not meant to imply that the entity theory should be used for all purposes of Subchapter K.\textsuperscript{76} Indeed, the 1954 Code also contains specifically directed aggregate theory provisions to prevent taxpayers from shifting income amongst partners and converting ordinary income to capital gain.\textsuperscript{77}

This policy of subchapter K is reflected in provisions relating to the sale of a partnership interest. Applying the entity theory, Section 741 provides that the seller of a partnership interest generally realizes capital gain or loss.

To curb potential abuses of this pure entity approach, Congress enacted Section 751.\textsuperscript{78} Congress created Section 751 to prevent taxpayers from converting to capital gain ordinary income inherent in certain types of partnership assets. To effect its purpose, Section 751 treats the transferor of a partnership interest in a partnership with “unrealized receivables”\textsuperscript{79} or “inventory”\textsuperscript{80} (collectively “Section 751 property”) “as though he disposed of (Section 751 property) independently of the rest of his partnership interest.”\textsuperscript{81} In other words, with respect to Section 751 property, subchapter K applies the aggregate theory to partnership interest sales. Accordingly, the selling partner is treated as selling an interest in his share of the partnership’s Section 751 property.

The Section 751 asset bases used by Sections 751(a) (governing transfers of partnership interests to third parties) and 751(b) (governing certain partnership distributions) to determine shares of ordinary income are identical, with one small but material difference. As noted above, the targeted income items that serve as the bases for Section 751 calculations are derived from “unrealized receivables” and “inventory items.” The small but material difference between the bases for Sections 751(a) and Section 751(b) concerns inventory items. Under Section 751(b)


\textsuperscript{77} S. Rep. No. 1622, 83\textsuperscript{rd} Cong., 2d Sess. 98 (1954).

\textsuperscript{78} S. Rep. No. 1622 at 401.

\textsuperscript{79} Unrealized receivables are (a) contractual rights to payments for goods and services; (b) gains from certain properties under I.R.C. §§ 617(f)(2), 992, 1248, 1252, and 1253; and (c) recapture of depreciation and costs under I.R.C. §§ 1245, 1250, 1251(e)(1), and 1254.

\textsuperscript{80} Inventory items are (a) inventory and trade accounts receivable; (b) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in I.R.C. § 1231; (c) any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under I.R.C. § 1246(a) (relating to gain on foreign investment company stock), and (d) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in paragraph (a), (b), or (c) above.

\textsuperscript{81} S. Rep. No. 1622 at 98, 99.
such items must be “substantially appreciated,” whereas there is no such qualifier for purposes of Section 751(a).\textsuperscript{82}

Note that a distribution to a partner is treated, to the extent of gain realized under Section 731, as a sale or exchange of a partnership interest under Section 741.\textsuperscript{83} The general rule is applied, however, only to the extent that Section 751 does not apply.\textsuperscript{84} This interplay of the general rule and the Section 751 exception reflects Congressional policy to apply a qualified entity theory for purposes of determining the character of gain or loss realized on the sale of such interest. The question is whether Section 751 actually changes the property sold, or merely changes the character of the income derived from the sale of a partnership interest, a capital asset. If the character of the property sold changes, then Section 751 could apply to the sale of an Investment Option. If only the character of the income is changed, then Section 751 should not apply.

Mechanically, Sections 751(a) and 751(b) operate differently, though the starting point for each is the same.

(c) \textit{Section 751 Administrative Interpretation - Regulations.}

(i) Section 751(a). Regulations under Section 751(a) applying to transactions entered into before December 15, 1999 (the “\textit{Old 751(a) Regulations}”), set forth certain steps to determine the amount and the character of the gain or loss recognized by a partner upon a transfer of a partnership interest. These steps involved allocating both the partner’s outside basis in his or her partnership interest and the sale proceeds between the partner’s proportionate share of Section 751 property and the remainder of the partnership property.

Regulations under Section 751(a) (the “\textit{New 751(a) Regulations}”) applying to sales or exchanges of partnership interests after December 14, 1999 provide a different method of determining the character of income realized on a sale or exchange of a partnership interest. Under the New 751(a) Regulations, Section 751 applies to a sale or exchange of a partnership interest to the extent the selling partner would be allocated (with respect to such sold interest) income, gain, or loss from Section 751 property on a cash sale of all partnership property in the partnership immediately before the sale or exchange of the interest.\textsuperscript{85}

\textsuperscript{82} As of August 5, 1997, generally, Section 1062(a) of the Taxpayer Relief Act of 1997 (P.L. 105-34). Section 1062(c) of the Taxpayer Relief Act of 1997 contained a special provision “grandfathering” all binding sale or exchange agreements in effect on June 8, 1997.

\textsuperscript{83} I.R.C. § 731(a).

\textsuperscript{84} I.R.C. § 741(a).

\textsuperscript{85} Treas. Reg. § 1.751-1(a)(2).
Based upon differences between the New 751(a) Regulations and the Old 751(a) Regulations, one could reasonably infer a shift in the Service’s policy with respect to the application of Section 751(a) to partnership interest sales. The Old 751(a) Regulations arguably reflect an aggregate theory application of Section 751(a). Those Regulations speak in terms of deemed sales by the partner of the Section 751 property. That approach is supported by Congressional Reports on the Internal Revenue Code of 1954.\textsuperscript{86} In contrast to the Old 751(a) Regulations, the New 751(a) Regulations arguably apply the entity theory changing only the character of the income realized on the sale of the partnership interest, not the underlying assets.\textsuperscript{87}

However, it appears the Service, in drafting the New 751(a) Regulations, was more interested in efficiency than it was in changing tax policy. The Preamble to the New 751(a) Regulations (in their proposed form), reads as follows: “Rather than attempting to allocate a portion of the transferor partner’s amount realized and adjusted basis to section 751 property, the proposed regulations adopt a hypothetical sale approach.”\textsuperscript{88} Clearly, this statement undermines any inference that the Service intended to change substantive tax policy with respect to Section 751. Rather, it appears the change was made purely for administrative convenience. On the other hand, similar arguments for efficiency and simplicity in tax administration could be made in reference to whether Section 751 should apply to partnership options.

(ii) Section 751(b). Section 751(b) treats the distributee partner as entering into a two-step transaction to the extent that such partner receives in such distribution:

(a) Section 751 property\textsuperscript{89} in exchange for all or part of his or her interest in other partnership property, or

(b) other property in exchange for all or part or his or her share of Section 751 property.

If the distributee partner receives other property in exchange for his or her share of partnership Section 751 property, that partner is treated as (A) receiving a distribution of Section 751 property from the partnership with a value equal to that partner’s pre-distribution share of that property, and (B) immediately following that deemed distribution, selling the Section 751

\textsuperscript{86} H.R. Rep. No. 1337, 83\textsuperscript{rd} Cong., 2d Sess. 70; S. Rep. 1622, 83\textsuperscript{rd} Cong., 2d Sess. 98, 99.

\textsuperscript{87} Note that the new regulations were issued in connection with changes to regulations under I.R.C. §§ 734 and 743. These new regulations arguably updated administrative rules of Subchapter K and reflect increasing acceptance of a broader use of the entity approach in commercial law and taxation generally. See, Appendix A.

\textsuperscript{88} 1998-17 I.R.B. 24.

\textsuperscript{89} I.R.C. § 751 property for purposes of I.R.C. § 751(b) is unrealized receivables and \textit{substantially appreciated} inventory items. Inventory items are substantially appreciated only if their fair market value exceeds 120 percent of the adjusted basis to the partnership of such property. I.R.C. § 751(b)(3)(A).
property to the partnership for other property of equal value actually received in the distribution. The second part of the two-step exchange transaction is treated as a sale or exchange of Section 751 property, producing ordinary income. The amount of ordinary income produced by the deemed sale of Section 751 property determines the extent to which Section 751(b) applies to the distribution.

The Section 751(b) Regulations resemble the Old Section 751(a) Regulations. Both Regulations treat the selling or distributee partner as directly selling shares of partnership Section 751 property. In other words, both the Regulations under Section 751(b) and the Old 751(a) Regulations support the view that Section 751 actually changes the property being sold in a sale or exchange of a partnership interest to the extent Section 751 applies.

(iii) Regulations Section 1.701-2(e). This Regulation provides that the Service can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or the Regulations. For example, pursuant to this Regulation, the Service may treat a partnership of two corporate partners as an aggregate of such partners where the partnership was established to avoid the corporate-level interest deduction limitations of Section 163(e)(5). However, that Regulation by its own terms is limited. It will not apply to the extent that a provision of the Code prescribes the treatment of a partnership as an entity, and that treatment and the ultimate tax results, taking into account all relevant facts and circumstances, are contemplated by that provision.

(d) Section 751 Administrative Interpretation - Revenue Rulings. Revenue Ruling 89-108 supports the view that Section 751 actually changes the properties sold on the sale or exchange of a partnership interest. That Revenue Ruling concerns a sale of a partnership interest under the installment method. Under the facts of the ruling, partner sold an interest in a partnership which had, for some of its assets, substantially appreciated inventory. The ruling decided the extent to which the installment method of reporting under Section 453 could be used to report the sale of a partnership interest. The holding turned upon whether the interest sold was a partnership interest, or whether the inventory was taken into account separately. If the latter, then part of the transaction would not qualify for installment sale reporting.

The ruling states that the sale of a partnership interest generally is treated as the sale of a single capital asset without regard to the nature of the underlying partnership property. The ruling then distinguishes this treatment from the treatment accorded the sale of a business operated as a sole proprietorship. Such a sale is treated as the sale of the individual assets of the business. Accordingly, when the Service was presented with the issue of whether the sale of a

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90 Treas. Reg. § 1.701-2(f), Ex. 1.
91 Treas. Reg. § 1.701-2(c)(2).
93 Citing, H.R. Rep. No. 1377 at 70.
94 See, e.g., Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945).
sole proprietorship can qualify as an installment sale, the Service held that such a sale is generally considered a sale of the individual assets. Thus, installment sale reporting was permitted to the extent of gain realized on assets of the business that were permitted to be sold on the installment basis.\footnote{Rev. Rul. 68-13, 1968-1 C.B. 195.}

The ruling then referred to legislative history showing that Congress intended Section 751 to treat gains from sales of partnership interests as gains from the sale of individual assets, to the extent attributable to Section 751 property. In effect, the transferor partner is treated as disposing of Section 751 assets independently of the rest of his partnership interest. With respect to these assets, the partner is treated as though he were a sole proprietor selling these assets as part of a sale of his business. Accordingly, the ruling holds that the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership's substantially appreciated inventory (within the meaning of Section 751(d)) which would not be eligible for the installment sale treatment if sold directly.

\begin{enumerate}
\item \textbf{Section 751 Case Law.} Case law generally favors the view that Section 751 supersedes Section 741. In \textit{Ware v. Commissioner},\footnote{906 F.2d 62 (2d Cir. 1990).} Judge Oakes of the Second Circuit opined that “\textit{t}he point behind denying capital gain treatment for unrealized receivables to the departing partner is that they correspond to \textit{income that has not yet become part of the partnership interest} and, absent that partner’s exchange of his interest, would be taxable to him as ordinary income.”\footnote{Id. at 64. (Emphasis supplied).} In that case, the Circuit Court upheld Judge Tannenwald’s opinion in which the Tax Court held that Section 751 applied to the sale of a lawyer’s partnership interest in a partnership (his former law firm) to the extent such interest related to certain unrealized receivables of the law firm.\footnote{Id. at 66.}

The Tax Court in \textit{Ledoux v. Commissioner}\footnote{77 T.C. 293 (1981).} held likewise in a case involving the sale of a partnership interest in a partnership, the principal asset of which was a contract to operate a dog racing track. The court looked to “\textit{the underlying right assigned},” and held the contract to be Section 751 property.\footnote{Id. at 305 (citing, \textit{United States v. Woolsey}, 326 F.2d 287, 291 (5th Cir. 1963), rev’g 208 F.Supp. 325 (S.D. Tex. 1962)).}

In \textit{United States v. Eidson},\footnote{310 F.2d 111 (5th Cir. 1962), rev’g an unreported opinion (W.D. Tex. 1961).} the Fifth Circuit Court of Appeals went even further, holding that, to the extent that the amount realized on the sale of a partnership interest related to
Section 751 property, “what was being assigned was not a capital asset whose value accrued over a period of years; rather, the (Section 751 property itself) was the real subject of the assignment.” In short, the Court said, “consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.”

7.2. Appropriateness of applying Section 751 to Investment Option Sales.

(a) Applying Section 751 to Investment Option Sales. Section 751 applies only to transactions in which a partner sells or exchanges a partnership interest or receives a partnership distribution. Thus, by its terms, Section 751 does not apply to sales or exchanges made by anyone other than a partner. Further, Section 751 applies only to the extent that a partner’s share of Section 751 property is deemed sold or exchanged. Therefore, Section 751 should apply to the sale of an Investment Option only if, with respect to the underlying interest, the optionee is treated as a partner.

One could argue that the parenthetical of Section 1234(a) provides authority for treating the seller of an Investment Option as though she is deemed to have exercised the option and acquired the underlying partnership interest for the purposes of determining the character of the gain or loss on the sale. The parenthetical provides that the character of gain on the sale of an option is determined with reference to the character that the underlying asset would have in the hands of the taxpayer had the taxpayer exercised the option.

(b) Section 751 should not generally apply to Investment Option Sales. We believe that treating an optionee as a partner with respect to the interest underlying an Investment Option would violate fundamental partnership tax policy. A partner is a member of a partnership. Determining whether a person is a member of a partnership depends upon whether such person

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102 Id. at 116.

103 Id. at 115 (citing, Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 266 (1958)).

104 I.R.C. § 751 applies to the “[a]mount of any money, or the fair market value of any property, received by a transferor partner”, while I.R.C. § 751(b) applies “[t]o the extent a partner receives in a distribution” interests in I.R.C. § 751 property in exchange for interests in other property, or vice versa (emphasis supplied).

105 Treas. Reg. § 1.751-1(a) (“To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of (section 751 property)”; Treas. Reg. § 1.751-1(b)(3) (“To the extent that a partner receives a distribution of partnership property (including money) other than section 751 property in exchange for any part of his interest in section 751 property”) (emphasis supplied).

106 We believe that if a partner engages in an bona fide option transaction with the partnership, that such partner should be treated, with respect to the underlying interest, as being other than a partner. This treatment is consistent with the provisions of Section 707(a).

107 I.R.C. § 761(b).
has, in good faith and acting with a business purpose, “joined together” with the other members of the partnership in the conduct of business enterprise. Subchapter K is intended to permit taxpayers to conduct joint business activities through a flexible arrangement without incurring an entity-level tax. If an assignee of bare profits does not participate in management or contribute capital, she cannot be treated as a partner.

An optionee with a typical and commercially standard option has no management rights and does not contribute “capital” to the partnership. Further, she has no right to inspect the books and records of the partnership or to obtain other partnership information. Without such rights, she has not acquired substantially all of the dominion and control of an interest in the partnership necessary for being treated as a partner.

In addition to lacking the state law qualities of a partner, an optionee, as such, lacks the investment risk of a partner. Committee Reports issued in connection with amendments to Section 707 in the Deficit Reduction Act of 1984 state that a key element of determining whether one is acting as a partner is the degree to which she takes entrepreneurial risk with respect to the return of capital invested in the partnership’s business. If, with respect to a purported allocation of partnership income, a person does not bear such entrepreneurial risk, she generally should not be treated as a partner.

Applying these principles to an optionee, an optionee, as such, should not be treated as a partner. She has not invested in the partnership business; rather, she has invested in the option itself. While, on account of such investment, her economic interests with respect to the increase in the value of the partnership are aligned with those of the true partners, her rights to a share of such increase reflect a return on the option investment, not on any investment in the partnership. Absent any investment in the partnership, the optionee lacks the entrepreneurial risk that is the hallmark of partner status.

However, authorities generally support the argument that Section 751 actually changes the property sold (or assigned) on the sale or exchange of a partnership interest. If so, Section

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110 Pagetto v. U.S., 306 F.2d 76 (9th Cir. 1962); PLR 8052065.
111 See, Treas. Reg. § 1.83-7(b) (an option privilege is the right to share in profits without risking capital).
114 Id.
115 See, footnote 106, supra.
751 could affect the character of gain realized on the sale of an Investment Option. As noted above, the character of gain from the sale of an Investment Option is determined with reference to the character of the underlying asset(s) in the hands of the optionee (had the optionee exercised the option).\textsuperscript{116}

Because of the lack of certainty in this area, we recommend that the Service promulgate guidance as to whether the application of Section 1234 to the disposition of Investment Options would include an application of Section 751.

7.3. Substance over Form. While we believe Section 751 should not be applied to sales of Investment Options generally, we also believe that the substance over form doctrine should be used to treat certain optionees as partners when the facts and circumstances support such treatment.

7.4. Sale of an Investment Option. Assuming that Section 751 does not cause the property underlying an Investment Option to be, in part, the optionee’s deemed share of partnership Section 751 property, then the character of gain or loss realized on the sale or exchange of the Investment Option should be determined with reference to the character of the underlying partnership interest. Since the optionee is not a partner with respect to such interest, Section 741 should not apply in determining the character of the underlying partnership interest. Rather, the character of such partnership interest should be determined under general Section 1221 principles. Under such principles, the underlying partnership interest should, except in extremely rare cases, be a capital asset in the hands of the optionee. This conclusion is consistent with principles of Section 1221’s predecessor in the Internal Revenue Code of 1939 as applied to partnership interests by the vast majority of Federal courts. Before Section 751 was enacted, Federal courts nearly unanimously rejected any argument that the aggregate approach should apply to partnership interest sales. Further, in applying pre-Section 751 tax law to partnership interest sales, Federal courts applied the “substance over form” doctrine, as opposed to the aggregate theory, to properly characterize gain recognized by taxpayers assigning income or selling business assets under the guise of selling a partnership interest.

In view of the foregoing, we recommend that the character of gain or loss on the sale or exchange of an Investment Option should be made with reference to the underlying partnership interest. Further, we recommend that such underlying interest should be treated as a capital asset in the hands of the optionee, except in rare and unusual cases.

7.5. Purchase of Investment Option by Partnership. If the partnership purchases an Investment Option, the transaction should be treated as a sale or exchange for purposes of determining the tax consequences to the partnership. Assuming the partnership interest is not “property” for purposes of Section 1234(b),\textsuperscript{117} the partnership should recognize ordinary income

\textsuperscript{116} I.R.C. § 1234(a).

\textsuperscript{117} See, I.R.C. § 1234(b)(2)(B) (which very narrowly defines “property” for this purpose as “stocks and securities . . . commodities, and commodities futures”).
or loss on the transaction.\textsuperscript{118} The income (or loss) is measured by the difference between the option premium over the amount paid for the option. If the difference is positive, the partnership has income; if the difference is negative, the partnership has a loss.

As to the optionee, the transaction is treated as a purchase of the Investment Option. Accordingly, the character of gain or loss realized on the transaction should be, under our analysis, treated as a capital gain or loss under the analysis recommended above in Section 7.5.

Upon closing, the applicable Deferred Account would be debited by the amount of the option premium and the amount paid by the partnership would be credited (to cash) and the difference in these adjustments would result in income or loss, as the case may be. There should be no basis adjustments under Section 734 or Section 743 on account of the partnership’s purchase of the Investment Option.

7.6. Lapse of an Investment Option. On the lapse of an Investment Option, the partnership should recognize income equal to the option premium. The optionee should be treated, as discussed above, as having a capital loss of an equal amount.\textsuperscript{119}

The applicable Deferred Account would be debited by the balance in the account and income of the partnership would be credited by a comparable amount.

7.7. Examples. The following examples describe the consequences that we believe apply (or should apply) to the lapse or purchase of an Investment Option.

\textbf{Example 7.7.} Same facts as in Example 5.1. The option goes unexercised and lapses on February 1, 2011. In the alternative, on March 1, 2002, P1 repurchases I’s option for $25.

(i) \textbf{Consequences to Option Holder.} I has a basis in the option equal to the option premium paid by I ($10). On the lapse of the option, I is entitled to a $10 long-term capital loss.

If P1 repurchases the option for $25, I recognizes a $15 capital gain. The holding period of the option determines whether it is long-term or short-term gain.

(ii) \textbf{Consequence to Partnership; Historic Partners.} In the event that the option lapses, P1 should recognize $10 of ordinary income, which is allocable to A and B as provided in the partnership agreement.

In the event of a repurchase for $25, assuming the partnership interest is not “property” for purposes of Section 1234(b), P1 will realize a $15 ordinary loss.

\textsuperscript{118} Treas. Reg. § 1.1234-1(b).

\textsuperscript{119} I.R.C. § 1234(a). Under I.R.C. § 1234(a)(2) the option is deemed sold or exchanged by the optionee on the day it expires.
(iii) **Capital Account Adjustment.** In the event of a lapse, the Deferred Account with respect to that option is debited by $10, the amount of the option premium, and the income of the partnership would be credited by a comparable amount.

On a repurchase for $25, the applicable Deferred Account would be debited by $10, the amount of the option premium, the amount paid by the partnership would be credited (to cash) and the difference in these adjustments, or $15, would result in a debit to an expense/loss account, as the case may be. There should be no basis adjustments under Section 734 or Section 743 on account of the partnership’s purchase of the Investment Option.

7.8. Lapse/Repurchase of a Service Option.

**Example 7.8.** Same facts as in **Example 6.1.** The option goes unexercised and on January 1, 2011, the option lapses. In the alternative, on March 1, 2002, P2 repurchases S’s option for $20.

(i) **Consequences to Option Holder.** Since the grant of the option to S did not represent income to S, there is no loss to S when the option lapses.

If P2 repurchases the option for $20, under Regulations Section 1.83-7, S has ordinary income of $20. Regulations Section 1.83-7 provides that S recognizes compensation income when an option not included in income on issuance is subsequently “disposed of” for cash.\(^{120}\)

(ii) **Consequences to Partnership; Historic Partners.** In the event the option lapses, since there has been no income to S, there is no deduction to P2 or A and B.

In the event of a repurchase, P2 would have a $20 deduction that would be allocated equally to A and B, assuming the $20 would not be treated as a capital item.\(^{121}\)

(iii) **Capital Account Adjustment.** No adjustment is required.

7.9. Sale of Service Option.

**Example 7.9.** Same facts as in **Example 6.1,** except that S sells the option in an arm’s length transaction to S2 for $20.

(i) **Consequences to Option Holder.** S has ordinary income of $20. Regulations Section 1.83-7 provides that S recognizes compensation income when an option not included in income on issuance is subsequently “disposed of” for cash.

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\(^{120}\) Treas. Reg. § 1.83-7 provides that I.R.C. §§ 83(a) and (b) apply to the transfer of money or property received on an arm’s length sale or other disposition of a compensatory option.

\(^{121}\) I.R.C. § 83(h) and Treas. Reg. § 1.83-7.
(ii) **Consequences to Partnership/Historic Partners.** Following from the above application of Section 83 to the transaction, the sale of S’s option to a third party should result in a deduction under Section 83(h) at the time and in the amount included in S’s income. Other than such a deduction the transfer should not be a tax significant event to P2, A or B, except to the extent that Sections 754 and 743 might come into play.

(iii) **Capital Account Adjustments.** Unless there is some grafting of Sections 754 and 743 onto the treatment of the sale of a Service Option, no adjustments need be made to the capital or other accounts of the partnership upon such sale.

7.10. **Summary.** For the foregoing reasons, while Section 751 may cause the seller of an interest in a partnership to another person to be treated as actually selling assets other than capital assets, we believe that in light of the New 751(a) Regulations this result is not mandated under current law and is not the appropriate conclusion when applied to options. We further believe that Section 751 generally should not apply to an option transaction. Section 1234 should govern the lapse or purchase by the issuing partnership of an Investment Option. Section 83 should govern the lapse or purchase by the issuing partnership of a Service Option.

8. **PARTNERSHIP MERGERS AND INCORPORATIONS.**

8.1. **Mergers.** This portion of our Comments addresses the proper treatment of partnership options upon a merger of two partnerships. No known authorities address the tax treatment of partnership options upon a merger of two partnerships. The general analytical approach of these Comments, that the treatment of options in respect of partnership interests should be given treatment parallel to the treatment of corporate options, arguably supports the Service providing authority for nonrecognition upon the exchange of partnership options in a merger of partnerships, at least in certain circumstances, but we also recognize that in the case of mergers of partnerships, there are other policy arguments and authorities that could support other conclusions. As is explained in more detail below, existing law could be interpreted to cause such an exchange to be taxable in the case of Investment Options. A majority of the contributors to these Comments believe that the exchange of options in the context of a merger of two partnerships should not be taxable under one or more of the following theories: an open transaction theory, under Section 1001, on application of Section 1031, or as a policy matter because the optionee has not yet liquidated his or her investment. However, a portion of the Options Group believes that the tax treatment of such an exchange is unclear and that no recommendation should be made. For the reasons set forth below, we believe that exchanges of Service Options in a partnership merger should not be taxable.

(a) **Investment Options.** No direct authority addresses whether the exchange of options in a merger of two tax partnerships should be taxable.122 Existing law could support at least three alternative approaches for the treatment of Investment Options in partnership mergers:

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122 Arguably, when no direct authority exists, Section 1001 could result in taxability of the exchange.
1. The exchange is tax-free under Section 721;

2. The exchange is taxable; or

3. The exchange is taxable if the new option is “materially different” from the old option.

Each of these alternatives is addressed in turn. As is explained below, we believe that policy arguments can be made to support each of the three conclusions.

(i) The Service could provide guidance that the exchange is tax-free. There are sound policy reasons supporting the conclusion that the exchange of Investment Options in a merger of two tax partnerships is tax-free. First, that result provides similar treatment for partnership and corporate options.\(^{123}\) As explained in Section 4.4, conformity of treatment between entities taxed as partnerships and corporations has the virtue of matching taxpayers’ expectations.

Second, a conclusion that such an exchange is taxable may cause too broad a category of transactions to be taxable. As discussed in greater detail below, if the Service were to conclude that the exchange of Investment Options is taxable, the underlying authority for this conclusion would likely be Section 1001 and *Cottage Savings Assoc. v. Commissioner*.\(^{124}\) The *Cottage Savings* threshold, however, is arguably so low that even the most minor of changes could result in taxation. For example, a partnership conversion, an amendment to the partnership agreement or the sale of substantially all of the assets of the partnership might constitute realization events for the optionee under *Cottage Savings*. Such a low threshold seems inappropriate for options and would unnecessarily hinder changes to parties’ arrangements undertaken for valid business reasons. Indeed, two separate actions of the Service arguably reflect a recognition of this point: first, its determination to promulgate Regulations under Section 354 that facilitate the tax-free exchange of options in connection with tax-free reorganizations and, second, the statement within the preamble to Regulations Section 1.1001-3 (sometimes referred to as the *Cottage Savings* Regulations) that “[f]or equity instruments in particular, the Service and Treasury believe that the application of certain rules in these regulations would be inappropriate.”\(^{125}\)

It is not clear that there is existing authority that would cause the exchange of options to be tax free. However, the merger of two partnerships is, generally, tax free under Section 721. Section 721(a) provides that “[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.” However, it seems inconsistent with the general principle that optionees are not treated as partners to treat a partnership option as an interest in the partnership within the

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\(^{123}\) It is important to note, however, that the exchange of stock options will generally be tax-free only for Section 368 reorganizations that qualify for nonrecognition under Section 354.


\(^{125}\) T.D. 8675.
meaning of Section 721(a). Indeed, case law from the corporate context suggests that options might be properly viewed as securities, which presumably do not constitute an interest in the partnership.\footnote{See, Raymond v. Commissioner, 37 B.T.A. 423 (1938). See, also, Treas. Reg. § 1.354-1(e) (For purposes of I.R.C. § 354, rights to acquire stock are generally treated as zero-principal securities.).}

Nonetheless, if one concludes that the exchange should be tax free, administrative or regulatory authority could be promulgated stating that, for purposes of exchanges of Investment Options in connection with a partnership merger, an Investment Option is an interest in the partnership, and the optionee could be granted nonrecognition treatment similar to that of a partner, just as in the case of a corporate merger, the holder of a stock option is given nonrecognition treatment similar to that of a stockholder. This approach would be consistent with the Code’s treatment of corporate options in a number of different contexts.\footnote{See, I.R.C. § 305(d)(1) (“For purposes of this section, the term “stock” includes rights to acquire such stock.”); I.R.C. § 306(d)(1) (“For purposes of this section . . . stock rights shall be treated as stock.”); I.R.C. § 1032(a) (treating corporate options and stock the same); Treas. Reg. § 1.305-1(d)(1) (“For purposes of this section and §§1.305-2 through 1.305-7, the term “stock” includes rights or warrants to acquire such stock.”); Treas. Reg. § 1.306-3 (“For the purpose of section 306, rights to acquire stock shall be treated as stock.”); Treas. Reg. § 1.1032-2(e) (“The rules of this section shall apply to an option to buy or sell P stock issued by P in the same manner as the rules of this section apply to P stock.”); Treas. Reg. § 1.1032-3(d) (“The rules of this section shall apply to an option to buy or sell P stock issued by P in the same manner as the rules of this section apply to P stock.”). Indeed, regulations under I.R.C. § 305 go so far as to specify that an option holder shall be regarded as a shareholder for purposes of I.R.C. § 305. Treas. Reg. § 1.305-1(d)(2) (“For purposes of §§1.305-2 through 1.305-7, the term “shareholder” includes a holder of rights or warrants or a holder of convertible securities.”). See also I.R.C. § 318(a)(4) (“If any person has an option to acquire stock, such stock shall be considered as owned by such person.”).}

(ii) Certain case law arguably supports taxing the exchange of Investment Options. An argument can be made that the exchange of Investment Options in a partnership merger is a taxable event. \textit{Cottage Savings} suggests that relatively small changes in legal rights can constitute a realization event under Regulations Section 1.1001-1. Authorities in the corporate context suggest that a partnership merger may constitute a sufficient change to be a realization event. If so, Section 721 appears to be the only statutory basis for nonrecognition, but, as discussed above, there is some question about the application of Section 721 to an exchange of Investment Options.

\textit{Cottage Savings} sets a low threshold for a property exchange to be treated as a realization event. In this case, a bank exchanged an interest in home mortgages that had lost value for an interest in an economically identical pool of mortgage loans. The two interests were sufficiently similar that the exchange fell within a rule promulgated by the Federal Home Loan Bank Board that the bank need not record the loss from an exchange where the properties are substantially identical.\footnote{Cottage Savings, 499 U.S. at 557.}
Under Regulations Section 1.1001-1, the exchange was taxable if the interests were “materially different.” Because the taxpayer was attempting to recognize tax losses, the government argued that the exchange was not a realization event as the “underlying mortgages were essentially economic substitutes.” The Supreme Court rejected this argument, concluding that “properties are ‘different’ in the sense that is ‘material’ to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent.”

The Supreme Court’s analysis reveals how easily the threshold for realization may be triggered. The Court contrasted *Eisner v. Macomber* and *Weiss v. Stearn* with *United States v. Phellis* and *Marr v. United States.* In each of these cases, “the stockholders of the old corporation received shares in the new corporation equal to their proportional interest in the old corporation.”

The distinguishing factor between these cases is that in *Eisner* and *Weiss*, the corporations did not change their state of incorporation, whereas in *Phellis* and *Marr* they did. The Supreme Court expressly recognized that “[o]bviously, the distinction in *Phellis* and *Marr* that made the stock in the successor corporations materially different from the stock in the predecessors was minimal.”

Thus, it seems likely that – if *Cottage Savings* applies – a substantial portion of option exchanges in connection with a partnership merger will constitute realization events. For such exchanges, the question becomes whether a nonrecognition provision applies.

While the argument may be made that an exchange of Investment Options in connection with a merger is taxable, it is worth noting that there are policy concerns raised by such a result.

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129 *Id.* at 559-60.
130 *Id.* at 565.
131 252 U.S. 189 (1920) (stock split not a taxable event).
132 265 U.S. 242 (1924) (exchange of shares in reorganized corporation not taxable).
133 257 U.S. 156 (1921) (exchange of shares for corporation reincorporated in a different state taxable).
134 268 U.S. 536 (1925) (same).
135 *Cottage Savings*, 499 U.S. at 564.
136 *Id.* (“[B]ecause a company incorporated in one State has ‘different rights and powers’ from one incorporated in a different State, the taxpayers in *Phellis* and *Marr* acquired through the transactions property that was ‘materially different’ from what they previously had.”).
137 *Id.* See, also, FSA 1998-83 (“One can argue that *Cottage Savings* clearly provides that minor differences in instruments exchanged by different holders meet the ‘materially different’ standard of section 1.1001-1(a) of the regulations.”).
First, it may simply add a trap for the unwary. The optionee should be able to avoid taxation by simply exercising before the merger. Tax might also be avoided by having the two combining partnerships simply contribute all of their assets to a new lower-tier partnership. Second, as is discussed in greater detail at Section 8.1(a)(i) above, a conclusion that such an exchange is taxable may cause too broad a category of transactions to be taxable.

(iii) The Service could promulgate authority that the exchange of Investment Options in a merger of partnerships is taxable when there is a “fundamental change” in the option. The preamble to Regulations Section 1.1001-3 states that “for contracts that are not debt instruments, the final regulations do not limit or otherwise affect the application of the ‘fundamental change’ concept articulated in Revenue Ruling 90-109.”\(^{138}\) This passage suggests that Revenue Ruling 90-109\(^{139}\) could be an alternative standard for determining whether an exchange of Investment Options in a partnership merger is a taxable event and also suggests that the Service feels that the application of *Cottage Savings* should be limited to debt instruments.

The facts of Revenue Ruling 90-109 were as follows. Corporation X purchased key man insurance covering employee A. The policy contained a clause that allowed X to change the insured at its option. A’s employment was terminated, and X changed the policy to cover B. The substitution of B under the policy did not cause either the premiums or the benefits of the policy to change. The Service concluded that the substitution of B “resulted in a change in the fundamental substance of the original contract because the essence of a life insurance contract is the life that is insured under the contract.”\(^{140}\) Therefore, the substitution was a taxable exchange.

If Revenue Ruling 90-109 set the standard for taxability of option exchanges, one could argue that partnership mergers where the option holder was simply diluted pro rata is not a change in the fundamental substance of the original option and, therefore, is not a taxable exchange.

This approach suffers from a number of difficulties, although it is not clear that any are fatal. First, practically no law exists interpreting the fundamental change standard of Revenue Ruling 90-109. Thus, while it provides some preexisting authority that articulates a different standard than *Cottage Savings*, it does little to separate taxable exchanges from nontaxable exchanges. A set of rules would need to be developed to guide the analysis of whether an exchange of Investment Options is taxable. Is the economic relationship of the parties the only relevant inquiry? What if the surviving partnership shares control in a way that differs fundamentally from the preexisting partnership? What if the surviving partnership operates a fundamentally different business? Stating that an Investment Option exchange is taxable only if the fundamental substance of the option changes may simply beg the question of whether the

\(^{138}\) T.D. 8675.

\(^{139}\) 1990-2 C.B. 191.

\(^{140}\) *Id.*
exchange is taxable. Without a set of fully thought out rules, it will often be difficult, perhaps impossible, to discern whether an exchange changes the fundamental substance of the option.  

Second, it is unclear whether the Service meant to suggest that Revenue Ruling 90-109 should govern the exchange of options. The preamble to Regulations Section 1.1001-3 seems to divide the world into at least three categories: debt instruments, equity instruments and “contracts that are not debt instruments.” Regulations Section 1.1001-3 governs the debt instruments, and Revenue Ruling 90-109 appears to govern contracts that are not debt instruments. For equity instruments, the preamble states only that “[f]or equity instruments in particular, the Service and Treasury believe that the application of certain rules in these regulations would be inappropriate.” Because its value relates to equity of the partnership, Investment Options are often thought of as a form of equity.

Taxing exchanges of Investment Options in a merger of partnerships only when there is a “fundamental change” does have at least three virtues, however. First, it might support nontaxability for a significant portion of Investment Option exchanges made in connection with partnership mergers, which seems the more appropriate treatment for the reasons set forth above. Second, this result is based on preexisting authority. Third, it would more closely approximate the tax treatment of stock options in mergers, in that some exchanges would be taxable and some would be tax-free.

Although the law is not clear in this area, a majority of the Options Group recommends that to promote clarity, simplicity, and efficient administration of the tax law, the Service promulgate administrative guidance similar to the provisions of Regulations Section 1.1001-3(e)(4) providing that the Service will not treat an exchange of options as a taxable event if an option is exchanged as result of a merger of an issuing partnership into another partnership or conversion of an issuing partnership into another form of entity that is treated by Subchapter K as a partnership. A portion of the Options Group believes that the law is not certain enough to make a recommendation.

(b Service Options. Following authorities in the corporate context, exchange of Service Options should be tax-free to the optionee. As these Comments discuss earlier, Section 83 should govern Service Options. Under Regulations Section 1.83-7, a Service Option, both before and after the merger, will, in all likelihood, not have a readily ascertainable value. As the Service has reasoned in PLR 9031009 (May 3, 1990), PLR 9023092 (May 15, 1990) and G.C.M.  

141 One possible way to identify exchanges that change the fundamental substance is to ask whether there has been a termination of the partnership. There are at least two problems with this solution. It creates the possibility that any technical termination results in current taxation for an optionee, which seems to be an absurd result. It also is contrary to the general proposition that technical terminations do not cause current taxation.
with respect to compensatory corporate options, the issuance of new Service Options in connection with a partnership merger should therefore not be taxable.\textsuperscript{143}

8.2. Incorporeations of Partnerships. Many factors have motivated business owners to utilize partnerships as a form of entity in which to conduct business. One such factor is the relative ease with which a partnership can be converted into a corporation. Numerous business considerations may motivate owners to incorporate a partnership. If a partnership has outstanding options, those options will need to be taken into account in the incorporation transaction. Options to acquire partnership interests may lapse, be repurchased, sold or exercised in conjunction with the incorporation of the partnership. In addition, options to acquire partnership interests may be converted into options to acquire stock in the resulting corporation. In order to relate the tax treatment of partnership options to corporate options, we believe the Service should issue guidance addressing the treatment of options when a partnership is converted into a corporation.

(a) \textit{Pre-Incorporation Lapse, Repurchase, Sale or Exercise of Partnership Options.} We have previously considered the tax consequences of the lapse, repurchase, sale and exercise of Service Options and Investment Options. We believe the tax consequences should be the same as previously discussed if options to acquire partnership interests are allowed to lapse or are repurchased, sold or exercised in conjunction with the incorporation of a partnership. The tax consequences associated with the lapse, repurchase, sale or exercise of partnership options as part of the incorporation of a partnership should be taken into account immediately prior to the incorporation transaction to ensure that any necessary adjustments are made to the partners’ capital accounts in determining the amount of stock they are entitled to receive in the resulting corporation.

(b) \textit{Conversion of Partnership Options Into Stock Options.} We believe the manner in which a partnership is incorporated should not affect the tax consequences associated with converting partnership options (whether Service Options or Investment Options) into options to acquire stock in the resulting corporation. A partnership may be converted into a corporation in a number of ways, including: (i) contribution by the partners of partnership interests to a corporation in exchange for stock, followed by liquidation of the partnership into the corporation; (ii) distribution to the partners of partnership assets in liquidation of the partnership, followed by contribution by the partners of the partnership assets to a corporation in exchange for stock; and (iii) contribution by the partnership of partnership assets to a corporation in exchange for stock, followed by distribution to the partners of the corporation's stock in liquidation of the partnership.\textsuperscript{144} In Revenue Ruling 84-111,\textsuperscript{145} the Service concluded that the

\textsuperscript{142} The following section on incorporations of partnerships includes a further discussion of the analysis employed by the Service in these rulings.

\textsuperscript{143} \textit{See, also, Mitchell v. Commissioner, 65 T.C. 1099 (1976)} (where neither option had a readily ascertainable fair market value, option for option exchange not taxed at time of exchange, instead taxed at time of exercise), \textit{aff'd}, 590 F.2d 312 (9\textsuperscript{th} Cir. 1979).

\textsuperscript{144} Certain states (e.g., Colorado) also allow a partnership to be merged or converted directly into a corporation. For tax purposes, we believe the merger or conversion of a partnership directly into a corporation should be
method chosen for incorporating a partnership would be respected by the Service and noted that
the primary difference between incorporation methods relates to determining the corporation's
basis in the assets received in the transaction (i.e., where there is a difference between the
partnership's basis in its assets and the partners’ bases in their partnership interests). We do not
believe the basis consequences associated with the different methods of incorporating a
partnership should be affected if options to acquire partnership interests are converted into
options to acquire stock in the resulting corporation. Although the incorporation transaction
must be structured to accommodate converting partnership options into stock options, we believe
there are sound policy reasons for treating the conversion as a non-taxable event without regard
to the manner in which the transaction is structured.

If partnership options are exchanged for options to acquire stock as part of incorporating
a partnership, we believe the character of the stock options received in the transaction (i.e., as
Service Options or Investment Options) should be the same as the character of the partnership
options given up. Characterizing the stock options received in the same manner as the
partnership options relinquished will preserve the tax consequences that the holder of the options
would have realized upon lapse, repurchase, sale or exercise of the partnership options.

(i) **Service Options.** If a person who provided services to a partnership exchanges
Service Options for options to acquire stock in connection with incorporation of the partnership,
we believe the tax consequences of the exchange should be governed by Section 83. This
approach would be consistent with the approach that the Service and the Tax Court have used to
determine the tax consequences associated with the exchange of compensatory options in
corporations.146

Under the general rule of Section 83(a), if a person receives property in consideration for
the performance of services, the service provider must include in gross income (in the first
taxable year in which the service provider's rights in the property are transferable or are not
subject to a substantial risk of forfeiture, whichever is applicable) the excess of (1) the fair
market value of the property (determined without regard to any restriction other than a restriction
which by its terms will never lapse), over (2) the amount (if any) paid for the property. If
property is not taxable in the year of transfer under Section 83(a), Section 83(b) provides that the
service provider may elect to include in his gross income, for the taxable year in which such
property is transferred, the excess of (i) the fair market value of such property at the time of
transfer (determined without regard to any restriction other than a restriction which by its terms
will never lapse), over (ii) the amount (if any) paid for such property. If an election is made
treated as the contribution by the partnership of partnership assets to a corporation in exchange for stock,
followed by distribution to the partners of the corporation's stock in liquidation of the partnership. See,
PLR 9701029 (Oct. 2, 1996) (merger of a corporation into a limited liability company treated in a similar
manner).


146 See, e.g., G.C.M. 39399 (Aug. 26, 1985); PLR 9031009 (May 3, 1990); Mitchell v. Commissioner, 65 T.C. 1099
(1976), aff’d, 590 F.2d 312 (9th Cir. 1979).
under Section 83(b), Section 83(a) does not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction is allowed in respect of such forfeiture. Regulations Section 1.83-7(a) provides that Section 83(a) applies to the grant of an option to an employee or independent contractor if the option has a readily ascertainable fair market value at the time the option is granted.

Section 83(e)(3) provides that Section 83 does not apply to the transfer of an option without a readily ascertainable fair market value. Regulations Section 1.83-7(a) provides that if Section 83(a) does not apply to the grant of an option because the option does not have a readily ascertainable fair market value at the time of grant, Sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time. If the option is exercised, Sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise, and the employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under Section 83(a) or 83(b). If the option is sold or otherwise disposed of in an arm’s length transaction, Sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as Sections 83(a) and 83(b) would have applied to the transfer of property pursuant to an exercise of the option.

The Service and the Tax Court have relied upon the preceding rules to determine the tax consequences of exchanging compensatory options in corporations. In General Counsel Memorandum 39399 (Aug. 26, 1985), the Service noted that it has been Treasury’s position since 1923 to measure the gain on the exercise of an option without a readily ascertainable fair market value at the date of exercise. As noted in General Counsel Memorandum 39399, Regulations Section 1.83-7 refers to the disposition of an option for property or money but is silent with respect to the subject of the substitution of one option for another, when neither option has a readily ascertainable fair market value. Consequently, the Service has concluded that Regulations Section 1.83-7 should not be read to apply Sections 83(a) and 83(b) to an option without a readily ascertainable fair market value. On this basis, the Service and the Tax Court have not treated the substitution of one option without a readily ascertainable fair market value for another option without a readily ascertainable fair market value as a taxable event until the substituted option is exercised.\textsuperscript{147}

We believe the rationale applied by the Service and the Tax Court in not taxing the exchange of compensatory options in the corporate context could be extended to the exchange of Service Options for corporate options (if none of the options has a readily ascertainable fair market value) in the context of incorporating a partnership. For policy reasons, we recommend that if the optionee exchanges one option without a readily ascertainable fair market value for another option without a readily ascertainable fair market value, the transaction should not be taxed until the option received is exercised, both instruments being governed by Regulations Section 1.83-7 and having the tax consequences generally deferred until exercise under that Regulations Section.

\textsuperscript{147} G.C.M. 39399 (Aug. 26, 1985); PLR 9031009 (May 3, 1990); Mitchell v. Commissioner, 65 T.C. 1099 (1976), aff’d, 590 F.2d 312 (9\textsuperscript{th} Cir. 1979).
(ii) Investment Options. In contrast to the exchange of Service Options for options to acquire stock, there is no direct legal authority that would support treating the exchange of Investment Options for stock options, in connection with incorporation of the partnership, as a non-taxable event. On the contrary, we recognize that existing legal authority would treat such an exchange as a taxable event. Nevertheless, we believe that there are reasonable policy reasons for treating the exchange of Investment Options for options to acquire stock, in connection with the incorporation of a partnership, as a non-taxable event.

As discussed in the preceding section on partnership mergers, Section 1001 and *Cottage Savings* would treat the exchange of Investment Options for stock options as a taxable event. However, because practically any exchange is taxable under the rationale of *Cottage Savings*, we believe the *Cottage Savings* standard is administratively unworkable. We believe the Service should establish a more workable standard under which the exchange of Investment Options for stock options, in connection with the incorporation of a partnership, would not be treated as a taxable event. Although there is no direct legal authority in support of this result, we believe there are sound policy reasons that would allow the Service to treat the exchange of Investment Options for stock options as part of incorporating the partnership on a non-taxable basis.

First, we note that the optionee could avoid recognizing income by exercising an Investment Option immediately prior to incorporation of the partnership. The exchange of Investment Options for stock options should place the optionee in the same economic position that they held immediately prior to incorporation of the partnership. Provided the exchange of Investment Options for stock options does not enhance the optionee’s economic position, we believe it is reasonable to not tax the exchange of Investment Options for stock options.

We also believe the Regulations issued under Section 1001 provide a basis for treating the exchange of Investment Options for stock options, as part of incorporation of the partnership, as a non-taxable event. Regulations Section 1.1001-3(b) provides that an alteration of a debt instrument that results in the substitution of a new obligor constitutes a modification of the debt instrument. However, the substitution of a new obligor on a debt instrument does not necessarily result in a significant modification of the debt instrument. For example, the substitution of a new obligor on a nonrecourse debt instrument is not a significant modification. The substitution of a new obligor on a recourse debt instrument is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration of the debt instrument. In a similar manner, the exchange of Investment Options for stock options can be viewed as the substitution of a new obligor under the option. We believe the rationale under the Regulations Section 1.1001-3 could also apply to the exchange of Investment Options for stock options.

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Until exercised, an option to acquire an interest in a partnership is an open transaction. Until a partnership option lapses, is repurchased, sold or exercised, the appropriate tax consequences to the issuer and the holder of the option cannot be determined. We do not believe the substitution of stock options for partnership Investment Options should alter that result.

As with the exchange resulting from a merger of the issuing partnership with another partnership, a majority of the Options Group recommends that to promote clarity, simplicity, and efficient administration of the tax law, the Service promulgate administrative guidance similar to the provisions of Regulations Section 1.1001-3(e)(4) providing that that the Service will not treat an exchange of options in the context of the incorporation of a partnership as a taxable event if the new optionor corporation acquires substantially all the assets of the original optionor and takes a carryover basis in such assets. A portion of the Options Group believes that the law is not certain enough to make a recommendation.

In summary, we recognize that Section 1001 could be applied to treat the exchange of Investment Options for stock options, in connection with incorporation of the partnership, as a taxable event. Nevertheless, we believe sound policy reasons exist (including the tax consequences to the holder upon exercise of an Investment Option and Regulations Section 1.1001-3) for treating such an exchange as a non-taxable event.

(c) Post-Incorporation Lapse, Repurchase, Sale or Exercise of Stock Options. The character of an option should not change if options to acquire partnership interests are converted into options to acquire stock as part of the incorporation of a partnership. A Service Option or Investment Option in a partnership should be characterized in the same manner in the resulting corporation. The holder's basis (if any) and holding period in partnership Investment Options should carryover to the stock options received in the incorporation transaction. If the holder of the options pays a premium that the partnership credits to a Deferred Account, the amount credited to the Deferred Account should be treated in the same manner as any other cash or property of the partnership and added to the capital of the resulting corporation in the incorporation transaction.

After the incorporation transaction is complete, the lapse, repurchase, sale or exercise of the stock options received in the resulting corporation should be taxed under the existing rules that govern the taxation of stock options. If the stock options are received in exchange for Service Options, the tax treatment should be governed by Section 83. Conversely, if the stock options are received in exchange for Investment Options, Section 1234 should dictate the appropriate tax treatment.
APPENDIX A

ENTITY/AGGREGATE THEORIES

The issue of whether tax partnerships are or should be treated as separate legal entities or aggregations of their partners has been discussed or considered in tax cases for at least 75 years.\(^{150}\) Recent commentators have suggested that the proper tax treatment of the issuance and exercise of options issued by tax partnerships may be governed, in part, by the characterization of the tax partnership as an entity or as an aggregation of its partners for the purposes of the analysis.\(^{151}\) Unfortunately, the commentators have not reflected agreement on the resolution of this threshold issue. We, therefore, viewed an examination of the application of the entity / aggregate theories in the context of the issuance of interests in tax partnerships to be a relevant, if not essential, part of the consideration of the tax treatment of the issuance and exercise of options issued by tax partnerships.

1. INTRODUCTION. Tax law has historically used a blended approach to viewing partnerships – sometimes as an entity, sometimes as an aggregate of its partners, sometimes as a combination of the two approaches.\(^{152}\) Case law and legislative history have developed in such a way that authority may be found to support the application of either the entity or the aggregate theory when addressing new areas of tax analysis.

Although the tax bar has been discussing the issue of the correct tax treatment of the issuance of a capital interest in a partnership other than for cash or property for at least four decades,\(^{153}\) no direct authority mandates the application of the entity or the aggregate theories in


the context of the issuance of options for interests in partnerships. In the absence of direct authority mandating one or approach or the other, it would appear that the decision as to whether to apply the entity or the aggregate approach within a particular context should be made based upon general policy reasons.

State law characterization of entities classified for tax purposes as partnerships has moved increasingly toward a view of such entities as separate from the owners. With the introduction of the check-the-box regulations, tax law now treats as partnerships entities that are not treated as aggregates for other purposes.

The aggregate approach generally applied prior to the 1954 Act was a reflection of state law treatment of partnerships. The state trend toward treatment of tax partnerships as entities, and the increasing use of complex entities under the check-the-box regulations, both support the use of an entity approach.

2. DESCRIPTION OF THE THEORIES.

2.1. Entity Theory. Under the “entity” theory, a partnership is viewed as a separate entity from the partners. Under the “entity” theory, the incidence of taxation is determined at the partnership level. The income of the partnership is then allocated among the partners.

154 The statement that no direct authority mandates a result is not intended to mean that no authority has been discovered that might be applied to the area. As stated in Revenue Ruling 75-62, 1975-1 C.B. 188:

Under subchapter K of the Code, a partnership is considered for various purposes, to be either an aggregate of its partners or an entity, transactionally independent of its partners See S. Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954) and H.R. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954). There exists no exclusive rule as to when a partnership will be viewed as an entity or an aggregate. The resolution is generally dependent upon the question to be resolved.

See, also, Coggin Automotive Corp. v. Commissioner, 115 T.C. 349 (2000). Instead, the statement is intended to mean that the statute, legislative history and case law do not apply consistent analysis or conclusions in the area. Compare Casel v. Commissioner, 79 T.C. 424 (1982) with Brown Group, Inc., v. Commissioner, 77 F.3d 217 (8th Cir. 1996).


156 Willis, at 1-64,1-65.

157 McKee, at 1-6; Youngwood, p. 39.


159 I.R.C. §§ 701, 702, 703, 704; Bayse.
Under the “entity” theory, partners do not have a direct interest in partnership assets or attributes, and each partner’s interest in the partnership is viewed as property separate from the underlying assets and operations of the partnership.¹⁶⁰

2.2. Aggregate Theory. Under the “aggregate” theory, a partnership is viewed as an aggregation of partners.¹⁶¹ When the aggregate theory is applied to the income of the partners from the partnership, the partnership is viewed as a mere conduit passing the income through to the partners.¹⁶² When a pure aggregate theory is applied to the assets of a partnership, each partner is viewed as having a direct interest in each partnership asset.¹⁶³

3. THE RESULT OF THE APPLICATION OF THE ENTITY OR AGGREGATE THEORIES TO THE ISSUANCE OF A CAPITAL INTEREST IN EXCHANGE FOR SERVICES UNDER CURRENT LAW.

3.1. If the aggregate theory applies, and the partners are viewed as transferring a portion of their undivided interest in partnership property in exchange for services, the partners are likely to individually recognize gain. The leading commentators conclude that the gain recognized will be equal to the excess of the value of the portion of the property transferred over the tax bases to the partnership of such property.¹⁶⁴ Presumably, the bases of the property in the hands of the partnership would be increased to the extent gain is recognized. Subject to the general limitations of the Code, the partners would be eligible for a deduction to the extent the interest is included the income of the service provider.¹⁶⁵

¹⁶⁰ McKee, at 1-6; Youngwood, p. 39.

¹⁶¹ Youngwood, p. 39. A relatively pure application of the aggregate theory is illustrated by the decision in Benjamin v. Hoey, 139 F.2d 945 (1st Cir. 1944). In Benjamin v. Hoey, the court considered the whether the income of a partner in a brokerage firm included his proportionate share of the commission he, individually, paid to the firm. The court held that to the extent of the partner’s interest in the partnership the partner was dealing with himself and did not create income. This approach was specifically rejected under almost identical facts in Heggestad v. Commissioner, 91 T.C. 778 (1988), under the authority of I.R.C. § 707.

¹⁶² Youngwood, p. 39.

¹⁶³ McKee, at 1-6.

¹⁶⁴ McKee, at ¶ 5.08[2][b]; Willis, at ¶ 4.05[5][a]. See, also, McDougal v. Commissioner, 62 T.C. 720 (1974); I.R.C. § 1001; Treas. Reg. § 1.83-6(b).

¹⁶⁵ Treas. Reg. § 1.83-6(a)(1). Some additional confusion in the area has been generated by the promulgation of hybrid approaches. For example, Lehman v. Commissioner, 19 T.C. 659 (1953), seems to recognize the partnership as a separate entity, but analyses a transfer to a service partner as coming from the individual partners. The Tax Court effectively deemed a distribution out of the partnership to the partners, who were deemed to make a transfer to the service partner, who was deemed to transfer the funds to the partnership. If the entity is recognized but the partners are viewed as transferring a portion of their partnership interests in exchange for services, the partners are likely to individually recognize gain to the extent of the excess of
3.2. If the entity theory applies and the partnership is viewed as exchanging an interest in itself other than for money or property, the partnership may recognize gain to the extent of the value of the interest transferred (i.e., as though it has a zero basis in its own partnership interests). Subject to the general limitations of the Code (such as Section 263A), the partnership would be eligible for a deduction to the extent the interest was included in the income of the service provider. If the entity theory applies but the partnership is viewed as exchanging an interest in partnership property for services, the partnership alternatively may recognize gain to the extent the value of the interest transferred exceeds the tax bases of the shares of the assets transferred.

3.3. Several of the above theories were considered in Commissioner v. Lehman, 165 F.2d 383 (2d Cir. 1948). In Lehman, the Service unsuccessfully argued several alternative variations of the aggregate theory. The issue in Lehman was the amount of gain recognized and holding period for partnership interests sold. The Commissioner argued in the alternative that (i) the holding period for a partnership interest should be determined from the holding period of each partnership asset, (ii) the holding period of a partnership interest begins again if any partner dies, (iii) that a partner whose interest is increased (by reason of the death of another partner) has a different holding period for the increased interest than he might for the original interest.

The court noted that in common law, prior to the adoption of the Uniform Partnership Act, a partnership was no more than a joint ownership of the firm assets. The court further noted that courts of equity and bankruptcy had imposed limitations on the rights of partners in regard to the assets so that partners only had a right to firm profits and any surplus left upon winding up. The court rejected each of the Service’s arguments and affirmed the Tax Court’s ruling that the holding period of the interest sold dated from the time the selling partner entered the firm.

3.5. In a different case with the same name, Lehman v. Commissioner, 19 T.C. 659 (1953), the court seems to have applied the aggregate theory without consideration of the theory being applied. In this second Lehman case, pursuant to the partnership agreement at a predetermined point $5,000 was credited to the capital account of each of the general partners and subtracted from the capital accounts of the limited partners. The court concluded that the result should be no different than if the limited partners had paid the amount the amount credited to the general partners’ capital accounts directly to the general partners with the general partners then contributing the sum to the partnership as their capital contribution. Such a conclusion, ignores the partnership as a separate entity and treats the partnership as an aggregate of individuals.

\[ \text{the value of the partnership interest transferred over the outside basis in the interest. Presumably, the basis in the newly admitted partner’s partnership interest would be increased to the extent that gain is recognized.} \]

166 Treas. Reg. § 1.83-6(a)(1).

4. THE HISTORY OF PARTNERSHIPS AND LIMITED LIABILITY COMPANIES.

4.1. General Partnerships. The original reporter of the Uniform Partnership Act had started down the direction of emphasizing the entity theory but the final reporter changed directions emphasizing the aggregate theory. Even under the original Uniform Partnership Act, some states supported a modified entity theory by not permitting creditors to attack the assets of the partners until the assets of the partnership had been exhausted. The Revised Uniform Partnership Act has an express adoption of the entity theory.

4.2. Limited Partnerships. Under the Revised Uniform Limited Partnership Act, partners have only an interest in intangible personal property (their partnership interest) without regard to the character of the underlying property held by the partnership. This approach is continued in Section 104 of the Uniform Limited Partnership Act (2001).

4.3. Limited Liability Partnerships. Limited liability partnerships are, in many states, a form of partnership governed by the state’s version of the Uniform Partnership Act, creating an entity level liability shield for electing partnerships under some circumstances.

4.4. Limited Liability Companies. Limited liability companies, now accepted in all 50 states, have often been described as an entity that combines the flexibility of a partnership with the corporate level limitation of liability. Separate entity characterization is adopted in many state LLC statutes.

4.5. Foreign Entities Classified as Partnerships. With the introduction of the check-the-box regulations, many foreign entities, that would not have been classified as partnerships under the Kintner regulations, are now partnerships for U.S. tax law.

5. HISTORY OF THE APPLICATION OF THE ENTITY / AGGREGATE ISSUE WITHIN SUBCHAPTER K.

5.1. Law before the 1954 Act – Aggregate Theory. In general, prior to the 1954 Act partnerships were viewed as an aggregate of their partners based upon the English common

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169 Horn’s Crane Service v. Prior, 182 Neb. 94 (1967).

170 RUPA § 201(a).

171 See, Section 201 of the Uniform Limited Liability Company Act (1996).

172 Although McKee cites Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945) for the proposition that a pure aggregate theory applied before the 1954 code, resulting in a disposition of each underlying asset when a
Cases determining whether the disposition of a partnership interest resulted in capital gain looked to the underlying assets of the partnership rather than to the interest of the partnership itself.\(^{174}\)

5.2. The 1954 Act. Congress recognized that under the law prior to the 1954 Act partners could not form, operate or dissolve a partnership with any assurance as to tax consequences.\(^{176}\) Congress intended to establish clear rules for the taxation of partnerships and partners.\(^{177}\) As a general rule, the 1954 Act adopted the “entity” rule,\(^{178}\) although it permitted the aggregate rule for contributed property with pre-contribution appreciation.\(^{179}\) Partnership income was determined at the partnership level, recognizing the partnership as an entity for the

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\(^{173}\) But see, Helvering v. Walbridge, 70 F.2d 683 (2d Cir. 1934) (holding that a partner realizes no income when a partnership sells partnership property); Commissioner v. Lehman, 165 F.2d 383 (2d Cir. 1948) (holding that the holding period of a partnership interest sold dated from the time the selling partner entered the firm rather than the time the partnership purchased its property).

\(^{174}\) Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937).

\(^{175}\) McClellan v. Commission, 117 F.2d 988 (2d Cir. 1941). But see, Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937), denying capital gain treatment to a retiring service partner. The court held that, as to a service partner, the payment was for future income rather than the partner’s interest in firm assets. The 1954 Act generally reversed the rule that the nature of the gain on the disposition of a partnership interest was determined by the nature of the assets of the partnership. I.R.C. § 741 specifically provides that, except as provided in I.R.C. § 751, the gain or loss from the disposition of a partnership interest is considered gain or loss from the sale or exchange of a capital asset. The assets which would cause a “look through” under the 1954 Act were unrealized receivables and inventory which had appreciated substantially in value. I.R.C. § 751 (1954 Code). Although the list of assets that are treated as unrealized receivables or inventory has increased since the provision was originally introduced, the list is still limited in nature and application. The application of a pure aggregate theory would make I.R.C. § 751 meaningless, because the result required in the described circumstances would be mandated in respect of all ordinary income property held by a partnership.


\(^{177}\) Id.

\(^{178}\) In Weller v. Brownwell, 240 F. Supp. 201, 208-209 (M.D. Pa 1965), the court found that Congress expressly adopted the “entity” approach in the 1954 Code. On the other hand, it has been suggested that I.R.C. § 701 is the application of an aggregate concept. See, Willis, at 1-63. However, what is absent from such a suggestion is the implicit acknowledgement that, but for the statutory provision, partnerships may be subject to taxation. Indeed, prior to the 1954 Act, no explicit provision excluding partnerships from taxation was included in the 1939 Code. S. Rep. No. 1622, 83d Cong., 2d Sess., 376 (1954). The addition of the explicit exclusion of partnerships from taxation should, therefore, be viewed as part of Congress’ general adoption of the entity theory rather than an application of the aggregate theory.

purposes of income reporting. After determination at the partnership level, income was allocated among the partners according to the partnership agreement. Only in the absence of provisions in the agreement would the Code itself provide a mechanism.

Congress explicitly adopted the “entity” approach in regard to transactions between a partner and a partnership. In general, both Section 707(a) and Section 707(c) characterize transactions as occurring between a partner and the partnership, rather than as transactions between a partner and the aggregate of the other partners. The 1954 Act codified the treatment of a transfer of an interest in a partnership being a transfer of a capital asset, distinct from the assets of the partnership. In general, the sale of a partnership interest did not affect the basis of the partnership assets. However, an election was provided, to be made at the partnership level, for an adjustment to the basis of the partnership assets to be made on the sale or exchange of a partnership interest. The 1954 Act also provided a limited method of electing the aggregate theory. Section 761 allowed certain unincorporated organizations to elect out of Subchapter K and apply a pure aggregate theory, but only under narrow circumstances.

5.3. H.R. 9662, 86th Cong. 2d Sess., (1960). Although the 1954 Act had intended to answer many entity-aggregate questions, the issue of the treatment of interests issued for services was viewed by some as unclear. H.R. 9662, which was not adopted, would have applied an aggregate approach to the issue, and provided that the partners relinquishing an interest in capital would not have gain or loss on the issuance of an interest in the partnership in exchange for services. The Congressional debate for H.R. 9662 suggests that at least some persons giving


181 Some commentators have pointed to the fact that income flows through to the partners as the basis for the application of the aggregate theory. In the Bayse decision, discussed below, the Supreme Court first applies the entity theory for the determination of partnership income, then applies a conduit analysis for the determination of a partner’s income. Such an analysis is not internally inconsistent. In fact, it parallels exactly the manner in which the income of S corporation shareholders is determined.


testimony before Congress were under the impression that the issues covered by H.R. 9662 were adequately treated by well settled law.\textsuperscript{186}

5.4. The Kintner Regulations. The prior regulations for partnership classification created a four factor test for determining whether an entity would be classified as a partnership or as an association for tax purposes.\textsuperscript{187} By requiring only two of the four tests to be present for an entity to be classified as a partnership, the Treasury permitted increasingly complex entities and entities administratively remote from the owners to be classified as partnerships. Entities could be classified as partnership even though an individual partner had no more rights than a shareholder in the management of the partnership and the partnership had perpetual life.\textsuperscript{188}

5.5. The Supreme Court. The Supreme Court has expressed its opinion on the entity-aggregate theory controversy twice since the 1954 Act. In \textit{U.S. v. Basye},\textsuperscript{189} the court seemingly expressed its frustration that the entity-aggregate issue was still an issue. Apparently hoping to settle the issue, the court held that the partnership is recognized as an independent entity for the purposes of calculating its income and determining the character of income. After the income is calculated, the court held that a partnership is then treated as a conduit through which the income must pass. In \textit{Bellis v. U.S.},\textsuperscript{190} a non-tax case, the Supreme Court held that a professional partnership was a separate and distinct entity sufficient to cause the partners individually to have no right to claim a defense of self incrimination as to records of the partnership. Although considering a three-person law partnership the court noted:

\begin{quote}
We think it is similarly clear that partnerships may and frequently do represent organized institutional activity…. Some of the most powerful private institutions in the Nation are conducted in the partnership form. These are often large, impersonal, highly structured enterprises of essentially perpetual duration. Wall Street law firms and stock brokerage firms provide significant examples.
\end{quote}

\textsuperscript{186} Statement of James B. Lewis, Chairman, Committee on Taxation, The Association of the Bar of the City of New York, Hearings before the U.S. Senate Committee on Finance on H.R. 9662, 86\textsuperscript{th} Cong., 2d Sess., 205 (April 22, 1960).

\textsuperscript{187} Prior Treas. Reg. § 301.7701-2 (1993 regulations, herein referred to as the “Kintner regulations”).

\textsuperscript{188} From a technical compliance perspective, under the Kintner regulations a partnership may have perpetual life either by (i) explicitly providing that the term of the partnership would be perpetual or by (ii) providing that a partnership would terminate on the death, dissolution or liquidation of its general partner which could itself be an entity with perpetual life such as a corporation. Under the laws of some states, a limited partner had no right to force a liquidation of the partnership, and the term of the partnership could be much longer than the natural life of any living partner.

\textsuperscript{189} 410 U.S. 441 (1973).

\textsuperscript{190} 417 U.S. 85 (1974).
5.6. The Section 761 Regulations. Section 761 provides a definition of a partnership and a method of electing out of the application of Subchapter K. The result of electing out of the application of Subchapter K is that a pure aggregate theory is applied. Each partner determines his or her income separately at the partner level. Congress limited the availability of the election out of Subchapter to organizations (i) formed for investment purposes only, (ii) for the joint production, extraction or use of property, or (iii) by dealers of securities during the underwriting or distribution of a particular issue of securities. The current regulations further restrict the ability of partnerships to elect out of Subchapter K, choosing the aggregate method by requiring electing partnerships to (i) own the property as co-owners and (ii) reserve the right for the co-owners to separately take or dispose of their shares of any property acquired or retained. The Service has taken the position that the provision in the regulations that the property be owned as co-owners generally precludes the election by any entity formed under state law.

5.7. The Special Allocation Regulations. In 1986, the Treasury finalized regulations permitting partnerships to provide for special allocations among the partners, so long as the allocations had substantial economic effect. The regulations acknowledged that partners could have differing interests in different aspects of partnership income, gain, loss or deduction. Also, the definition of a special allocation was an allocation other than in accordance with the partners’ interests in the partnership. Conceptually, making allocations other than in accordance with the partners’ interests in the partnership, with the increasing complexity of partnership level allocations, an individual partner’s interest in the tax aspects of a partnership became increasingly difficult to determine without first viewing the partnership as an entity.

5.8. The Check-the-Box Regulations. Upon the promulgation of the check-the-box regulations, entities that had state-law identities quite separate from the owners (and which would have been classified as associations under the Kintner regulations) became treated as partnerships, in some cases by default, in some cases by election.

6. THE APPLICATION OF THE ENTITY / AGGREGATE THEORY TO RELEVANT SECTIONS.

Section 701. The Supreme Court took an entity approach to determining the character of income in Bayse.

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191 For partnerships formed for the joint production, extraction or use of property, the co-ownership may either be in fee or under lease or other form of contract granting exclusive operating rights. Treas. Reg. § 1.761-2(a)(3); Rev. Rul 82-61, 1982-1 C.B. 13. For investing partnerships, this expanded test does not apply. Treas. Reg. § 1.761-2(a)(2).


193 FSA 199923017 (June 11, 1999).

194 See discussion of Bayse, above.
Section 703. The Supreme Court took an entity approach to determining the character of income in *Bayse*.

Section 704. The current regulations allow for complex systems of allocations at the entity level that would be meaningless if the entity were viewed as a pure aggregate. It is only by separating the business and assets from the partners, viewing the income as first at an entity level distinct from the partners, that allocations of differing interests in separate tax aspects may be made.

Section 721. Conceptually, the Section separates the partners from the partnership supporting an entity approach. However, the current final regulations suggest an aggregate approach under some circumstances. The Service proposed, 30 years ago, regulations that would replace the current regulations, but the proposed regulations were never finalized. In *Magneson v. Commissioner*, nonrecognition under Section 1031 was allowed on the exchange of real property for an undivided interest in other real property which was immediately contributed to a general partnership. Relying upon (i) that general partners are managers of a partnership, and (ii) that partners own the assets of a partnership, citing California law defining partners as co-owners in a tenancy in partnership, the court held that the nature of the control over the property as a general partner is of the same nature as the control of a tenant in common.

Section 736. In general, Section 736 uses the entity approach. For example, in *Chase v. Commissioner*, the court held that a deed of an undivided interest in an apartment building by a limited partnership to its partners followed by a series of exchanges did not qualify under Section 1031 when the partners did not act as owners of the property.

Section 741. In general, Section 741 uses the entity approach providing that gain recognized from the sale or disposition of a partnership interest would be treated as gain from the

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195 In certain contexts, an aggregate approach is applied in a I.R.C. § 721 context, Treas. Reg. § 1.1032-3; Rev. Rul. 99-57 (the gain on the sale by a partnership of stock of one of its partners is excluded under I.R.C. § 1032); PLR 200118041 (May 7, 2001) (the assets of a regulated investment company are determined by looking through to the assets of a partnership).

196 The current regulations provide for a blend of the entity and the aggregate approaches. Treas. Reg. § 1.721-1(b)(1) provides that to the extent that any of the partners gives up any part of his right to be repaid his contributions in favor of another partner as compensation for services (or in satisfaction of an obligation), I.R.C. § 721 does not apply. This would seem to put the analysis at the partner level (the aggregate theory). Treas. Reg. § 1.721-1(b)(2), however, distinguishes between services performed for the partnership and services performed for an individual partner. This would support the entity theory. It has been occasionally suggested that, for the purposes of the parenthetical phrase “in satisfaction of an obligation” in Treas. Reg. § 1.721-1(b)(1), options should, themselves, be treated as an obligation. However, options have traditionally been viewed as a continuing offer that is transformed into a contract on exercise rather than obligations. *See, Palmer v. Commissioner*, 302 U.S. 63 (1937); Treas. Reg. § 1.421-6(b)(1); Rev. Rul. 58-234, 1958-1 C.B. 247.

197 753 F.2d 1490 (9th Cir. 1985).

sale of a capital assets, except as otherwise provided. If the Section had reflected an aggregate approach, the Section would have provided that the gain or loss on the sale or disposition of a partnership interest would be determined by the character of the gain or loss that would have been recognized by the partner had the partnership disposed of all of its assets.

Section 751. Although Section 751 has been occasionally cited as authority for an aggregate analysis, the Section is actually structured with an entity treatment presumption with specified exceptions. If Section 741 were written as described above reflecting an aggregate approach, Section 751 would be unnecessary.

Section 752. With the prevalence of debt in respect of which no owner has personal liability, it would be difficult, if not impossible to deal with debt allocations other than on an entity level. From an economic perspective, ignoring the separate existence of the entity raises interesting conceptual issues when debts are recourse to the entity but nonrecourse to the owners. To apply the aggregate theory, one would conclude that each partner was at risk to the extent of the partner’s interest in partnership property. Such an approach contrasts significantly with the approach of the current regulations.

Section 754. In general, elections are made at the entity level creating the possibility for a difference between the inside and outside basis.

Section 761. The Code and the regulations make it difficult to voluntarily elect pure aggregate treatment.199

Section 1001. Regulations Section 1.1001-2(a)(4) uses an aggregate approach in both (iv) and (v).

Section 83. In Sol Diamond v. Commissioner, 56 TC 530 1971, aff’d, 33 AFTR 2d 74-852 (7th Cir.), although the Service relies on Section 61 rather than 83, the case applies a classic Section 83 analysis – the receipt of valuable property for services. The court applies the entity approach by looking to the value of the interest received rather than the value of the property of the partnership. The appellate court noted that some commentators had tried to explain the case by suggesting that the partnership had incorrectly valued the underlying property. Noting that the record of the case did not justify such a conclusion, the court found that that interest received had value under a classic income analysis.200

Section 856. Regulations Section 1.856-3(g) applies an aggregate theory.

199 See, discussion above.

7. OTHER ISSUES.

7.1. The Expansion of Eligibility under Subchapter S. Subchapter S originally permitted only a small group (10) of shareholders to qualify. Now the qualifying number has expanded to 75. Over the course of the same period, partnership treatment is now disallowed for most publicly traded partnerships. Because the Investment Company Act of 1940 imposes a practical 100 member limitation on most partnerships, the difference between the number of owners of a partnership and the number of shareholders of an S corporation has been significantly reduced. Ironically, the requirement that S corporations have a single class of stock might make S corporations more administratively suitable for applying an aggregate concept than tax partnerships, with the broad discretion allowed for creation of varying economic interests and tax allocations in tax partnerships.

7.2. Administrative Ease. For both the tax partnership and a recipient partner, using the entity theory is generally simpler and more consistent with the parties actual understanding of the economic relationship. Applying an entity theory would be simpler in the context of partnership options because the issuance or exercise of the option would require valuing only the interest in the entity as separate property rather the underlying property of the partnership.

8. COMMENTATORS.

8.1. Both McKee and Willis rely on McDougal v. Commissioner, 62 T.C. 720 (1974) for the conclusion that a grant of a capital interest to a service partner should be treated as a partnership transferring a proportionate share of each of the partnership’s assets. The issue in McDougal was the correct treatment of a grant of a half interest in a horse to the horse’s trainer. The court in McDougal did reach the conclusion that on the formation of a joint

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201 Subject to some limitations and exceptions. The limitation comes from a requirement of the Investment Company Act that investment entities with more than 100 owners are generally required to register as investment companies with the Securities Exchange Commission. Unless the partnership meets one of the exceptions to the application of I.R.C. § 7704, the result would be taxation as a corporation.

202 McKee, at par. 5.08[2][b] n. 166. McKee states that Treas. Reg. § 1.83-6(b) should apply to an existing partnership. Without citing authority, other than the limited reference to McDougal, McKee concludes that the partnership should be treated as having disposed of an undivided interest in each of its assets.

203 Willis, at par. 4.05[5][a] n.390.

204 It should be noted that the approach taken by both McKee and Willis in this context is a blend of both the entity and the aggregate approaches. An application of a pure aggregate approach would have the partners transfer a proportionate share of the partnership assets. An application of a pure entity approach would have the partnership transferring a partnership interest.

205 Although the court discussed and analyzed the grant as being of a half interest in the horse, the grant was actually of a half interest in the horse once the owners had recovered the costs and expenses of acquisition. The grant of the interest in the horse was made at the time of the purchase of the horse. The combination of the requirement of the recovery of the costs before the split and the timing of the grant raises the issue as to whether the case should have been decided on the basis that the grant was of a profits interest under Treas. Reg. § 1.721-1(b)(1) rather than a capital interest.
venture, a party contributing appreciated assets satisfies an obligation by granting a capital interest in the venture. Hence, the contributing venturer is first deemed to satisfy the obligation with an undivided interest in the assets, and the two parties are deemed to contribute to assets in concert to the joint venture. The italicized language supports the conclusion that the case should be limited to its facts: a situation in which no partnership existed prior to the satisfaction of an obligation by a transfer of an interest in an asset. If no partnership existed prior to the transfer, then the transaction must be viewed as a transfer of an interest in the property that then results in a partnership after that interest is transferred. It is also questionable whether the case would reach the same result under current law.\textsuperscript{206}

8.2. Simon Friedman, in 1993, concluded that “[a]s a substantive matter, it would appear that the better view would be to adopt the entity theory.”\textsuperscript{207}

8.3. Richard Castanon suggested in 2000 \textit{TNT} 185-19 that the legislative history of Section 707 suggests that the aggregate theory should be applied to the grant of a capital interest in a partnership.

8.4. Sherwin Kamin suggests in \textit{Tax Notes}, May 7, 2001, p. 976, that in analyzing any issue under Subchapter K involving a partners transaction for which there is no clear authority, the analysis should first be done on a pure aggregate theory, and then a determination made as to whether a departure from the aggregate analysis should be made for policy or consistency reasons.

8.5. Lee Sheppard in “The Fairies, the Magic Circle and Partnership Options”, \textit{Tax Notes} 721 (Feb. 5, 2001) suggests that “[a] partnership is not an entity…. Sometimes a partnership has to be treated as entity for administrative simplicity…”

9. CONCLUSIONS – AS TO THE ISSUANCE AND EXERCISE OF PARTNERSHIP OPTIONS.

9.1 Neither the entity nor the aggregate theory has been determined by the courts, ruled administratively by the Service or overwhelmingly adopted by commentators to be the theory applicable in all situations arising under Subchapter K.

9.2. The extent that any trend has developed, the entity theory appears to be dominant.

9.3. Both theories have been utilized – by the Government, the taxpayers and the commentators – to support whatever was ultimately deemed to be the appropriate policy result.

9.4. The entity approach more accurately reflects the direction of state and foreign law entities classified as partnerships for federal income tax purposes.

\textsuperscript{206} Although Rev. Proc. 93-27, 1993-2 C.B. 343 explicitly deals only with the tax treatment to the recipient of a profits interest, it may be a reasonable extension of Rev. Proc. 93-27 to conclude that the transferor of a profits interest should have no tax consequences on the transfer.

9.5. A pure aggregate theory would not be practical in an entity that had special allocations. The application of the entity approach would generally be administratively simpler in the context of options.

9.6. Both the legislative history and the Supreme Court have suggested that the entity approach should generally be used as a starting place in connection with the transfer of partnership interests.

9.7. The analysis of the treatment of persons receiving interests in partnerships pursuant to options should be made by applying the entity approach, which is consistent with the appropriate policy results.

10. OBSERVATIONS.

Although existing law and public policy support the application of the entity approach, regulatory changes are recommended to clarify treatment and to apply treatment consistently.
APPENDIX B

PROFITS INTERESTS

Revenue Procedure 93-27 1993-2 C.B. 343 provides a safe harbor so that receipt of a “qualifying” profits interest is not a taxable event. A “qualifying” profits interest is one received by a person for services provided to a partnership either as a partner or in anticipation of becoming a partner. The safe harbor does not apply if (1) the profits interest is an interest in a substantially certain and predictable stream of income from partnership assets such as high quality debt securities or a high quality net lease, (2) the partner disposes of the profits interest within two years of the grant, or (3) if it is a limited partnership interest in a publicly traded partnership.

For purposes of the revenue procedure, a capital interest is an interest that entitles the holder to a share of the proceeds if the partnership assets are sold at fair market value and then the proceeds are distributed in a complete liquidation of the partnership at the date the interest is granted. A profits interest is then defined as an interest other than a capital interest, i.e., an interest that is not entitled to a capital account on a fair market value basis.

Revenue Procedure 93-27 was clarified by Revenue Procedure 2000-43, 2001-34 IRB 191 (August 3, 2001). Here the Service clarified that the determination as to whether an interest is a profits interest is made at the time the interest is granted, even if it is substantially nonvested with in the meaning of Regulations Section 1.83-3(b). Neither the grant of the profits interest or the subsequent vesting of the interest will be a taxable event.

Taking the revenue procedures at their face value, the issuance of a profits interest is a non-event for tax purposes. Accordingly, as the profits interest is an interest that by definition has no capital account, no adjustment to the capital of the accounts of the partnership or other partners is made. Further, neither the partnership nor the existing partners receives a deduction or has a “capital shift” that would potentially cause the recognition of gain or loss.

There is the risk under this revenue procedure that the valuation by the partnership used to determine whether an interest is a profits interest is incorrect. For example, if the parties value the enterprise at one million dollars when a partner is granted the profits interest and, in fact, the entity is worth two million dollars, then notwithstanding that the profits partner has a zero capital account balance on the partnership’s books, the partner has an interest that would receive proceeds if the assets were sold and the partnership liquidated. It would seem, however, that the partnership and partner should be able to rely on Regulations Section 1.704-1(b)(2)(iv)(h). The regulation provides that the fair market value assigned to (1) property contributed to a partnership, (2) property distributed by partnership and (3) property otherwise revalued by the partnership will be regarded as correct provided that such value was reasonably agreed to among the partners in arm’s length negotiations and the partners have sufficiently adverse interests. It would seem that this concept should apply as well in issuing a profits interest. Presumably, the partners will have an adverse interest as the receiving partner would like as low a value as
possible assigned to the partnership assets while the issuing partnership will want to have as high a value as possible assigned to its assets.

This approach also seems consistent with the regulations under the incentive stock option rules. Under the incentive stock option rules, the option price must equal or exceed the fair market value of the stock at the time the option is granted. Under Regulation S Section 14a.422 A-1 Q &A 2(c)(4) this requirement is deemed satisfied if there has been a good faith attempt to value the stock accurately, even if the option price is less than the stock value. It would seem, therefore, that in the profits interest context, as long as the parties are acting at arm’s length and have reasonably adverse interests in determining the value, their values should be respected.
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