COMMENTS IN RESPONSE TO REG-103580-02

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 or the American Bar Association.

These Comments were prepared by individual members of the following three Committees of the ABA Section of Taxation: Partnerships and LLCs, Real Estate, and Employee Benefits. The principal draftperson of these Comments is Paul Carman, with substantial contributions by Adam M. Cohen, Chuck Fassler, Victor Keen, John Maxfield, Christopher McLoon, Todd Molz, Marty Pollack, Steven Schneider, Walter Schwidetzky, Kevin Thomason and Thomas Yearout. In addition, significant contributions were made by Sheldon Banoff, David Culpepper, Allan Donn, Steve Frost, Leigh Griffith, Robert Keatinge, and Scott Ludwig. The Comments were reviewed by Charles Egerton of the Section’s Committee on Government Submissions and by Jerry August, 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.

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I. Treasury/Service Request for Comments.

In Notice 2000-291 (the “Notice”), the Internal Revenue Service (the “Service”) and the Department of the Treasury (the “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.” Comments of individual members of the Section of Taxation’s Partnerships and LLCs, Real Estate and Employee Benefits committees were submitted to the Treasury in response to the Notice dated January 30, 2002.2 REG-103580-023 (the “Notice of Proposed Rule Making”) requested further comments to be submitted to the Treasury, both on the proposed regulations promulgated pursuant to such document (the “Proposed Regulations”) and on other issues related to the issuance of a Capital Interest in a partnership and an option exercisable into a partnership interest in exchange for services. These Comments address certain issues raised by the Proposed Regulations related to the issuance of Noncompensatory Options by entities classified as partnerships. In addition, these Comments address certain issues related to the issuance of a Capital Interest in a partnership and options exercisable into a partnership interest in exchange for services or as payment of an item of income to the recipient other than compensation.

II. Executive Summary.

A. Primary Conclusions and Recommendations Regarding to Noncompensatory Options.

In general, we believe that the treatment of Noncompensatory Options issued by partnerships should be substantially similar to the treatment of noncompensatory options issued by corporations. We applaud the Treasury and the Service for the Proposed Regulations, which we believe take substantial steps forward in clarifying of the relevant issues.

However, we recommend the elimination or substantial limitation of the Corrective Allocations created by the Proposed Regulations. In recognition that the actual FMV of a partnership interest received may be different than the value of such interest based on a deemed sale of the partnership assets, we also recommend that the Final Regulations expressly permit book-ups based upon the value of the partnership interest related to the event calling for the book-up in addition to continuing to allow book-ups based on the FMV of partnership property.

We believe that the Proposed Regulations under section 761 create a great deal of uncertainty and should be clarified in the Final Regulations. In particular, the word “modified” should be explained and limited by some reasonable standard. We also recommend that safe harbors similar to those provided in the second-class-of-stock rules under Regulations section 1.1361-1(l) be incorporated in the Final Regulations.

1  2000-1 C.B. 1241 (May 11, 2000).
2  56 The Tax Lawyer 203 (Fall 2002) (the “Original Comments”).
3  68 F.R. 2930 (January 22, 2003).
In connection with disregarded entities, it is our recommendation that treatment under section 721 be extended to the exercise of Options that are structured in a manner similar to the second situation described in Revenue Ruling 99-5.4

B. Primary Conclusions and Recommendations in Regard to Compensatory Options.

As with Noncompensatory Options, we recommend that to the extent possible Compensatory Options should be treated substantially similarly to compensatory options issued by corporations. To that end, we recommend that section 83 apply to Compensatory Options, and that the regulations under sections 721 and 707 be conformed to permit this result. In applying section 83, we recommend that the true FMV of the partnership interest received (rather than the liquidation value of the interest received) be the measure of the compensation income of the recipient. We also recommend that on exercise of a Compensatory Option and on the issuance of a Capital Interest in respect of services, as with corporations under section 1032, the issuance be treated for purposes of section 721 as the payment of cash for services followed by the contribution of property in exchange for an interest in the partnership.

These Comments do not suggest any change to the treatment of Profits Interests under Revenue Procedure 93-275 and Revenue Procedure 2001-436. Providing safe harbors to give certainty to transactions where the value of the Profits Interest is likely to be highly speculative is sensible from both administrative and economic efficiency perspectives. The exclusions from the applicability of the revenue procedures are consistent with the recommendation of these Comments that the recipient of a Capital Interest should be taxed on the FMV rather than the LV of the interest received.

C. Other Conclusions and Recommendations.

T.D. 8883 states that it is generally acknowledged that section 1032 applies to an exchange of a corporation’s stock for its own debt. We recommend that the Treasury also acknowledge that section 721 applies to an exchange of a partnership’s interests for its own debt regardless of whether the debt instrument originally contained a “convertibility” feature.


A. Definitions.

“Adjustments on Exercise” means the capital account adjustments required pursuant to Proposed Regulations § 1.704-1(b)(2)(iv)(s).

“Basic Option Principles” means: (i) Option contracts are generally treated as open transactions until exercise or expiration; (ii) there is no federal income tax consequence on

4 1999-1 C.B. 434.
account of either the receipt or the payment of the Option premium (the amount paid to acquire the option) by either the issuer or the Option holder until the Option is exercised or terminated; (iii) the Option premium is recognized as income to the issuer in the year the Option lapses without exercise; (iv) upon exercise, both the issuer and the Option holder use the total of the Option premium and the exercise price to determine the amount realized on the sale and the cost basis of the property acquired, respectively, and (v) the exercise of a Noncompensatory Option at a time when the value of the relevant property had risen above the exercise price of the Option does not cause the Option holder to be taxed on the Option Deferral Amount.7

“Book-Up Rules” means the rules for increasing or decreasing capital accounts to reflect certain events pursuant to Regulations § 1.704-1(b)(2)(iv) as modified by the Proposed Regulations.

“Capital Account Adjustment” means an increase or decrease in the value assigned to partnership property in the partnership capital accounts pursuant to the Book-Up Rules.

“Capital Account Maintenance Rules” means the rules for maintenance of capital accounts under Regulations § 1.704-1(b)(2)(iv)(f) and (h) as modified by the proposed regulations.

“Capital Account Reallocation” means the shift between capital accounts required pursuant to Proposed Regulations § 1.704-1(b)(2)(iv)(s)(3).

“Capital Interest” means any interest in an entity treated as a partnership for federal income tax purposes other than a Profits Interest.


“Compensatory Option” means an Option issued in connection with the performance of services.

“Corrective Allocations” means the allocations required pursuant to Proposed Regulations § 1.704-1(b)(2)(iv)(s)(4).

“Final Regulations” means the final Regulations dealing with Options issued by Partnerships.

“FMV” means the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.8 In the absence of an appraisal, the fair market value assigned to property should be regarded as correct, if (i) such value is reasonably agreed to


among the parties in arms-length negotiations and (ii) the parties have sufficiently adverse interests.\(^9\) The foregoing notwithstanding, the fair market value assigned to property revalued by a partnership pursuant to a Capital Account Adjustment will also be regarded as correct if it is based upon the fair market value of a partnership interest. The use of the fair market value of a partnership interest will not be considered correct if, as of the date of the Capital Account Adjustment, there is a strong likelihood that the use of the fair market value of the partnership interest as the basis of the Capital Account Adjustment would result in a substantial reduction in the present value of the partners’ aggregate tax liabilities. In addition, the use of the fair market value of the partnership interest as the basis of the Capital Account Adjustment will not be viewed as correct if substantially all of the partnership’s property (excluding money) consists of stock, securities, commodities, options, warrants, futures or similar instruments that are readily tradable on an established securities market.

“LLC” means a limited liability company treated as a partnership for federal income tax purposes.

“LV” means the liquidation value of the relevant interest.

“LVAE” means the liquidation value assuming the exercise of the relevant option.

“Noncompensatory Option” means an Option other than a Compensatory Option or an Option issued in payment of an item of income to the recipient.

“Option” means a call option or warrant to acquire an interest in the issuing partnership (or in the issuing disregarded entity that would become a partnership upon exercise), the conversion feature of convertible debt or the conversion feature of convertible equity.

“Option Deferral Amount” means an amount equal to the excess of the LV of the partnership interest received on exercise over the sum of the Option premium and the exercise price.

“Original Comments” means the comments submitted by individual members of the Partnership and LLCs, Real Estate and Employee Benefits Committees of the ABA Section of Taxation dated January 30, 2002, in response to Notice 2000-29, 2000-1 C.B. 1241.

“Preamble” means the preamble to the Proposed Regulations.

“Profits Interest” means a qualifying profits interest for the purposes of Revenue Procedure 93-27.\(^10\)

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“Regulations” means the regulations promulgated under the Code by the Department of the Treasury.

“SRF” means a substantial risk of forfeiture as defined in Regulations § 1.83-3.

B. Assumptions.

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

1. With regard to any Compensatory Options, those Options do not have a readily ascertainable fair market value within the meaning of section 83.11

2. All of the partners, Option holders and assignees of Options are unrelated to each other.

3. Each Option grant is made at arms-length.

4. 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.

5. All of the Options are for interests in partnership capital and profits, and not solely for interests in partnership profits.12

6. Sections 707(a)(2)(B), 731, 751 and 752 do not apply.

7. In each example, the partnership is the grantor of the Option.

8. With respect to Noncompensatory Options, no consideration is given for the option other than the specified option premium of cash or other property.

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11 Unless otherwise indicated, “section” or “sections” indicate a section or sections of the Code.

12 The combination of Revenue Procedure 93-27, 1993-2 C.B. 343 and Revenue Procedure 2001-43, 2001-2 C.B. 191 greatly simplified the treatment of a recipient of a Profits Interest in a partnership (see discussion of the two Revenue Procedures in Appendix B of the Original Comments). 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 we are aware that documents attempting to accomplish this result have been drafted by some tax practitioners.
C. Issues to Be Addressed.

1. Issues Related to Noncompensatory Options.
   a. The scope of the Proposed Regulations.
   b. The appropriateness of Corrective Allocations.
   c. The approaches to book-ups.
   d. The interpretive uncertainties of the Proposed Recharacterization Rules.
   e. The treatment of Options issued by disregarded entities.
   f. The need for safe harbors.

2. Issues Related to Compensatory Options.
   a. The recommendation that Proposed Regulations § 1.721-1(b)(1) be withdrawn.
   b. The treatment of the issuance of a Capital Interest in exchange for services.
   c. The treatment of the issuance of a Profits Interest in exchange for services.
   d. The application of section 83 to Options.
   e. The application of the Proposed Recharacterization Rules to Compensatory Options.
   f. The need for safe harbors.

3. Other Issues.

   We also briefly address the issuance of options issued in respect of other items that would be income in the hands of the recipient.
D. Analytical Framework.

1. *Desire to Approximate Corporate Treatment.*

We believe that where appropriate, it is preferable for the grant, lapse, repurchase, sale and exercise of Options for partnership interests to have tax treatment consistent with that of options for corporate stock to simplify the administration of tax in general and also to promote the voluntary compliance system by making the results of transactions reasonably predictable. 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 language differences, there is little if any 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 so covered only exchanges of stock for money or property. This would have caused a corporation issuing its own stock in consideration for services to recognize income.\(^{13}\) However, Regulations § 1.1032-1(a), as finally adopted, 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.\(^{14}\)

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\(^{13}\) 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).

\(^{14}\) 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. However, “it is generally acknowledged that section 1032 applies to an exchange of a corporation’s stock for its debt.” T.D. 8883 (May 12, 2000).
These final Regulations 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),\textsuperscript{15} section 721 does not apply.\textsuperscript{16}

Thus, the Service has by Regulation interpreted nearly identical statutory language with diametrically opposed results. Corporations are protected from recognition of income on the issuance of stock in payment for services by a deemed circular flow of cash created by the Service through 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 under the current Regulations\textsuperscript{17} because the partnership is paying compensation with a partnership interest in which the it has a zero basis.

To the extent possible, these Comments treat partnership options like stock options. In applying this principle, we have first assumed that the issuance of a Capital Interest in a partnership would be treated like the issuance of stock in a corporation. That result may require the promulgation of administrative guidance, but the Regulations under section 1032 demonstrate that such guidance is within the Treasury’s authority.

\textsuperscript{15} It should be noted that the Treasury recently defined “obligation” in Prop. Reg. § 1.752-7 to include options. An obligation for this purpose is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, and futures contracts. The definition of a liability contained in Prop. Reg. § 1.752-7 does not follow Helmer v. Commissioner, T.C. Memo 1975-160. (The Tax Court, in Helmer, held that a partnership’s issuance of an option to acquire property did not create a partnership liability for purposes of section 752.) Without a revision of the language in Treas. Reg. § 1.721-1(b), a potential conflict is created between Prop. Reg. § 1.721-2 and Treas. Reg. § 1.721-1(b).

\textsuperscript{16} Treas. Reg. § 1.721-1(b). Arguments have been made that the quoted language causes gain recognition only to the recipient partner. However, in the absence of the application of section 721, it is unclear what authority protects the partnership or the historic partners from income recognition.

\textsuperscript{17} The satisfaction of an obligation to pay compensation with appreciated property is taxable to the payor. Treas. Reg. § 1.83-6(b). See, U.S. v. Davis, 370 U.S. 65 (1962). See, also, Willis at ¶ 4.05. However, the circular flow of cash approach is consistent with the analysis of the court in U.S. v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960). The U.S. Court of Appeals for the Sixth Circuit concluded in General Shoe that the gain an employer should recognize upon payment of compensation with appreciated property is the same as if the employer had sold the property for the fair market value and paid the compensation in cash. If a partnership sells an interest in itself for cash it would recognize no gain under section 721 and if a partnership sells an option to acquire an interest in itself it would recognize no gain under the Basic Option Principles, discussed below. The Sixth Circuit opinion in General Shoe was cited with approval by the U.S. Supreme Court in Davis, so the two opinions should be read consistently.
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 second sentence:

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).

Prior to the addition of this second sentence to section 1032(a), the issuing corporation’s treatment of an option in respect of its own stock was described in Revenue Ruling 72-198. 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, as the Service interpreted the first sentence of section 1032 to support nonrecognition by the issuing entity on the issuance of options, it is within the authority of the Service to similarly interpret the parallel language of section 721.

Although section 1032 now has 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, and the statutory changes to section 1032 were made to codify Treasury interpretation rather than to express a legislative choice of treatment. By contrast, the regulations under section 721 reflect the approach of the Treasury originally proposed for section 1032, but quickly withdrew under nearly identical statutory language.

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 where a subsidiary entity exchanges stock of the parent for money or other property. 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. Thus, for 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.

The Proposed Regulations substantially clarify the treatment of Noncompensatory Options in respect of partnership interests. Although many questions remain, the Treasury and

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19 Treas. Reg. § 1.1032-3.

the Service should be applauded for their significant strides towards clarifying the treatment. As recommended by the Original Comments, the Proposed Regulations generally provide Noncompensatory Options with treatment similar to corporate options by applying the Basic Option Principles. Actually, the Proposed Regulations do not explicitly contain rules pertaining to the treatment of the issuance of an option by a partnership. However, the Preamble and the example under Proposed Regulation § 1.721-2 evidence an intent to treat the issuance of a Noncompensatory Option under the Basic Option Principles. Under these principles, the issuance of a Noncompensatory Option is generally an open transaction for the issuer. The issuer’s income or loss from the Noncompensatory Option does not become fixed and determinable until the lapse, exercise, repurchase, or other termination of the option. Similarly, under the Proposed Regulations for the holder of the Noncompensatory Option, the purchase of the option is merely an investment in the option - a capital expenditure that is neither taxable to, nor deductible by, the holder.\(^{21}\)

These Comments encourage the Treasury and the Service to treat Compensatory Options in a substantially similar manner as compensatory options issued by corporate employers are treated.

2. **Use of Basic 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.\(^ {22}\) In Revenue Ruling 58-234,\(^ {23}\) the IRS established the basis for current option treatment. For call options (options to purchase property), Revenue Ruling 58-234 established five basic principles (herein the “Basic Option Principles”) generally applicable to such options which were as follows: (i) Option contracts are generally treated as open transactions until exercise or expiration; (ii) there is no federal income tax consequence on account of either the receipt or the payment of the Option premium (the amount paid to acquire the option) by either the issuer or the Option holder until the Option is exercised or terminated; (iii) the Option premium is recognized as income to the issuer in the year the Option lapses without exercise; (iv) upon exercise, both the issuer and the Option holder use the total of the Option premium and the exercise price to determine the amount realized on the sale and the cost basis of the property acquired, respectively; and (v) the exercise of a Noncompensatory Option at a time when the value of the relevant property had risen above the exercise price of the Option does not cause the Option holder to be taxable on the Option Deferral Amount.\(^ {24}\)


\(^{22}\) Prior to the addition of the second sentence of section 1032, Basic 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.

\(^{23}\) 1958-1 CB 279. See also Rev. Rul. 59-242, 1959-2 CB 125.

\(^{24}\) Palmer v. Commissioner, 302 U.S. 63 (1937).
3. **Entity vs. Aggregate Theories.** Much of the discussion surrounding the issues raised in the Notice 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,\(^{25}\) 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\(^{26}\) – should control the treatment of partnership Options. Underlying these discussions seems to be the view that one theory should dominate in each area of the Subchapter K arena, and once the superior theory is determined that theory would guide the treatment of the specific issue being examined.

Because so much attention has been devoted to the controlling theory debate, we undertook an analysis of the theories’ application in the Original Comments.\(^{27}\) Our conclusions were that (i) neither theory has been determined by the courts, ruled administratively upon by the Service or overwhelmingly adopted by commentators to be the theory applicable in all situations arising under Subchapter K;\(^{28}\) (ii) to the extent that any trend has developed, the entity theory appears to be ascending; and (iii) both theories have been utilized – by the Government, taxpayers and 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. As discussed above, a zero basis issue may theoretically exist once an entity approach is applied to the issuance of Options. However, as with the general treatment related to options issued by corporations, we have generally applied (i) the Basic Option Principles to defer characterization of the tax treatment until the Option’s lapse or exercise and (ii) applied the cash-out cash-in approach to the exercise of a Compensatory Option and Options issued in payment of other items that are income to the recipient.

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26 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.

27 Our analysis is attached as Appendix A to the Original Comments.

28 See, e.g., the discussion of the two theories in Rev. Rul. 75-62, 1975-1 C.B. 188.
IV. Comments on the Proposed Regulations.

A. A Brief Summary of the Proposed Regulations.

The Proposed Regulations propose amendments to sections 704, 721, 761, 1272, 1273 and 1275. Those proposed amendments can be summarized as follows:

1. Proposed Regulations § 1.721-2 provides (a) for nonrecognition treatment upon the exercise of a Noncompensatory Option; (b) that such nonrecognition treatment does not apply upon the transfer of appreciated or depreciated property in exchange for the Option; (c) that section 721 nonrecognition treatment does not apply upon the lapse of a Noncompensatory Option; and (d) definitions of the key words and phrases used in this and certain other sections of the Proposed Regulations.

2. Proposed Regulations § 1.704-1(b)(2)(iv)(s) provides for mandatory Capital Account Adjustments upon the exercise of a Noncompensatory Option, including adjustments for unrealized income, gain, deduction or loss attributable to the Option holder and Capital Account Reallocations for items that have been booked to capital accounts of the historic partners prior to such exercise but that economically “belong” to the Option holder.

3. Proposed Regulations § 1.704-1(b)(2)(iv)(d)(4) provides rules for determining the fair market value of the property contributed on the exercise of a Noncompensatory Option (whether a stand-alone option or an option embedded in convertible debt or convertible equity of the partnership), a valuation that is necessary in order to make the adjustments required by Proposed Regulations § 1.704-1(b)(2)(iv)(s). For a similar reason, Proposed Regulations §§ 1.704-1(b)(2)(iv)(f)(1) and 1.704-1(b)(2)(iv)(h)(2) provide rules for determining the fair market value of the partnership’s property.

4. Proposed Regulations § 1.704-1(b)(4)(ix) provides that allocations by a partnership while a Noncompensatory Option is outstanding must satisfy certain technical requirements in order for such allocations to be deemed in accordance with the partners’ interests in the partnership. Proposed Regulations § 1.704-1(b)(4)(x) provides that Corrective Allocations of gross income or gain or gross loss or deduction must be made to match any Capital Account Reallocations. Proposed Regulations § 1.704-3(a)(6) specifically applies the principles of section 704(c) to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues property under Proposed Regulations § 1.704-1(b)(iv)(s), i.e., reverse section 704(c) allocations.

5. Proposed Regulations § 1.704-1(b)(5) has been amended by adding Examples 20 through 24.

6. Proposed Regulations § 1.704-1(b)(1)(ii) has been amended to provide that the Proposed Regulations apply to Noncompensatory Options that are issued on or after the date final Regulations (the “Final Regulations”) are published in the Federal Register.

7. The Proposed Regulations introduce a new proposed § 1.761-3, which determines when certain rights, including Options, would be treated as a partnership interest.
B. Miscellaneous Issues Arising in the Preamble.

1. **Scope.** Treasury officials have informally indicated that they interpret the Proposed Regulations as applying to any provision that causes an adjustment to the partners’ interests in the partnership. Many partnership agreements provide for the contribution of additional capital either upon specified circumstances or at the partner’s discretion. If “Options” are interpreted to include such provisions allowing capital contributions, the Proposed Regulations potentially will have a very broad effect. We recommend that a right of an existing partner to make an additional capital contribution should not, in and of itself, be included in the meaning of Options for the purposes of the Final Regulations. In addition, there are many other instances in which agreements among the parties may result in an adjustment to the partners’ interests in the partnership. For example, redeeming a partner at a discount would result in an adjustment to the other partners’ interests in the partnership at the same time that capital either shifts or disappears. We strongly encourage the Treasury to clearly define the scope of the Final Regulations and then limit their interpretation to the situations specifically covered.29

The portion of the section 721 Proposed Regulations defining “noncompensatory options” excludes Options issued in respect of interest on convertible debt accrued by the partnership (including original issue discount). The informal indication of Treasury representatives is that they intend to exclude all Options issued in respect of items that would be either income in the hands of the recipient or deductible to the issuing partnership. The current language of the Proposed Regulations does not reflect that breadth of exclusion. Not only are rent and royalty options not excluded, but also Options issued in respect of interest on non-convertible debt are also not excluded. We recommend that the Final Regulations address such Options. We have included a discussion of our recommended treatment of such Options below.29

2. **Basic Option Principles.** The Proposed Regulations do not generally contain rules governing the treatment of the issuance of an Option by a partnership. The Preamble indicates that the intent is to treat the issuance of a Noncompensatory Option under the Basic Option Principles.30 As discussed above, these principles consider the issuance of a Noncompensatory Option as an open transaction for the issuer. The issuer’s income or loss from the Noncompensatory Option does not become fixed and determinable until the lapse, exercise, repurchase, or other termination of the Option. For the holder of the Noncompensatory Option, the purchase of the Option is merely an investment in the Option - a capital expenditure that is neither taxable to, nor deductible by, the holder.31

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29 Much of our objection to the characterization of a right or privilege to contribute additional capital as an Option would be eliminated if the Final Regulations drop the requirement for Corrective Allocations. However, if the definition of Option is extended to rights or privileges to contribute additional capital, the Proposed Recharacterization Rules should provide an exception for reasonable discounts to the purchase price to buy the interest or contribute the capital of a defaulting partner.

30 The example under Prop. Reg. § 1.721-2 also explicitly applies the open transaction doctrine to the issuance of the option.

Although the Preamble clearly indicates the intent that neither the Option holder nor the partnership recognizes income upon the Option’s issuance, it would be preferable to have such a statement repeated in the text of the Final Regulations themselves. While more a matter of practical convenience than a substantive change, we recommend this modification because it is more difficult to locate preamble text than regulatory text, and because the regulation text carries more authoritative weight.32

3. Cash Settlement Options. The Preamble makes clear that the Proposed Regulations apply both when the asset to be obtained is a partnership interest and when such asset is cash or property having a value equal to the value of such interest. Thus, so-called “cash settlement Options,” where the parties never intend the Option holder to become a partner, but instead plan to pay the holder a cash amount derived from the value of the partnership interest are covered by the Proposed Regulations.

Although the Proposed Regulations make it clear that they are intended to apply also to cash settlement Options, it is not clear how the Corrective Allocations would apply to the holder of a cash settlement Option that was respected as an option under Proposed Regulations § 1.761-3. To allocate income to the Option holder from the period prior to exercise would seem to be a retroactive allocation prohibited by section 706(d)(2)(A). If the taxable year of the Option holder in respect of the partnership ends on the date of the cash settlement,33 the only income that could be allocated to the cash settlement Option holder would be the income from the day of exercise.34

It seems more appropriate to cause the holder of the cash settlement Option to have tax consequences that are derived solely from the gain or loss recognized by any excess or deficit of the settlement amount over the Option holder’s basis in the Option. An alternative approach would be to treat such Options under the disguised sale rules and, thus, exclude them from the Final Regulations. Another alternative would be to limit the treatment of the cash settlement Options under the Proposed Regulations to the Proposed Recharacterization Rules, and treat a cash settlement Option that is respected under those rules as if the Option holder never becomes a partner on exercise. Such an approach would, at a minimum, require the deletion of the reference to cash settlement Options in Proposed Regulations § 1.721-1(e)(1).

4. Disregarded Entities. Excluded from the “nonrecognition on exercise” regime for eligible entities and the Adjustments on Exercise are Options issued by disregarded single-member LLCs that would become partnerships upon the exercise of the Option.35 Because the owners of such disregarded entities are treated as owning the assets of such entities directly, the Option exercise does not occur wholly within Subchapter K, but rather transitions to a

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33 I.R.C. § 706(c)(2)(A) and Treas. Reg. § 1.706-1(c)(2)(i).
34 Treas. Reg. § 1.706-1(c)(2)(ii) does permit the pro rata allocation of income, so 1/365 of the income of the partnership could be available for allocation to the Option holder.
Subchapter K regime. Such transition is either (i) more akin to the outright sale of the LLC’s assets than to the transactions targeted by the Proposed Regulations or (ii) the joint formation of a partnership. However, such Options are not excluded from the Recharacterization Rules, so the Recharacterization Rules may be invoked by the Service to create a partnership where the parties may believe only a disregarded entity exists. We have included a discussion of our recommendations as to the treatment of Options issued by disregarded entities in both a noncompensatory and a compensatory context, below.

5. Use of Appreciated/Depreciated Property to Purchase Option. The Preamble and the text of the Proposed Regulations provides that no nonrecognition theory —be it an extended application of section 721 or the Basic Option Principles —will shield the Option holder from having section 1001 gain or loss recognition if a Noncompensatory Option is purchased with appreciated or depreciated property. The Preamble also makes it clear that the section 1001 rules remain circumscribed by all other generally applicable rules governing the allowance of losses, such as section 707(b).

6. Lapse and Repurchase of Options—No Guidance. Although the Preamble and Proposed Regulations § 1.721-2(c) state that section 721 does not apply to the lapse of a Noncompensatory Option, no affirmative statement regarding the application of section 1234 is made in the Proposed Regulations. An extended discussion of the issues regarding the application of section 1234 was included in the Original Comments. Clarification of this issue in the Final Regulations would be helpful. Of particular importance are: (i) whether section 1234(a) requires an application of section 751 to determine the character of the gain or loss recognized and (ii) whether a partnership interest is or should be considered to be a security for the purposes of section 1234(b).

7. Corrective Allocations Generally. As discussed below, the Proposed Regulations provide for Corrective Allocations if, at the time of an Option’s exercise, a Capital Account Reallocation is required. Although we respect that the purpose of the Corrective Allocation is to reduce the book-tax disparity created in part by the Capital Account Reallocation, this is the same reason the principles of section 704(c) are applied when the Adjustments on Exercise result in previously unbooked appreciation being allocated to the Option holder creating a book-tax disparity. There seems to be little policy reason for treating the book-tax disparity created by a Capital Account Reallocation differently from a book-tax disparity created by the Book-Up Rules, particularly when the nature of a Corrective Allocation merely exaggerates the difference between options issued by corporations and Options issued by partnerships.

Representatives of the Treasury have informally signified that they adopted the Corrective Allocation approach to prevent Option arrangement abuses that shifted taxable income to tax-indifferent parties. This concern may be remedied under the Proposed Recharacterization Rules discussed below. To the extent that it is not, the use of Corrective Allocations is likely to merely shift the focus of abusive transactions rather than to prevent them. In other words, the situation that has seemed to concern representatives of the Treasury is when

\[36\text{ See also, Prop. Reg. § 1.721-2(c).}\]
tax-indifferent partners are current parties and a taxable party is the Option holder. However, if the Final Regulations include the concept of Corrective Allocations, tax planners who wish to abuse the provisions are likely to put the taxable parties into the transaction as partners and the tax-indifferent party in the transaction as the Option holder. The result that appears to be required by the Proposed Regulations if a book-up occurs shortly before the Option is exercised is exactly the result that was intended to be prevented -- the artificial shifting of taxable income to a tax-indifferent party.

Also, Corrective Allocations are fundamentally inconsistent with the basic principles of our recommended operative guidelines, i.e., consistency with corporate treatment to the extent possible, entity as opposed to aggregate treatment, and consistency with the Basis Option Principles.

Where a Corrective Allocation is required, as it would be in the case of a capital shift resulting from neither appreciation nor depreciation of partnership assets, the holder of a Noncompensatory Option can be taxed under the Proposed Regulations in the year of exercise on the entire Capital Account Reallocation even if the value of the asset the Option holder actually received (i.e., the partnership interest) may not exceed the sum of the price paid for the Option and its exercise price. Moreover, the character of such income could be ordinary.

Example:

Year 1: A and B form partnership P by contributing $1,000 each. P purchases unimproved land (the “Property”) for $2,000 and grants to C for $100 an Option to acquire an interest in P which entitles C to no voting rights and a one-third interest in the capital and profits of P for $567 (the “discount” is attributable to the fact that C will be a minority partner with no voice, and A and B continue to share control of P). P has no income or loss in year 1.

Year 2: On January 1, C exercises the Option at a time when the interest acquired has a FMV of $667 (C’s Option price plus Option premium). In that year P has no net income and gross income and deductions of $222, each. The value of the Property is unchanged at $2,000. Under the agreement, C’s share of partnership capital immediately upon exercise is $889, one-third of the total capital of $2,667. Under Proposed Regulations § 1.704-1(b)(2)(iv)(s)(2), C’s capital account includes the sum of (i) the Option premium, (ii) Option price paid and (iii) built-in gain to the extent necessary to produce a capital account equal to C’s actual share of capital. Since there is no built-in gain, under the Proposed Regulations, C’s capital account would consist of (i) the option premium and (ii) option price paid, or a total of $567, $322 less than his actual share of capital.

Year 3: The Property is sold on January 1 for $2,000 and P is liquidated. Each of the Partners receives $889 in liquidation of their interest.

Since the reallocation of partnership capital does not relate to any appreciation or depreciation in partnership assets, Proposed Regulation § 1.704-1(b)(2)(iv)(s)(3) requires a Capital Account Reallocation, and for such reallocation to be accounted for by making a Corrective Allocation. Under Proposed Regulation § 1.704-1(b)(2)(iv)(s)(4)(x), where a Corrective Allocation is required:
The partnership must, beginning with the taxable year of the exercise and in all succeeding taxable years until the allocations required are fully taken into account, make corrective allocations so as to take into account the capital account reallocation. A corrective allocation is an allocation (consisting of a pro rata portion of each item) for tax purposes of gross income and gain, or gross loss and deductions, that differs from the partnership’s allocations of the corresponding book item.

Thus, in the example, C will be allocated $222 of ordinary income and A and B will be allocated $111 each of deductions in year 2. In year 3, there would be no gain or loss at the P level and the partners would have no gain or loss on the liquidation. This would seem to be an inappropriate result. C acquired an interest in P for $667 that was worth $667 when he acquired it and at all subsequent times. Any gain he might realize inheres in his partnership interest and should not be recognized until he disposes of it. In fact, in this example, no gain is inherent in the partnership interest in year 2 (C’s interest has an FMV equal to his basis in the interest). Thus, the Corrective Allocation causes an economic distortion by forcing C’s tax basis to exceed the FMV of his interest.

The Preamble suggests that the Proposed Regulations intend to follow the general rule that an Option holder is not to be taxed on the exercise of the option. We have indicated above that we believe that the tax treatment of the issuance of Options by partnerships should generally parallel the tax treatment of the exercise of options by corporations and that we, therefore, have generally applied an entity theory in the Comments.

However, at least in regard to the application of the Proposed Regulations to the above Example, the results are aggregate-like because A and B are allocated losses in the same amount that would have been generated had they been treated as selling a portion of the Property to C at a discount.

This case should be the base case for following one of the Basis Option Principles, i.e., that no gain be recognized by the Option holder on exercise. C should not recognize the built-in gain, which is not in the partnership assets but embedded in his partnership interest, until the interest is disposed of.

The broad applicability of Corrective Allocations under the Proposed Regulations raises significant policy concerns. The case in which there is no built-in gain would seem to be the strongest one for no tax event upon exercise to the option holder or the existing partners. In the Example, the application of the Proposed Regulations causes the Option holder to recognize gain, taxable as ordinary income, and enables the existing partners to claim ordinary losses, all of which occur in the year of exercise.

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As stated above, the built-in gain is not actually in the partnership interest itself, because the partnership interest has a FMV equal to C’s tax basis in the interest. The built-in gain, in this case, is the difference between the FMV of the partnership’s assets and C’s tax basis in the interest.
When gain is recognized on which tax is paid by the existing partners during a period in which an option is outstanding, the gain could be characterized as gain “attributable” to the option holder. However, assuming that the terms of the Option do not run afoul of the Recharacterization Rules and that the other partners are not tax indifferent parties, there is no inherent policy reason why the gain should necessarily be, in effect, reallocated to the option holder after he becomes a partner. If there is game-playing potential not caught by the Recharacterization Rules, perhaps there should be an anti-abuse rule that comes into play when there are tax indifferent parties.

The inappropriate result in the above case stems in part from the combination of the Corrective Allocation rule and the rule that bases capital account adjustments on the value of partnership property rather than the value of the interest received. We address this issue in the subsection “Practice vs. Theory” under “Allocations and Book-Ups While the Option is Outstanding.”

We, therefore, recommend that the Corrective Allocations be eliminated in the Final Regulations.

If Corrective Allocations are not eliminated from the Final Regulations, at a minimum they should be limited in scope. One approach to appropriately limit the scope of Corrective Allocations would be to apply the allocations only to capital shifts that cause the continuing partners’ capital to exceed or fall below their tax bases. Thus, the Corrective Allocation would occur in the potentially abusive situation where the historical partners (possibly tax exempt) have taxable gain from the sale of assets that economically inures to the benefit of the Option holder. Another method of limiting the scope of Corrective Allocations is to provide the Option holder with a pseudo capital account, at least to avoid Corrective Allocations in the following example:

Assume A and B contribute $100 each to LLC. LLC buys assets X and Y for $100 each. LLC issues an option to C for a one-third interest for a $100 strike price (assume zero premium). After the issuance, but before the exercise, LLC undergoes a book-up event (ignoring, for the purposes of the example, the numerical effect of the contribution or distribution that gave rise to the book-up) when both X and Y are valued at $250 each. Of this $300 of appreciation, $100 inures to the benefit of each of A, B, and C. The Proposed Regulations tell us to book the X and Y assets only to $200 (not $250) to account for the fact that $100 of appreciation inures to the benefit of C. Now assume that a year later C exercises the option when X and Y are worth only $200 each (net $200 of appreciation). Although C is entitled to one third of that appreciation ($66.67), there is no unrealized appreciation to book to C, and, under the Proposed Regulations, a net capital shift results, as well as a future Corrective Allocation of ($66.67). If, at the time of the earlier book-up, C was given a pseudo capital account of $100,38 and, upon the exercise of the option, the capital accounts of A, B, and C were reduced by one third of the $100 of depreciation, the capital shift and Corrective Allocation could have been avoided. This approach

38 See, Rev. Rul. 78-182, 1978-1 C.B. 265, describing a “deferred account” created for carrying the option premium. Such a deferred account could also be used to keep track of economic impact on the relative rights of the Option holder of events occurring prior to exercise.
also makes more intuitive sense than to book assets up to something less than their gross FMV as proposed by the Proposed Regulations.

In addition, if Corrective Allocations are not eliminated, we request that the Final Regulations provide clarification of the mechanics of applying Corrective Allocations in a year in which there is both income and loss. The Proposed Regulations provide that:

A corrective allocation is an allocation (consisting of a pro rata portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the partnership’s allocation of the corresponding book item.

Example 21 of the Proposed Regulations applied the Corrective Allocation only to the gross income and left the gross losses as a pro rata allocation. The language of the Proposed Regulations seems to imply that either the income or the loss items could have been used. However, it is unclear whether the choice is completely in the partnership’s discretion, or whether there are some unstated limitations on the use of gross losses as the basis of a Corrective Allocation when both are present in a year. Clarification of this issue would be helpful.

C. The Application of Section 721.

The Proposed Regulations provide that the exercise of a Noncompensatory Option does not cause recognition of gain or loss to either the issuing partnership or the Option holder. According to the Preamble, the Option holder may be viewed as having contributed property in the form of the premium, the exercise price, and the Option privilege to the partnership in exchange for the partnership interest. Accordingly, the Proposed Regulations generally provide that section 721 applies to the holder and the partnership upon the exercise of a Noncompensatory Option.39

1. The Use of Appreciated Property to Pay the Option Premium.

Proposed Regulations § 1.721-2(f) sets forth the following example,40 the first portion of which illustrates the basics of the issuance of an Option for property having a basis different from its fair market value:

**Example.** In Year 1, L and M form general partnership LM with cash contributions of $5,000 each, which are used to purchase land, Property D, for $10,000. In that same year, the partnership issues an Option to N to buy a one-third interest in the partnership at any time before the end of Year 3. The exercise price of the Option is $5,000, payable in either cash or property. N transfers Property E with a basis of $600 and a value of $1,000 to the partnership in exchange for the Option. N provides no other consideration for the Option. Assume that N’s Option is a Noncompensatory Option and that N is not treated as a partner with respect to the Option. Under paragraph (b) of this section,
section 721(a) does not apply to N’s transfer of Property E to LM in exchange for the Option. In accordance with § 1.1001-2, upon N’s transfer of Property E to the partnership in exchange for the Option, N recognizes $400 of gain. Under open transaction principles applicable to Noncompensatory Options, the partnership does not recognize any gain upon receipt of appreciated property in exchange for the Option. The partnership has a basis of $1,000 in Property E . . .

The “paragraph (b)” referred to in this passage is the following portion of Proposed Regulations § 1.721-2:

(b) Transfer of property in exchange for a noncompensatory option. Section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option. For example, if a person purchases a noncompensatory option with appreciated property, the person recognizes income or gain to the extent that the fair market value of the noncompensatory option exceeds the person’s basis in the surrendered property.

The section 1001 gain treatment and the stand-alone treatment of the Option purchase transaction reinforce the position that section 721 does not apply to a transfer of property to a partnership in exchange for a Noncompensatory Option. Also, the gain or loss is determined by comparing the basis of the surrendered property to the fair market value of the Option, not the fair market value of the property. Although one would think that those values would be the same out of economic necessity, discount theories in family partnerships and other areas support the possibility that the fair market value of the Option may be substantially less than the fair market value of the surrendered property.41

It should be recognized that such treatment is a deviation from Basic Option Principles. Some would argue against immediate recognition of gain on the purchase of an Option with appreciated property on the theory that the tax treatment of the transfer of the appreciated property to the partnership in exchange for an Option should be held “open” until it is clear that the Option will be exercised or lapse. Those in favor of open transaction treatment would argue that if the Option is exercised, the in-kind property transferred as the Option premium should be accorded tax-free exchange treatment under section 721. According to this school of thought, gain or loss realized from the transfer of such property to the partnership should be recognized by the holder only if the Option lapses or is repurchased by the partnership.42

Although this theory has technical merit, we agree with the approach taken in the

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41 Although this statement is counterintuitive it is the theoretical result of the application of discounts to the value of the interest. On a practical level, the issue is likely to generally apply only on initial formation, or shortly thereafter, where all parties to the transaction are subject to similar discounting. After initial formation, one would generally expect the contributing party to either ask for a larger interest or to contribute less.

Proposed Regulations that section 721 does not apply (and thus, generally, gain or loss will be recognized) upon the transfer of appreciated or depreciated property to the partnership in payment of the Option premium. The approach taken in the Proposed Regulations is a concession to the practical reality that in many, if not most, cases the partnership simply must know from the moment it receives the property whether it will have a carryover basis under section 723 or a cost basis under section 1012.

This debate is best illustrated by an example. Suppose that in Year 1 the Option purchaser transfers to the issuing partnership the following assets in payment of the premium to acquire an Option: (a) equipment with an FMV of $10,000 and an adjusted tax basis of zero, (b) a building with an FMV of $70,000 and an adjusted tax basis of $15,000, and (c) intellectual property with an FMV of $20,000 and an adjusted tax basis of zero. Assume that the issuing partnership has five equal partners and that in exchange for payment of the Option premium the Option holder will have the Option to acquire a one-sixth interest in partnership profits, losses and capital for $1 million. Further assume that (i) at the end of Year 2 the partnership sells the equipment for $5,000, (ii) at the end of Year 3, two of the original five partners sell their interests to a new partner, (iii) at the end of Year 4 the partnership sells the building for $80,000 and sells the intellectual property for $50,000, and (iv) at the end of Year 10 the Option lapses unexercised. Because ultimately the Option lapsed, section 721 treatment was never appropriate.

2. Use of Appreciated/Depreciated Property to Pay Exercise Price. The key distinction between the treatment of the Option holder upon the issuance of the Option and upon the exercise thereof is the applicability of section 721, literally and in principle. Continuing the example from Proposed Regulations § 1.721-2:

In Year 3, when the partnership property is valued at $16,000, N exercises the Option, contributing Property F with a basis of $3,000 and an FMV of $5,000 to the partnership. Under paragraph (a) of this section, neither the partnership nor N recognizes gain upon N’s contribution of property to the partnership upon the exercise of the Option. Under section 723, the partnership has a basis of $3,000 in Property F. . .

Here, the indicated controlling provision of the Proposed Regulations is Proposed Regulations § 1.721-2(a), which reads as follows:

(a) Exercise of a noncompensatory option. Notwithstanding § 1.721-1(b)(1), section 721 applies to the exercise (as defined in paragraph (e)(4) of this section) of a noncompensatory option (as defined in paragraph (d) of this section). . .

Thus, the nonrecognition provisions of section 721, while not available upon the issuance of the Option, are fully effective to prevent recognition of gain or loss to the exercising Option holder and the historic partners upon the exercise of a noncompensatory option where the Option holder uses appreciated or depreciated property to pay his exercise price. There are no “open transaction” issues to delay the determinations of basis and holding period that theoretically could exist if the use of such property to purchase the Option were deemed not to cause gain or loss recognition.
D. Allocations and Book-Ups While the Option is Outstanding.

The most complex set of mechanics found in the Proposed Regulations applies when a Capital Account Adjustment event, such as the entry of a new partner, occurs while a Noncompensatory Option is outstanding. The temptation under the existing Book-Up Rules was to book to the capital accounts of the historic partners (and even the entering partner) unrealized appreciation rightly attributable to the economic interest of the Option holder. Because there is no real accounting mechanism for booking that appreciation to any kind of account attributable to the Option holder prior to exercise, one must approach the situation as follows: (a) if you revalue the partnership’s assets, the balance sheet must increase to the objective fair market value amounts, and, (b) therefore, since assets must equal liabilities plus capital, an equivalent amount must be booked into the only capital accounts available, i.e., the capital accounts of the existing partners.

However, to do so completely ignores the economic realities of the bundle of rights owned by the Option holder. Moreover, if such a book-up regime were followed, upon exercise of the option the amounts erroneously booked to the capital accounts of the historic partners must then be “shifted” to the exercising Option holder’s capital account, looking like a “capital shift” that may somehow result in a taxable event.

1. Example 22: The “Simple” Mechanics of the Book-Up. The facts of Example 22 are as follows: In Year 1 two members form LLC with capital contributions of $10,000 apiece, obtaining 100 units apiece in LLC which uses those funds to purchase nondepreciable Properties A and B for $10,000 apiece. In the same year, DR purchases, for a cash option premium of $1,000, an option to purchase 100 identical LLC units for an exercise price of $15,000 in Year 2.

Prior to DR’s exercise of his option, ML contributes $17,000 to LLC for 100 identical units in LLC at a time when Property A has a value of $30,000, Property B has a value of $5,000, and the fair market value of DR’s option is $2,000.

a. First, utilizing the principles of Regulations § 1.704-1(b)(2)(iv)(f), as they are proposed to be amended by the Proposed Regulations, the partnership’s property is revalued. Starting with the “gross” fair market value of LLC’s property (here $36,000; $30,000 in Property A, $5,000 in Property B and the $1,000 option premium), the amount of the option premium is subtracted.

b. Next, Proposed Regulations § 1.704-1(b)(2)(iv)(h)(2) requires a computation that subtracts the consideration paid for the Option, here $1,000, from the “fair market value” of the Option. The Proposed Regulations do not state how the FMV of the Option should be computed. However, the value that is consistently used in the examples is the liquidation value of the Option assuming exercise and payment of the Option premium (“LVAE”). As noted in the definition of FMV above, in many cases the parties may have sufficiently adverse interests that they may be able to agree that the FMV is the LVAE for the purposes of this calculation. However, because the entire calculation is dependent upon the FMV of the Option in fact being the LVAE, it would be preferable if the Final Regulations stated that the calculation in the book-up is based upon the LVAE of the Option (assuming alternative suggestions discussed below are not adopted).
c. If the amount obtained in step b. above is a positive number, then the value of the LLC’s property is reduced by that amount. A positive number indicates the existence of value in LLC’s assets that is economically “owned” by the Option holder, and the reduction in the value of the LLC’s assets that is necessary in order to reach invisibility for the Option as a whole is to be allocated to those assets that have unrealized appreciation, here only Property A.

d. Thus, LLC’s gross assets of $36,000 are reduced by $1,000 two different times (once to eliminate the premium and once to eliminate the appreciation attributable to the option), for these purposes, down to $34,000. The basis of the non-cash assets of LLC is $20,000. Thus, there is $14,000 of unrealized appreciation in the non-cash assets of LLC to be allocated equally to the capital accounts of the original two members, bringing each of their capital account balances up to $17,000—the same as was paid by ML upon his admission.

The result is a function of the fact that the Proposed Regulations appear to have backed into the LVAE—stated in the example to be $2,000—by simply subtracting the $15,000 exercise price from the liquidation value, that is, $17,000. So, if the FMV of the Option is not derived from the LVAE, then the formula would not achieve the goal stated in the Preamble -- to avoid booking to the capital accounts of the partners an amount in excess of the amount economically attributable to the outstanding partnership interests.

2. Practice vs. Theory. The practical method used by practitioners and partnerships for adjusting (a/k/a “booking-up” or “booking-down”) capital accounts upon the admission of a new partner has long departed from what the Regulation’s language seems to require. We will next discuss this divergence, why it matters now, and some suggestions for clarifying the procedures for adjusting capital accounts.

In relevant part, the Regulations have long provided that, upon the admission of a new partner (or other adjustment event), the book capital accounts of the partners may be adjusted to reflect a revaluation of the partnership’s property and that such revaluation must be “based on the fair market value of partnership property . . . on the date of adjustment.”

In practice, when a new partner is admitted to the partnership in exchange solely for a capital contribution of cash or other property, the revaluation of the partners’ capital accounts under Regulations § 1.704-1(b)(2)(iv)(f) seldom results in adjusting the partnership assets to an amount equal to their respective FMVs. Rather, the book-up or book-down, as the case may be, is generally reverse-engineered from the starting point of the capital contribution of the new

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43 Example 22 appears to quantify the unrealized gain in the LLC’s assets by reference only to the non-cash assets, presumably because cash always has a basis equal to its value.

44 Admission of a new partner is just one among several events specified in Treas. Reg. § 1.704-1(b)(2)(iv)(f) which result in a permissible adjustment to capital accounts.


46 REG-139796, 68 F.R. 39498 (July 2, 2003), proposes regulations that would expand the circumstances under which the partners’ capital accounts could be revalued.
partner and the percentage interest obtained by the partner in exchange for such contribution.\footnote{This practice is consistent with the observation by TD 9059 (June 6, 2003) that “[i]f a partnership interest is transferred in a taxable transaction, the transferee’s basis in its partnership interest provides a frame of reference for determining partnership gross value.”} The effect of this approach is that the adjusted capital accounts of the partners are actually derived, not from the FMV of each of the partnership’s assets net of the partnership’s liabilities, but from the FMV of the new partner’s partnership interest, \textit{i.e.}, the amount that the partner and the partnership agreed would be the new partner’s purchase price for such interest in a willing-buyer/willing-seller transaction.

This approach does not generally result in adjusting the partners’ capital accounts to an amount derived from the FMV of the partnership’s assets,\footnote{Arguably, the existing Regulations do not require the book-up or book-down to result in the partnership assets being adjusted to their fair market value, because Treas. Reg. § 1.704-1(b)(2)(iv)(f) merely requires that: “[t]he adjustments be based on the fair market value of partnership property…” (emphasis added). However, this issue is unclear.} because a partner who purchases a partnership interest from the issuing partnership presumably discounts the amount he is willing to pay for his partnership interest by an amount equal to marketability, minority or other appropriate discounts that are applicable to such interest.\footnote{The case support for the use of various discounts is quite broad. \textit{See, e.g.}, \textit{Gross v. Commissioner}, 272 F.3d 333 (6th Cir. 2001); \textit{Church v. Commissioner}, 268 F.3d 1063 (5th Cir. 2001).} Consequently, a book-up or book-down which is calculated by working backwards from the amount contributed to the partnership by the new partner in exchange for his interest is generally going to result in a valuation that is lower than a simple pro rata extrapolation from the FMV of the partnership’s assets on a liquidation basis.

For example, if equal partners A and B admit new partner C as an equal one-third partner in their partnership in exchange for $100x, then as long as the capital accounts of A, B and C are each equal to $100x immediately upon C’s admission, the capital accounts reflect their economic arrangement, \textit{i.e.}, that they are equal partners. Assume that the net FMV of the partnership’s assets immediately before C’s admission is $350x, and that immediately after C’s contribution of $100x, the net FMV of the partnership assets is $450x. Thus, the net FMV of the partnership’s assets attributable to C is $150x ($450x/3). Assume further that the reason the partnership and C agreed to a purchase price of $100x for C’s one-third interest is because the parties recognized and took into account the fact that such partnership interest was devalued by transfer, control and liquidation restrictions contained in the partnership agreement and that these restrictions caused the FMV of C’s newly acquired interest to be worth only $100x, even though the liquidation value of the partnership’s net assets attributable to C’s interest was $150x.

As a practical matter, there is nothing wrong with reverse-engineering the amount of each partner’s booked-up capital account based on the capital contribution of the new partner as long as the capital accounts of all partners are in sync with their economic deal. Such is the case if the capital accounts of A, B and C are adjusted to $100x in the preceding example. However, potential problems arise if the Regulations and Proposed Regulations are not clarified to both: (i)
recognize that the net FMV of partnership assets that correspond to a partnership interest ordinarily will not equal the FMV of such partnership interest; and (ii) expressly provide that capital account book-ups and book-downs occasioned by the admission of a new partner may properly be determined with reference to the FMV of the newly issued partnership interest.

Specifically, if upon the admission of a new partner (or other revaluation event) and if the partnership opts to adjust capital accounts as permitted by the Regulations, the partnership assets must be adjusted to an amount equal to their respective FMVs – in which case the aggregate capital accounts must be adjusted to an amount which equals the total net FMV of the partnership’s assets on a liquidation basis--then in the preceding example C would seemingly be required to have an opening capital account balance of $150x, even though he contributed only $100x in exchange for his one-third partnership interest. Moreover, in order to arrive at this adjustment, the partnership would be forced to make a determination (perhaps by way of costly appraisal) of such FMVs. In contrast, the reverse-engineered capital accounts of $100x for each of A, B and C do not require the partnership to obtain an appraisal and do not result in the counterintuitive booking of C’s capital account to an amount which is substantially higher than the amount he contributed in exchange for such interest.

Further, adjusting the capital accounts based on the FMV of the partnership’s assets leads to confusion in both compensatory transfers under section 83, and donative transfers. In the preceding example, if immediately after C’s admission to the partnership A transferred her one-third partnership interest worth $100x to E in exchange for services rendered by E to A, then E should have compensation income equal to $100x, not the $150x liquidation value of the partnership’s net assets attributable to such partnership interest.50 Similarly, if B gifted his one-third interest worth $100x to his daughter immediately after C’s admission to the partnership, the value of such gift for gift tax purposes should be $100x, not $150x.

The Proposed Regulations seem to adhere to the premise that the aggregate FMVs of the partnership’s net assets attributable to a partnership interest are equal to the FMV of such partnership interest. This is illustrated in Example 22. In that example, the newly admitted partner ML contributes to the partnership an amount that equals the amount that ML would receive from the partnership on a liquidation basis (after subtracting out the FMV of the outstanding Option). The problem is that in practice ML will ordinarily discount the price he is willing to pay for his partnership interest (in relation to the underlying partnership asset values) to account for the fact that he does not have the unfettered ability to sell the partnership’s assets and liquidate his partnership interest for cash. In other words, in Example 22, the amount ML pays for his interest in LLC provides simplicity from a calculation perspective, but is unrealistically high given the reality of the true value of minority interests in illiquid investments such as LLC.

The analysis of what would happen if ML actually discounted the purchase price of his partnership interest is illustrated by Example 1 in Appendix B. As is illustrated in Example 1, the mechanics of the Proposed Regulations still work. However, when the economics of the transaction are given a more realistic portrayal, no Capital Account Reallocation or Corrective

50 See, I.R.C. § 83(a).
Allocation results because DR’s Option is always out of the money -- and, therefore, not exercised.

It should be noted, however, that the same results as those set forth in Example 1 would also have been obtained if the capital accounts of the partners had been “reverse engineered” from ML’s purchase price. In either case, the economic relationship between the partners is correctly established.

A similar problem in the mechanics of the Proposed Regulations is illustrated by Example 2 in Appendix B. In Example 2, the Option value is below the LVAE. Because the Proposed Regulations use a subtraction approach to compute the capital accounts of the historic partners on the exercise of the Option, if the Option FMV is below the LVAE, the resulting capital accounts of the historic partners are above the economic value that would be attributable to the historic partners if the Option were exercised and then the partnership were liquidated. The result of such “over booking” the capital accounts of the historic partners is that there is no longer sufficient built-in gain in the assets of the partnership to cause the capital account of DR to reflect its LV after the Adjustments on Exercise. Under the Proposed Regulations, a Capital Account Reallocation is then required -- in the same amount that the FMV was below the LVAE. Unlike the result in Example 1, where the mechanics worked correctly but came up with the same result as a book-up based upon the buy-in value, the mechanical calculation required by the Proposed Regulations in Example 2 creates a distortion for which DR is improperly penalized. Because DR’s Option is worth less than the LVAE, DR is forced to receive Corrective Allocations of gross income.

As is illustrated in Example 3 in Appendix B, the economic distortion created by the subtraction method of the Proposed Regulations when the Option FMV is below its LVAE does not necessarily occur when the buy-in value is used as the basis for the book-up. Under substantially the same facts as Example 2, not only do the book-up values in Example 3 reflect the correct economic relationship between the historic partners, but also no Capital Account Reallocation results where none is justified based upon the economic agreement of the parties.

It would be helpful if the Government took this opportunity to clarify existing Regulations § 1.704-1(b)(2)(iv)(h) by providing that adjustments to the capital accounts that are based on the FMV of a partnership interest issued to a partner are permissible even though the resulting adjustments will not necessarily cause the partnership properties to be adjusted to an amount equal to their FMVs. It would also be helpful if Example 22 could be similarly clarified to acknowledge that the fair market value of the newly acquired partnership interest may not equal the amount that such new partner would receive if the partnership sold its properties at FMV and then liquidated.

An example of language that would clarify Regulations § 1.704-1(b)(2)(iv)(h) is included in Exhibit A.
E. The Proposed Recharacterization Rules.

1. Overview.

Proposed Regulations §1.761-3 (the “Proposed Recharacterization Rules”) treats a Noncompensatory Option as a partnership interest if two tests are met. First, there must be “a strong likelihood that failing to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners’ and the holder’s aggregate tax liabilities” (the “Strong Likelihood Test”). Second, the Option (and any rights associated with it) must provide its holder with “rights that are substantially similar to the rights afforded to a partner” (the “Substantially Similar Test”). However, these broader tests actually imply additional tests. More precisely, a Noncompensatory Option that satisfies the five largely subjective tests described below will be treated as a partnership interest. We assume that if the Government was not concerned about the potential for abusive Options, there would be no Proposed Recharacterization Rules. Representatives of the Treasury have indicated that the heart of their concern is that partnerships with tax-indifferent partners could issue Options to high-tax-bracket taxpayers who hold their unexercised Options for significant periods of time during which the partnership might be expected to have substantial taxable income.

However, treatment of an Option holder as a partner is not a small matter, at least not in terms of complexity and administrative burden on the Option holder, the partnership and the partners. All of these parties generally will have significantly different tax consequences if the Option holder is treated as a partner, rather than as an Option holder, prior to the exercise (or lapse) of such Option. The stakes are even higher for an Option holder that is highly sensitive to recognizing the type of partnership income that would be allocated to such holder if it were treated as a partner while the Option remains unexercised, such as a tax-exempt organization that may have a strong aversion to unrelated business taxable income.

The other partners may also be negatively impacted if an Option holder is treated as a partner prior to his exercise of the Option, primarily because such treatment would mean that the historic partners would recognize, in the aggregate, a different amount of income or loss than they would recognize absent application of the Proposed Recharacterization Rules. Similarly, the partnership itself faces a daunting task if it incorrectly treats an Option holder as an Option holder for a period of three years, only to find out later upon audit that the Option holder should have been treated as a partner from the moment the Option was issued. In such a case, presumably the partners’ Schedule K-1s must be retroactively amended for all open years, which would also require the open tax returns of the historic partners to be amended and may ultimately reveal that tax or other distributions have been made in incorrect proportions.

The burdens of recharacterization would be further magnified if an Option holder were treated as a partner, only to have the Option lapse unexercised many years later. If that were to occur, it would appear that upon such lapse the Option-holder-deemed-partner would be treated as though she had abandoned her partnership interest to the partnership as of the date that the Option lapsed. Such abandonment treatment could have myriad implications including, to name a few, debt shifts and deemed cash distributions under sections 752 and 731, basis adjustments under section 734 (if a section 754 election has been made), and “hot asset” shifts pursuant to section 751.
Given the potential for havoc to all concerned, the drafters should strive to have the Proposed Recharacterization Rules satisfy two objectives: (1) to apply only where it is likely that the fisc will be substantially economically whipsawed by the failure to do so; and (2) to allow taxpayers to be able to predict with a high degree of certainty when it applies.

As discussed below, we believe that the Proposed Recharacterization Rules accomplish the first objective, but come up short in accomplishing the second due to a lack of sufficient guidance with respect to when the rule will be applied.

2. **Mechanics.**

In order for a taxpayer to be treated as a partner under the Proposed Recharacterization Rules, the following five questions must be answered in the affirmative:

(i) Is the arrangement with the taxpayer an Option?

(ii) Is the Option noncompensatory?

(iii) Is there an event of issuance, transfer or modification with respect to the Option (an “ITM Event”)?

(iv) Is there a strong likelihood that the failure to treat the Option holder as a partner will result in a substantial reduction in the present value of the partners’ and the Option holder’s aggregate tax liabilities (the “Strong Likelihood Test”)?

(v) Does the Option (and any of the rights associated with it) provide its holder with rights substantially similar to the rights afforded to a partner in the partnership (the “Substantially Similar Test”)? Although the Substantially Similar Test is initially stated in the Proposed Recharacterization Rules in terms of a consideration of all facts and circumstances, the Test appears to be satisfied if the answer to any one of the following three questions is “yes” at the time of the occurrence of an ITM Event:

(a) Is the Option reasonably certain to be exercised?  

or

(b) Does the holder possess “partner attributes”?  

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51 Prop. Reg. § 1.761-3.

52 Prop. Reg. § 1.761-3(c)(1) explicitly provides, “if a noncompensatory option is reasonably certain to be exercised, then the holder of the option ordinarily has rights that are substantially similar to the rights afforded to a partner.”

53 Example 3 of Prop. Reg. § 1.761-3 concludes, in spite of assuming that the relevant Option was not reasonably certain to be exercised, that, because the Option provided the Option holder with rights
or

(c) Are there any other facts and circumstances that cause the holder to possess rights substantially similar to those afforded to a partner? 54

This test is depicted below:

54 The Proposed Regulations do not explicitly state that other facts and circumstances without a reasonable certainty of exercise and partner attributes would be alone sufficient to meet the Substantially Similar Test. However, the Proposed Regulations also do not appear to require either a reasonable certainty of exercise or partner attributes to meet the Substantially Similar Test. The implication of the two preceding sentences is that there may be some facts and circumstances that would not otherwise create a reasonable certainty of exercise or partner attributes, but that may satisfy the Substantially Similar Test.
When an option holder is treated as a partner under Proposed Reg. 1.761-3

- Is the arrangement an option?
  - No: CONGRATULATIONS! Prop. Reg. 1.761-3 is n.a.
  - Yes: Is the option non-compensatory?
    - No: No
    - Yes: Is there an issuance, transfer, or modification event? ("ITM Event")
      - No: No
      - Yes: Is the Strong Likelihood Test met?
        - No: No
        - Yes: Is the option reasonably certain to be exercised?
          - No: No
          - Yes: BAD NEWS! The option holder must be treated as a partner. The Option holder’s distributive share of partnership items must be determined in accordance with interests in partnership rules of 1.704-1(b)(3).

- Are there any other facts and circumstances that cause the option holder to possess rights substantially similar to those afforded to a partner?
If each of the five questions depicted above is answered in the affirmative, the Option holder and the partnership must treat the Option holder as a partner even though the Option remains unexercised. In that event, the Option holder’s distributive share of partnership income, gain, loss and other partnership items will be determined in accordance with the “partner’s interest in the partnership” rules contained in Regulations § 1.704-1(b)(3). Application of those rules could be especially problematic for partnerships and partners that are required to maintain capital accounts in accordance with the safe harbor capital account maintenance rules of Regulations § 1.704-1(b), such as partnerships with tax-exempt partners that are relying on compliance with the so-called “fractions rule” to avoid unrelated business taxable income treatment on their distributive share of partnership income. If the Recharacterization Rule applies to treat an Option holder as a partner, and further, if the partnership has other Options outstanding, will the partnership’s allocations fail Regulations § 1.704-1(b)(4)(ix)(c)? This provision states that while Noncompensatory Options are outstanding allocations will be deemed in accordance with the partners’ interests in the partnership only if (among other things) all material allocations and capital account adjustments under the partnership agreement not pertaining to Noncompensatory Options are recognized under section 704(b). If an Option holder is treated as a partner and the partnership must reallocate items of partnership income, will the original allocations be “material allocations … under the partnership agreement” in paragraph (c), or will the adjusted allocations (the allocations following adjustments for treating the Option holder as a partner) be the “material … allocations”? What if an Option is exercised in the year the recharacterized Option is granted or the year the recharacterization takes place? What happens to the adjustments on exercise of the respected Option? Because of the uncertainty of these and other questions, recharacterization should be applied sparingly and subject to well-defined rules.

If any one of the following questions is answered “no,” then the Option holder will not be

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55 The Preamble to the Proposed Regulations states:

For this purpose, the partner’s interest in the partnership generally must reflect the economic differences between holding an option to acquire a partnership interest and holding the partnership interest itself. For example, unlike a partner, a noncompensatory option holder is not required initially to contribute to the partnership the full amount of the purchase price for the partnership interest. Instead, the noncompensatory option holder generally pays an option premium that is considerably smaller than the purchase price and may wait until the option is about to expire to decide whether to exercise the option and pay the exercise price. The computation of the noncompensatory option holder’s share of partnership items should reflect this lesser amount of capital investment to the extent appropriate in a particular case. In addition, a noncompensatory option holder’s cumulative distributive share of partnership losses and deductions may be limited under Sections 704(b) and (d) to the amount paid by the holder to the partnership for the option. Preamble, at 2933.

It is unclear what “to the extent appropriate” means. It seems reasonable that if the option is itself determined to bear substantially the same risk of loss and profit as a direct interest in the partnership, then the relevant investment in the partnership would be the Option premium. However, if the option holder is determined to be economically compelled to exercise the Option, the relevant investment should be the Option premium plus the equivalent of a commitment to contribute the exercise price.
treated as a partner.  

a. Is the Arrangement an Option?

If the arrangement is not an Option, then the Proposed Regulations are not applicable. As set forth above, “Option” is defined to include a call option or warrant to acquire an interest in the issuing partnership and convertible debt, convertible equity and cash settlement options.

This definition leaves room for considerable uncertainty.

b. Is The Option Noncompensatory?

The Proposed Recharacterization Rules applies only to Noncompensatory Options. Although the Preamble indicates that no one may rely upon the Proposed Regulations for Options other than Noncompensatory Options, these Comments generally assume that the Proposed Regulations will be the starting point for any proposed regulations relating to Compensatory Options. Issues specifically related to Compensatory Options and other Options that are not Noncompensatory Options are discussed below.

c. Is There an ITM Event?

Perhaps the issue of greatest uncertainty of the Proposed Recharacterization Rules is identifying the point in time when the Option should be tested for possible recharacterization of the holder as a partner. The Proposed Regulations provide that the Strong Likelihood Test and the Substantially Certain Test are applied upon an issuance, transfer or modification of an Option. Few will be surprised by the requirement that the Option be tested when it is issued. However, it is unclear what events may constitute a transfer or modification of an Option. It is not clear whether the Service was intending to suggest that standards such as those applied in Cottage Savings Ass'n v. Commissioner or under Regulations § 1.1001-3 should be applied in determining whether a modification of an Option has occurred. Under Regulations § 1.1001-3, a significant modification of a debt instrument results in a deemed exchange of the instruments. In other words, after a “significant modification” the holder of a debt instrument is deemed (for federal income tax purposes) to have turned in the original debt instrument in exchange for a

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56 If each of the first four questions is answered in the affirmative and the option is reasonably certain to be exercised, then the Proposed Regulations provide that the Option holder will “ordinarily” be treated as a partner.

57 Prop. Reg. § 1.761-3(b)(2).

58 See IV.B. above.

59 Prop. Reg. §1.761-3(a).

60 499 U.S. 554 (1991). Under Cottage Savings, properties are materially different if their respective possessors enjoy legal entitlements that are different in kind or extent. Thus, a modification that resulted in an instrument that had legal entitlements that are different in kind or extent might under Cottage Savings result in a new instrument.
new debt instrument – even though the holder of the debt instrument may still have the original pieces of paper representing the original instrument. However, in the preamble to Regulations § 1.1001-3, the Treasury indicated that application of the same rules to equity instruments is inappropriate.61 If the Treasury does not intending to apply a Cottage Savings standard or the standard under Regulations § 1.1001-3, what standard should be applied?

Regulations § 1.1361-1(l)(4) tests whether options are considered a second class of stock for S corporation purposes upon their issuance, transfer from an eligible shareholder to an ineligible shareholder or after material modification of the option. There does not appear to be any policy rationale for heightened scrutiny of Options to acquire partnership interests -- testing upon any modification, while testing options to acquire S corporation stock only upon a material modification.

Regulations § 1.1504-4(c)(4) defines “measurement date” for purposes of testing whether a corporation is a member of a consolidated group based upon options and warrants being treated as having been exercised as any date on which the option is issued, transferred or on which the terms of an existing option or the underlying stock are adjusted (including an adjustment pursuant to the terms of the option or the underlying stock). The definitional regulation also to specifically exclude issuances or transfers by gift, at death, pursuant to section 1041, between members of an affiliated group, or between persons that are not members of the issuing corporation’s affiliated group (if such persons are not related to the issuing corporation or any member of the issuing corporation’s affiliated group and if such issuance or transfer is not part of a plan to avoid the application of section 1504). This regulation also excepts adjustments to the terms of the option that do not materially increase the likelihood that the option will be exercised and adjustments that are determined by a bona fide, reasonable, adjustment formula that has the effect of preventing dilution of the interests of the holders of the option.

The rationale for excluding issuances and transfers by gift or pursuant to section 1041 appears to be that the transferee’s basis in the option is in part determined by the basis of the option in the hands of the transferor. This rationale should be expanded, in the context of partnership Options, to allow the exclusion of other types of non-recognition transfers to reflect the underlying policy for their non-recognition (i.e., the form of investment has not changed sufficiently for a realization event to occur for tax purposes). Therefore, we recommend that transfers for which neither gain nor loss is recognized should not be testing events under the Proposed Recharacterization Rules. These would include a section 708(b)(1)(B) termination of the partnership; death of the Option holder; a state law conversion of the Option holder or the issuing partnership into another form of entity that is ignored for federal tax purposes; a tax-free merger, reorganization or division of the Option holder or the issuing partnership; and tax-free transfers pursuant to sections 332, 351, 368(a), 721 or 731.

As recognized by the consolidated return regulations, certain modifications may be built into the Option agreement. Many Option holders will be unable to prevent partnerships from making any distributions, as is assumed in Proposed Regulations § 1.761-3(d). At the least, current partners usually will demand that they be entitled to receive tax distributions. Some

Option agreements undoubtedly will provide for adjustable exercise prices to the extent that (certain) distributions are made to the partners while the Option is outstanding. To prevent dilution or to account for the admission or withdrawal of partners during the pendency of the Option, some Option agreements may provide that the exercise price or the interest to be received on exercise adjusts upon the issuance or redemption of interests in the issuing partnership. Because of the variety of anti-dilution provisions that may be utilized, it would be beneficial for the Proposed Regulations to build in exceptions similar to those set forth in the consolidated return Regulations.

By including exceptions for adjustments that do not materially increase the likelihood of exercise and that are determined by a bona fide, reasonable formula, the Proposed Regulations will more effectively deal with other events that necessitate transfers or modifications of Options. For example, a transfer or modification might occur upon the admission of a new partner; the withdrawal of a partner; an amendment to the partnership agreement; an amendment to the Option agreement; dissolution, liquidation or bankruptcy of the Option holder; and a taxable merger, reorganization or division of the Option holder or the issuing partnership.

Taxpayers should have some idea of what may constitute a transfer or modification. They will desire some certainty as to when the Strong Likelihood Test and Substantially Certain Test will apply. By defining what may constitute a transfer or modification, Option agreements should be able to proactively address those events to prevent an “inadvertent” exercise. We recommend that the dates for measuring whether an Option is treated as a partnership interest be restricted to the issuance, transfer or material modification of the Option (including an adjustment pursuant to the terms of the Option or the underlying partnership interest), but excluding (i) issuances or transfers by gift, at death or pursuant to transfers in which gain or loss is not recognized, (ii) modifications that do not materially increase the likelihood that the Option will be exercised and (iii) modifications that are pursuant to a bona fide, reasonable formula that has the effect of preventing dilution of the interests of the holders of the Option.

data. Is the Strong Likelihood Test Met?

The Option holder will not be treated as a partner unless, as of the time of an ITM Event, there is a “strong likelihood” that failing to treat the Noncompensatory Option holder as a partner would result in a substantial reduction in the present value of the partners’ and the Option holder’s aggregate tax liabilities.

Regulations sections 1.704-1(b)(2)(iii)(b)(2) and 1.704-1(b)(iii)(c)(2) provide that the economic effect of allocations will not be substantial, in part, if there is a strong likelihood that “the total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with the partner tax attributes that are unrelated to the partnership).” This test differs from the Strong Likelihood Test because it specifically accounts for unrelated partner tax attributes, while the Strong Likelihood Test focuses upon the present value of tax liabilities.

The cited Regulations under section 704 deal with allocations that shift tax consequences
among partners and allocations that will largely be offset by other allocations. The concern addressed by the Strong Likelihood Test (i.e., that taxpayers will utilize Option arrangements to minimize overall tax liabilities) is the same concern addressed by the Regulations. In addition, these Regulations have been in effect since December 24, 1985, and practitioners and the Service have reached a comfort level with their meaning and application. Representatives of the Treasury have informally indicated that the intent was that the proposed Strong Likelihood Test would take into account unrelated partner tax attributes (i.e., the existence of NOLs, tax exemption, etc.), but this should be made explicit. Finally, the rule set forth in the Strong Likelihood Test includes a present value concept that may be difficult to apply, as it will require decisions about how to discount, discount factors, etc.

If an Option arguably meets the Substantially Similar Test, a taxpayer may need to be able to determine whether the Option also meets the Strong Likelihood Test. In order to demonstrate that the Option fails the aggregate tax liabilities portion of the Strong Likelihood Test, the partnership and the Option holder may be required to anticipate (i) the amount and character of taxable income that will be recognized by the partners over the term of the Option, (ii) the timing of the recognition of such income, (iii) the effective tax rates of the partners over the term of the Option, (iv) the effective tax rate of the Option holder over the term of the Option, (v) the timing, character and amounts of income that will be forced upon the Option holder on exercise pursuant to the Adjustments on Exercise, and (vi) the effective tax rates of both the historic partners and the Option holder in regard to the income that will be forced upon the Option holder pursuant to the Adjustments on Exercise.

It seems likely that it will be the exception, rather than the rule, that the partnership and the Option holder will be able to determine all of this information at the issuance, transfer or modification of an Option. If the parties are all related, the information may be obtainable or predictable. If the partnership invests only in a specific type of publicly traded commodity, stock or security, the information may be obtainable or predictable. However, if the partnership operates an active business or has a variable mix of investments, the information may not be predictable with any significant level of accuracy.

For these reasons, we recommend that the Strong Likelihood Test utilize language similar to that used in the Regulations § 1.704-1(b)(iii)(b)(2) and (c)(2).

We also request that the relationship of the Strong Likelihood Test to existing common law and rulings be clarified. Specifically, under current common law and rulings, an Option that is substantially certain to be exercised may (absent certain limited exceptions) be treated as having been exercised. The Proposed Regulations appear to create a contrary result in circumstances in which the Strong Likelihood Test is not met. Treasury seems conflicted about the proper result because informal remarks of representatives have at times indicated they intend a shift and at other times indicated that no change to existing common law and rulings was intended. We respectfully request that the Treasury and the Service clarify their position on this issue so that taxpayers may plan with certainty.

e. Is the Substantially Similar Test Met?

The holder of a Noncompensatory Option will not be treated as a partner if the Option
does not “provide the holder with rights that are substantially similar to the rights afforded to a partner.”

To analyze the Substantially Similar Test, the Proposed Regulations consider all facts and circumstances, including whether the option is “reasonably certain to be exercised” at certain testing dates. Regulations § 1.1361-1(l)(4)(iii) looks at whether options are “substantially certain to be exercised” at certain testing dates to determine whether an option is a second class of stock for S corporation purposes. In addition, section 163(l)(3) states that disqualified debt involving an option will be considered required to be paid in equity of the issuer or that of a related party only if there is a “substantial certainty” the option will be exercised. On the other hand, Regulations § 1.1504-4(b)(2)(i)(B) provides that an option is treated as exercised for determining whether a corporation is a member of an affiliated group, in part, if it is reasonably certain that the option will be exercised (as defined in Regulations § 1.1504-4(g)). Regulations § 1.1504-4(g) is quite a bit more extensive than Proposed Regulations § 1.761-3(c)(2).

It is not apparent from the Proposed Regulations whether the “reasonably certain to be exercised” portion of the Substantially Similar Test should be analyzed identically to the cited consolidated return Regulations, the cited second class of stock regulations, or the disqualified debt provisions or differently from any of them. Both partnerships and S corporations are treated similarly in a variety of circumstances, which indicates that the appropriate language under the Substantially Similar Test should be “substantially certain to be exercised.” Further, Congress has sanctioned the “substantially certain” test in the one area where it has been imposed legislatively.62 As such, we recommend that the Regulations utilize the “substantially certain to be exercised” language.

The Substantially Similar Test is generally met if any one of the following three subsidiary questions is answered in the affirmative as of the time of the ITM Event. First, is the Option reasonably certain to be exercised? Second, does the Option holder possess so-called “partner attributes”? Third, do other facts and circumstances indicate that the holder possesses rights substantially similar to the rights afforded to a partner?63 These three constituent parts of the Substantially Similar Test are discussed below.

(i) **Reasonably Certain to Be Exercised.** The Proposed Recharacterization Rules state that the following factors are relevant in determining whether at the time of the occurrence of an ITM Event the Option is “reasonably certain”64 to be exercised:

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62 See Section 163(l)(3).

63 The Proposed Recharacterization Rules give no indication of when these “other facts and circumstances” may exist.

64 “Substantially certain” is used in the S corporation regulations in connection with the analogous issue of whether a call option or warrant to acquire shares from the issuing S corporation is to be exercised. Treas. Reg. § 1.1361-1(l)(4)(iii).
The fair market value of the partnership interest that is the subject of the Option;\(^{65}\)

- The exercise price of the Option;
- The term of the Option;
- The volatility, or riskiness, of the Option;
- The fact that the Option premium and, if the Option is exercised, the Option exercise price will become assets of the partnership;
- Anticipated distributions by the partnership during the term of the Option;
- Any other special Option features such as an exercise price that declines over time or declines contingent on the happening of specific events;
- The existence of related Options, including reciprocal Options; and
- Any other arrangements (express or implied) affecting the likelihood that the Option will be exercised.

Relatively few Options to acquire an interest in a partnership that conducts a risky trade or business should be “reasonably certain to be exercised” at the time they are issued, because of the inherent, undeniable risk of these businesses.

(ii) Partner Attributes. In determining whether an Option holder possesses “partner attributes,” the Proposed Recharacterization Rules seem most concerned with the following three attributes: (i) the extent to which the Option holder will share in the economic benefit of partnership profits (including distributed profits); (ii) the extent to which the Option holder shares in the economic detriment associated with partnership losses;\(^{66}\) and (iii) the existence of any arrangement (either within the Option agreement or in a related agreement) that, directly or indirectly, allows the holder of a Noncompensatory Option to control or restrict the activities of the partnership.

However, the very nature of most Options causes the holder to partake in some measure of all three of these “partner attributes,” so, the question cannot be simply whether the Option holder possesses the above-described partner attributes. In most cases he will possess all three of them to varying degrees. The question apparently is whether the holder possesses an

\(^{65}\) See, Rev. Rul. 82-150, 1982-2 C.B. 110.

\(^{66}\) See, Prop. Treas. Reg. §§ 1.761-3(c) and 1.761-3(d), Ex. 3.
impermissibly high measure of these (and perhaps other unstated) partner attributes. Unfortunately, other than the examples contained in the Proposed Recharacterization Rules, no explanation is given of how much is too much for this purpose.

Among other partnership attributes, Proposed Regulations § 1.761-3(c)(3) includes “arrangements . . . that, directly or indirectly, allow the holder of a noncompensatory option to control or restrict the activities of the partnership” as partner attributes. Proposed Regulations § 1.761-3(d) assumes for each example that the “option agreement provides that the partnership cannot make distributions to its partners while the option remains outstanding; and the option holders do not have any significant rights to control or restrict the activities of the partnership (other than restricting distributions and dilutive issuances of partnership equity).” If the ability to restrict distributions and dilutive issuances of partnership equity do not cause an Option holder to possess partner attributes, as implied in these examples, Proposed Regulations § 1.761-3(c)(3) should so state.

In addition, a well-advised Option holder may desire to cover a cornucopia of other possible events with respect to the issuing partnership to protect the interest underlying the Option. Option holders may want the right to veto the admission of certain potential partners. Because of the effect that book-ups and capital contributions will have after exercise, the Option holder may want to designate which section 704(c) method will apply and whether non-mandatory book-ups will be made. The Option holder and the partnership may desire to address various exit strategies during the pendency of the Option, including mechanisms to buy back the Option or drag along the Option holder (or allow the Option holder to tag along) in a sale of the partnership assets or partnership interests. Because the Strong Likelihood Test and Substantially Certain Test are triggered by a transfer or modification of the Option, the Option agreement will need to address who may consent to or provide notification upon transfer or modification-type events. The Option holder may require that the partnership provide access to certain partnership information. To comply with the Proposed Regulations, the Option agreement may require that the partnership agreement contain the provisions set forth in Proposed Regulations § 1.704-1 and may address the requirements for an amendment to the partnership agreement. Some Option agreements may address compliance with federal or state securities laws and registration of securities. If an Option agreement does not completely restrict distributions, as is assumed in Proposed Regulations § 1.761-3(d), the agreement may provide a formula or principle for reducing the exercise price of the Option when the issuing partnership makes distributions. Option agreements that address these issues should not be subject to re-characterization merely because the Option holder has prevented degradation of the optioned interest.

Certain contributors to these Comments believe that the management and/or consent rights that might be given to the Option holder should be irrelevant because the economics of the Option will dictate whether the holder is in substance a partner. Just as a manager of a limited liability company is not a member merely because of the management rights given to that person, an Option holder that can protect the original economics of the Option and the optioned interest should not be treated as a partner merely because of those protections.

Different Options will be entitled to different sets of rights. An Option given to a rank-and-file employee will not have many of the above-described protections, as its terms will tend
to favor the partnership. On the other hand, an Option given to a lender, landlord or executive is more likely to be even-handed, or its terms may even favor the Option holder. Additionally, an ability of an existing partner with a preferred interest to convert that interest into a common interest, will, in many cases, entitle such partner to many (if not all) of the same rights granted to partners holding non-convertible preferred or common interests. Because of this variance, we recommend that the partner attributes considered for purposes of the Substantially Certain Test specifically exclude commercially reasonable arrangements and, with respect to convertible preferred interests, take into account only those attributes that the preferred partner has that are disproportionate to other partners that do not have the Option engendered by the conversion feature.

The Government’s concern about the potential for abusive option transactions is legitimate. Moreover, the willingness in the Proposed Recharacterization Rules to treat an Option holder as a partner only if the Strong Likelihood Test is met evidences the Government’s intention to be as unobtrusive upon taxpayers’ business arrangements as they possibly can be, as long as the fisc is not highly likely to be economically whipsawed. Nonetheless, there are a great many circumstances in which both the Strong Likelihood Test will be satisfied (i.e., where some or all of the partners are tax indifferent and the Option holder is not tax indifferent) and where the Option is issued in a non-abusive transaction in which the Option holder and perhaps the partnership and/or historic partners need to know with a high degree of certainty whether the Option holder will be treated as a partner. The Final Regulations should provide additional guidance to taxpayers in these circumstances without jeopardizing the Government’s legitimate concern about being whipsawed.

Support for the application of a partner attribute test to treat an Option holder as a partner even though the Option is not substantially certain to be exercised can be derived from cases such as *Culbertson v. Commissioner* and *Luna v. Commissioner*, all of which look at all the facts and circumstances to determine whether a partnership exists -- and by extension, whether the parties to the arrangement are partners.

In *Culbertson*, the court addressed a purported partnership formed by a father and his sons. The father contributed capital to the partnership, while the sons purchased an undivided fifty percent interest in the partnership in exchange for a note. The Tax Court held that a partnership was not formed due to the fact that none of the sons had contributed to the “partnership” either “vital services” or “capital originating with him.” The Supreme Court determined that the focus placed upon the contributions by the Tax Court was improper:

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts -- the agreement, the conduct of the parties in execution of its provisions, their statements, the

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testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent – the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.69

In *Luna v. Commissioner*, the taxpayer argued that payments received as commissions were actually received from a joint venture formed by the taxpayer with his employer, rather than payments received as an employee. The Tax Court rejected the taxpayer’s arguments, finding that a joint venture had not been formed between the taxpayer and his employer. The Tax Court looked to the following factors:

The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties’ control over income and capital and the right of each to make withdrawals; whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint ventures; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.70

The Tax Court determined that the contract was unambiguously an employment contract, that the parties’ conduct with respect to the contract was clearly indicative of an employment arrangement, and that a partnership was never discussed or contemplated. The court found that the taxpayer shared in neither profits nor losses with the employer, that the taxpayer had no control over the business, and that it had no proprietary interest in profits.

Further support for treatment of an Option holder as the owner of the optioned property prior to the time that the Option holder exercises the Option can be derived from Revenue Ruling 82-150.71 In Revenue Ruling 82-150, A paid B a $70x option premium to purchase all of the stock of a foreign corporation worth $100x, with an exercise price of $30x. The option arrangement was tax motivated. The Revenue Ruling applied the doctrine of “substance over form.” Reasoning that the Option holder had assumed the benefits and burdens of the ownership of the optioned stock, the ruling concluded that the sale of such stock to the Option holder was completed when the option was issued.

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69 *Culbertson*, 337 U.S. at 742.

70 *Luna*, 42 T.C. at 1077-78.

(iii) Other Facts and Circumstances. The Proposed Recharacterization Rules state that, in determining whether the Substantially Similar Test is met, “all facts and circumstances are considered, including whether the option is reasonably certain to be exercised . . . and whether the option possesses partner attributes.” However, nowhere in the Proposed Recharacterization Rules is there any guidance with regard to what circumstances might be problematic in the absence of substantial certainty of exercise and too large a measure of partner attributes. We therefore request that the other facts and circumstances that would be taken into consideration be clarified, including the facts and circumstances that would indicate that an Option holder is not a partner. Alternatively, the Final Regulations could provide that, in the absence of reasonable certainty of exercise and sufficient partner attributes, the holder will “ordinarily not be treated as possessing rights that are substantially similar to a partner.” If the Regulation drafters do have “other facts and circumstances” in mind, the Final Regulations should describe them.

f. Can the Characterization of an Option as a Partnership Interest Be Reversed?

The Proposed Regulations will treat an Option as a partnership interest if the Strong Likelihood Test and the Substantially Certain Test are met at the time the Option is issued, transferred or modified. Assuming that an Option is treated as a partnership interest and the Option is later transferred or modified (before exercise or lapse), it is unclear under the Proposed Regulations whether the relationship must be retested under the Strong Likelihood Test and the Substantially Certain Test to determine whether the Option is still treated as a partnership interest or may be characterized at the time of the later transfer or modification as an Option. The alternative to retesting upon each transfer or modification of the Option is to have this portion of the Proposed Regulations provide that, once the Proposed Recharacterization Rules treat an Option as a partnership interest, the deemed partnership interest would not revert to Option treatment for the continuing application of the Proposed Recharacterization Rules. In that case, an Option holder (or his transferee) that has been characterized as a partner would continue to be so treated unless and until the Option (deemed to be a partnership interest) lapses unexercised, irrespective of any other transfer or modification of the Option.

Much of the Proposed Regulations seems designed to handle the issues created by book-tax differences created on the exercise of Options. If the Proposed Recharacterization Rules apply to recharacterized Options (so that Options recharacterized as partnership interests could later be recharacterized as Options), the issues related to maintaining capital accounts and section 704(c) accounts are magnified.

Each application of the Strong Likelihood Test and the Substantially Certain Test requires an involved analysis imposing a significant administrative burden on Option holders and issuing partnerships. If such determinations must be made on each currently proposed, broadly defined ITM Event, in addition to the resulting capital account adjustments and section 704(c) recalculations, full compliance with the Regulations would be almost impossible. In addition, the potential abuse that this portion of the Proposed Regulations is designed to prevent will be effectively curtailed if an Option is re-characterized as a partnership interest. Therefore, we

72 Prop. Reg. §1.761-3(c)(1).
recommend that the Regulations clarify that an Option that has been re-characterized as a partnership interest cannot be re-characterized again as an Option by making an explicit statement to that effect in the definition of an “Option” in the 1.761-3 regulations.

3. **The Need for Safe Harbors.**

The Strong Likelihood Test and the Substantially Certain Test are facts and circumstances tests that present inherent uncertainty in every application. To facilitate legitimate use of Options, it would be prudent to provide a safe harbor. Without such a safe harbor, Options will not be used by any taxpayer that has legitimate concerns about being a partner for any particular length of time. It will also prevent their use by legitimate business enterprises utilizing limited liability companies (or other forms of tax partnerships) to obtain funds that would have been available if those business enterprises had utilized the corporate form.

In addition, the consequences of re-characterizing an Option as a partnership interest will lead to a great variety of consequences. An Option holder that is treated as a partner will be required to report his distributive share of partnership items, rather than the historic partners. Distributions may need to be made in different proportions and to different persons. Testing for partnership terminations under section 708(b)(1)(B) may be impacted. If the Option is deemed to be a partnership interest at issuance, the payment of the Option premium with appreciated property would presumably be tax-free under section 721, with the partnership obtaining a transferred basis in the property. To allow taxpayers some certainty regarding these and other consequences, a safe harbor is necessary.

A safe harbor also applies in determining whether a call option, warrant, convertible debt or similar instrument constitutes a second class of stock in a small business corporation, under Regulations § 1.1361-1(l)(4)(iii)(C). It provides that an option is not treated as a second class of stock on the testing dates if its strike price meets or exceeds 90 percent of the underlying stock’s fair market value on that date. Similarly, whether options to acquire stock will be treated as exercised for determining a corporation’s membership in a consolidated group is guided by the safe harbor provided by Regulations § 1.1504-4(g)(3)(i). Options that may be exercised no more than 24 months after the measurement date for an exercise price that is equal to or greater than 90 percent of the fair market value of the underlying stock on the measurement date or that have an exercise price equal to or greater than the fair market value of the underlying stock on the exercise date are not considered reasonably certain to be exercised. We recommend that a safe

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73 This will be true until a body of administrative and judicial law develops to delineate what Option arrangements cross the line and what do not.

74 This Regulation goes on to state that “a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of value was not performed with reasonable diligence to obtain a fair value.” In addition, failure to fit within the safe harbor does not necessarily result in the option otherwise being treated as a second class of stock.

75 Use of a formula that represents a bona fide attempt at issuance to arrive at the fair market value on the exercise date will be respected as having an exercise price equal to the fair market value on the exercise
harbor similar to the one provided in the second class of stock regulations be implemented to provide taxpayers with certainty regarding their legitimate use of Noncompensatory Options.

A safe harbor from the Recharacterization Rules would presumably include the same auxiliary rules. Specifically, good faith determinations of fair market value should be respected unless it can be shown that the value was substantially in error and the determination of value was not performed with reasonable diligence to obtain a fair value. In addition, failure to fit within the safe harbor should not necessarily result in the Option otherwise being treated as a partnership interest. Additionally, it may be necessary to limit the term of an Option that otherwise qualifies for the safe harbor to ensure a clear delineation between Options and Profits Interests.

In addition to the 90-percent of FMV safe harbor discussed above, the second class of stock regulations also provide exceptions for (i) options issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan and (ii) options issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the issuer or a related entity. Subject to the limitations on those exceptions in the second class of stock regulations, adding those exceptions to the Proposed Recharacterization Rules would cause similarly situated taxpayers (taxpayers with options with substantially similar economic terms but which defer as to the nature of the entity to which the option relates) to be treated similarly, which generally reduces transaction costs promoting productive activity.76

It is apparent from Proposed Regulations § 1.761-3(d) Example 2 that there is concern that partnership businesses with substantially certain and predictable income streams will utilize Options to defer income for persons who will become partners (with the certainty that the person will become a partner being derived from the relationship of the highly predictable income stream to the exercise price and the assumption that no distributions are made). Substantially certain and predictable income streams could come from high-quality debt securities or high-quality net leases. We recommend that any safe harbor be specifically inapplicable to partnerships involving substantially certain and predictable income streams if such partnerships prohibit distributions while the option is outstanding.


In sum, the drafters of the Proposed Recharacterization Rules have faced a daunting task of protecting the Government against a substantial economic whipsaw and providing sufficiently clear guidance to enable taxpayers to structure “garden variety” Options with some degree of certainty that the Options will not be recharacterized. As discussed in the preceding pages, we

76 It would be helpful if the final regulations provided an example clarifying the application of the lender exception to the relatively common “penny warrants” where lenders receive a warrant with a very small strike price as an equity “kicker” to the loan.
would suggest that the objectives of providing sufficiently clear guidance to taxpayers could be better achieved without jeopardizing Treasury’s objectives by providing the following additional guidance in the Final Regulations:

(i) Provide a laundry list of events that ordinarily will, and will not, constitute “transfer” or “modification” events (with a view to avoiding hair triggers);

(ii) Conform the testing dates to those provided in the S corporation regulations and consolidated regulations by testing only on “material modifications;”

(iii) Ignore adjustments that do not materially increase the likelihood of exercise; adjustments that are determined by a bona fide, reasonable formula that has the effect of preventing dilution of interests of the holders of the Option; and issuances and transfers by gifts, at death or pursuant to transfers in which gain or loss is not recognized;

(iv) Provide that an Option will not be regarded as substantially certain of exercise so long as at the time of the ITM Event the optioned partnership interest does not relate to a substantially certain and predictable stream of income from partnership assets, such as from high-quality debt securities or a high-quality net lease;

(v) Provide additional examples of situations in which the Strong Likelihood Test will or will not be met;

(vi) Consider deleting the “other facts and circumstances” portion of the Substantially Similar Test or, alternatively, state in the Final Regulations that the holder of an Option that is neither substantially certain of exercise nor has sufficient partner attributes will not ordinarily be treated as a partner prior to exercising the Option;

(vii) Provide a safe harbor that will allow taxpayers certainty regarding the use of certain Options;

(viii) Provide a definition of an Option that is based on the underlying economics of an option;

(ix) Provide a definition of an Option that prevents an Option that has been re-characterized as an interest in a partnership from subsequently being re-characterized as an Option;

(x) Provide a Strong Likelihood Test that utilizes established section 704(b) regulation-type tests rather than establishing a new test;

(xi) Allow Option holders to have commercially reasonable partner attributes without risking re-characterization; and
(xii) Determine the partner attributes of partners having convertible preferred interests with regard to those attributes that are not held by non-convertible preferred interest holders or common interest holders.

F. Issues Unaddressed by the Proposed Regulations.

(1) Characterization of the Transfer of Options Recharacterized on Transfer. The Proposed Recharacterization Rules provide that on an ITM Event, an Option is retested to determine whether it is treated as an Option or recharacterized as a partnership interest. The Proposed Regulations are unclear as to whether, on a transfer of an Option that is recharacterized because of facts existing at the time of the transfer, the transaction is viewed as (i) a purchase of an Option followed by an exercise, (ii) the exercise of an Option followed by the transfer of a partnership interest or (iii) the sale of an Option and the purchase of a partnership interest. We request guidance on this issue.

(2) Potential Application of Disguised Sale Rules to Options.

We request guidance as to the potential applicability of the disguised sale regulations to the following common fact pattern. On January 1, 2001 X paid $10 cash to Partnership for an option to buy one-third interest in Partnership for $100. On July 1, 2003, when X’s “as converted” interest is worth $300, Partnership plans to incorporate using the “assets over” form described in Revenue Ruling 84-111. As part of this incorporation, X plans to exercise its option (treated under the Proposed Regulations as a contribution of an option with basis of $10 and value of $200 and cash of $100 in a section 721(a) transaction). Immediately following the exercise, Partnership will contribute its assets to a newly formed corporation in exchange for stock and then liquidate with X’s share of the stock being valued at $300.

Two disguised sale issues arise in this fact pattern. First, will any part of X’s contribution (namely the appreciated option) be treated as a disguised sale of property to the partnership in exchange for stock pursuant to Regulations § 1.707-3? Second, will the Partnership’s transfer of the stock to X as part of the assets-over incorporation be treated as a disguised sale of property to X pursuant to Regulations § 1.707-6? One suggestion is that, for purposes of applying the two-year presumption under the disguised sale regulations, the contribution date of the premium and the option should be the date that the original option was issued and not the later exercise date.

(3) The Treatment of the Exercise of Noncompensatory Options issued by Disregarded Entities.

Proposed Regulations § 1.721-2(a) provides that the nonrecognition rule of section 721 applies to the exercise of a Noncompensatory Option. For purposes of that section, the term “Noncompensatory Option” is defined as an option issued by a partnership. 78 By defining

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77 1984-2 C.B. 88 (situation 1).

“Noncompensatory Option” by reference only to instruments issued by business entities classified as partnerships, the Proposed Regulations exclude from the nonrecognition rule of section 721 options and convertible debt issued by business entities that are disregarded for federal tax purposes.\(^\text{79}\)

The activities of a disregarded entity are treated in the same manner as a sole proprietorship, branch or division of the owner.\(^\text{81}\) Upon exercise of an option or conversion of convertible debt issued by a disregarded entity, the entity will become a partnership for federal tax purposes.\(^\text{82}\) The federal income tax consequences that result when a disregarded entity is converted into a partnership are described in Revenue Ruling 99-5.\(^\text{83}\)

Revenue Ruling 99-5 addresses two factual situations. In the first (“**Situation One**”), a person purchases one-half of another person’s ownership interest in a disregarded entity. The facts indicate that the purchase price is equal to one half the value of the disregarded entity’s assets. No portion of the purchase price is contributed to the entity. The ruling concludes that the sale converts the entity into a partnership for federal tax purposes. The sale of one-half of the ownership interests in the entity is treated as a sale of one half of each of the entity’s assets. The seller recognizes gain or loss from the deemed sale of one half of the entity’s assets.\(^\text{84}\) After the deemed sale, seller and purchaser are each treated as contributing their respective interests in the entity’s assets to the partnership in exchange for ownership interests in the partnership. Neither the seller nor the purchaser recognizes any gain or loss upon the deemed contributions of their respective interests in the entity’s assets to the partnership.\(^\text{85}\)

In situation two (“**Situation Two**”) of Revenue Ruling 99-5, a person contributes funds to a disregarded entity in exchange for one half of the ownership interests in the entity. The facts indicate that the amount of the contribution is equal to the value of the entity’s assets. The entity uses all of the contributed funds in its business. The ruling concludes that the disregarded entity is converted into a partnership when a person contributes funds to the entity in exchange for one half of the entity’s ownership interests. The person making the contribution to the entity is

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\(^\text{79}\) Issuance of convertible equity by a disregarded entity would cause the entity to become a partnership for federal tax purposes.

\(^\text{80}\) The discussion in this section assumes that Noncompensatory Options and convertible debt issued by a disregarded entity will be respected under Prop. Treas. Reg. § 1.761-3. The following section discusses the tax consequences if Noncompensatory Options and convertible debt issued by a disregarded entity are not respected under the characterization rule.

\(^\text{81}\) Treas. Reg. § 301.7701-2(a).

\(^\text{82}\) Alternatively, a disregarded entity or a partnership could elect to be classified as an association taxable as a corporation. Treas. Reg. § 301.7701-3(a).

\(^\text{83}\) 1999-1 C.B. 434.

\(^\text{84}\) I.R.C. § 1001.

\(^\text{85}\) I.R.C. § 721(a).
treated as making a contribution to a partnership in exchange for an ownership interest in the partnership. Similarly, the owner of the entity is treated as contributing all of the entity’s assets to a partnership in exchange for an ownership interest in the partnership. Neither the person making the actual contribution nor the owner of the entity making the deemed contribution recognizes any gain or loss on the conversion of the disregarded entity into a partnership.86

As previously discussed, the Proposed Regulations provide that section 721 does not apply to a Noncompensatory Option issued by a disregarded entity.87 The Proposed Regulations, however, do not specify the tax consequences on exercise of a Noncompensatory Option issued by a disregarded entity.88

It might be assumed that, because the owner of the disregarded entity is treated as owning the assets of the entity, the exercise of the option would be treated in a manner similar to the analysis in Situation One of Revenue Ruling 99-5. Under this view, exercise of the option would convert the disregarded entity into a partnership for federal tax purposes. Upon exercise, the Option holder would be treated as purchasing a portion of each of the entity’s assets, thereby causing the owner of the entity to recognize gain or loss from the deemed sale. Thereafter, the Option holder and seller would be treated as contributing their respective interests in the entity’s assets to the partnership in exchange for ownership interests in the partnership.

It is not clear that exercise of an option issued by a disregarded entity should be analogized to Situation One of Revenue Ruling 99-5. If a disregarded entity issues an Option, the Option holder should pay the premium and the exercise price to the entity instead of the owner of the entity. In contrast, in Situation One of Revenue Ruling 99-5, the purchase price is paid to the owner of the entity. Based upon this distinction, issuance and exercise of an Option in a disregarded entity is similar to Situation Two. If properly structured, the purchase and exercise of an Option issued by a disregarded entity should be comparable to the economics of Situation Two at the point when the value of the Option equals the consideration paid for the Option plus the exercise price. Under Situation Two, neither the Option holder nor the owner of the disregarded entity should recognize any gain or loss on the conversion of the entity into a partnership. The following example illustrates that exercise of a properly structured Option issued by a disregarded entity is analogous to Situation Two of Revenue Ruling 99-5.

**Example 1.** In Year 1, CB contributes $10,000 to LLC, a newly formed limited liability company classified as a disregarded entity for federal tax purposes. LLC uses the cash contribution to purchase a non-depreciable property, Property A, for $10,000. Also in Year 1, at a time when Property A is still valued at $10,000, LLC issues an option to JB. The option allows JB to buy a one-half interest in LLC for an exercise price of $15,000 in Year 2. JB pays $1,000

86 Id.


88 The discussion in this section is limited to Noncompensatory Options issued by disregarded entities. If the owner of a disregarded entity issues an Option to acquire part of the owner’s interest in the disregarded entity, the tax consequences on exercise of such an Option should arguably be governed by Situation One of Revenue Ruling 99-5.
to the LLC for the issuance of the option. In Year 2, JB exercises the option, contributing the $15,000 exercise price to LLC. At the time the Option is exercised, the value of Property A is $16,000.

On exercise of JB’s Option, JB is entitled to one half of the value of LLC’s assets. Immediately after exercise of the Option, LLC’s assets are worth $32,000 (cash in the amount of $16,000 and Property A worth $16,000). Because JB acquired a one-half interest in LLC on exercise of the Option, JB’s capital account should reflect $16,000 (one-half of $32,000). JB’s capital account should be credited with $16,000 on exercise of the Option ($1,000 paid for the Option and $15,000 paid to exercise the option). Similarly, CB’s capital account should be credited with $16,000 on JB’s exercise of the Option (the value of Property A). Thus, exercising the Option when the sum of the amounts paid to acquire and exercise the Option equals the value of the disregarded entity’s property is consistent with the conversion of a disregarded entity into a partnership under Situation Two.

If the Proposed Regulations are extended to exercise of an Option issued by a disregarded entity, the Proposed Regulations should allow for capital shifts between the owner of the disregarded entity and the option holder, as illustrated by the following example.

Example 2. Assume the same facts as in the previous Example. JB exercises the option, contributing the $15,000 exercise price to LLC, in Year 2. When the option is exercised, the value of Property A is $20,000.

On exercise of JB’s Option, JB is entitled to one-half of the value of LLC’s assets. Immediately after exercise of the Option, LLC’s assets are worth $36,000 (cash in the amount of $16,000 and Property A worth $20,000). Because JB acquired a one-half interest in LLC on exercise of the Option, JB’s capital account should reflect $18,000 (one-half of $36,000). On exercise of the Option, JB’s capital account should first be credited with $16,000 ($1,000 paid for the Option and $15,000 paid to exercise the Option). Similarly, CB’s capital account should initially be credited with $20,000 on exercise of the Option (the value of Property A). Because all of the value of Property A is initially credited to CB’s capital account on exercise of the Option, Property A cannot be revalued immediately after exercise. Therefore, $2,000 of capital should be reallocated from CB to JB immediately after exercise. Any book-tax differences resulting from the Capital Account Reallocation between CB and JB should be addressed by applying reverse section 704(c) principles (or, under the Proposed Regulations, Corrective Allocations as appropriate). The adjustments to CB and JB’s capital accounts can be illustrated as follows:

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<thead>
<tr>
<th></th>
<th>CB</th>
<th>JB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Capital Contributions on Exercise of Option</td>
<td>$10,000 $20,000</td>
<td>$16,000 $16,000</td>
</tr>
<tr>
<td>Capital Account Reallocation</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Capital Accounts After Exercise of Option</td>
<td>$10,000 $18,000</td>
<td>$16,000 $18,000</td>
</tr>
</tbody>
</table>

Possibly an Option issued by a disregarded entity could be structured so that exercise is equivalent to the sale of part of the disregarded entity owner’s interest in the entity (i.e., the equivalent of Situation One under Revenue Ruling 99-5). Taxing Options issued by a
disregarded entity in the manner provided for by Situation Two of Revenue Ruling 99-5, however, should not result in abusive tax planning that Subchapter K does not already address. If a disregarded entity is converted into a partnership on exercise of an Option issued by the entity and the entity subsequently distributes cash or property to the original owner of the entity or the original Option holder, the disguised sales rules under section 707 could apply to cause the original owner or original Option holder, as appropriate, to recognize gain. Similarly, if a disregarded entity is converted into a partnership on exercise of an issued Option and the entity subsequently distributes cash or property to the original owner of the entity or to the original Option holder, the anti-mixing bowl rules under sections 704(c)(1)(B) and 737 could apply to cause the original owner or original Option holder to recognize gain as appropriate. In addition, if an Option is structured in a manner that subverts the purposes of Subchapter K, the structure may arguably be disregarded under the partnership anti-abuse rule.89

The form of an Option issued by a disregarded entity should be respected. However, the proper tax treatment of an Option issued by a disregarded entity is uncertain under the Proposed Regulations. Treasury and the IRS should issue guidance extending the Proposed Regulations to Options issued by disregarded entities when the Proposed Regulations are finalized.

(4) Characterization of the Holder of an Option Issued by a Disregarded Entity as a Partner.

The Proposed Regulations generally respect Noncompensatory Options and do not characterize them as partnership equity. However, as discussed above, the Proposed Recharacterization Rules of the Proposed Regulations sometimes characterize the Option holder of a Noncompensatory Option as a partner if the holder’s rights are substantially similar to the rights afforded to a partner.90 Included in the definition of Noncompensatory Options, for purposes of the Proposed Recharacterization Rules, are:

A noncompensatory option issued by an eligible entity (as defined in § 301.7701-3(a)) that would become a partnership under [Regulations] section 301.7701-3(f)(2) of this chapter if the option holder were treated as a partner under this section is also a noncompensatory option for purposes of this section. If a noncompensatory option is issued by such an eligible entity, then the eligible entity is treated as a partnership for purposes of applying this section.91

If the holder of an Option issued by a disregarded entity is treated as a partner, the holder’s distributive share of the partnership’s income, gain, loss, deduction or credit (or items

89 Treas. Reg. § 1.701-2.


91 Prop. Treas. Reg. § 1.761-3(b)(1). The definition of “noncompensatory option” under the characterization rule is not the same as the definition under the nonrecognition rule governing exercise of a Noncompensatory Option. For purposes of the nonrecognition rule, “noncompensatory option” means an option issued by a partnership, other than in connection with the performance of services. Prop. Treas. Reg. § 1.721-2(b).
thereof) is determined in accordance with the holder’s interest in the partnership (taking into account all facts and circumstances).\footnote{Id.} Thus, a disregarded entity will become a partnership for tax purposes if it issues a Noncompensatory Option under which: (i) the Option holder’s rights are substantially similar to the rights afforded to a partner under the Recharacterization Rule; and (ii) the failure to treat the holder as a partner on an ITM date would result in a substantial reduction in the present value of the disregarded entity owner’s and the holder’s aggregate tax liabilities.\footnote{1999-1 C.B. 434.}

The Proposed Regulations do not address the tax consequences upon the conversion of a disregarded entity into a partnership as a result of an option characterized as a partnership interest. The tax consequences of exercising an option issued by a disregarded entity should be governed by Revenue Ruling 99-5.\footnote{Id.} There is no apparent reason for distinguishing the tax consequences of conversion of a disregarded entity into a partnership due to recharacterization of the option from a conversion resulting from exercise of an option issued by a disregarded entity.

Under Situation One of Revenue Ruling 99-5, the option holder is treated as purchasing a portion of each of the entity’s assets, thereby causing the owner of the entity to recognize gain or loss from the deemed sale. In contrast, under Situation Two of Revenue Ruling 99-5, neither the holder nor the owner of the disregarded entity would recognize any gain or loss on the conversion of the entity into a partnership. If properly structured, the exercise of an option issued by a disregarded entity should reflect the economics of Situation Two. Situation One and Situation Two are different in certain respects and the proper tax treatment of the conversion of a disregarded entity into a partnership under the Recharacterization Rule is unclear under the Proposed Regulations.

(5) \textit{Holding Periods.} The Final Regulations should clarify that, unlike holding periods with corporate options, the holding period on exercise of a Noncompensatory Option is based on the holding period in its contributed assets (e.g., the holding period in the Option itself and the holding period in the assets contributed for the strike price). Representatives of the Treasury have informally indicated that this result was self-evident. However, because this result differs from that of corporate options (since section 1223(6) mandates that the exercise date be the first day of the holding period for stock or securities acquired pursuant to the exercise of a corporate option), we recommend that the Final Regulations explicitly state the intended result.

\section*{V. Comments on Proposed Regulations § 1.721-1(b)(1).}

A. Suggested Withdrawal of the 1971 Proposed Regulations.

\footnote{\textit{Id.} The factors considered in determining whether an Option holder’s rights are substantially similar to the rights afforded to a partner are discussed in the section immediately above.}
Although Proposed Regulations § 1.721-1(b)(1) is consistent with our recommendation that section 83 should apply to the issuance of a Capital Interest in connection with the performance of services, the proposed regulation also provides that section 721 will not apply to such a transaction. The combination of the two approaches likely subjects either the issuing partnership, the historic partners or both to realization of income upon issuance of a compensatory Capital Interest. Such a result creates an unwarranted and dramatic difference in the treatment of partnerships and corporations based solely upon the nature of the entity without regard to the statutory language or underlying tax policy.

As mentioned above, although current sections 721 and 1032 have certain differences in language, there is little if any basis for the distinction. Therefore, we respectfully recommend the withdrawal of Proposed Regulations § 1.721-1(b)(1).

B. Suggested Amendment to Current Regulations § 1.721-1(b).

We respectfully suggest that Regulations § 1.721-1 also be amended in a manner consistent with the language as the example in Appendix A.


A. Introduction.

As discussed in section III.D. 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. When the interests are being issued for services, 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.

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

[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. The value of an interest in partnership

95 It should be noted that the Treasury recently defined “obligation” in Prop. Reg. § 1.752-7 to include options. An obligation for this purpose is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, and futures contracts. The definition of a liability contained in Prop. Reg. § 1.752-7 does not follow Helmer v. Commissioner, T.C. Memo 1975-160. (The Tax Court, in Helmer, held that a partnership's issuance of an option to acquire property did not create a partnership liability for purposes of section 752.) Without a revision of the language in Treas. Reg. § 1.721-1(b), a potential conflict is created between Prop. Reg. § 1.721-2 and Treas. Reg. § 1.721-1(b).
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.

Since the non-recognition provisions of section 721 are inapplicable to transfers of partnership interests for services (at least as they relate to the income recognition to the service provider), one might expect section 83 to establish the rules for the timing and amount of compensation income and deduction arising from transfers of property in connection with the performance of services. Section 83 on its face applies to any property transferred in exchange for services. However, the Regulations promulgated under section 83 are limited on their face to transfers of property to employees and independent contractors. Partners have generally not been treated as employees or independent contractors in respect to the partnership in which they are partners. The plain language of Regulations § 1.721-1(b) would establish the timing and amount of the income and deduction recognized on the transfer of a Capital Interest in exchange for services. In addition, section 707 and other provisions of Subchapter K purport to apply to transactions between a partner and a partnership. An ambiguity is thus created as to which is the correct Code provision and Regulations to apply in the context.

As mentioned above, because we believe that similarly situated taxpayers should be treated similarly, we recommend that the timing and amount of income and deduction recognized in connection with the issuance of a Capital Interest for services be governed by section 83, just as it governs in the corporate context with respect to the issuance of stock for services rendered.


Under section 83(a), if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property determined on the first day that the rights to the property are either transferable or not subject to a substantial risk of forfeiture, over the amount paid for the property, is included in the service provider’s gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture.

For purposes of section 83, property is substantially nonvested when it is both subject to a substantial risk of forfeiture and nontransferable. Property is substantially vested when it is either transferable or is not subject to a substantial risk of forfeiture. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or


97 See, Rev. Rul. 69-184, 1969-1 CB 256.
indirectly, on the future performance (or refraining from performance) of services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if that condition is not satisfied.98 The rights of a person in property are transferable if that person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in that property are not subject to a substantial risk of forfeiture.99

Under section 83(f), the holding period of transferred property to which section 83(a) applies begins just after the property is substantially vested. However, if the service-provider made an election under section 83(b), then the holding period of such property begins just after the date that the property is transferred. If property to which section 83 and the regulations thereunder apply is transferred at arms-length, the holding period of such property in the hands of the transferee is determined in accordance with the rules in section 1223.100

If property is transferred in connection with the performance of services but is subject to a substantial risk of forfeiture and is not transferable, the transferee is not treated as the owner of the property until such property become substantially vested, unless the recipient files an 83(b) election.101

In general, an employer recognizes gain on the transfer of appreciated property to an employee in connection with the performance of services to the extent that the amount the employer receives exceeds the employer’s basis in the property transferred.102 In determining the amount the employer receives, the employer is treated as having sold the property for cash in an amount equal to the fair market value of such property.103 When the employer is a corporation transferring its own stock to its employees, section 1032 prevents the employer from recognizing any gain or loss on the issuance of the stock.104 In addition, at the time a deduction is allowed under section 83(h), gain or loss is recognized to the employer to the extent of the difference between (i) the sum of the amount paid plus the amount allowed as a deduction under section 83(h) and (ii) the sum of the employer’s basis in the property plus any amount recognized by the employer pursuant to the rule stated in the first sentence of this paragraph.105

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98 Treas. Reg. § 1.83-3(c).
102 Treas. Reg. § 1.83-6(b).
103 U.S. v. General Shoe Corp. 282 F.2d 9 (6th Cir. 1960).
104 Treas. Reg. § 1.83-6(b). See also, TD 8883 (May 3, 2000); Duncan Industries, Inc. v. Commissioner, 73 TC 266 (1979).
105 Treas. Reg. § 1.83-6(b). Oddly, this sentence is not qualified by the introductory phrase “except as provided in section 1032.” However, it is still generally acknowledged that section 1032 applies to an
C. The Application of Section 83 to Capital Interests in Partnerships.

“Property,” for purposes of section 83, includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. The term includes a beneficial interest in assets that are transferred or set aside from the claims of creditors of the transferor.

Partnership interests have long been recognized as property separate from the underlying assets of the partnership. Under section 83, a compensatory transfer of a partnership Capital Interest results in taxable income to the transferee to the extent that the fair market value of the interest exceeds the amount paid for the interest, if the interest is not subject to an SRF.

In accordance with our recommendation that section 83 apply to issuance of compensatory Capital Interests, the service provider would have compensation income in an amount equal to the excess of the fair market value of the partnership interest (which may differ from the service provider’s share of the net fair market value of the partnership’s assets) over the exercise price. Consistent with section 83(h), the partnership would be entitled to a deduction (or will be deemed to have made a capital expenditure, as the case may be) for its taxable year in which the partner is required to recognize the income. The compensation deduction should be generally allocated solely to the historic partners, and not to the service provider, because the historic partners bear the economic risk of the expense through the diminution of their capital (i.e., a portion of the historic partners’ value is shifted to the service provider).

We believe that it is appropriate to apply section 83, rather than section 707(c), to determine when the service provider is required to include the compensation in income.

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exchange of a corporation’s stock for its obligations, subject to section 61(a)(12) and section 108. TD 8883 (May 12, 2000).

106 Treas. Reg. § 1.83-3(e).


109 See, Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991) (the fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither under compulsion to buy nor sell and both being informed of all relevant circumstances.); Schulman v. Commissioner, 93 T.C. 623 (1989) (actual arms-length sales of the partnership unit within a reasonable time before or after the valuation date are the best criteria of the market value.); Hensel Phelps Construction Co. v. Commissioner, 74 T.C. 939 ((1980) (the value of the Capital Interest received was equal to the value of the services provided). But see, Mark IV Pictures, Inc. v. Commissioner, 969 F.2d 669 (8th Cir. 1992) (a Capital Interest received as compensation for services is a portion of the property contributed to the partnership by the other partners at the value which the property had when it was contributed.), citing Willis at §45.02. Outside the area of compensatory partnership interests, the authorities supporting the use of the FMV of the partnership interest rather than the LV are numerous. See, e.g., McCord v. Commissioner, 120 T.C. No. 13 (2003). It is difficult to find a policy justification for treatment of the FMV of a partnership interest differently in the context of a compensatory issuance than in other contexts.
Regulations § 1.707-1(c) currently provides that the partner receiving a guaranteed payment must include the guaranteed payment as ordinary income for the partner’s taxable year within “or with which ends the partnership taxable year in which the partnership deducted such payment.” The service provider who receives a Capital Interest for his services should be required to include that income at the time of the issuance of the Capital Interest, regardless of the taxable year of the partnership, unless the Capital Interest is subject to an SRF.

Whether the Capital Interest is granted to a service provider who is already a partner, or one who becomes a partner when the Capital Interest vests should be of no consequence. The treatment of a Capital Interest subject to an SRF is discussed in greater detail below.

When the service provider becomes a partner, a revaluation and book-up should occur in accordance with Regulations § 1.704-1(b)(2)(iv)(f). A book-up is appropriate even if the exercise price is de minimis (but the amount deemed contributed, which includes the compensation income recognized by the service provider, is likely to result in a contribution that is not de minimis).

In order to coordinate sections 721, 707 and 83 on such treatment, we recommend that the partnership be viewed as paying the compensation amount in cash,110 followed immediately thereafter by a purchase of a partnership interest by the service provider in exchange for the cash received. Thus, the service provider should be viewed as acquiring a Capital Interest in exchange for property in addition to the compensation income and deduction recognized. Such treatment enables the partnership and the historic partners to apply the nonrecognition provisions of section 721, just as a corporation applies the nonrecognition provisions of section 1032 in the similar situation.

Because under section 83 the service provider is taxed on the FMV of the property received, book-tax disparities may result from the issuance of a Capital Interest in a partnership in exchange of services. As mentioned above, we recommend that the regulations under section 721 be amended consistently with the illustrative examples provided in Appendix A to clearly apply a cash-out cash-in method when a Capital Interest is issued in exchange for services. Such an approach will reduce, but not eliminate, the resulting book-tax disparities, since the amount treated as a payment and reconstitution is the FMV of the interest issued. In those situations, a book-up of the capital accounts would be appropriate to reflect the economic agreement of the parties,111 and a Capital Account Reallocation may be necessary to cause the book accounts to reflect the economic agreement of the parties.

Although we recognize that some Capital Account Reallocations may be necessary, the we recommend that any Capital Account Reallocation not be treated as a transfer of property for

110 Other than for the purposes of Treas. Reg. § 1.83-3(e).

111 REG-139796, 68 F.R. 39498 (July 2, 2003), proposes regulations that would expand the circumstances under which the partners’ capital accounts could be revalued. According to the notice of proposed rule making, the circumstances under which a book-up is permitted is proposed to be expanded to include the issuance of an interest in exchange for services.
the purposes of section 83 or 1001 if the change is the result of adjustments to the capital accounts to reflect the issuance of a Capital Interest pursuant to Regulations § 1.704-1(b)(2)(iv)(q) or (s). As discussed above, the Proposed Regulations provide for Corrective Allocations if, at the time of an Option exercise, a Capital Account Reallocation is required. Although we respect the Corrective Allocation’s purpose to reduce the book-tax disparity created in part by the Capital Account Reallocation, that is the same reason the principles of 704(c) are applied when the Adjustments on Exercise cause previously unbooked appreciation to be allocated to the Option holder creating a book-tax disparity. There seems to be little policy reason for treating the book-tax disparity created by a Capital Account Reallocation differently from a book-tax disparity created by the Book-Up Rules, particularly when the nature of a Corrective Allocation merely exaggerates the difference between options issued by corporations and Options issued by partnerships and between the restricted stock issued by corporations and compensatory Capital Interests issued by partnerships. We, therefore, recommend that the Corrective Allocations be eliminated in the Final Regulations.

In general, the deduction (if any) resulting from the payment of the compensation expense under section 83 should be allocated to the historic partners. However, the deduction should be allocated to reduce, to the greatest extent possible, any Capital Account Reallocation.

Example 1 in Appendix C illustrates our recommended treatment of the issuance of a Capital Interest for services performed for a partnership.

In a separate but related issue, if a cash-out cash-in approach is applied to the issuance of a Capital Interest for services, section 721 is applicable to the recontribution of the cash unless section 721(b) applied. Because we believe it as inappropriate to view a service partner as having diversified the assets of the partnership, we recommend that Regulations under section 721(b) be amended to provide that the deemed contribution of property to a partnership resulting from an issuance of a partnership interest for services does not result in a diversification of assets and thus is not subject to section 721(b) limitations.

D. Capital Interests Subject to a Substantial Risk of Forfeiture.

We believe that for tax purposes Capital Interests subject to an SRF (an “SRF Capital Interest”) should be treated like shares of stock subject to an SRF. Therefore, the SRF Capital Interest holder would not (i) recognize any compensation income upon issuance and acceptance of the SRF Capital Interest, (ii) be allocated income, gain, loss or deduction from the partnership, and (iii) be treated as a partner until the SRF Capital Interest vested in whole or in part.113

112 It should be noted that section 721 would not prevent the service provider from recognizing compensation income under section 83. Section 721 prevents the recognition of gain on a contribution but does not affect the recognition of income on the receipt of property in exchange for services. The corporate equivalent hypothetical would be a service provider who received over 80 percent of the stock of a corporation in exchange for services. It seems unlikely that the Service would take the position that the language of Treas. Reg. § 1.1032-1 treating the issuance of stock as in exchange for money or other property would prevent the service provider from recognizing income under section 83.

113 Such treatment would be similar to the treatment of a shareholder of an S corporation whose stock was subject to an SRF. Treas. Reg. § 1.1361-1(b)(3).
However, the holder of such an SRF Capital Interest should also be eligible for an election under section 83(b) to include in gross income an amount equal to the fair market value of the SRF Capital Interest (determined without regard to any restrictions other than those which will never lapse) received at the time the interest was issued over the amount paid (if any) for the SRF Capital Interest. If such an election is made, then the holder of the SRF Capital Interest should be treated as a partner for the purposes of Subchapter K at the time of issuance as well.

The tax accounting treatment for a partnership before and after the time at which the Capital Interest vests should be substantially similar to the treatment of a partner before and after a Compensatory Option is exercised.

This is consistent with the court’s holding in *Schulman v. Commissioner*,114 one of the few authorities to directly address the issue of the tax treatment of Compensatory Options issued by partnerships. In *Schulman*, a hospital administrator was given options to purchase units in his employer-partnership under his employment contract. The court determined that the tax treatment of the administrator should be governed by section 83 and Regulations § 1.83-7. Applying that approach, the court held that the option was not taxable when issued, but was taxable when it became transferable.

We do not believe it should matter whether the Capital Interest is granted to a service provider who is already a partner, or the service provider becomes a partner when the Capital Interest vests. For example, assume the service provider is not a partner and is granted an SRF Capital Interest for 100 units of the partnership with the units vesting 20 units per year. When the units vest after Year 1, the service provider will become a partner. When the units vest after Year 2, the service provider already would be a partner (by virtue of the vesting of the first 20 units). We think it would be anomalous for the results to differ, merely because the service provider was not a partner when the first 20 units vested, whereas he was a partner when the second 20 units vested (by reason of the first 20 units having vested). We believe that in such circumstances, (i) the income recognized upon the first vesting should be treated as wages if the service provider was an employee immediately before the issuance of the SRF Capital Interest, or self-employment income if the service provider was an independent contractor, and (ii) the income recognized upon the exercise of the second vesting should be treated as a section 707(a) payment.

Generally, upon the vesting of a Capital Interest, the service provider recognizes income in an amount equal to the fair market value of the Capital Interest received at the time the interest vests over the amount paid (if any) for the Capital Interest.115 Similarly, the partnership should have a deduction (or shall be deemed to have made a capital expenditure, as the case may be) in the same amount and at the same time. We recommend that, in order to coordinate sections 721, 707 and 83 on such treatment, the partnership be viewed as paying the compensation in cash and the service provider be viewed as purchasing a partnership interest in exchange for the cash

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received. Thus, other than the compensation income and deduction recognized, the service provider should be viewed as acquiring a Capital Interest in exchange for property.

The Proposed Regulations provide rules for revaluing the partners’ capital accounts while a Noncompensatory Option is outstanding. Regulations § 1.704-1(b)(2)(iv) contains rules for maintaining a partnership's capital accounts. Regulations § 1.704-1(b)(2)(iv)(f) provides that a partnership may increase or decrease the partners’ capital accounts to reflect a revaluation of partnership property upon the occurrence of certain events (including the contribution of money to the partnership by a new or existing partner). If one or more Options are outstanding when a revaluation occurs, and the revaluation does not account for the value associated with the outstanding Options, the partners’ capital accounts will not reflect the true economic value of their interests. Similarly, if an SRF Capital Interest is outstanding when a revaluation occurs, and the revaluation does not account for the value associated with the SRF Capital Interest, the partners’ capital accounts will not reflect the true economic value of their interests. For example, in partnerships with appreciated property, the historic partners’ capital accounts often would overstate the distributions that would be made upon liquidation, because a portion of the partnership’s assets may ultimately be paid to the holder of the SRF Capital Interest. We therefore recommend that the proposed regulations modify Regulations § 1.704-1(b)(2)(iv)(f) and (h) to provide that any revaluation made when SRF Capital Interests are outstanding generally must account for any economic value attributable to outstanding SRF Capital Interests.116

As discussed above in connection with Noncompensatory Options, an interim book-up based upon the FMV of an SRF Capital Interest will likely result in unnecessary Corrective Allocations if the subtraction method of the Proposed Regulations is used, because the FMV will generally be below the LV. We, therefore, recommend that the proposed regulations modify Regulations § 1.704-1(b)(2)(iv)(f) and (h) to provide that any revaluation made when SRF Capital Interests are outstanding may use the buy-in value rather than the FMV of the SRF Capital Interest.

E. Treatment of Compensatory Profits Interests in Partnerships.

The proper tax treatment of compensatory Profits Interests in partnerships was the subject of litigation for many years. Many theories were advanced by both taxpayers and the Service, with varying degrees of success.

In Hale v. Commissioner,117 a pre-section 83 case, the Service successfully argued that a Profits Interests constituted an unrealized receivable. In Diamond v. Commissioner,118 also a pre-section 83 case, the court found the taxpayer taxable on the receipt of a Profits Interest. But

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116 The treatment of an interim Book-Up while an SRF Capital Interest is outstanding is illustrated by Example 5 in Appendix C.

117 TC Memo 1965-274,

118 492 F.2d 286 (7th Cir. 1974). Although Diamond is occasionally discussed as a Capital Interest case, the Seventh Circuit Court of Appeals expressly noted that this was not the basis of its decision.
in *Campbell v. Commissioner*,¹¹⁹ the Eighth Circuit Court of Appeals found that a Profits Interest had only speculative, if any, value, and was, therefore, not taxable.¹²⁰

Much of the uncertainty regarding the treatment of Profits Interests was resolved through the promulgation of Revenue Procedure 93-27.¹²¹

Revenue Procedure 93-27 provides a safe harbor so receipt of a “qualifying” Profits Interest is not a taxable event. 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.

Under 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 distribution in liquidation after a sale on a fair market value basis.

Revenue Procedure 93-27 does not purport to create a substantive rule of law that partnership interests should be valued based upon their LVs. Instead, the revenue procedure appears to establish a rule of convenience to provide certainty to taxpayers within the limited safe harbors of the revenue procedure. The exclusions from the applicability of the revenue procedures imply that the Service may assert that a taxpayer who receives a Profits Interest that is excluded from the safe harbors should be taxed on the FMV of the Profits Interest notwithstanding that the Profits Interest, by definition, has no positive LV.¹²²

Revenue Procedure 93-27 was clarified by Revenue Procedure 2001-43, 2001-34 IRB 191 (August 3, 2001). In Revenue Procedure 2001-43, the Service clarified that, if certain conditions are met, the determination as to whether an interest is a Profits Interest may be made at the time the interest is granted to the service provider, even if the Profits Interest is substantially nonvested within the meaning of Regulations § 1.83-3(b). Neither the grant of the Profits Interest nor the subsequent vesting of the Profits Interest will be a taxable event.

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¹¹⁹  943 F.2d 815 (8th Cir. 1991).

¹²⁰  *Mark IV Pictures, Inc. v. Commissioner*, 969 F.2d 669 (8th Cir. 1992), is often included in the litany of Profits Interest cases. However, although the taxpayer argued that the interest received was a Profits Interest, the court found that the interest was a Capital Interest.


¹²²  If the recipient were to be taxed on the LV of a Profits Interest, there would be no reason to include any exclusions because the recipient would never be subject to tax -- if the LV were positive the interest would not be a Profits Interest.
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 partnership or other partners is made. Further, neither the partnership nor the historic partners receive a deduction or have a “capital shift” that would potentially cause the recognition of gain or loss.

There is the risk under these revenue procedures that the valuation used by the partnership to determine whether an interest is a Profits Interest is incorrect. For example, if the parties value the enterprise at $1 million when a partner is granted the Profits Interest and, in fact, the entity is worth $2 million, 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 § 1.704-1(b)(2)(iv)(h). That Regulation provides that the fair market value assigned to (1) property contributed to a partnership, (2) property distributed by a partnership and (3) property otherwise revalued by the partnership will be regarded as correct if such value was reasonably agreed to among the partners in arms-length negotiations and the partners have sufficiently adverse interests. This concept should also apply in issuing a Profits Interest. Presumably, the historic partners will have adverse interests, 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 these rules, the option price must equal or exceed the fair market value of the stock when the option is granted. Under Regulations § 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 stock value exceeds the option price. It would seem, therefore, that in the Profits Interest context, as long as the parties are acting at arms-length and have reasonably adverse interests in determining the value, their values should be respected.

We do not suggest there be any change to the treatment of Profits Interests under Revenue Procedure 93-27 and Revenue Procedure 2000-43. Providing safe harbors to give certainty to transactions where the value of the Profits Interest is likely to be highly speculative is sensible from both administrative and economic efficiency perspectives. The exclusions from the applicability of the revenue procedures are consistent with the recommendation of these Comments that the recipient of a Capital Interest should be taxed on the FMV rather than the LV of the interest received.

We do, however, recommend that the Regulations clarify that a partnership interest may be treated as a Profits Interest to the extent that the interest does not entitle the recipient to proceeds in a hypothetical liquidation immediately following the issuance. The currently applicable Revenue Procedures define a Profits Interest in terms of whether the recipient is entitled to proceeds in a hypothetical liquidation rather than “to the extent” creating an ambiguity as to the treatment of an interest issued partially in respect of capital and partially in respect of services.
VII. The Application of Section 83 to Compensatory Partnership Options.

A. Introduction.

As discussed in section III.D. above, we recommend that same treatment be accorded to the issuance of partnership options as is 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. Regarding the issuance of the Option itself (as opposed to the issuance of a Capital Interest in the partnership), parallel treatment for partnership Options and stock options could be best obtained by applying the existing rules under Regulations § 1.83-7.

B. Treatment of Corporate Nonqualified Options under Section 83.

If an employer-corporation issues non-qualified options to a service provider, the employer does not recognize gain or loss on the issuance.124

The service provider recognizes ordinary income upon issuance of the option if the option has a readily ascertainable fair market value125 unless the option is subject to an SRF.126 The option’s value is not readily ascertainable unless the options are actively traded on an established market or (i) the option is transferable, (ii) the option is exercisable immediately in full, (iii) the option or property subject to the option is not subject to any restriction or condition which has a significant effect upon the fair market value of the option, and (iv) the fair market value of the option privilege (i.e., the contractual right to benefit from any appreciation in the value of the option property during the option period without the risk of capital) is readily ascertainable.127

If the value of an option issued in respect of services is not readily ascertainable at the time of issuance, generally the service provider recognizes ordinary income at the time of exercise of the option or when the option is sold or otherwise disposed of in an arms-length

124 I.R.C. § 1032(a). However, there is no indication that the Service sought to tax corporate employers on the issuance of compensatory options (as the payment of compensation with appreciated property) prior to the addition of the second sentence in section 1032(a). Before that time, the employer would have been protected from taxation on the issuance of the option through a combination of the analysis of U.S. v. General Shoe Corp. 282 F.2d 9 (1960) (the gain to the employer is determined as if the employer disposed of the appreciated property for cash and paid the compensation in cash) and the Basic Option Principles. John Utz notes, in Nonstatutory Stock Options, Tax Management Portfolios 383-3rd, A-36 (2001), that under some theories the corporate employer could recognize gain on the issuance of options to employees. He concluded, however, that the “better view” is that the application of the Basic Option Principles protects the employer from current taxation.

125 Treas. Reg. § 1.83-7(a).


127 Treas. Reg. § 1.83-7(b).
transaction. The amount of income the service provider recognizes is the excess of the fair market value of the stock received at the time of exercise or disposition of the option (determined without regard to any restrictions other than a restriction which by its terms will never lapse) over the amount paid for the stock, unless the stock received is subject to an SRF.

If property is subject to an SRF, income will be recognized by the service provider when the restriction lapses in an amount equal to the excess of (i) the fair market value of the property, or percentage of the property, released from the restriction, over (ii) the amount paid for such property, or percentage of such property, if any.

C. Treatment on Exercise of a Compensatory Option.

On exercise of the Option, the tax consequences to the partnership and the historic partners should be the same as if the partnership had issued the resulting partnership interest to the service provider in exchange for an amount of cash equal to the sum of the exercise price plus the compensation income recognized by the service provider. Thus, no gain or loss should be recognized to the partnership or the historic partners because section 721 would be applicable.

Consistent with the view expressed above, section 83 would apply to the exercise of the Option by the service provider. Accordingly, the service provider would have compensation income in an amount equal to the excess of the FMV of the partnership interest (which may differ from the net FMV of the partnership’s assets) received by the service provider over the exercise price. Applying the cash-out cash-in construct discussed above, the capital account of the service provider would be credited with an amount equal to the sum of the exercise price of the option plus the amount of compensation income recognized by the service provider. For the same reason that Regulations § 1.61-15 does not apply in the case of compensatory corporate stock options, that Regulation should not apply to the exercise of a partnership Compensatory Option.

Consistent with section 83(h), the partnership will be entitled to a deduction (or will be deemed to have made a capital expenditure, as the case may be) for its taxable year in which the partner is required to recognize the income. The compensation deduction should be allocated solely to the historic partners, and not to the service provider.

The foregoing treatment comports with the court’s holding in Schulman v. Commissioner, one of the few authorities to directly address the tax treatment of Compensatory Options issued by partnerships. In Schulman, a hospital administrator was given

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129 I.R.C. § 83(a).
options to purchase units in his employer-partnership pursuant to his employment contract. The court determined that the tax treatment of the administrator should be determined under section 83 and Regulations § 1.83-7. The court held that the option was not taxable when issued but was taxable when the options became transferable.132

We believe it appropriate to apply section 83, rather than section 707(c), in determining when the service provider must include the compensation in income. Regulations § 1.707-1(c) currently provides that the partner receiving a guaranteed payment must include the guaranteed payment as ordinary income for the partner’s taxable year within “or with which ends the partnership taxable year in which the partnership deducted such payment.” We believe that the service provider should be required to include that income in his or her taxable year of the exercise, regardless of the taxable year of the partnership.

It should make no difference if the Option is granted to a service provider who is already a partner, or becomes a partner when the Option is exercised. For example, assume the service provider is not a partner and is granted an Option to buy 100 units of the partnership with the units vesting 20 units per year. If the service provider exercises the Option with respect to the first 20 units which vest after Year 1, the service provider will not have been a partner at the time the Option is exercised. However, if the service provider thereafter exercises the Option to purchase the second 20 units at a time after the Option to acquire the first 20 units has been exercised and such units have become vested, the service provider already would be a partner at the time of exercise of the second Option. It would be anomalous for the result to differ, merely because the service provider was not a partner when the first 20 Units were purchased, but he was a partner when the second 20 units were purchased (by reason of having purchased the first 20 Units and such units are vested). However, in such circumstances, (i) the income recognized upon the exercise of the first Option should be treated as wages if the service provider was an employee immediately before the exercise of the Option, or self-employment income if the service provider was an independent contractor, and (ii) the income recognized upon the exercise of the second Option should be treated as a section 707(a) payment.

A revaluation and book-up should occur in accordance with Regulations § 1.704-1(b)(2)(iv)(f) upon admitting the service provider as partner. Such a book-up would be appropriate even if the exercise price is de minimis (although the amount deemed contributed, which includes the compensation income recognized by the service provider, is likely to result in a contribution which is not de minimis).

Because many Compensatory Options can be exercised in a year, we recommend that the Regulations permit partnerships to adopt conventions which would require only periodic

132 Two pre-section 83 cases on the treatment of the disposition of a Compensatory Option illustrate the uncertainty that existed prior to the enactment of section 83. In Saunders v. U.S., 450 F.2d 1047 (9th Cir. 1971), the court, seemingly focusing on the fact that the option included a cash-settlement election, held that the disposition of a Compensatory Option resulted in ordinary income. However, in Frazer v. Commissioner, 64 T.C. 41 (1975), the court distinguished Saunders on the ground that the option before it did not have a cash settlement election and held that the disposition of the Compensatory Option resulted in capital gain.
revaluations resulting from Compensatory Options’ exercise (such as monthly or quarterly) and would apply the same conventions to income allocations in the affected partnerships.

Should partnership asset revaluation be based on the FMV of partnership assets or the FMV of the partnership interest received for services (which may be discounted from the FMV of the partnership’s assets due to minority and marketability discounts) while an Option is outstanding or upon exercise of a Compensatory Option? We believe that either method should be acceptable.

If the revaluation is based upon the FMV of the partnership interest, no Capital Account Reallocation would generally be required, because the capital account of the service provider will always reflect the FMV of the partnership interest by virtue of the cash-out cash-in method. In other words, if the Adjustments on Exercise permitted the historic partners’ capital accounts to be reduced or increased by the partnership interest’s FMV on exercise, the capital accounts should reflect the economic agreement of the parties without requiring a Capital Account Reallocation. If the capital accounts are revalued based upon the FMV of the partnership’s assets, and the amount of the gain in the revaluation is sufficient to increase the service provider’s capital account to the appropriate share of the FMV of the assets of the partnership, no Capital Account Reallocation would be required. If, on the other hand, there is not sufficient gain resulting from the revaluation to increase the service provider’s capital account appropriately, then it will be necessary to increase the service provider’s capital account and simultaneously decrease the capital accounts of the historic partners in equal amounts to reflect the economic arrangement of the partners. Following the Proposed Regulations, this would result in required Corrective Allocations.

The foregoing may be illustrated by an example. In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in the LLC. Under the LLC agreement, each unit is entitled to participate equally in the capital, profits and losses of LLC. LLC uses the cash contributions to purchase a non-depreciable property, Property A, for $20,000. Also in Year 1, at a time when Property A is still valued at $20,000, LLC issues an Option to DH for DH’s services to LLC. The Option allows DH to buy 100 units in LLC for an exercise price of $7,000 in Year 2. DH pays no premium to the LLC for the Option. Assume that the Option Agreement requires that, upon exercise, LLC comply with the Adjustments on Exercise rules, and that all material allocations and capital account adjustments under the LLC Agreement unrelated to options are recognized under section 704(b). Assume that DH’s option is a Compensatory Option and DH is not treated as a partner with respect to the Option. In Year 2, DH exercises the Option, contributing the $7,000 exercise price to the LLC. When the Option is exercised, the value of Property A is $53,000. DH obtains an appraisal of the partnership interest, and the parties treat the interest issued to DH as being worth $14,000. Also assume that the value of

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133 Under the Proposed Regulations, a Corrective Allocation would be required only to the extent that the FMV of the partnership interest acquired on exercise was less than the LV of such interest and there was insufficient non-booked appreciation to allocate to the Option holder.
DH’s services maintains the value of the assets of LLC, but does not add any net value (after the consideration of the compensation expense).

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>BASIS</th>
<th>VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A</td>
<td>$20,000</td>
<td>$53,000</td>
</tr>
<tr>
<td>Exercise Price</td>
<td>$7,000</td>
<td>$7,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$27,000</strong></td>
<td><strong>$60,000</strong></td>
</tr>
</tbody>
</table>

(i) Under the cash-out cash-in method, DH’s capital account is credited with the exercise price of the option ($7,000) and the excess of the fair market value of the LLC interest ($14,000) over the exercise price ($7,000), or $7,000. The book value of Property A is also increased to reflect Property A’s value. To reflect the economic agreement of the parties, the difference between the tax basis of Property A ($20,000) and its book value ($53,000) must be allocated $6,000 first to DH to bring DH’s capital account up to the one third of the economic value represented by DH’s interest, with the balance being allocated to the two other partners.

<table>
<thead>
<tr>
<th></th>
<th>TM</th>
<th>PK</th>
<th>DH</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital accounts after exercise:</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Compensation deduction:</td>
<td>($3,500)</td>
<td>($3,500)</td>
<td>($3,500)</td>
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<tr>
<td>Capital accounts after compensation deduction:</td>
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<td>$6,500</td>
<td>$6,500</td>
</tr>
<tr>
<td>Book-up:</td>
<td>--</td>
<td>$13,500</td>
<td>--</td>
</tr>
<tr>
<td>Capital accounts after book-up:</td>
<td>$6,500</td>
<td>$20,000</td>
<td>$6,500</td>
</tr>
</tbody>
</table>

If, on the other hand, the revaluation was based upon the FMV of DH’s interest, then the following would occur:

(ii) The $7,000 compensation deduction would be allocated $3,500 to each of TM and PK and the book-up, based upon a value for Property A of $35,000 (the difference between the presumed value of all of the assets of $42,000 and the $7,000 contributed by DH upon exercise of the option), would be allocated $7,500 to each of TM and PK. As a result, each of the members of LLC would have a $14,000 book capital account.

Assume the same facts as above, except that immediately prior to DH’s exercise, the LLC sold Property A for its fair market value of $53,000 and reinvested the proceeds in Property B.

(i) Under the cash-out cash-in method, DH’s capital account is credited with the exercise price of the option ($7,000) and the excess of the fair market value of the LLC interest ($14,000) over the exercise price ($7,000), or $7,000. The book value of Property B is equal to its fair market value, so there is no gain to allocate upon a revaluation. To reflect the economic agreement of the parties, a $6,000 capital account adjustment must be made in favor of DH, and TM’s and PK’s capital accounts must each be reduced by $3,000.

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As a result of the foregoing, Corrective Allocations would be required by the Proposed Regulations to be made with respect to DH in the amount of $6,000.

If, on the other hand, the revaluation was based upon the FMV of DH’s interest, then the following would occur:

(ii) The $7,000 compensation deduction would be allocated $3,500 to each of TM and PK and there would be a book-down, based upon a value for Property B of $35,000 (the difference between the presumed value of all of the assets of $42,000 and the $7,000 contributed by DH upon exercise of the option), which would be allocated $9,000 to each of TM and PK. As a result, each of the members of LLC would have a $14,000 book capital account.

The Proposed Regulations require that the Corrective Allocations be made as soon as possible in the case of Noncompensatory Options. As stated above, we generally believe that treating a book-tax difference created by a Capital Account Reallocation differently from other book-tax differences is inappropriate and creates an unnecessary additional layer of complexity. In addition, we believe this is inappropriate in the case of Compensatory Options because (i) it would put partnerships at a competitive disadvantage to corporate employers when seeking to provide incentive compensation to its service providers, (ii) many of the recipients of Compensatory Options are likely to be unsophisticated taxpayers (unlike the purchasers of Noncompensatory Options) who would not be able to understand the Corrective Allocations, and (iii) the result would be different from the party’s expectations. Accordingly, we recommend that to the extent that the concept of Corrective Allocations is retained, that the Corrective Allocations be required to be included in income over an extended period of time (perhaps 15 years based upon the section 197 period of amortization of purchased intangibles), but in no event later than when the service provider ceases to be a partner.

The Corrective Allocations should not be considered compensatory. Any Corrective Allocations do not represent further compensation paid to a service provider in connection with services. The FMV of the property transferred to the service provider in connection with the performance of services has been taken into account by the service provider as compensation at the time of the exercise of the Option. Such FMV should have already taken into account the full FMV of the Option holder’s attributable share of the partnership assets, less any appropriate discounts. Instead, any Corrective Allocation is the result of a perceived need to bring the tax accounts of the partners in line with the book accounts of the partners -- in exactly the same
manner that Corrective Allocations function in regard to Noncompensatory Options. In regard to Noncompensatory Options, the Proposed Regulations indicate that the Corrective Allocations are allocations of gross income earned by the partnership to the extent that it exists. Similarly, Corrective Allocations in regard to Compensatory Options should be treated as allocations of partnership income whose character would be determined under the normal partnership pass through rules.

It should be noted that the manner in which the revaluation is determined (i.e., FMV of the partnership’s assets or FMV of partnership interest) will have an effect on the reverse section 704(c) allocations which would be required in connection with such revaluation. In the foregoing Examples, if the revaluation is based upon the FMV of LLC’s assets, and the real property is subsequently sold for $62,000, LLC would have a tax gain of $43,000 ($63,000 - $20,000) and a book gain of $9,000 ($62,000 - $53,000). The book gain would be allocated $3,000 to each of the members and the tax gain would be allocated $16,500 ($13,500 reverse section 704(c) gain + $3,000 book gain) to TM and PK and $9,000 ($6,000 reverse section 704(c) gain + $3,000 book gain) to DH.

If, on the other hand, the revaluation is based upon the fair market value of DH’s interest, then the book gain would be $27,000 ($62,000 - $35,000), allocated $9,000 to each of the members. The tax gain would be allocated $16,500 ($7,500 reverse section 704(c) gain + $9,000 book gain) to TM and PK, and $9,000 (the book gain) to DH. While the total gain allocated to the parties is the same in both instances, the manner of arriving at the gain differs.

VIII. Other Issues.

A. Application of the Proposed Recharacterization Rules to Compensatory Options.


We have provided extensive comments on the Proposed Recharacterization Rules above in the section of these Comments dealing with Noncompensatory Options. The same issues would arise in connection with Compensatory Options and compensatory SRF Capital Interests if the Proposed Recharacterization Rules were extended to Compensatory Options and such Capital Interests.


In addition to Proposed Recharacterization Rules issues discussed above, the common law doctrine of constructive receipt potentially impacts Options issued for services. Under the doctrine, a taxpayer may be forced to recognize as income property that has not yet been reduced to possession. In some circumstances, the doctrine of constructive receipt could cause a taxpayer to be in deemed receipt of an underlying Capital Interest for which the taxpayer holds an Option -- even when Section 83 and the Proposed Recharacterization Rules do not require the taxpayer to recognize receipt of the Capital Interest.

Judicially approved regulations under section 451 reflect the constructive receipt doctrine. Regulations § 1.451-2(a) provides that income not actually reduced to possession is
constructively received by a taxpayer in the taxable year it is credited to his account, set apart for him, or otherwise available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions. Stated differently, to the extent that a taxpayer’s receipt of income is subject to any kind of limitation or restriction, the issue is whether the limitation or restriction is substantial enough so that a court would determine that the taxpayer was not free to deliberately turn his back on the income to which the limitation or restrictions apply.134

Whether limitations and restrictions are substantial enough to preclude constructive receipt depends upon the facts and circumstances concerning the rights of the taxpayer to the income.135 There are no generally applicable rules, and cases appear to have applied the concepts inconsistently.136

Although presumably the facts and circumstances that would be taken into consideration if the Proposed Recharacterization Rules are extended to Compensatory Options would include the facts and circumstances that have historically been considered under the doctrine of constructive receipt, the historical application of the doctrine of constructive receipt gives taxpayers no clear certainty as to the treatment of their transactions. We recommend, therefore, that all of the provisions and doctrines potentially applicable to the issuance of Compensatory Options be coordinated with clear rules consistent with these Comments.

B. The Need for Safe Harbors.

As with the application of the Proposed Recharacterization Rules to Noncompensatory Options, we strongly recommend the creation of safe harbors as part of any extension of the Proposed Recharacterization Rules to Compensatory Options or compensatory SRF Capital Interests. Safe harbors will allow the partnership, the historic partners and the Option holder certainty of the Option’s treatment while it is outstanding. We recommend that any proposed regulations dealing with Compensatory Options and such Capital Interests adopt a standard for a safe harbor based upon the standard that currently exists in Regulations § 1.1361-1(l)(4)(iii)(B)(2). Such Regulation currently provides (in part),


136 Compare, Patterson v. Commissioner, 510 F.2d 48 (9th Cir. 1975), reversing TC Memo PH ¶ 73,039 (the taxpayer was not in constructive receipt because the taxpayer was required to purchase insurance prior to being entitled to payment), with Estate of Shelton v. Commissioner, 612 F.2d 1276 (10th Cir. 1980) (the requirement to post bond did not prevent the taxpayer from being in constructive receipt of the amount held in probate). See also, Rutland v. Commissioner, TC Memo 1977-8; Aldridge v. Commissioner, 51 T.C. 475 (1968); Rev. Rul. 80-177, 1980-2 C.B. 109; Rev. Rul. 80-300, 1980-2 C.B. 165. Rev. Rul. 82-121, 1982-1 C.B. 79.
corporation or a related corporation (and that is not excessive by reference to the services performed) is not treated as a second class of stock for purposes of this paragraph (l) if—

(i) The call option is nontransferable within the meaning of § 1.83-3(d); and

(ii) The call option does not have a readily ascertainable fair market value as defined in §1.83-7(b) at the time the option is issued.

If the call option becomes transferable, this paragraph (l)(4)(iii)(B)(2) ceases to apply.

Applying that exception to Compensatory Options and SRF Capital Interests would exclude Compensatory Options and SRF Capital Interests from the Proposed Recharacterization Rules if the Option is nontransferable and does not have a readily ascertainable FMV. Such an approach not only produces a clear rule, but also reduces differences between the treatment of similarly situated taxpayers.

C. The Treatment of Capital Interests Issued by Disregarded Business Entities.

The preamble to the Proposed Regulations solicits comments on the application of section 83 to issuance of partnership Capital Interests in connection with the performance of services.137 We believe that the tax treatment of Capital Interests issued by a disregarded entity in connection with the performance of services should also be addressed.

Tax treatment of the issuance of a Capital Interest for services by a disregarded entity should appropriately follow those of a partnership. Accordingly, we should analyze the issuance of a Capital Interest as a contribution of services to a newly formed partnership in exchange for a partnership interest, with the disregarded entity’s preexisting owner contributing property to the newly formed partnership in exchange for a partnership interest. Consistent with our recommendations regarding the issuance of a Capital Interest in a partnership for services, the service provider would be taxed in accordance with the rules of section 83, and the preexisting owner’s contribution would be tax-free under section 721.138

If the issuance of a Capital Interest by a disregarded entity were taxed differently from an issuance by a partnership, well-advised taxpayers could elect the more favorable treatment by simply creating a tax partnership. If the owner of the single-member entity were an individual, he could create a tax partnership by transferring a portion of his interest to an S corporation. Similarly, if the single-member entity were owned by a corporation, it could create a tax partnership by transferring a portion of its interest to a subsidiary. Accordingly, only ill-advised (or unadvised) taxpayers would be unable to elect the more favorable tax treatment.


138 See also, Rev. Rul. 99-5, 1999-1 C.B. 434.
McDougal v. Comm’r, 62 T.C. 720 (1974), acq. 1975-2 CB 2, arguably suggests that a disregarded entity’s issuance of a Capital Interest should be a taxable event for the preexisting owner. In that case, a horse trainer was given a half-interest in a horse for training services. The Tax Court held that the horse owner, McDougal, was taxed on the transfer of half of his interest in the horse, and that the service provider, the trainer, recognized compensation income. It reasoned that “[w]hen on the formation of a joint venture a party contributing appreciated assets satisfies an obligation by granting his obligee a capital interest in the venture, he is deemed first to have transferred to the obligee an undivided interest in the assets contributed, equal in value to the amount of the obligation so satisfied. The contributing obligor will recognize gain on the transaction to the extent that the value of the undivided interest which he is deemed to have transferred exceeds his basis therein. The obligee is considered to have realized an amount equal to the fair market value of the interest which he receives in the venture and will recognize income depending upon the character of the obligation satisfied.” 139 The trainer was deemed to then contribute his interest in the horse to a newly formed joint venture taxed as a partnership, and McDougal received a compensation deduction.

This description of the transaction in McDougal fits more closely with the description and tax treatment of Situation 1 in Revenue Ruling 99-5. 140 In Revenue Ruling 99-5, A owns 100% of the interests in an LLC treated as a disregarded entity. In Situation 1, B buys 50% of A’s LLC interest for $5,000, and A does not contribute any portion of the $5,000 to the LLC. Revenue Ruling 99-5 holds that A is taxed on his disposition of his LLC interest as if he sold half of the assets to B, and B then contributed the assets to the LLC in connection with the formation of a new tax partnership.

Where a disregarded entity issues a Capital Interest for services, however, Situation 2 offers the better framework for analysis. In Situation 2, B contributes $10,000 to the LLC in exchange for a 50% ownership interest in the LLC and the LLC retains the contributed cash. Revenue Ruling 99-5 holds that A and B are deemed to make contributions to a newly formed partnership that is tax-free for each under section 721. Accordingly, A is not taxed on a deemed disposition of the LLC’s assets.

Generally, a service provider contributes future services to a business in exchange for equity interests. As a result, in the typical fact pattern, the service provider will be contributing the services to the single member entity in exchange for a Capital Interest. Those services will in effect be “retained” by the LLC (now a newly formed partnership) into the future. Accordingly, it seems more appropriate to provide treatment analogous to Situation 2. The owner of the disregarded entity should not be taxed on a deemed disposition of the LLC’s assets. In addition, following the cash-out cash-in construct that we advocate in a partnership context, if the services are being performed for the newly formed entity, the deemed cash contribution establishing the capital account would run to the benefit of the partnership -- not the owner of the formerly single member LLC.

139 62 T.C. at 725-26.
140 1999-1 C.B. 434.
McDougal can be distinguished on at least two bases. First, McDougal predated disregarded entities and Revenue Ruling 99-5. It did not have those concepts and authorities to draw upon, and would perhaps have reached a different result had they existed at that time. Second, it addressed the tax treatment of the transfer of an asset for past services, whereas Capital Interests generally are issued for future services. One difficulty with this latter distinction is that it seems undesirable to provide for different tax treatment based on a factual distinction (i.e., whether the interest is issued for past or future services) that may not always be easy to draw. Nonetheless, the benefit of providing uniform treatment for the tax treatment of the issuance of Capital Interests for partnerships and disregarded entities seems to outweigh any detriment attributable to arguable inconsistencies with McDougal.

For the same reasons outlined above, the treatment of the issuance and exercise of an Option by a disregarded entity should follow that of a partnership. Indeed, the case is arguably stronger in the case of an Option issued by a disregarded entity, because the disregarded entity is clearly the legal counterparty to the Option holder. The owner of the disregarded entity will often not have any direct legal relationship with the Option holder, and therefore no legal obligation that is satisfied if and when the Option is exercised. This fact provides an additional distinction from the McDougal case and further supports the application of rules analogous to those found in Situation 2 of Revenue Ruling 99-5.

IX. Treatment of Options Issued in Respect of Other Income Items.

Proposed Regulations § 1.721-2 applies only to Noncompensatory Options and does not apply to any interest on convertible debt that has been accrued by the partnership (including accrued OID). Treasury representatives have, in informal conversations, indicated that they intended to exclude all Options issued in respect of items that would be income in the hands of the recipient or deductible to the issuing partnership. The current language of the Proposed Regulations does not reflect the breadth of such intended exclusions. Not only are rent and royalty Options not excluded, but also Options issued in respect of interest on non-convertible debt are also not excluded.

As with Noncompensatory Options and Compensatory Options, we recommend that Options issued for other items that would be income in the recipient’s hands or deductible to the issuing partnership be treated substantially similarly to Options issued by corporations in respect of such items.

Although neither section 1032 on its face nor the Regulations under such section reach the issuance of stock in respect of its debt, “it is generally acknowledged that section 1032 applies to an exchange of a corporation’s stock for its debt, subject to sections 61(a)(12) and 108.” 141 It also appears that the payment of expenses that are otherwise deductible by a

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141 T.D. 8883 (May 12, 2000).
A corporation with stock gives rise to a deduction by the corporation issuing the stock even though no gain is recognized on the issuance.\textsuperscript{142}

Similarly, when a corporation issues a warrant in payment of a deductible expense, the deduction may be allowed\textsuperscript{143} regardless of whether the issuing corporation must recognize income.\textsuperscript{144}

We recommend that similar treatment apply to a partnership Capital Interest or an Option issued in respect of a noncompensatory expense. More specifically, we recommend that (i) the issuing partnership be allowed a deduction to the extent of the FMV of the Capital Interest or Option, if a deduction would be allowable if the expense were paid in cash, (ii) no gain be recognized to the partnership on the issuance of either the Capital Interest or the Option, (iii) in the case of the issuance of a Capital Interest, the cash-out, cash-in approach should be applied using the FMV of the Capital Interest, and (iv) in the case of an Option, the recipient should be treated as having purchased the Option for its fair market value for the purposes of determining the capital account and basis of the partnership interest resulting if the Option is exercised.


\textsuperscript{143}Subject to the limitations of section 83.

APPENDIX A

SUGGESTED REGULATORY CHANGES


Regulations § 1.83-8(a)(3) notwithstanding, the treatment of options issued in connection with the performance of services after June 30, 1969, shall be governed by Regulations § 1.83-7, except as provided in section 421 and the regulations thereunder.


Add new paragraph (3) to subsection (b):

If a person acquires an option in payment of amounts constituting income to the recipient other than amounts constituting compensation, the recipient will recognize gross income equal to the fair market value of such option. The recipient of such option shall be treated as if the issuer of such option had paid the recipient in cash in an amount equal to the fair market value of such option.


Add new subsection (a)(4):

For the purposes of this section and the other sections of the Regulations promulgated under section 83, “employee or independent contractor” includes a partner in a partnership in the context of the transfer of property in connection with the performance of services by such partner to or for the benefit of such partnership.


Add at the end of the current text:

For the purposes of this section and Regulations § 1.61-2, a change in the capital account balances of partners in a partnership is not a transfer of property if the change is the result of adjustments to the capital accounts to reflect the issuance of a partnership interest pursuant to Regulations § 1.704-1(b)(2)(iv)(q) or (s).

5. Treas. Reg. § 1.83-6. Amend subsection (b) to read:

Except as provided in section 1032 or section 721, (1) at the time of a transfer of property in connection with the performance of services, the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor’s basis in the property, and (2) in addition, at the time a deduction is allowed under section 83(h) and paragraph (a) of this section, gain or loss is recognized to the extent of the difference between (i) the sum of the amount paid plus the amount allowed as a deduction under section 83(h), and (ii) the sum of the taxpayer’s basis in the property plus any amount recognized pursuant to the previous clause.

The foregoing notwithstanding, the fair market value assigned to property revalued by a partnership under paragraph (b)(2)(iv)(f) (a “capital account adjustment”) will also be regarded as correct if it is based upon the fair market value of a partnership interest. The use of the fair market value of a partnership interest will not be regarded as correct if, as of the date of the capital account adjustment, there is a strong likelihood that the use of the fair market value of the partnership interest as the basis of the capital account adjustment would result in a substantial reduction in the present value of the partners’ aggregate tax liabilities. In addition, the use of the fair market value of the partnership interest as the basis of the capital account adjustment will not be viewed as correct if substantially all of the partnership’s property consists of cash, cash equivalents, stock, securities, commodities, options, warrants, futures or similar instruments that are readily tradable on an established securities market.


Add at the end of § 1.707-1(a):

For treatment of the payment of expenses, obligations or liabilities of a partnership with capital interests in the partnership or options exercisable into interests in the issuing partnership, see Treas. Reg. 1.721-1(a).

8. Treas. Reg. § 1.707-1(c).

Delete the following:

However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(c) and paragraph (a) of § 1.706-1.

Substitute:

The timing and amount of income recognition shall be determined by section 83 and the regulations thereunder to the extent applicable.


a. Cash-out Cash-In.

(1) Amend Treas. Reg. §1.721-1(a) to provide that: “If a partnership issues a partnership interest in payment of an expense, obligation or liability of the partnership, the transaction shall be treated as if (other than for the purposes of Treas. Reg. §1.83-3(e)), immediately before the issuance of the partnership interest, the partnership paid such expense, obligation or liability of the partnership in cash in an amount equal to the difference, if any, between the fair market value of the interest issued over the amount
actually paid by the recipient for such interest, and immediately thereafter the recipient purchased such interest from the partnership for such cash plus the amount actually paid for such interest.

(2) Because the exclusion under section 721(a) is broader than the exclusion under section 1032(a), the following limitation may need to be added for clarity: “; except, however, this sentence shall not reduce or limit the amount recognized as payment of an expense, obligation or liability by the partnership to the recipient partner under the appropriate Code sections.”

(3) To bring the capital account of the recipient partner up to where it should be, the following provision should be added to Treas. Reg. § 1.704-1(b)(2)(iv)(b): “For the purposes of the adjustments required by this paragraph, a partner who receives a partnership interest as payment of an expense, obligation or liability of the partnership shall be deemed to have contributed to the partnership property with a value equal to the amount of income recognized by the recipient partner on receipt of the partnership interest.”

b. 1.1032-1 language alternative.

(1) Amend Treas. Reg. § 1.721-1(a) to provide that: “A transfer by a partnership of interests in itself as payment of an expense, obligation or liability of the partnership is considered, for purposes of section 721(a), as a contribution of property to the partnership in exchange for an interest in the partnership.”

c. Coordination with Section 83.

Amend Treas. Reg. § 1.721-1(a) to provide that: “except, however, if such partnership interest is issued in connection with the performance of services but the interest is subject to a substantial risk of forfeiture, as defined in Treas. Reg. §1.83-3(c), the timing and amount of income recognition by the recipient of such interest and any available deduction by the partnership shall be governed by section 83 and Treas. Reg. §§ 1.83-1 and 1.83-6 unless an election is made by the recipient of the interest under section 83(b) to treat such interest as fully taxable in the year of receipt.

d. Coordination with Section 83 and Option Treatment.

Amend Treas. Reg. §1.721-1(a) to provide that “The rules of this section shall apply to an option issued by a partnership to buy an interest in such partnership in the same manner as the rules of this section apply to the issuance of a partnership interest; except, however, unless an option issued by a partnership to buy an interest in such partnership has a readily ascertainable fair market value, if such option is issued in connection with the performance of services, the timing and
amount of income recognition by the recipient of such option and any available deduction by the partnership shall be governed by section 83 and Treas. Reg. § 1.83-7.


Delete everything after the parenthetical “(or in satisfaction of an obligation)” and add the following language:

the transaction shall be recharacterized under Regulations § 1.721-1(a) as a payment of cash by the partnership to the recipient of the additional interest followed by a recontribution of cash by the recipient to the partnership, or in appropriate circumstances, as a disguised sale either between the partnership and the recipient partner or the partner whose interest has been reduced and the recipient partner. See section 707 and the regulations thereunder.


Add new subparagraph (d):

(d) The deemed contribution of property to a partnership resulting from an issuance of a partnership interest in connection with the payment of an expense, obligation or liability of the partnership (including, but not limited to, the exercise of an option issued in payment of an expense, obligation or liability of the partnership) shall be deemed not to result in a diversification of assets and thus is not subject to the exception of section 721(b).


The second sentence of Treas. Reg. § 1.761-3(a) should be replaced with:

This paragraph applies only if, as of the date that the noncompensatory option is issued, transferred or materially modified, there is a strong likelihood that the total tax liability of the partners and the holder of the noncompensatory option (for their respective taxable years during which the option is outstanding) will be less than if the holder were treated as a partner (taking into account tax consequences that result from the interaction of the option with partner tax attributes that are unrelated to the partnership).
An issuance, transfer or material modification of a noncompensatory option shall be disregarded for purposes of this section if (i) the issuance or transfer is by gift, at death or pursuant to a provision of the Code in which gain or loss is not recognized or (ii) the material modification is either in a manner that does not materially increase the likelihood that the option will be exercised or pursuant to a bona fide, reasonable formula that has the effect of preventing dilution of the interests of the holder of the option.


Add the following language:

A call option or warrant to acquire an interest in the issuing partnership that has been treated as a partnership interest pursuant to this section shall not thereafter be an option for purposes of this section.


Add the following language at the end of the second sentence:

other than commercially reasonable arrangements, including, without limitation, the ability to restrict distributions and dilutive issuances of partnership equity. For purposes of determining the partner attributes of an option inherent in a convertible preferred interest, there shall be taken into account only those attributes that are not also held by partners holding non-convertible preferred interests or partners holding common interests.

15. Treas. Reg. § 1.761-3(d).

Move the examples to 1.761-3(e) and add the following language:

(d) Safe harbor for certain option. A noncompensatory option is not treated as a partnership interest if the option must be exercised or will lapse on or before the 10th anniversary of the date the option is issued and, on the measurement date, the option would not be recharacterized as a second class of stock under Treas. Reg. § 1.1361-1(l) if the option were issued by an S corporation. For purposes of this paragraph (d), a good faith determination of fair market value by the partnership will be respected unless it can be shown that the value was substantially in error and the determination of value was not performed with reasonable diligence to obtain a fair value. This paragraph (d) does not apply to options to obtain an interest in a partnership the assets of which generate a substantially certain and predictable stream of income, such as a partnership primarily invested in high-quality debt securities or a high-quality net lease. Failure of an option to meet this safe harbor will not necessarily result in the option being treated as a partnership interest.
APPENDIX B

NONCOMPENSATORY EXAMPLES

1. Index of Examples.

   Example 1. Using the Buy-In Value Method of the Proposed Regulations when the Buy-In Value is Below LV.

   Example 2. Using the Subtraction Method of the Proposed Regulations when the Option FMV is Below LVAE.

   Example 3. Using the Buy-In Value Method of the Proposed Regulations when the Option FMV is Below LVAE.

2. Examples.

   Example 1. Using the Buy-In Value Method of the Proposed Regulations When the Buy-In Value is Below the LV.

   (i) In Year 1, AC and NE each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to DR. The option allows DR to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DR pays $1,000 to LLC for the issuance of the option. Assume that the LLC agreement requires that on the exercise of a Noncompensatory Option LLC must comply with the rules of the Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to Noncompensatory Options are recognized under section 704(b). Also assume that DR’s option is a Noncompensatory Option and that DR is not treated as a partner with respect to the option.

   (ii) Prior to the exercise of DR’s option, ML contributes $10,000 to LLC for 100 units in LLC. At the time of ML’s contribution, Property A has a value of $30,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of DR’s option is ($1,000).146

   (iii) Upon ML’s admission to the partnership, the capital accounts of AC and NE (which were $10,000 each prior to ML’s admission) are, in accordance with the Book-Up Rules,

145 This example corresponds to Example 22 in the Proposed Regulations modified to reflect a buy-in value below LV.

146 The excess of $10,000 FMV of 100 units over the exercise price ($15,000) is zero. Zero minus the option premium ($1,000) is -$1,000.
adjusted upward to reflect their shares of the unrealized appreciation in the partnership’s assets. Under the Book-Up Rules, those adjustments must be based on the fair market value of LLC property\textsuperscript{147} on the date of the adjustment.\textsuperscript{148} The fair market value of partnership property\textsuperscript{149} ($36,000) must be reduced by the consideration paid by DR to the partnership to acquire the option ($1,000),\textsuperscript{150} and the excess of the fair market value of the option as of the date of the adjustment over the consideration paid by DR to acquire the option (-$1,000),\textsuperscript{151} but only to the extent of the unrealized appreciation in LLC property ($15,000). Therefore, the revaluation adjustments must be based on a value of $36,000.\textsuperscript{152} Accordingly, AC, NE and ML’s capital accounts must each be increased to $15,333. This $16,000 increase\textsuperscript{153} is allocated to Property A and the option premium. Therefore, the book value of Property A is $30,000. The $20,000 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between AC, NE and ML in accordance with section 704(c) principles.

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\textsuperscript{147} Taking section 7701(g) into account.

\textsuperscript{148} Immediately prior to the entry of ML into the LLC. See Treas. Reg. § 1.704-1(b)(5) ex. 14.

\textsuperscript{149} Other than the cash contributed by ML.


\textsuperscript{152} Treating for these purposes the upward adjustment from the negative value of the option as unrealized appreciation.

\textsuperscript{153} The value of the option pursuant to Prop. Reg. § 1.704-1(b)(2)(iv)(h)(2).
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**Example 2.**  
*Using the Subtraction Method of the Proposed Regulations When the Option Value is Below the LVAE*

(i) In Year 1, AC and NE each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to DR. The option allows DR to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DR pays $1,000 to LLC for the issuance of the option. Assume that the LLC agreement requires that on the exercise of a Noncompensatory Option LLC must comply with the rules of the Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to Noncompensatory Options are recognized under section 704(b). Also assume that DR’s option is a Noncompensatory Option and that DR is not treated as a partner with respect to the option.

(ii) Prior to the exercise of DR’s option, ML contributes $17,000 to LLC for 100 units in LLC. At the time of ML’s contribution, Property A has a value of $30,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of DR’s option is $1,700.\(^{155}\)

(iii) Upon ML’s admission to the partnership, the capital accounts of AC and NE (which were $10,000 each prior to ML’s admission) are, in accordance with the Book-Up Rules, adjusted upward to reflect their shares of the unrealized appreciation in the partnership’s assets. Under the Book-Up Rules, those adjustments must be based on the fair market value of LLC property\(^{156}\) on the date of the adjustment.\(^{157}\) The fair market value of partnership property

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154 This example corresponds to Example 22 in the Proposed Regulations modified to reflect an option value below LVAE.

155 \[30,000 + 5,000 + 17,000 + 1,000 + 15,000 = 68,000. \quad 68,000 / 4 = 17,000. \quad 17,000 - 15,000 = 2,000, \text{ less a 15\% discount} = 1,700. \] A 15\% discount has been used for illustration purposes only. An option that is not immediately exercisable may have a value above or below the LVAE.

156 Taking section 7701(g) into account.

157 Immediately prior to the entry of ML into the LLC. See, Treas. Reg. \$ 1.704-1(b)(5) Ex. 14.
($36,000) must be reduced by the consideration paid by DR to the partnership to acquire the option ($1,000),\footnote{Under Prop. Reg. § 1.704-1(b)(2)(iv)(f)(1).} and the excess of the fair market value of the option as of the date of the adjustment over the consideration paid by DR to acquire the option ($700),\footnote{Under Prop. Reg. § 1.704-1(b)(2)(iv)(h)(2).} but only to the extent of the unrealized appreciation in LLC property ($15,000). Therefore, the revaluation adjustments must be based on a value of $34,300. Accordingly, AC and NE’s capital accounts must each be increased to $17,150. This $700 reduction\footnote{The value of the option pursuant to Prop. Reg. § 1.704-1(b)(2)(iv)(h)(2).} is allocated entirely to Property A, the only asset having unrealized appreciation. Therefore, the book value of Property A is $29,300. The $19,300 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between AC and NE in accordance with section 704(c) principles.

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<th>ASSETS</th>
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<th>OPTION ADJUSTMENT</th>
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<tr>
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(iv) After the admission of ML, when Property A still has a value of $30,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, DR exercises the option. On the exercise of the option, DR’s capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, DR is entitled to LLC capital corresponding to 100 units of LLC (1/4 of LLC’s capital). Immediately after the exercise of the option, LLC’s assets are worth $68,000 ($15,000

contributed by DR, plus the value of LLC assets prior to the exercise of the option, $53,000. DR is entitled to LLC capital equal to 1/4 of this value, or $17,000. As DR is entitled to $1,000 more LLC capital than DR’s capital contributions to LLC, the Adjustments on Exercise apply.

(v) Under the Adjustments on Exercise, LLC must increase DR’s capital account from $16,000 to $17,000 by first revaluing LLC’s property in accordance with the Book-Up Rules and allocating the first $1,000 of book gain to DR. The net increase in the value of LLC’s properties since the previous revaluation is $700 (the difference between the actual value of Property A, $30,000, and the book value of Property A, $29,300). The entire $700 of book gain is allocated to DR.

(vi) Because the revaluation of LLC assets under the second rule of the Adjustments on Exercise does not increase DR’s capital account to the amount agreed on by the members, the LLC is required to make a Capital Account Reallocation. Because the economic agreement is that all partners share equally, the amount of the Capital Account Reallocation ($300) must be taken proportionately from each of AC and NE, because their capital accounts are disproportionately high as compared to their economic interests.

(vii) Beginning in the year in which the option is exercised, LLC must make corrective allocations so as to take into account the Capital Account Reallocation.

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161 An argument can be made that the book accounts of AC and NE should be reduced by $50 a piece with the reduction shifted over to ML to equalize the capital accounts, reflecting their economic agreement pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(q). Because the amount shifted under the “q” adjustment would still be reallocated to DR in the Capital Account Reallocation immediately following, this example does not illustrate this additional step.
Example 3.\textsuperscript{162} Using the Buy-In Value Method When the Option Value is Below the LVAE.

(i) In Year 1, AC and NE each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to DR. The option allows DR to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DR pays $1,000 to LLC for the issuance of the option. Assume that LLC agreement requires that on the exercise of a Noncompensatory Option LLC must comply with the rules of the Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to Noncompensatory Options are recognized under section 704(b). Also assume that DR’s option is a Noncompensatory Option and that DR is not treated as a partner with respect to the option.

(ii) Prior to the exercise of DR’s option, ML contributes $17,000 to LLC for 100 units in LLC. At the time of ML’s contribution, Property A has a value of $30,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of DR’s option is $1,600.\textsuperscript{163}

(iii) Upon ML’s admission to the partnership, the capital accounts of AC and NE (which were $10,000 each prior to ML’s admission) are booked-up to reflect the deemed fair market value of the partnership assets based upon ML’s purchase price. Accordingly, AC and NE’s capital accounts must each be increased to $17,000. The $1,000 paid by DR as an option premium is not taken into consideration. Because the assets reflect a combination of $20,000 of built-in gain in Property A and $5,000 of built-in loss in Property B, in order to increase the capital accounts by a net of $14,000, the book value of Property A must be increased to $29,000 and the book value of Property B must be reduced to $5,000. The $19,000 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between AC and NE in accordance with section 704(c) principles.

\textsuperscript{162} This example corresponds to Example 22 in the Proposed Regulations modified to apply discounts to determine fair market value. However, the interim book-up is done based on the buy-in price. The example should also correspond with Example V.B(2) in the original report.

\textsuperscript{163} $30,000 + $5,000 + $17,000 + $1,000 + $15,000 = $68,000$. $68,000 / 4 = $17,000$. $17,000 - $15,000 = $2,000$, less a 20% discount = $1,600$. A 20% discount has been used for illustration purposes only. An option that is not immediately exercisable may have a value above or below the LVAE.
(iv) After the admission of ML, when Property A still has a value of $30,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, DR exercises the option. On the exercise of the option, DR’s capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, DR is entitled to LLC capital corresponding to 100 units of LLC (1/4 of LLC’s capital). Immediately after the exercise of the option, LLC’s assets are worth $68,000 ($15,000 contributed by DR, plus the value of LLC assets prior to the exercise of the option, $53,000). DR is entitled to LLC capital equal to 1/4 of this value, or $17,000. As DR is entitled to $1,000 more LLC capital than DR’s capital contributions to LLC, the Adjustments on Exercise apply.

(v) Under the Adjustments on Exercise, the LLC must increase DR’s capital account from $16,000 to $17,000 by first revaluing LLC’s property in accordance with the Book-Up Rules and allocating the first $1,000 of book gain to DR. The net increase in the value of LLC’s properties since the previous revaluation is $1,000 (the difference between the actual value of Property A, $30,000, and the book value of Property A, $29,000). The entire $1,000 of book gain is allocated to DR.
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APPENDIX C

COMPENSATORY EXAMPLES

1. Index of Examples.

   (a) No Appraisal. Book-up Based upon LV. Services Add No Value.
   (b) No Appraisal. Book-up Based upon LV. Services Add Value.
   (c) Appraisal. Book-up Based upon Appraised Value of Interest.
   (d) Appraisal. Book-up Based upon LV.

Example 2. Option with No Interim Book-Up (Based upon Ex. 20).
   (a) No Appraisal. Book-up Based upon LV. Services Add No Value.
   (b) No Appraisal. Book-up Based upon LV. Services Add Value.
   (c) Appraisal. Book-up Based upon Appraised Value of Interest.
   (d) Appraisal. Book-up Based upon LV.

Example 3. Option with Reinvestment (Based upon Ex. 21).

Example 4. Option with Interim Book-Up (Based upon Ex. 22).
   (a) Using the Subtraction Method of the Proposed Regulations when the
       Option Value is Below the LVAE.
   (b) Using the Buy-In Price Method when the Option Value is Below the
       LVAE.
   (c) Using the Buy-In Price Method when the Option Value and the Buy-In
       Price are Below the LVAE.
   d. Using the Subtraction Method of the Proposed Regulations Without
       Valuation Discounts

Example 5. Capital Interest Subject to a Substantial Risk of Forfeiture.

2. Examples.

   (a) No Appraisal. Book-Up Based Upon LV. Services Add No Value.
(i) In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company, classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a non-depreciable property, Property A, for $20,000. In Year 2 when Property A is worth $30,000, LLC issues 100 units in LLC to DH in connection with DH’s services. DH does not obtain an appraisal of the interest, and the parties treat the interest issued to DH as being worth $10,000. Also assume that the value of DH’s services maintains the value of the assets of LLC but does not add any net value (after the consideration of the compensation expense).

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>BASIS</th>
<th>VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A</td>
<td>$20,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Total</td>
<td>$20,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

(ii) Under the Capital Account Maintenance Rules, DH is treated as having contributed property to LLC in an amount equal to the amount included in income ($10,000). The compensation deduction attributable to the issuance of the interest to DH ($10,000) is allocated equally between TM and PK. The book value of the Property A is also increased to reflect Property A’s $30,000 value. The difference between the tax basis of Property A ($20,000) and its book value ($30,000) is allocated equally between TM and PK to reflect the parties’ economic agreement.

<table>
<thead>
<tr>
<th></th>
<th>TM TAX</th>
<th>TM BOOK</th>
<th>PK TAX</th>
<th>PK BOOK</th>
<th>DH TAX</th>
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<td>Compensation deduction:</td>
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<td>$5,000</td>
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<td>$10,000</td>
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<tr>
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<td>$5,000</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
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</tbody>
</table>

(b) No Appraisal. Book-Up Based Upon LV. Services Add Value.

(i) In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company, classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a non-depreciable property, Property A, for $20,000. In Year 2 when Property A is worth $20,000, LLC issues 100 units in LLC to DH in connection with DH’s services. DH does not obtain an appraisal of the
interest, and the parties treat the interest issued to DH as being worth $10,000. Also assume that the value of DH’s services increases the value of the assets of LLC and is capitalized as part of the basis of Property A.

<table>
<thead>
<tr>
<th>ASSETS</th>
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</tr>
<tr>
<td>Total</td>
<td>$30,000</td>
<td>$30,000</td>
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</table>

(ii) Under the Capital Account Maintenance Rules, DH is treated as having contributed property to LLC in an amount equal to the amount included in income ($10,000). The compensation deduction attributable to the issuance of the interest to DH ($10,000) is allocated equally between TM and PK. The book value of the Property A is also increased to reflect Property A’s $30,000 value. The increase in the book value of Property A to $30,000 is allocated equally between TM and PK to reflect the parties’ economic agreement.

<table>
<thead>
<tr>
<th></th>
<th>TM</th>
<th></th>
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<td>BOOK</td>
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<td>Capital accounts after book-up:</td>
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<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

(c) *Appraisal. Book-Up Based Upon Appraised Value.*

(i) In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company, classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a non-depreciable property, Property A, for $20,000. In Year 2 when Property A is worth $30,000, LLC issues 100 units in LLC to DH in connection with DH’s services. DH obtains an appraisal of the interest, and the parties treat the interest issued to DH as being worth $7,000. Also assume that the value of DH’s services maintains the value of the assets of LLC but does not add any net value (after the consideration of the compensation expense)
(ii) Under the Capital Account Maintenance Rules, DH is treated as having contributed property to LLC in an amount equal to the amount included in income ($7,000). The compensation deduction attributable to the issuance of the interest to DH ($7,000) is allocated equally between TM and PK. The book value of the Property A is also increased to reflect Property A’s deemed value based upon the appraisal of DH’s interest (3 x $7,000 = $21,000). The difference between the tax basis of Property A ($20,000) and its book value ($21,000) is allocated equally between TM and PK to reflect the parties’ economic agreement.

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<tr>
<th>ASSETS</th>
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<td>Property A</td>
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<td><strong>$30,000</strong></td>
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<td>Book-up:</td>
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<td>Capital accounts after book-up:</td>
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(d) **Appraisal. Book-Up Based Upon LV.**

(i) In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company, classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a non-depreciable property, Property A, for $20,000. In Year 2 when Property A is worth $30,000, LLC issues 100 units in LLC to DH in connection with DH’s services. DH obtains an appraisal of the interest, and the parties treat the interest issued to DH as being worth $7,000. Also assume that the value of DH’s services maintains the value of the assets of LLC but does not add any net value (after the consideration of the compensation expense)
(ii) Under the Capital Account Maintenance Rules, DH is treated as having contributed property to LLC in an amount equal to the amount included in income ($7,000). The compensation deduction attributable to the issuance of the interest to DH ($7,000) is allocated equally between TM and PK. The book value of Property A is also increased to reflect Property A’s $30,000 value. To reflect the economic agreement of the parties, the difference between the tax basis of Property A ($20,000) and its book value ($30,000) must be allocated $3,000 first to DH to bring DH’s capital account up to the one third of the economic value represented by DH’s interest, and the remaining $7,000 is allocated equally to TM and PK.

<table>
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<tr>
<th></th>
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<td>Compensation deduction:</td>
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Example 2.164 Option with No Interim Book-Up.

(a) No Appraisal. Book-Up Based Upon LV. Services Add No Value.

(i) In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company, classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a non-depreciable property, Property A, for $20,000. Also in Year 1, at a time when Property A is still valued at $20,000, LLC issues an option to DH in connection with DH’s services to LLC. The option allows DH to buy 100 units in LLC for an exercise price of $7,000 in Year 2. DH pays no premium to the LLC for the issuance of the option. Assume that the LLC agreement requires that, on the exercise of an option, LLC comply with the rules relating to Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to options are recognized under section 704(b). Assume that DH’s option is a Compensatory Option and DH is not treated as a partner with respect to the option. In Year 2, DH exercises the option, contributing the $7,000 exercise price to the partnership. At the time the option is exercised, the value of Property A is $23,000. DH does not obtain an appraisal of the interest, and the parties treat the interest issued to DH as being worth $10,000. Also

164 This example is based upon Example 20 of the Proposed Regulations.
assume that the value of DH’s services maintains the value of the assets of LLC but does not add any net value (after the consideration of the compensation expense).

<table>
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<tr>
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<th>BASIS</th>
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<tbody>
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<tr>
<td>Exercise Price</td>
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<td><strong>Total</strong></td>
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<tr>
<th>LIABILITIES AND CAPITAL</th>
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<td>TM</td>
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<tr>
<td>PK</td>
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<td>$10,000</td>
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<tr>
<td><strong>Total</strong></td>
<td>$27,000</td>
<td>$30,000</td>
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</tbody>
</table>

(ii) Under the Capital Account Maintenance Rules, DH’s capital account is credited with the amount paid for the option ($0) and the exercise price of the option ($7,000). In addition, under the Capital Account Maintenance Rules, DH’s capital account is treated as having contributed property to LLC in an amount equal to the amount included in income ($3,000). The compensation deduction attributable to the issuance of the interest to DH ($3,000) is allocated equally between TM and PK. The book value of the Property A is also increased to reflect Property A’s value ($23,000). The difference between the tax basis of Property A ($20,000) and its book value ($23,000) is allocated equally between TM and PK to reflect the parties’ economic agreement.

<table>
<thead>
<tr>
<th>TM</th>
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<tbody>
<tr>
<td>Capital accounts after exercise:</td>
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<tr>
<td>Compensation deduction:</td>
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<td>Capital accounts after compensation deduction:</td>
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<td>Book-up:</td>
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<tr>
<td>Capital accounts after book-up:</td>
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(b) No Appraisal. Book-Up Based Upon LV. Services Add Value.
In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company, classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a non-depreciable property, Property A, for $20,000. Also in Year 1, at a time when Property A is still valued at $20,000, LLC issues an option to DH in connection with DH’s services to LLC. The option allows DH to buy 100 units in LLC for an exercise price of $7,000 in Year 2. DH pays no premium to the LLC for the issuance of the option. Assume that the LLC agreement requires that, on the exercise of an option, LLC comply with the rules relating to Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to options are recognized under section 704(b). Assume that DH's option is a Compensatory Option and DH is not treated as a partner with respect to the option. In Year 2, DH exercises the option, contributing the $7,000 exercise price to the partnership. Also assume that the value of DH’s services increases the value of the assets of LLC and is capitalized as part of the basis of Property A. At the time the option is exercised, the value of Property A is $23,000, and the parties treat the interest issued to DH as being worth $10,000.

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<tr>
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<tr>
<td>Total</td>
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<td>$30,000</td>
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</table>
(ii) Under the Capital Account Maintenance Rules, DH’s capital account is credited with the amount paid for the option ($0) and the exercise price of the option ($7,000). In addition, under the Capital Account Maintenance Rules, DH’s capital account is treated as having contributed property to LLC in an amount equal to the amount included in income ($3,000). The compensation deduction attributable to the issuance of the interest to DH ($3,000) is allocated equally between TM and PK. The book value of the Property A is also increased to reflect Property A’s value ($23,000). The book-value increase is allocated equally between TM and PK to reflect the parties’ economic agreement.

(c) Appraisal. Book-Up Based Upon Appraised Value of Interest.

(i) In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company, classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a non-depreciable property, Property A, for $20,000. Also in Year 1, at a time when Property A is still valued at $20,000, LLC issues an option to DH in connection with DH’s services to LLC. The option allows DH to buy 100 units in LLC for an exercise price of $7,000 in Year 2. DH pays no premium to the LLC for the issuance of the option. Assume that the LLC agreement requires

<table>
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<th>LIABILITIES AND CAPITAL</th>
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<th>VALUE</th>
</tr>
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<tr>
<td>PK</td>
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<table>
<thead>
<tr>
<th>TM</th>
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</thead>
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<tr>
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<tr>
<td>Capital accounts after compensation deduction:</td>
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<tr>
<td>Capital accounts after book-up:</td>
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<td>$10,000</td>
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</table>
that, on the exercise of an option, LLC comply with the rules relating to Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to options are recognized under section 704(b). Assume that DH’s option is a Compensatory Option and DH is not treated as a partner with respect to the option. In Year 2, DH exercises the option, contributing the $7,000 exercise price to the partnership. At the time the option is exercised, the value of Property A is $23,000. DH obtains an appraisal of the interest, and the parties treat the interest issued to DH as being worth $7,000. Also assume that the value of DH’s services maintains the value of the assets of LLC but does not add any net value (after the consideration of the compensation expense).

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>BASIS</th>
<th>VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A</td>
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<td>$23,000</td>
</tr>
<tr>
<td>Exercise Price</td>
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<td>$ 7,000</td>
</tr>
<tr>
<td>Total</td>
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<tr>
<th>LIABILITIES AND CAPITAL</th>
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<th>VALUE</th>
</tr>
</thead>
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<td>$10,000</td>
</tr>
<tr>
<td>PK</td>
<td>$10,000</td>
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<tr>
<td>Total</td>
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<td>$30,000</td>
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</table>

(ii) Under the Capital Account Maintenance Rules, DH’s capital account is credited with the amount paid for the option ($0) and the exercise price of the option ($7,000). The book value of Property A is also reduced to reflect Property A’s deemed value based upon DH’s exercise price ($14,000). The difference between the tax basis of Property A ($20,000) and its book value ($14,000) is allocated to TM and PK to reflect the parties’ economic agreement.
(d) Appraisal. Book-Up Based Upon LV.

(i) In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company, classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a non-depreciable property, Property A, for $20,000. Also in Year 1, at a time when Property A is still valued at $20,000, LLC issues an option to DH in connection with DH’s services to LLC. The option allows DH to buy 100 units in LLC for an exercise price of $7,000 in Year 2. DH pays no premium to the LLC for the issuance of the option. Assume that the LLC agreement requires that, on the exercise of an option, LLC comply with the rules relating to Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to options are recognized under section 704(b). Assume that DH's option is a Compensatory Option and DH is not treated as a partner with respect to the option. In Year 2, DH exercises the option, contributing the $7,000 exercise price to the partnership. At the time the option is exercised, the value of Property A is $23,000. DH obtains an appraisal of the interest, and the parties treat the interest issued to DH as being worth $7,000. Also assume that the value of DH’s services maintains the value of the assets of LLC, but does not add any net value (after the consideration of the compensation expense).

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<thead>
<tr>
<th>ASSETS</th>
<th>BASIS</th>
<th>VALUE</th>
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<tbody>
<tr>
<td>Property A</td>
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<tr>
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<td>$7,000</td>
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<tr>
<td>Total</td>
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</table>
Example 3. Option with Reinvestment. 165

(a) No Appraisal. Book-up Based upon LV.

(i) Assume the same facts as in Example 2, except that in Year 1 LLC sells Property A for $40,000, recognizing gain of $20,000. LLC does not distribute the sale proceeds to its partners, and it has no other earnings in Year 1. With the proceeds ($40,000), LLC purchases Property B, a nondepreciable property. Also assume that DH exercises the Compensatory Option at the beginning of Year 2 and that, at the time DH exercises the option, the value of Property B is $41,000. In Year 2, besides the compensatory deduction, LLC has gross income of $3,000 and deductions of $1,500. Also assume that the value of DH’s services maintains the

165 This example is based upon Prop. Reg. 1.704-1(b)(5), Ex. 21.

166 Neither the examples nor the Proposed Regulations indicate whether the sale of the property constitutes a modification resulting in a required test at the moment of sale to see whether DH is a deemed partner under Prop. Reg. § 1.761-3(a).
value of the assets of LLC, but does not add any net value (after the consideration of the compensation expense).

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>BASIS</th>
<th>VALUE</th>
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<tr>
<td>Property B</td>
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<td>$41,000</td>
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<td><strong>$48,000</strong></td>
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<table>
<thead>
<tr>
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</thead>
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<tr>
<td>PK</td>
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<td>$16,000</td>
</tr>
<tr>
<td>DH</td>
<td>$16,000</td>
<td>$16,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$56,000</strong></td>
<td><strong>$48,000</strong></td>
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</tbody>
</table>

(ii) Under the Capital Account Maintenance Rules, DH's capital account is credited with the amount paid for the option ($0) and the exercise price of the option ($7,000). In addition, under the Capital Account Maintenance Rules, DH's capital account is treated as having contributed property to LLC in an amount equal to the amount included in income ($9,000). The compensation deduction attributable to the issuance of the interest to DH ($9,000) is allocated equally between TM and PK. The book value of the Property A is also increased to reflect Property A’s value ($41,000). The difference between the tax basis of Property B ($40,000) and its book value ($41,000) is allocated equally between TM and PK to reflect the parties’ economic agreement.

<table>
<thead>
<tr>
<th></th>
<th>TM</th>
<th>PK</th>
<th>DH</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account after exercise:</td>
<td>$20,000</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Compensation expense:</td>
<td>$4,500</td>
<td>$4,500</td>
<td>$4,500</td>
</tr>
<tr>
<td>Capital account after compensation expense:</td>
<td>$15,500</td>
<td>$15,500</td>
<td>$15,500</td>
</tr>
<tr>
<td>Revaluation:</td>
<td>--</td>
<td>$500</td>
<td>--</td>
</tr>
<tr>
<td>Capital account after revaluation:</td>
<td>$15,500</td>
<td>$16,000</td>
<td>$15,500</td>
</tr>
</tbody>
</table>

97
Example 4. 167 Option with Interim Book-Up.

(a) Using the Subtraction Method of the Proposed Regulations when the Option Value is Below the LVAE.

(i) In Year 1, AC and NE each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to DR. The option allows DR to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DR pays nothing to LLC for the issuance of the option because the option is issued in connection with services performed by DR for the LLC. Assume that the LLC agreement requires that on the exercise of a Compensatory Option LLC must comply with the rules of the Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to Compensatory Options are recognized under section 704(b). Also assume that DR’s option is a Compensatory Option and that DR is not treated as a partner with respect to the option. Also assume that the value of DR’s services maintains the value of the assets of LLC, but does not add any net value (after the consideration of the compensation expense).

(ii) Prior to the exercise of DR’s option, ML contributes $16,666 to LLC for 100 units in LLC. At the time of ML’s contribution, Property A has a value of $30,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of DR’s option is $1,333.168

(iii) Upon ML’s admission to the partnership, the capital accounts of AC and NE (which were $10,000 each prior to ML’s admission) are, in accordance with the Book-Up Rules, adjusted upward to reflect their shares of the unrealized appreciation in the partnership’s assets. Under the Book-Up Rules, those adjustments must be based on the fair market value of LLC property169 on the date of the adjustment.170 The fair market value of partnership property ($35,000) must be reduced by the excess of the fair market value of the option as of the date of the adjustment over the consideration paid by DR to acquire the option ($1,333),171 but only to the extent of the unrealized appreciation in LLC property ($15,000). Therefore, the reevaluation

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167 This example corresponds to Example 22 in the Proposed Regulations modified to apply discounts to determine fair market value and test the rules of the Proposed Regulations in a compensatory setting.

168 $30,000 + $5,000 + $16,666 + $15,000 = $66,666. $66,666 / 4 = $16,666. $16,666 - $15,000 = $1,666 less a 20% discount = $1,333. A 20% discount has been used for illustration purposes only. An option that is not immediately exercisable may have a value above or below the LVAE.

169 Taking section 7701(g) into account.

170 Immediately prior to the entry of ML into the LLC. See, Treas. Reg. § 1.704-1(b)(5), Ex. 14.

adjustments must be based on a value of $33,666. Accordingly, AC and NE’s capital accounts must be increased to $16,833. This $1,333 reduction\(^{172}\) is allocated entirely to Property A, the only asset having unrealized appreciation. Therefore, the book value of Property A is $28,666. The $18,666 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between AC and NE in accordance with section 704(c) principles.

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>BASIS</th>
<th>VALUE</th>
<th>OPTION ADJUSTMENT</th>
<th>704(c) BOOK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A</td>
<td>$10,000</td>
<td>$30,000</td>
<td>($1,333)</td>
<td>$28,666</td>
</tr>
<tr>
<td>Property B</td>
<td>$10,000</td>
<td>$5,000</td>
<td>0</td>
<td>$5,000</td>
</tr>
<tr>
<td>Cash</td>
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<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$20,000</td>
<td>$35,000</td>
<td>($1,333)</td>
<td>$33,666</td>
</tr>
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</table>

| Cash contributed by ML | $16,666 | $16,666 | 0 | $16,666 |
| Total                 | $36,666 | $51,666 | ($1,333) | $50,333 |

<table>
<thead>
<tr>
<th>LIABILITIES AND CAPITAL</th>
<th>TAX</th>
<th>BOOK VALUE</th>
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</thead>
<tbody>
<tr>
<td>AC</td>
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</tr>
<tr>
<td>NE</td>
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<td>$16,833</td>
</tr>
<tr>
<td>ML</td>
<td>$16,666</td>
<td>$16,666</td>
</tr>
<tr>
<td>Option</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$36,666</td>
<td>$50,333(^{173})</td>
</tr>
</tbody>
</table>

(iiv) After the admission of ML, when Property A still has a value of $30,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, DR exercises the option. On the exercise of the option, DR’s capital account is credited with the amount paid for the option ($0) and the exercise price of the option ($15,000). In addition, DR is deemed to have contributed value to the partnership equal to the excess of the amount paid for the LLC interest and the value of the LLC interest. Although the liquidation value of the LLC interest is $16,666, DR obtains an appraisal that the fair market value of the LLC interest is $15,000 that DR paid to exercise the option, so DR recognizes no income and is not deemed to contribute any additional property. Under the LLC agreement, however, DR is entitled to LLC capital corresponding to 100 units of LLC interests (1/4 of LLC’s capital). Immediately after the exercise of the option, LLC’s assets are worth $66,666 ($15,000 contributed by DR, plus the value of LLC assets prior to the exercise of the option, $51,666). DR is entitled to LLC capital equal to 1/4 of this value,

\(^{172}\) The value of the option pursuant to Prop. Reg. § 1.704-1(b)(2)(iv)(h)(2).

\(^{173}\) This number has been adjusted to correct for a rounding issue.
or $16,666.  As DR is entitled to $1,666 more LLC capital than DR’s capital contributions to LLC, the Adjustments on Exercise apply.

(v) Under the Adjustments on Exercise, LLC must increase DR’s capital account from $15,000 to $16,666 by first revaluing LLC’s property in accordance with the Book-Up Rules and allocating the first $1,666 of book gain to DR. The net increase in the value of LLC’s properties since the previous revaluation is $1,333 (the difference between the actual value of Property A, $30,000, and the book value of Property A, $28,666). The entire $1,333 of book gain is allocated to DR.

<table>
<thead>
<tr>
<th>AC</th>
<th>NE</th>
<th>ML</th>
<th>DR</th>
</tr>
</thead>
<tbody>
<tr>
<td>TAX</td>
<td>BOOK</td>
<td>TAX</td>
<td>BOOK</td>
</tr>
<tr>
<td>$10,000</td>
<td>$16,833</td>
<td>$10,000</td>
<td>$16,833</td>
</tr>
<tr>
<td>$16,666</td>
<td>$16,666</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

(vi) Because the revaluation of LLC assets under the second rule of the Adjustments on Exercise does not increase DR’s capital account to the amount agreed on by the members, the LLC is required to make a Capital Account Reallocation.

<table>
<thead>
<tr>
<th>AC</th>
<th>NE</th>
<th>ML</th>
<th>DR</th>
</tr>
</thead>
<tbody>
<tr>
<td>TAX</td>
<td>BOOK</td>
<td>TAX</td>
<td>BOOK</td>
</tr>
<tr>
<td>$10,000</td>
<td>$16,833</td>
<td>$10,000</td>
<td>$16,833</td>
</tr>
<tr>
<td>$16,666</td>
<td>$16,666</td>
<td>$15,000</td>
<td>$16,333</td>
</tr>
</tbody>
</table>

(vii) Beginning in the year in which the option is exercised, LLC must make Corrective Allocations so as to take into account the Capital Account Reallocation.

(viii) If the assets of LLC are sold the day after DR exercises his option, an allocation of the $15,000 ($30,000 fair market value less $10,000 tax basis and $5,000 fair market value less a $10,000 basis) taxable gain cannot have economic effect since it cannot properly be reflected in the partners’ book capital accounts (because the full fair market value is already reflected in the capital accounts). Instead, these items must be shared among the partners in a manner that

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174 These numbers reflect rounding.

takes account of the variation between the adjusted tax basis of such property and its book value
in the same manner as variations between the adjusted tax accounts and the book capital
accounts are taken into account under the principles of section 704(c).176

<table>
<thead>
<tr>
<th>AC</th>
<th>NE</th>
<th>ML</th>
<th>DR</th>
</tr>
</thead>
<tbody>
<tr>
<td>TAX</td>
<td>BOOK</td>
<td>TAX</td>
<td>BOOK</td>
</tr>
</tbody>
</table>

| Capital account after Capital Account Reallocation: | $10,000 | $16,666 | $10,000 | $16,666 | $16,666 | $15,000 | $16,666 |
| Allocation of taxable gain under section 704(c) principles: | $6,666 | - | $6,666 | - | $16,666 | - | $1,666 | - |
| Capital account after allocation under section 704(c) principles: | $16,666 | $16,666 | $10,000 | $16,666 | $16,666 | $16,666 | $16,666 | $16,666 |

(b)177 Using the Buy-In Price Method when the Option Value is Below the LVAE.

(i) In Year 1, AC and NE each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to DR. The option allows DR to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DR pays nothing to LLC for the issuance of the option because the option is issued in connection with services performed by DR for the LLC. Assume that the LLC agreement requires that on the exercise of a Compensatory Option LLC must comply with the rules of the Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to Compensatory Options are recognized under section 704(b). Also assume that DR’s option is a Compensatory Option and that DR is not treated as a partner with respect to the option. Also assume that the value of DR’s services maintains the value of the assets of LLC, but does not add any net value (after the consideration of the compensation expense).

(ii) Prior to the exercise of DR’s option, ML contributes $16,666 to LLC for 100 units in LLC. At the time of ML’s contribution, Property A has a value of $30,000 and a basis of

---


177 This example corresponds to Example 22 in the Proposed Regulations modified to apply discounts to determine fair market value and test the rules of the Proposed Regulations in a compensatory setting. However, the interim book-up is done based on the buy-in price. The example should also correspond with Example V.B(2) in the original report.
$10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of DR’s option is $1,333.\(^{178}\)

(iii) Upon ML’s admission to the partnership, the capital accounts of AC and NE (which were $10,000 each prior to ML’s admission) are booked-up to reflect the deemed fair market value of the partnership assets based upon ML’s purchase price. Accordingly, AC and NE’s capital accounts must each be increased to $16,666. Because the assets reflect a combination of $20,000 of built-in gain in Property A and $5,000 of built-in loss in Property B, in order to increase the capital accounts by a net of $13,333 the book value of Property A must be increased to $28,333 and the book value of Property B must be reduced to $5,000. The $18,333 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between AC and NE in accordance with section 704(c) principles.

\[
\begin{array}{llll}
\text{ASSETS} & \text{BASIS} & \text{VALUE} & 704(\text{C}) \\
\hline
\text{Property A} & $10,000 & $30,000 & $28,333 \\
\text{Property B} & $10,000 & $5,000 & $5,000 \\
\text{Cash} & - & - & - \\
\hline
\text{Subtotal} & $20,000 & $35,000 & $33,333 \\
\hline
\text{Cash contributed by ML} & $16,666 & $16,666 & $16,666 \\
\hline
\text{Total} & $36,666 & $51,666 & $50,000 \\
\hline
\end{array}
\]

\[
\begin{array}{llll}
\text{LIABILITIES AND CAPITAL} & \text{TAX} & \text{BOOK VALUE} \\
\hline
\text{AC} & $10,000 & $16,666 \\
\text{NE} & $10,000 & $16,666 \\
\text{ML} & $16,666 & $16,666 \\
\text{Option} & - & - \\
\hline
\text{Total} & $36,666 & $50,000\(^{179}\) \\
\hline
\end{array}
\]

(iv) After the admission of ML, when Property A still has a value of $30,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, DR exercises the option. On the exercise of the option, DR’s capital account is credited with the amount paid for

\[^{178}\] $30,000 + $5,000 + $16,666 + $15,000 = $66,666. $66,666 / 4 = $16,666. $16,666 - $15,000 = $1,666 less a 20% discount = $1,333. A 20% discount has been used for illustration purposes only. An option that is not immediately exercisable may have a value above or below the LVAE.

\[^{179}\] This number has been adjusted to correct for a rounding issue.
the option ($0) and the exercise price of the option ($15,000). In addition, DR is deemed to have contributed value to the partnership equal to the excess of the amount paid for the LLC interest and the value of the LLC interest. Although the liquidation value of the LLC interest is $16,666, DR obtains an appraisal that the fair market value is the $15,000 that DR paid to exercise the option, so DR recognizes no income and is not deemed to contribute any additional property. Under the LLC agreement, however, DR is entitled to LLC capital corresponding to 100 units of LLC (1/4 of LLC’s capital). Immediately after the exercise of the option, LLC’s assets are worth $66,666 ($15,000 contributed by DR, plus the value of LLC assets prior to the exercise of the option, $51,666). DR is entitled to LLC capital equal to 1/4 of this value, or $16,666. As DR is entitled to $1,666 more LLC capital than DR’s capital contributions to LLC, the Adjustments on Exercise apply.

(v) Under the Adjustments on Exercise, LLC must increase DR’s capital account from $15,000 to $16,666 by first revaluing LLC’s property in accordance with the Book-Up Rules and allocating the first $1,666 of book gain to DR. The net increase in the value of LLC’s properties since the previous revaluation is $1,666 (the difference between the actual value of Property A, $30,000, and the book value of Property A, $28,333). The entire $1,666 of book gain is allocated to DR.

<table>
<thead>
<tr>
<th></th>
<th>AC TAX</th>
<th>AC BOOK</th>
<th>NE TAX</th>
<th>NE BOOK</th>
<th>ML TAX</th>
<th>ML BOOK</th>
<th>DR TAX</th>
<th>DR BOOK</th>
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<td>$10,000</td>
<td>$16,666</td>
<td>$16,666</td>
<td>$16,666</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Capital account after exercise of DR’s option</td>
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<td>$10,000</td>
<td>$16,666</td>
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<td>Capital account after revaluation</td>
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<td>$16,666</td>
<td>$16,666</td>
<td>$16,666</td>
<td>$15,000</td>
<td>$16,666</td>
</tr>
</tbody>
</table>

(viii) If the assets of LLC are sold the day after DR exercises, an allocation of the $15,000 ($30,000 fair market value less $10,000 tax basis and $5,000 fair market value less a $10,000 basis) taxable gain cannot have an economic effect since it cannot properly be reflected in the partners’ book capital accounts (because the full fair market value is already reflected in the capital accounts). Instead, these items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax accounts and the book capital accounts are taken into account under the principles of section 704(c).

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Using the Buy-In Price Method when the Option Value and the Buy-In Price are Below the LVAE.

(i) In Year 1, AC and NE each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to DR. The option allows DR to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DR pays nothing to LLC for the issuance of the option because the option is issued in connection with services performed by DR for the LLC. Assume that the LLC agreement requires that on the exercise of a Compensatory Option LLC must comply with the rules of the Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to Compensatory Options are recognized under section 704(b). Also assume that DR’s option is a Compensatory Option and that DR is not treated as a partner with respect to the option. Also assume that the value of DR’s services maintains the value of the assets of LLC but does not add any net value (after the consideration of the compensation expense).

(ii) Prior to the exercise of DR’s option, ML contributes $15,000 to LLC for 100 units in LLC. At the time of ML’s contribution, Property A has a value of $30,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of DR’s option is $1,000.\(^\text{183}\)

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\(^\text{182}\) This example corresponds to Example 22 in the Proposed Regulations modified to apply discounts to determine fair market value and test the rules of the Proposed Regulations in a compensatory setting. However, the interim book-up is done based on the buy-in price. The example should also correspond with Example V.B(2) in the original report.

\(^\text{183}\) $30,000 + $5,000 + $15,000 + $15,000 = $65,000. $65,000 / 4 = $16,250. $16,250 - $15,000 = $1,250 less a 20% discount = $1,000. A 20% discount has been used for illustration purposes only. An option that is not immediately exercisable may have a value above or below the LVAE.
Upon ML’s admission to the partnership, the capital accounts of AC and NE (which were $10,000 each prior to ML’s admission) are booked-up to reflect the deemed fair market value of the partnership assets based upon ML’s purchase price. Accordingly, AC and NE’s capital accounts must each be increased to $15,000. Because the assets reflect a combination of $20,000 of built-in gain in Property A and $5,000 of built-in loss in Property B, in order to increase the capital accounts by a net of $10,000 the book value of Property A must be increased to $25,000 and the book value of Property B must be reduced to $5,000. The $15,000 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between AC and NE in accordance with section 704(c) principles.

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>BASIS</th>
<th>VALUE</th>
<th>704(C) BOOK</th>
</tr>
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<tbody>
<tr>
<td>Property A</td>
<td>$10,000</td>
<td>$30,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Property B</td>
<td>$10,000</td>
<td>$ 5,000</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$20,000</td>
<td>$35,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Cash contributed by ML</td>
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<td>$15,000</td>
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</tr>
<tr>
<td>Total</td>
<td>$35,000</td>
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<tr>
<th>LIABILITIES AND CAPITAL</th>
<th>TAX</th>
<th>BOOK VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>AC</td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>NE</td>
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<td>$15,000</td>
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<tr>
<td>ML</td>
<td>$15,000</td>
<td>$15,000</td>
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<tr>
<td>Option</td>
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<td>Total</td>
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</tr>
</tbody>
</table>

After the admission of ML, when Property A still has a value of $30,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, DR exercises the option. On the exercise of the option, DR’s capital account is credited with the amount paid for the option ($0) and the exercise price of the option ($15,000). In addition, DR is deemed to have contributed value to the partnership equal to the excess of the amount paid for the LLC interest and the value of the LLC interest. Although the liquidation value of the LLC interest is $16,250, DR obtains an appraisal that the fair market value is the $15,000 that DR paid to exercise the option, so DR recognizes no income and is not deemed to contribute any additional property. Under the LLC agreement, however, DR is entitled to LLC capital corresponding to 100 units of LLC (1/4 of LLC’s capital). Immediately after the exercise of the option, LLC’s assets are worth $65,000 ($15,000 contributed by DR, plus the value of LLC assets prior to the exercise of the option, $50,000). DR is entitled to LLC capital equal to 1/4 of this value, or $16,250. As DR is
entitled to $1,250 more LLC capital than DR’s capital contributions to LLC, the Adjustments on Exercise apply.

(v) Under the Adjustments on Exercise, the LLC must increase DR’s capital account from $15,000 to $16,250 by first revaluing LLC property in accordance with the Book-Up Rules and allocating the first $1,250 of book gain to DR. The net increase in the value of LLC properties since the previous revaluation is $5,000 (the difference between the actual value of Property A, $30,000, and the book value of Property A, $25,000). The first $1,250 of book gain is allocated to DR. The remaining $3,750 of gain must be allocated among the remaining partners to reflect their economic agreement:

<table>
<thead>
<tr>
<th></th>
<th>AC</th>
<th>NE</th>
<th>ML</th>
<th>DR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account after admission of ML</td>
<td>$10,000</td>
<td>$15,000</td>
<td>$10,000</td>
<td>$15,000</td>
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<tr>
<td>Capital account after exercise of DR’s option</td>
<td>$10,000</td>
<td>$15,000</td>
<td>$10,000</td>
<td>$15,000</td>
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<tr>
<td>Revaluation</td>
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<td>$15,000</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Capital account after revaluation</td>
<td>$16,250</td>
<td>$16,250</td>
<td>$15,000</td>
<td>$16,250</td>
</tr>
</tbody>
</table>

(viii) If the assets of LLC are sold the day after DR exercises, an allocation of the $15,000 ($30,000 fair market value less $10,000 tax basis and $5,000 fair market value less a $10,000 basis) taxable gain cannot have an economic effect since it cannot properly be reflected in the partners’ book capital accounts (because the full fair market value is already reflected in the capital accounts). Instead, these items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax accounts and the book capital accounts are taken into account under the principles of section 704(c).

(d) Using the Subtraction Method of the Proposed Regulations Without Valuation Discounts.

(i) In Year 1, AC and NE each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to DR. The option allows DR to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DR pays nothing to LLC for the issuance of the option because the option is issued in connection with services performed by DR for the LLC. Assume that the LLC agreement requires that on the exercise of a Compensatory Option LLC must comply with the rules of the Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to Compensatory Options are recognized under section 704(b). Also assume that DR’s option is a Compensatory Option and that DR is not treated as a partner with respect to the option.

(ii) Prior to the exercise of DR’s option, ML contributes $16,666 to LLC for 100 units in LLC. At the time of ML’s contribution, Property A has a value of $30,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of DR’s option is $1,666.\(^{186}\)

(iii) Upon ML’s admission to the partnership, the capital accounts of AC and NE (which were $10,000 each prior to ML’s admission) are, in accordance with the Book-Up Rules, adjusted upward to reflect their shares of the unrealized appreciation in the partnership’s assets. Under the Book-Up Rules, those adjustments must be based on the fair market value of LLC property\(^{187}\) on the date of the adjustment.\(^{188}\) The fair market value of partnership property ($35,000) must be reduced by the excess of the fair market value of the option as of the date of

\[^{186}\] $30,000 + $5,000 + $16,666 + $15,000 = $66,666. $66,666 / 4 = $16,666. $16,666 - $15,000 = $1,666.

\[^{187}\] Taking Code section 7701(g) into account.

\[^{188}\] Immediately prior to the entry of ML into the LLC. See, Treas. Reg. § 1.704-1(b)(5), Ex. 14.
the adjustment over the consideration paid by DR to acquire the option ($1,666),\textsuperscript{189} but only to the extent of the unrealized appreciation in LLC property ($15,000). Therefore, the revaluation adjustments must be based on a value of $33,333. Accordingly, AC and NE’s capital accounts must be increased to $16,666. This $1,666 reduction\textsuperscript{190} is allocated entirely to Property A, the only asset having unrealized appreciation. Therefore, the book value of Property A is $28,333. The $18,333 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between AC and NE in accordance with section 704(c) principles.

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>BASIS</th>
<th>VALUE</th>
<th>OPTION ADJUSTMENT</th>
<th>704(C) BOOK</th>
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</thead>
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<tr>
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<tr>
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<td>ML</td>
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<td>Total</td>
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</table>

(iv) After the admission of ML, when Property A still has a value of $30,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, DR exercises the option. In connection with the admission of DR as a partner, the Partnership would book-up the value of Property A to $30,000 in accordance with Regulations § 1.704-1(b)(2)(iv)(f). The increase in the book value ($1,666) would be allocated equally to AC, NE and ML, increasing their capital accounts to $17,221. On the exercise of the option, DR’s capital account is credited with the amount paid for the option ($0) and the exercise price of the option ($15,000). In addition, DR is deemed to have contributed value to the partnership equal to the excess of the value of the LLC interest over the amount paid for the LLC interest, $16,666, so DR recognizes


\textsuperscript{190} The value of the option pursuant to Prop. Reg. § 1.704-1(b)(2)(iv)(h)(2).

\textsuperscript{191} This number has been adjusted to correct for a rounding issue.
$1,666 of income and is deemed to contribute $1,666 of property to the LLC, increasing DR’s capital account to $16,666. At the same time, LLC recognizes a $1,666 deduction that is allocated equally among AC, NE and ML, which reduces their capital accounts to $16,666, each.

<table>
<thead>
<tr>
<th></th>
<th>AC</th>
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</thead>
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<tr>
<td>admission of ML</td>
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<td>$16,666</td>
<td>$16,666</td>
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<tr>
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<tr>
<td>exercise of DR’s option</td>
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<td>$10,000</td>
<td>$10,000</td>
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<tr>
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<tr>
<td>Deemed Contribution</td>
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<td>$16,666</td>
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</tr>
<tr>
<td>Deduction</td>
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<td>$555</td>
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<td>Capital accounts after</td>
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<td>Deduction</td>
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<td>$16,111</td>
<td>$16,666</td>
<td>$16,666</td>
</tr>
</tbody>
</table>

(v) If the assets of LLC are sold the day after DR exercises, an allocation of the $15,000 ($30,000 fair market value less $10,000 tax basis and $5,000 fair market value less a $10,000 basis) taxable gain cannot have economic effect since it cannot properly be reflected in the partners’ book capital accounts (because the full fair market value is already reflected in the capital accounts).\(^{192}\) Instead, these items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax accounts and the book capital accounts are taken into account under the principles of section 704(c).\(^{193}\)


\(^{193}\) Treas. Reg. § 1.704-1(b)(4)(i).
Example 5. Capital Interest Subject to a Substantial Risk of Forfeiture.

(i) In Year 1, AC and NE each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues a Capital Interest to DR of 100 units in LLC. DR pays nothing to LLC for the issuance of the option because the option is issued in connection with services performed by DR for the LLC. However, if DR is not employed by LLC at the beginning of Year 2, DR will forfeit all rights to her interest in LLC. DR does not make an election in respect of the Capital Interest under section 83(b). Assume that the LLC agreement requires that on the vesting of a Capital Interest LLC must comply with the rules of the Adjustments on Exercise, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to vested Capital Interests are recognized under section 704(b). Also assume that the value of DR’s services maintains the value of the assets of LLC, but does not add any net value (after the consideration of the compensation expense).

(ii) Prior to the exercise of DR’s option, ML contributes $15,000 to LLC for 100 units in LLC. At the time of ML’s contribution, Property A has a value of $40,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of DR’s Capital Interest is $15,000.195

(iii) Upon ML’s admission to the partnership, the capital accounts of AC and NE (which were $10,000 each prior to ML’s admission) are, in accordance with the Book-Up Rules, adjusted upward to reflect their shares of the unrealized appreciation in the partnership’s assets. Under the Book-Up Rules, those adjustments must be based on the fair market value of LLC property196 on the date of the adjustment.197 The fair market value of partnership property

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194 $3 disappears because of rounding.
195 Without regard to the risk of forfeiture. $40,000 + $5,000 + $15,000 = $60,000. $60,000 / 4 = $15,000.
196 Taking Code section 7701(g) into account.
197 Immediately prior to the entry of ML into the LLC. See, Treas. Reg. § 1.704-1(b)(5), Ex. 14.
($45,000) must be reduced by the excess of the fair market value of DR’s Capital Interest as of the date of the adjustment,\textsuperscript{198} but only to the extent of the unrealized appreciation in LLC property ($15,000). Therefore, the revaluation adjustments must be based on a value of $30,000. Accordingly, AC and NE’s capital accounts must be increased to $15,000. This $15,000 reduction\textsuperscript{199} is allocated entirely to Property A, the only asset having unrealized appreciation. Therefore, the book value of Property A is $25,000. The $15,000 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between AC and NE in accordance with section 704(c) principles.

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>BASIS</th>
<th>VALUE</th>
<th>SRF INTEREST ADJUSTMENT</th>
<th>704(C) BOOK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A</td>
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</tr>
<tr>
<td>Property B</td>
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<td>0</td>
<td>$5,000</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>$20,000</td>
<td>$45,000</td>
<td>($15,000)</td>
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<td>Cash contributed by ML</td>
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<tr>
<td><strong>Total</strong></td>
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<td>$60,000</td>
<td>($15,000)</td>
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<table>
<thead>
<tr>
<th>LIABILITIES AND CAPITAL</th>
<th>TAX</th>
<th>BOOK VALUE</th>
</tr>
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<td>AC</td>
<td>$10,000</td>
<td>$15,000</td>
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<tr>
<td>NE</td>
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<td>$15,000</td>
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<tr>
<td>ML</td>
<td>$15,000</td>
<td>$15,000</td>
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<tr>
<td><strong>Option</strong></td>
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</tr>
<tr>
<td><strong>Total</strong></td>
<td>$35,000</td>
<td>$45,000</td>
</tr>
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</table>

(iv) After the admission of ML, when Property A still has a value of $40,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, DR’s Capital Interest becomes fully vested. In connection with the admission of DR as a partner for federal income tax purposes, the Partnership would book-up the value of Property A to $40,000 in accordance with Regulations § 1.704-1(b)(2)(iv)(f). The increase in the book value ($15,000) would be allocated equally among AC, NE and ML to bring their capital accounts up to $20,000. On the vesting of the Capital Interest, DR’s capital account is credited with the amount paid for the Capital Interest ($0). In addition, DR is deemed to have contributed value to the partnership equal to the excess of the value of the LLC interest over the amount paid for the LLC interest, $15,000, so DR recognizes $15,000 of income and is deemed to contribute $15,000 of property.


\textsuperscript{199} The value of the option pursuant to Prop. Reg. § 1.704-1(b)(2)(iv)(h)(2).
to the LLC, increasing DR’s capital account to $15,000. At the same time, LLC recognizes a $15,000 deduction that is allocated equally among AC, NE and ML, which reduces their capital accounts to $15,000, each.

<table>
<thead>
<tr>
<th>AC</th>
<th>NE</th>
<th>ML</th>
<th>DR</th>
</tr>
</thead>
<tbody>
<tr>
<td>TAX</td>
<td>BOOK</td>
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<tr>
<td>$5,000</td>
<td>$15,000</td>
<td>$5,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

(v) If the assets of LLC are sold the day after DR’s Capital Interest vests, an allocation of the $25,000 ($40,000 fair market value less $10,000 tax basis and $5,000 fair market value less a $10,000 basis) taxable gain cannot have an economic effect since it cannot properly be reflected in the partners’ book capital accounts (because the full fair market value is already reflected in the capital accounts).\(^{200}\) Instead, these items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax accounts and the book capital accounts are taken into account under the principles of section 704(c).\(^{201}\)

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\(^{201}\) Treas. Reg. § 1.704-1(b)(4)(i).
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<thead>
<tr>
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<th>NE TAX</th>
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Allocation of taxable gain under section 704(c) principles:

Capital accounts after Deduction:

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<th>ML TAX</th>
<th>DR TAX</th>
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Capital account after allocation under section 704(c) principles:

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<th>AC TAX</th>
<th>NE TAX</th>
<th>ML TAX</th>
<th>DR TAX</th>
<th>BOOK</th>
<th>BOOK</th>
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<td>$15,000</td>
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202 $3 disappear because of rounding.