July 14, 2014

The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Treatment of Noncompensatory Options on a Partnership Interest

Dear Commissioner Koskinen:

Enclosed are comments on the treatment of noncompensatory options on a partnership interest (“Comments”). These Comments represent the view of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

Michael Hirschfeld
Chair

Enclosure

cc: William J. Wilkins, Chief Counsel, Internal Revenue Service
Curt Wilson, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Benjamin Weaver, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Craig Gerson, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Paul Carman of the Partnerships & LLCs Committee of the Section of Taxation. Substantive contributions were made by Ari S. Berk, Jason Yen, Todd D. Golub and Howard Abrams. The Comments were reviewed by Adam M. Cohen, Committee Chair of the Partnership & LLCs Committee, and Matthew Stevens, Committee Chair of the Financial Transactions Committee. The Comments were further reviewed by William H. Caudill of the Section’s Committee on Government Submissions, Eric B. Sloan, Council Director for the Partnerships & LLCs Committee, and Lucy W. Farr, Council Director for the Financial Transactions Committee.

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

Contact: Paul Carman

Phone 312-845-3443

Email carman@chapman.com

Date: July 14, 2014
Executive Summary

On February 5, 2013, the Internal Revenue Service (the “Service”) and the Department of the Treasury (the “Treasury”) finalized regulations relating to the treatment of noncompensatory partnership options. Simultaneously, proposed regulations were issued expanding the list of measurement events for characterizing an option, and clarifying the application of section 1234(b) to the grantor of an option. The preamble requested comments on the proposed regulations as well as on the question of whether section 751 should apply to the lapse, repurchase, sale, or exchange of a noncompensatory partnership option (a “section 1234 event”).

Our specific recommendations are listed below. All of our recommendations attempt to balance the interest of the government in collecting taxes based upon the appropriate characterization of income with the practical limitations on the taxpayer’s ability to obtain the information to make a precise determination of the amount of tax owed.

Our recommendations are divided in three major sections. First, we discuss how the information that a measurement event has occurred may be conveyed among the relevant parties. Second, we discuss issues related to a potential non-application of section 751. Finally, we discuss both the mechanical issues and the information reporting issues if section 751 applies.

I. Measurement Events

We recommend that the final Regulations provide that, if an adjustment is made to the terms of a noncompensatory option, and if the issuing partnership determines that the option is characterized as equity as a result of the measurement event, then the issuing partnership must notify the option holder of the measurement event and the characterization of the option as equity within 45 days after the adjustment has become effective.

We recommend that the final Regulations provide that, if an adjustment is made to the terms of the partnership agreement of the issuing partnership, and if the issuing partnership determines that the option is characterized as equity as a result of the measurement event, then the issuing partnership must notify the option holder of the measurement event and the characterization of the option as equity within 45 days after the adjustment has become effective.

References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

A “noncompensatory option” in this context includes options issued by a partnership, other than an option issued in connection with the performance of services. Reg. § 1.761-3(b)(2). An option is a contractual right to acquire an interest in the issuing partnership, including a call option, warrant, or other similar arrangement. In addition, an option includes convertible debt (as defined in Reg. § 1.721-2(g)(2)) and convertible equity (as defined in Reg. § 1.721-2(g)(3)). To achieve the purposes of Regulation section 1.761-3, the Commissioner can treat other contractual agreements, including a forward contract, a futures contract, or a notional principal contract, as an option. A contract that otherwise constitutes an option will not fail to be treated as an option for these purposes merely because it may or must be settled in cash or property other than a partnership interest. Reg. § 1.761-3(b)(3).
We recommend that the final Regulations provide that, if a measurement event is the issuance, or modification of an interest in, or liquidation of, the issuing partnership, and if the issuing partnership determines that the option is characterized as equity as a result of the measurement event, then the issuing partnership must notify the option holder of the measurement event and the characterization of the option as equity within 45 days after the adjustment has become effective.

We recommend that the final Regulations provide that, if the measurement event is the transfer of the noncompensatory option (other than to the issuing partnership) and if the transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder, the option holder must notify the issuing partnership of the measurement event within 45 days after the transfer becomes effective but in all events at least 45 days before the partnership’s tax return for the relevant period is required to be filed (without extensions). We further recommend that if the partnership determines that the option is characterized as equity as a result of the measurement event, the issuing partnership must promptly notify the option holder of the characterization of the option as equity.

We recommend that the final regulations provide that, if the measurement event is the issuance, transfer or modification of an interest in any look-through entity that directly owns the noncompensatory option and if such event is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder, the person issuing, transferring or modifying must notify the issuing partnership of the measurement event within 45 days after the transfer becomes effective but in all events at least 45 days before the issuing partnership’s tax return for the relevant period is required to be filed (without extensions). We further recommend that if the partnership determines that the option is characterized as equity as a result of the measurement event, the issuing partnership must promptly notify the option holder of the characterization of the option as equity.

We recommend that the final regulations provide that, if the measurement event is (i) the transfer of an interest in the issuing partnership, (ii) the issuance, transfer or modification of an interest in any look-through entity that directly owns the noncompensatory option indirectly through one or more look-through entities, or (iii) the issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership and if the event described in clause (i), (ii) or (iii) is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder, the person issuing, transferring, or modifying the indirect interest must notify the partnership and the option holder of the measurement event within 45 days after the transfer, issuance or modification has become effective but in all events at least 45 days before the partnership’s tax return for the relevant period is required to be filed (without extensions). We further recommend that if the partnership determines that the option is characterized as equity after the measurement event, the issuing partnership must promptly notify the option holder of
the measurement event and the characterization of the option as equity.

II. Non-Application of Section 751

In this report, we do not address whether it is appropriate for section 751 to apply to section 1234 events. We addressed that issue in comments submitted in 2002 (the “Original Comments”). In section 7.2 of the Original Comments beginning on page 35, we recommended that section 751 should not apply to sales of investment options. Assuming this view is adopted, we do not believe there is need for any additional regulations relating to section 751 and noncompensatory partnership options.

III. Application of Section 751

We recommend that the final Regulations provide that, if section 751 applies to a section 1234 event, the transferor recognize ordinary income in proportion to the amount of gain that would have been treated as ordinary income had the option holder first exercised the option, and the partnership then sold its assets for their fair market value.

We recommend that the final Regulations provide that, if section 751 applies to a section 1234 event, and a partner transfers an interest in the partnership at a time when value within the partnership should more appropriately be attributed to an outstanding option issued by the partnership (e.g., because the option was substantially “in the money”), to the extent gain is recognized on a section 1234 event, gain will be recognized as ordinary to the transferor as though the option holder had exercised the option.

We recommend that the final Regulations provide that, if section 751 applies to a section 1234 event, the partnership is obligated to provide the option holder with the information to determine the amount of gain or loss subject to ordinary income treatment.

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I. Background

In Notice 2000-294 (the “Notice”), the Service and 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.” On January 20, 2002, the Partnerships & LLCs Committee of the ABA Section of Taxation (the “Committee”) submitted the Original Comments to the Treasury in response to the Notice. REG-103580-025 (the “Notice of Proposed Rule Making”) requested further comments to be submitted to the Treasury, both on the proposed Regulations issued as part of the Notice of Proposed Rule Making (the “2003 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. The Committee also submitted comments in response to the 2003 Proposed Regulations (the “2003 Comments”).

On February 5, 2013, the Service and the Treasury published final Regulations relating to the treatment of the issuance and exercise of noncompensatory partnership options (the “Regulations”). On the same day, the Service and the Treasury issued proposed Regulations expanding the characterization rule measurement events and providing additional guidance in determining the character of the grantor’s gain or loss as a result of a closing transaction with respect to, or a lapse of, an option on a partnership interest (the “Proposed Regulations”). In the preamble to the Proposed Regulations, the Treasury and the Service requested comments on the appropriate procedures for notifying the partners and the partnership upon the occurrence of a measurement event. In addition, the Treasury and the Service requested comments on (1) if section 751(a) applies to the lapse, repurchase, sale, or exchange of a noncompensatory option, (a) how the option holder's share of income or loss from section 751 property would be determined under Regulation section 1.751-1(a)(2), and (b) how a partner in the issuing partnership that transfers its partnership interest while the option is outstanding would determine its share of income or loss from section 751 property under Regulation section 1.751-1(a)(2) (that is, should that share be reduced by the amount of income or loss from section 751 property attributable to the option holder); and (2) if section 751(a) does not apply to the lapse,

4 2000-1 C.B. 1241.
6 American Bar Association Section of Taxation, Comments in Response to REG-103580-02, 2003 TNT 213-21 (Oct. 9, 2003).
9 78 Fed. Reg. at 8061.
repurchase, sale, or exchange of a noncompensatory option, what measures, if any, should be taken to ensure that ordinary income is not permanently eliminated.10

These Comments will address certain issues raised by the Proposed Regulations related to the issuance of noncompensatory options by entities classified as partnerships.

II. Procedures for Notification of a Measurement Event

The following Comments examine specific situations in which a measurement event may arise. In each case, we make recommendations to identify the person that we believe is best able to notify the issuing partnership and the option holder that a measurement event has occurred.

The Regulations provide that a noncompensatory option is tested to determine whether the option provides rights substantially similar to a partner and whether there is a strong likelihood that the failure to treat the holder as a partner would result in a substantial reduction in the present value of the aggregate federal tax liabilities of the partners and the option holder on the date of a measurement event.11 The Regulations list three measurement events:

(i) Issuance of the noncompensatory option;
(ii) An adjustment of the terms (modification) of the noncompensatory option or of the underlying partnership interest … (including an adjustment pursuant to the terms of the noncompensatory option or the underlying partnership interest);
(iii) Transfer of the noncompensatory option if either:
   (A) The option may be exercised (or settled) more than 12 months after its issuance, or
   (B) The transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate federal tax liabilities of the partners and the noncompensatory option holder.

The Proposed Regulations would add three measurement events to the list above, but apply only if those measurement events are pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate federal tax liabilities of the partners and the noncompensatory option holder.12 The three additional measurement events are: (1) the issuance, transfer, or modification of an interest in, or liquidation of, the issuing partnership; (2) the issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns the noncompensatory option; and (3)

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10 78 Fed. Reg. at 8062.
11 Reg. § 1.761-3(a)(1).
the issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership.\textsuperscript{13}

The preamble to the Proposed Regulations requests comments on the appropriate procedures for notifying the partners and the partnership upon the occurrence of a measurement event.

As to the measurement events in the final Regulations, the first two events are events in respect of which both the issuing partnership and the option holder would generally be involved. If both are involved, it would seem that no notice would be required from either, unless the issuing partnership determines that the measurement event results in the option being characterized as equity. Further, there may be adjustments to the terms of the underlying partnership agreement without the involvement of the option holder, such as pursuant to an agreement by the partnership with a third party or an amendment of the partnership agreement by the existing partners. In either case, it would appear reasonable to require the partnership to notify the option holder of the adjustment within a reasonable period of time after the adjustment became effective (such as 45 days).

We recommend that the final Regulations provide that, if an adjustment is made to the terms of the noncompensatory option, and if the partnership determines that the option is characterized as equity as a result of the measurement event, then the partnership must notify the option holder of the measurement event and the characterization of the option as equity within 45 days after the adjustment has become effective.

If an adjustment is made to the terms of the partnership agreement of the issuing partnership, and if the partnership determines that the option is characterized as equity as a result of the measurement event, then we recommend that the final Regulations provide that the partnership must notify the option holder of the measurement event and the characterization of the option as equity within 45 days after the adjustment has become effective.

Similarly, if a measurement event is the issuance, or modification of an interest in, or liquidation of, the issuing partnership, the option holder may not be involved in the process, so we recommend that the final Regulations provide that, if a measurement event is the issuance, or modification of an interest in, or liquidation of, the issuing partnership, and if the partnership determines that the option is characterized as equity as a result of the measurement event, then the partnership must notify the option holder of the measurement event and the characterization of the option as equity within 45 days after the adjustment has become effective.

If the measurement event is the transfer of the noncompensatory option (other than to the issuing partnership), then the partnership would need to be informed of the measurement date in order to make the necessary determinations as to whether the option should be recharacterized. However, because the transfer of the noncompensatory option is only relevant to the

\textsuperscript{13} \textit{Id.}
recharacterization of the option as equity if it is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder, transfers that are not pursuant to such a plan should not create notification obligations. Absent a risk to the fisc, transfers of noncompensatory options should not be constrained by imposing a notification obligation. Further, notification is unnecessary if the transfer is back to the issuing partnership. We recommend that the final Regulations provide that if the measurement event is the transfer of the noncompensatory option, the transfer is not back to the issuing partnership and the transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder, the option holder must notify the partnership of the measurement event within 45 days after the transfer has become effective but in all events at least 45 days before the partnership’s tax return for the relevant period is required to be filed (without extensions). We further recommend that if the partnership determines that the option is characterized as equity as a result of the measurement event, the issuing partnership must promptly notify the option holder of the characterization of the option as equity.

Similarly, if the measurement event is the issuance, transfer or modification of an interest in any look-through entity that directly owns the noncompensatory option, the option holder should have knowledge of the measurement event but the partnership may not know absent notice by the option holder. However, to avoid imposing undue burdens and given that such an event is only relevant to the recharacterization of the option as equity if it is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder, notification is not warranted unless the event is pursuant to such a plan. We recommend that the final Regulations provide that if the measurement event is the issuance, transfer or modification of an interest in any look-through entity that directly owns the noncompensatory option and if such event is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder, the option holder must notify the partnership of the measurement event within 45 days after the transfer has become effective but in all events at least 45 days before the partnership’s tax return for the relevant period is required to be filed (without extensions). We further recommend that if the partnership determines that the option is characterized as equity as a result of the measurement event, the issuing partnership must promptly notify the option holder of the characterization of the option as equity.

On the other hand, if the measurement event is (i) the transfer of an interest in the issuing partnership, (ii) the issuance, transfer or modification of an interest in any look-through entity that indirectly through one or more look-through entities, owns the noncompensatory option, or (iii) the issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership, it is possible that neither the partnership nor the option holder would have direct involvement in the transaction. In such a situation, it would seem more practical for the
obligation to provide notice to fall on the person making the transfer or issuing or modifying the indirect interest. This is because this measurement event only applies to such events that are pursuant to the original tax reduction plan and such person, therefore, would have necessarily been part of such plan.

The relevant party that is responsible for giving notice to the other parties of the measurement event should do so regardless of whether the option is ultimately treated as equity since both the option holder and the partnership must be aware of the relevant facts in order to make the determination of whether the option should be treated as equity. However, because such events are only relevant to the recharacterization of the option as equity if it is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder, notification should not be required absent the event being pursuant to such a plan. Additionally, if a publicly traded partnership were to issue a noncompensatory option, there are likely to be many transfers of interests in that partnership that will have nothing to do with whether the option should be treated as equity and imposing notification requirements on every transfer would likely be unworkable in many publicly traded partnerships (or in any widely held partnership).

We recommend that the final Regulations provide that if the measurement event is (i) the transfer of an interest in the issuing partnership, (ii) the issuance, transfer or modification of an interest in any look-through entity that indirectly through one or more look-through entities, owns the noncompensatory option, or (iii) the issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership and if such event is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder, the person issuing, transferring, or modifying the indirect interest must notify the partnership and the option holder of the measurement event within 45 days after the transfer, issuance or modification has become effective but in all events at least 45 days before the partnership’s tax return for the relevant period is required to be filed (without extensions). We further recommend that if the partnership determines that the option is characterized as equity as a result of the measurement event, the issuing partnership must promptly notify the option holder of the measurement event and the characterization of the option as equity.

III. Application of Section 751 to Lapse, Sale, Exchange or Other Termination of a Noncompensatory Option

a. Background

The preamble to the Proposed Regulations considers the effect of the application of section 1234(a) to the disposition of a noncompensatory option. Under section 1234(a), gain or loss on the sale, exchange, or lapse of an option is considered gain or loss from the sale or exchange of property that has the same character as the referenced property in the option would have in the hands of the taxpayer.
Gain from the sale of a partnership interest by a partner is generally treated as gain from the sale of a capital asset except to the extent that section 751 applies. Section 751(a) requires the amount of money or the fair market value of property received by a transferor partner in exchange for a partnership interest to be considered as an amount realized from the sale or exchange of property other than a capital asset to the extent attributable to unrealized receivables of the partnership or inventory items of the partnership.

Regulation section 1.751-1(a)(2) provides that the income or loss realized by a partner upon the sale or exchange of the partner’s interest in section 751 property is the amount of income or loss from section 751 property (including remedial allocations under Regulation section 1.704-3(d)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the partner’s transfer of the interest in the partnership.

The preamble to the Proposed Regulations indicates that the Treasury and the Service continue to study the issue of whether and how section 751 could appropriately be applied in the context of the application of section 1234 to an option on an interest in a partnership. The Treasury and the Service further requested comments on (1) if section 751(a) applies to the lapse, repurchase, sale, or exchange of a noncompensatory option, (a) how the option holder’s share of income or loss from section 751 property would be determined under Regulation section 1.751–1(a)(2), and (b) how a partner in the issuing partnership that transfers its partnership interest while the option is outstanding would determine its share of income or loss from section 751 property under Regulation section 1.751-1(a)(2) (that is, should it be reduced by the amount of income or loss from section 751 property attributable to the option holder); and (2) if section 751(a) does not apply to the lapse, repurchase, sale, or exchange of a noncompensatory option, what measures, if any, should be taken to ensure that ordinary income is not permanently eliminated.

b. Assuming Section 751 Should Not Apply to Section 1234 Events

Not applying section 751 to section 1234 events should not permanently eliminate ordinary income. There are two occasions in which ordinary income could be a factor—the lapse, repurchase, sale, or exchange of a noncompensatory option holder’s option, and the sale or exchange of a current partner’s partnership interest. The non-application of section 751 to section 1234 events would not eliminate ordinary income. Ordinary income is not inherent in the option, assuming that the option is held as a capital asset (and the referenced partnership interest would be held as a capital asset). It would only be the application of section 751 that would create ordinary income at the level of the option holder.

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14 I.R.C. § 741.

15 This issue was addressed in more depth in comments submitted in 2002. See note 3 and accompanying text.
Without the application of section 751 to a section 1234 event, the option holder does not have a potential ordinary income inclusion until it exercises the option and becomes a partner (or is deemed to have become a partner). Therefore, not applying section 751 cannot eliminate ordinary income to the option holder because without applying section 751 in the first place, the option holder does not yet have ordinary income potential. Section 751 would continue to apply to the existing partners, so the amount of section 751 gain would be preserved.

Section 751 already applies to a current partner’s sale or exchange of its partnership interest regardless of whether it applies to a section 1234 event. The existence of the noncompensatory option may cause the price at which a partnership interest would be sold to go down. That, however, will not normally affect the amount of ordinary income a current partner would recognize under section 751 on the sale or exchange of its partnership interest. As discussed previously, the Regulations under section 751 use a subtraction method for determining the amount of gain recharacterized as ordinary income. Therefore, the selling partner will recognize an amount of ordinary income on the sale or exchange of its partnership interest commensurate with the value of the partnership’s section 751 assets regardless of the selling price of its partnership interest.

Since section 751 itself is what would cause a noncompensatory option holder to recognize ordinary income on a section 1234 event, and the current partners will recognize a full share of ordinary income under section 751 even if section 751 does not apply to the noncompensatory option, ordinary income is not permanently eliminated, and we do not recommend any additional measures if section 751 does not apply to section 1234 events. Further, given Regulation section 1.761-3(a)(1)(ii) considers overall tax reduction, the Regulations already sufficiently police the possible use of options in a manner that might eliminate the incremental tax on ordinary income that some taxpayers bear.

c. Assuming Section 751 Applies

Assuming section 751 generally applies to section 1234 events, three issues arise: (i) calculating the gain to an option holder, (ii) calculating the gain to the other partners, and (iii) reporting information necessary to comply with section 751.

1. Calculating The Gain to the Option Holder

The regulations under section 751 require an allocation of ordinary income first, with the residual gain being treated as capital gain, instead of dividing the gain recognized in proportion to the partnership’s unrealized appreciation in section 751 assets to non-section 751 assets. If section 751 applies to a section 1234 event as though the option holder had exercised the option and then sold the interest, the ordinary income an option holder would recognize upon the section 1234 event appears to be a function of the particular approach of the Regulations under section 751.

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16 Reg. § 1.751-1(a)(2).
The following example is based on Example 31 in the regulations under section 704, with some modifications. It illustrates how the approach employed in the Regulations under section 751 can duplicate ordinary income when applied to a section 1234 event.

In Year 1, A and B each contribute cash of $9,000 to LLC. LLC uses $10,000 to acquire non-depreciable Capital Asset and $8,000 to acquire non-depreciable Ordinary Asset. Later in Year 1, when Capital Asset is worth $11,000 and Ordinary Asset is worth $9,000, LLC issues an option to C. The option allows C to buy a 1/3 interest in LLC for $15,000 in Year 2. C pays $1,000 to LLC to purchase the option. Assume that the option is a noncompensatory option and that C is not treated as a partner with respect to the option. Under Regulation section 1.704-1(b)(2)(iv)(f)(5)(iv), LLC revalues its property in connection with the issuance of the option. The $1,000 of unrealized gain in Capital Asset and $1,000 of unrealized gain in Ordinary Asset is allocated equally to A and B. In Year 2, C sells the option for $2,000 recognizing $1,000 of gain. At the time the option is sold, Capital Asset is worth $20,000 and Ordinary Asset is worth $15,000.

If section 751 applies to a section 1234 event as though the option is exercised and then the interest is sold, under Regulation section 1.704-1(b)(2)(iv)(s)(1), LLC would revalue its property after the deemed exercise. Under Regulation sections 1.704-1(b)(2)(iv)(b) and (b)(2)(iv)(d)(4), C’s capital account would be credited with $16,000, the amount paid for the option ($1,000) and the exercise price of the option ($15,000). However, C would be entitled to $17,000 (1/3 of LLC’s total property value of $51,000, made up of $35,000 for Capital Asset and Ordinary Asset, $15,000 for C’s exercise price, and $1,000 for C’s purchase price). Since C would be entitled to $1,000 more of LLC’s capital than C’s capital contributions, Regulation section 1.704-1(b)(2)(iv)(s) would apply. LLC would increase C’s capital account from $16,000 to $17,000 by, first, revaluing its property. The total unrealized book gain is $15,000, $9,000 in Capital Asset and $6,000 in Ordinary Asset (Capital Asset would be booked up to $11,000 and Ordinary Asset was booked up to $9,000 previously). The first $1,000 of this gain would be allocated to C and the remaining $14,000 of the gain would be allocated equally to A and B. $9,000 is 60% of $15,000, so $600 of the unrealized gain in Capital Asset would be allocated to C, and $400 of the unrealized gain in Ordinary Asset would be allocated to C. Thus, if C sold his interest in LLC immediately after exercising the option, C would have $400 of ordinary income under section 751(a), and C’s remaining gain, $600, would be capital gain.

But, what if C sells his option at a discount? All the facts are the same except that C sells his option for $1,500 and recognizes $500 of gain. Should C still recognize $400 of ordinary income, which means that 80% of C’s gain is ordinary income, even though the unrealized

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17 Reg. § 1.704-1(b)(5), Ex. 31.
appreciation in Ordinary Asset represented only 40% of the total unrealized appreciation in LLC’s assets? Because the Regulations under section 751 use the subtraction approach to determine gain recharacterized as ordinary income, C would recognize $400 of ordinary income on the sale, exchange or lapse of an option regardless of how much gain C recognizes on the section 1234 event.18

In order to capture more fairly an option holder’s purported share of ordinary income upon a section 1234 event, we recommend that the final Regulations provide that, if section 751 applies to section 1234 events, the transferor will recognize ordinary income in proportion to the amount of gain that would have been treated as ordinary income had the option holder first exercised the option, and the partnership sold its assets for their fair market value. In the examples given above, C would still have $400 of ordinary income when C sells C’s option for $2,000, but C would (under the proportionate approach) only have $200 of ordinary income when C sells C’s option for $1,500 (because 40% of C’s gain would have been ordinary had C exercised the option and sold its partnership interest for fair market value).

Under the proportionate approach, ordinary income will still be duplicated because C has recognized ordinary income on the disposition of its option (even though that ordinary income is less than it would be under a non-proportionate approach). The amount of ordinary income remaining within the partnership allocable to A and B has not changed, so if A and B sell their interests, they will recognize all of LLC’s ordinary income despite the fact that C already recognized some portion of it. Likewise, the purchaser of C’s option will become entitled to a portion of the ordinary income in the partnership should the purchaser exercise the option, without the total amount of ordinary income remaining within the partnership changing.19 That is, the fact that the purchaser’s cost basis in the option exceeds the option’s original issue price may cause the purchaser to recognize less capital gain or more capital loss on the disposition of its partnership interest after exercising the option. But, it should not affect its share of the partnership’s ordinary income. This outcome is the result of the Regulations under section 751 applying the subtraction approach, which ensures that a partner recognizes its full share of ordinary income regardless of the gain such partner recognizes on the sale of such partner’s partnership interest.

2. Calculating The Gain to Other Partners

In the example above, if A and B sold their partnership interests in Year 2 (after C sold its option but before the buyer exercises the option) for $34,000 ($35,000 asset value plus $1,000 cash less $2,000 option capital if exercised) and section 751 applied without modification, A and

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18 While we recognize that a similar issue arises if a partnership interest is sold at a discount, the issue is more acute as to options, which are more likely to be sold at a discount. Without an adjustment under section 743, upon the transfer of the option, the ordinary income is not eliminated upon such transfer, making the subtraction method uniquely ill suited to the transfer of an option.

19 The ordinary income in the partnership would not change on the transfer of an option that is not treated as equity because the option is not a partnership interest and no adjustment under section 743 will be made, whether or not an election has been made under section 754.
B would be allocated a total of $7,000 of ordinary income. If the partnership sold all of its property for its FMV, it would recognize $7,000 of ordinary income, all of which would be allocated to A and B because the new option holder is not necessarily treated as a partner. Regulation section 1.751-1(a)(2) provides that the partner’s ordinary income on the sale of its interest is equal to the gain from section 751 property that would be allocated to the partner if the partnership sold all of its property for cash in an amount equal to the fair market value of the property. The partner’s capital gain is the capital gain it would have recognized in the absence of section 751, minus its ordinary income. Here, A and B would recognize a total of $16,000 of gain ($34,000 amount realized less $18,000 outside basis). Of that, $7,000 would be ordinary income (if LLC sold Ordinary Asset it would recognize $7,000 of ordinary income because Ordinary Asset had a value of $15,000 and a basis of $8,000) and $9,000 would be capital gain (the remainder of A’s and B’s $16,000 of gain). The section 751 regulations do not take into account the possibility that the sales price of the partnership interest may be less than the value of the partnership’s assets attributable to that interest due to an outstanding option. This means that in total (taking into consideration the gain on the sale of the option and the gain on the sale of the partnership interests) $7,400 of ordinary income would have been recognized even though there was only $7,000 of unrealized ordinary income in the partnership’s assets.

If section 751 applies to section 1234 events and a partner transfers an interest in the partnership at a time when value within the partnership should more appropriately be attributed to an outstanding option issued by the partnership (if, for example, the option was substantially in the money), the pricing of the sale of the partnership interest should already reflect the value attributable to the option. However, as noted above, the Regulations under section 751 use a subtraction method for determining the amount of gain recharacterized as ordinary income. Because the option is unexercised, a partnership interest related to the option does not yet exist, and no ordinary income would be allocated to the option holder on a hypothetical sale of the partnership’s property. The result is that all of the partnership’s ordinary income would be allocated to the partners on a hypothetical sale of the partnership’s property even though some of the value giving rise to that ordinary income is more appropriately attributed to an outstanding option. The combination of the subtraction method and the fact that the option is unexercised, therefore, can increase the amount of duplication of ordinary income when an option is outstanding. We, therefore, recommend that the final Regulations provide that, if section 751 applies to section 1234 events in the context of noncompensatory options, the following treatment should apply. If a partner transfers an interest in the partnership at a time when value within the partnership should more appropriately be attributed to an outstanding option issued by the partnership, to the extent gain has already been recognized on a section 1234 event, gain be recognized as ordinary to the transferor as though the option holder had exercised the option.

If A and B sold their partnership interests after C sold its option, and if the final regulations treated A and B as though C had exercised its option, then the holder of C’s option would be treated as a partner for purposes of calculating A’s and B’s ordinary income. Because the holder of C’s option would be entitled to $400 of ordinary income if the holder of C’s option were a partner, A and B would be allocated only $6,600 of ordinary income ($1,000 of ordinary income from the original revaluation, and an additional $5,600 of ordinary income from the revaluation that would have occurred if C had been deemed to have exercised its option). If C had sold its option for $2,000, C would have recognized $400 of ordinary income as described
above, and the total ordinary income recognized by A, B, and C would be $7,000. If C had sold its option for $1,500, however, C would have recognized only $200 of ordinary income (applying the proportionate approach described above), and A, B, and C would have recognized only $6,800 of ordinary income—$200 less than was in the partnership. This, however, is the correct result because the parties whose ordinary income should add up to $7,000 are A, B, and whoever ultimately exercises C’s option (who would recognize $400 of ordinary income if it exercised the option and immediately sold the partnership interest regardless of the price at which C sold the option). 20

3. Information Reporting Necessary to Comply with Section 751

If section 751 applies to a section 1234 event on a partnership interest under section 1234(a), a strict, technical approach would require the option holder to determine the nature of the underlying assets of the partnership and allocate the amount realized on the section 1234 event to the appropriate class of assets under Regulation section 1.751-1. If the referenced partnership is the issuer of the option, this may be the appropriate answer. Given that Regulation section 1.721-2(g)(1) defines “option” as an option issued by the partnership, it seems appropriate to require the partnership, as the issuer of the option, to provide the option holder with the information to make the appropriate allocation.

We, therefore, recommend that the final Regulations provide that, if section 751 applies to a section 1234 event, the partnership is obligated to provide the option holder with the information to make the appropriate allocation.

20 This also illustrates why, if section 751 applies to a section 1234 event, ordinary income will in some part be duplicated. The fact that C recognizes some ordinary income on the disposition of its option does not reduce the total ordinary income in the partnership.