

# Client Alert

Latham & Watkins Tax Department

## IRS Issues Final Regulations on Noncompensatory Partnership Options

On February 4, 2013, the Internal Revenue Service (IRS) released final regulations addressing the tax treatment of noncompensatory partnership options (NPOs) and certain related matters. Prior to the release of the final regulations, the tax treatment of options to acquire equity in a partnership was uncertain. The IRS previously issued proposed regulations on NPOs in January 2003, which were generally well-received. Ten years later, the final regulations on NPOs largely adopt the 2003 proposed regulations with minor modifications. These regulations are effective for NPOs issued on or after February 5, 2013, and will provide taxpayers with greater certainty regarding the tax consequences of NPOs.

“New final regulations on noncompensatory partnership options largely adopt the 2003 proposed regulations with minor modifications, and will provide taxpayers with greater certainty regarding the tax treatment of such options.”

### Issuance, Exercise, Lapse, Repurchase and Other Terminations of an NPO

The final regulations apply to any option issued by a partnership, other than an option issued in connection with the performance of services. For this purpose, an option includes any contractual right to acquire an interest in the issuing partnership, including a call option, warrant or other similar arrangement, as well as the conversion feature of convertible debt or convertible equity. The regulations grant the IRS the authority to treat derivatives as options if necessary to achieve the purposes of the regulations.

*Issuance of an NPO.* The final regulations provide that the issuance of an NPO is treated as an open transaction for the issuing partnership, resulting in no immediate gain or loss recognition to the partnership. As for the holder of an NPO, the acquisition of the NPO is simply an investment (*i.e.*, a nondeductible capital expenditure). However, if the holder uses appreciated or depreciated property (*i.e.*, property with a value greater or less than the holder's tax basis in the property) to acquire the NPO, the holder would generally recognize gain or loss on the acquisition.

*Exercise of an NPO.* Subject to certain exceptions, the exercise of an NPO generally is treated as a tax-free capital contribution to the partnership, resulting in no gain or loss recognition by the NPO holder or the partnership. The NPO holder's capital contribution is the amount initially paid for the option plus any consideration paid to exercise the option. In order to prevent the conversion of ordinary income into capital gain, the regulations except from the general non-recognition treatment

any issuance of a partnership interest upon conversion of convertible debt of the partnership to the extent the issuance is in satisfaction of the partnership's obligation for unpaid interest on the debt that accrued on or after the date the holder acquired the debt. The regulations similarly except option exercises to the extent the exercise price is satisfied with the partnership's obligation to the option holder for unpaid rent, royalties or interest. Under either exception, the NPO holder will be required to recognize the rent, royalty or interest income, but the partnership will not recognize gain or loss.

*Lapse, Repurchase and Other Dispositions of an NPO.* The lapse of an NPO generally will be a taxable event for both the partnership and the option holder, with the partnership recognizing income and the holder recognizing loss, in each case equal to the amount initially paid for the option. Settlement of an NPO for cash or property other than a partnership interest likewise will be a taxable event. Under newly proposed regulations released concurrently with the final regulations, gain or loss recognized by the partnership in connection with the lapse or settlement of an NPO would be treated as short-term capital gain or loss, consistent with the rules applicable to stock options. The IRS is continuing to consider the appropriate character of gain or loss recognized by the NPO holder on the lapse, settlement, sale or exchange of an NPO.

## **Accounting for NPOs**

The final regulations generally adopt the approach of the 2003 proposed regulations with respect to accounting for the issuance and exercise of an NPO. In general, this approach requires that upon the exercise of an NPO, the exercising holder's initial capital account is credited with the amount initially paid for the option plus the option's exercise price. Immediately following the exercise of the NPO, the partnership is required to revalue its property and allocate any unrealized gain or loss in the partnership's assets first to the NPO holder until his capital account accurately reflects his right to share in partnership capital, and then to the historic partners. To the extent items of unrealized gain or loss are insufficient for this purpose, the partnership must reallocate capital between the historic partners and the NPO holder (a capital account reallocation). In such cases, the partnership must then make corrective allocations of gross taxable income or loss to the partners in the year in which the NPO is exercised to account for the capital account reallocation. If there are not sufficient actual partnership items in the year of exercise to conform the partnership's tax allocations to the capital account reallocation, corrective allocations are required in subsequent years.

Notable changes from the 2003 proposed regulations include:

- The partnership is permitted to revalue its property in connection with the issuance of the NPO and thereby may prevent the shifting of unrealized appreciation arising prior to the issuance of the option to the option holder.
- Upon conversion of convertible debt of the partnership, the convertible debt holder's capital account will be credited with the adjusted issue price of the debt rather than the holder's adjusted tax basis in the debt, providing economic parity to original holders and secondary purchasers.
- In allocating unrealized gain or loss in connection with any revaluation of the partnership property while an NPO is outstanding or in connection with the exercise of an NPO, the partnership may take into account special allocations and otherwise give effect to the economic arrangements among the partners.

## Re-Characterization of NPOs

Wary of potential abuse, both the 2003 proposed regulations and the final regulations authorize the re-characterization of an NPO as a partnership interest, and the option holder as a partner, if at the time the NPO is issued, modified or transferred, the rights of the option holder are substantially similar to those of a partner and there is a strong likelihood that the failure to treat the NPO holder as a partner would result in a substantial reduction in the present value of the partners' and holder's aggregate federal tax liabilities. The final regulations attempt to clarify and provide greater certainty regarding the application of this characterization rule, but ultimately require a facts and circumstances analysis.

*The "Substantially Similar" Test.* The final regulations evaluate whether a holder's rights are substantially similar to the rights of a partner by examining (1) whether the NPO is reasonably certain to be exercised and (2) whether the holder has partner attributes. Failure of either prong could result in characterization of an NPO as a partnership interest.

The final regulations provide two objective safe harbors for determining whether an NPO is reasonably certain to be exercised. Under the first safe harbor, an NPO is not considered reasonably certain to be exercised if it may be exercised no more than 24 months after the date of the applicable measurement event and it has a strike price equal to or greater than 110 percent of the fair market value of the underlying partnership interest on the date of the measurement event. Under the second safe harbor, an NPO is not considered reasonably certain to be exercised if the terms of the option provide that the exercise price of the option is equal to or greater than the fair market value of the underlying partnership interest on the exercise date. Neither of these safe harbors will apply if a principal purpose of the NPO was to reduce substantially the present value of the aggregate federal tax liabilities of the partners and the NPO holder.

Transactions outside these safe harbors will be evaluated based on all facts and circumstances. Similar to the 2003 proposed regulations, the final regulations enumerate a non-exclusive list of factors to be considered, including the fair market value of the underlying partnership interest, the exercise price and term of the NPO, the volatility of the underlying partnership interest and anticipated distributions by the partnership.

The final regulations similarly mandate that the determination of whether an NPO holder possesses partner attributes will be made based on all facts and circumstances. Relevant considerations include the extent to which the option holder shares in the economic benefit and detriment of partnership income and loss above and beyond the benefits and detriments inherent in an option, and the extent to which the option holder has the right to participate in the management of the partnership. Partner attributes generally do not include rights of an NPO holder to restrict partnership actions that could substantially affect the value of the underlying partnership interest, including typical dilution protections.

*The "Strong Likelihood" Test.* In determining whether there is a strong likelihood that the failure to treat the NPO holder as a partner would result in a substantial reduction in the present value of the partners' and holder's aggregate federal tax liabilities, the final regulations provide that all facts and circumstances should be considered, including: (1) the interaction of the partnership's allocations and the partners' and holder's federal tax attributes, (2) the absolute amount of the federal tax reduction, (3) the amount of the reduction relative to the overall federal tax liability and (4) the timing of income and deductions. If a partner or NPO holder

is a look-through entity, such as a partnership or S corporation, or a member of a consolidated group, the tax attributes of that entity's ultimate owners or consolidated group will be taken into account in determining whether there is a strong likelihood of substantial tax reduction.

*Testing Events.* The characterization of an NPO generally is required to be tested upon issuance, modification and certain transfers of the NPO. The following events are not measurement events that trigger the testing of an NPO's characterization: (1) a transfer of an NPO at death or between spouses or in a transaction that is disregarded for federal tax purposes, (2) a modification that neither materially increases the likelihood that the option will be exercised nor provides the option holder with partner attributes, (3) a change in the strike price or the underlying partnership interest made pursuant to a bona fide, reasonable adjustment formula intended to prevent dilution and (4) any other event provided in IRS guidance.

In a further effort to curb potential abuse, concurrently with the release of the final regulations, the IRS issued additional proposed regulations that would require testing the characterization of an NPO upon the following events: (1) issuance, transfer or modification of an interest in the issuing partnership, (2) 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 NPO and (3) 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. Testing would only be required if the relevant event is pursuant to a plan in existence at the time of the issuance or modification of the NPO that has as a principal purpose the substantial reduction in the present value of the partners' and holder's aggregate federal tax liabilities.

*Timing and Effect of Characterization.* The final regulations provide that the characterization of an NPO as a partnership interest applies upon the issuance of the NPO, or immediately prior to the measurement event that gave rise to the characterization. Once an NPO is treated as a partnership interest under the characterization rule, it may not be subsequently characterized as an option.

*Continued Application of General Tax Principles.* The final regulations clarify that the characterization rule does not supplant general tax principles that would characterize an NPO as a partnership interest. For example, a penny warrant with rights to current distributions from a partnership that would be treated as partnership equity under substance over form principles will be treated as partnership equity, without regard to the application of the characterization rule.

## **Miscellaneous**

The final regulations also provide guidance on the following additional matters relating to NPOs:

*Convertible Bond Provision.* Under existing rules, the amount of bond premium on a convertible bond does not include any amount attributable to the conversion feature of a bond. The final regulations provide that those rules apply to convertible debt of a partnership.

*Original Issue Discount (OID) Provisions.* Current regulations regarding OID contain special rules for convertible debt. The final regulations apply such rules to convertible debt of a partnership.

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