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New Tax Regulations on Noncompensatory Partnership Options

The Internal Revenue Service and Department of the Treasury published in the February 5, 2013 *Federal Register* final income tax regulations on noncompensatory partnership options (the "Regulations").[1] At the same time, the IRS and Treasury published a Notice of Proposed Rulemaking (NPRM) on noncompensatory partnership options.[2] The Regulations generally follow proposed regulations published in January 2003, but the IRS and Treasury made changes in response to comments received.

This outline summarizes and provides observations on the Regulations with particular emphasis on items that are likely to be of interest to mezzanine debt funds and other funds that occasionally receive warrants in limited liability companies or limited partnerships in connections with loans.

1. Effective Date.

   a. General Effective Date. The Regulations generally apply to noncompensatory options issued on or after February 5, 2013. They should not apply to noncompensatory options issued before that date, but if prior law is unclear, the IRS could assert that one or more provisions in the Regulations reflect prior law.

   b. **OBSERVATION:** *In some cases, partnerships may seek to apply provisions of the Regulations to noncompensatory options issued before the effective date because of the absence of other guidance. For example, the Regulations may provide a reasonable methodology for determining the consequences of the exercise of a noncompensatory option.*

   c. Noncompensatory Options.

      i. The term "noncompensatory option" means an option issued by a partnership other than in connection with the performance of services.

      ii. The term "option" means a contractual right to acquire an interest in the issuing partnership, including a call option, warrant or other similar arrangement. The term also includes convertible debt and convertible equity (equity convertible from one type of equity to another).

[1] The Regulations can be found at: http://www.gpo.gov/fdsys/pkg/FR-2013-02-05/pdf/2013-02259.pdf.

[2] The proposed regulations can be found at: http://www.gpo.gov/fdsys/pkg/FR-2013-02-05/pdf/2013-02260.pdf.

2. Options Treated as Partnership Interests.

a. General Rule. The Regulations treat a noncompensatory option as a partnership interest for all Federal tax purposes if, on the date of a "measurement event," the following two conditions (i. and ii.) are satisfied:

i. Rights Similar to Rights Afforded a Partner. The noncompensatory option provides the option holder with "rights that are substantially similar to rights afforded a partner." This condition can be satisfied in either of two ways:

a) Reasonably Certain To be Exercised. "[T]he option is reasonably certain to be exercised."

i) The Regulations provide a list of eight factors for determining whether an option is reasonably certain to be exercised and all are of the type one would expect to find on such a list. *See* Reg. § 1.761-3(d)(2)(i).

ii) The Regulations also provide safe harbors. The safe harbors generally look for a strike price that at least equals the fair market value of the underlying partnership interest.

iii) **OBSERVATION:** *This is a trap for the unwary because it is not obvious that such an option provides rights similar to rights afforded a partner.* ***This means that virtually all penny warrants, deep-in-the money options (and other warrants and options with low exercise prices relative to the value of the underlying interest) will be treated as providing "rights that are substantially similar to rights afforded a partner."***

b) Other Partnership Attributes. The option holder possesses "partnership attributes."

i) In determining whether a holder possesses "partnership attributes," the Regulations focus on voting rights and managerial rights arising from the option or related agreements, but generally exclude rights arising from the holder also being a partner.

ii) An option holder with rights "to participate in partnership profits through present possessory rights to share in current operating or liquidating distributions with respect to the underlying partnership interests" has partner attributes as does a holder that undertakes obligations that are similar to those undertaken by a partner to bear losses.

ii. <u>Strong Likelihood of a Substantial Tax Reduction</u>. "There is a **strong likelihood** that the failure to treat the holder of the option as a partner would result in a **substantial reduction** in the present value of the partners' and option holder's aggregate Federal tax liabilities."

a) In applying this test, look-through entities such as partnerships, members of consolidated groups, and S corporations are looked through to find the ultimate taxpayers.

b) The Regulations provide no guidance on the meaning of "strong likelihood" or "substantial reduction."

c) The determination is "based on all of the facts and circumstances, including:

i) "The interaction of the allocations of the issuing partnership and the partners' and noncompensatory option holder's Federal tax attributes (taking into account tax consequences that result from the interaction of the allocations with the partners' and noncompensatory option holder's Federal tax attributes that are unrelated to the partnership;

ii) "The absolute amount of federal tax reduction;

iii) "The amount of reduction relative to overall Federal tax liability; and

iv) "The timing of items of income and deduction."

d) **<u>OBSERVATIONS</u>:**

i) Since treating a fund as a partner in an operating company can lead to foreign members of the fund being treated as engaged in a U.S. trade or business and tax-exempt members of the fund having unrelated business taxable income (UBTI), many funds will have to make the present value assessment before accepting directly (as opposed to through a blocker corporation) a new warrant with a low exercise price.

ii) If the option holder is a pass-through entity with tax-exempt members, not allocating income to the option holder will often result in an increase (rather than reduction) in the present value of the taxation of the income of an operating company.

(a) *Individual partners of an operating company may pay income tax at a marginal rate as high as 39.6% and Medicare tax or net investment income tax at a rate of 3.8%. Individual partners who are not in the highest bracket may still have combined rates in excess of 35%. A tax-exempt entity subject to UBTI will pay tax at a maximum Federal income tax rate of 35%. Tax-exempt corporations are not subject to the 3.8% net investment income tax.*

(b) *The test may be easiest to apply in the case of funds with domestic governmental entities (including, in most cases, state and local governmental pensions funds) holding substantial ownership interests because the governmental entities should be fully exempt from tax. Allocating income away from them increases the present value of tax revenue.*

(c) *If the portfolio company's business plan is for the company to be sold in five years, consider the extent to which the consequences of a sale need to be taken into account in determining present value.*

iii) *In applying this test, potential option holders should watch for situations in which there are substantial up-front losses that the partners of the partnership are able to use, but some or all of option holder's members could not use or use currently because of passive loss rules or other loss limitation rules.*

iv) *It often will be difficult to obtain the information needed to make the present value calculation. For example, a fund manager may not know the tax positions of the fund participants or of the venture capitalists who have invested in the issuing partnership*

v) *This test creates a significant and repeated burden for analysis. The present value will need to be tested when the option is issued and on each measurement date.*

vi) *Funds with strong commitments not to generate U.S. source trade or business income or UBTI may feel compelled to use blocker corporations to hold their new warrants in LLCs and partnerships (or to require the LLC or partnership to elect to be taxed as a corporation).*

b. <u>General Principles of Federal Tax Law</u>. A noncompensatory option that is not treated as a partnership interest under the rules noted above can be treated as a "partnership interest under general principles of Federal tax law." This throws more uncertainty into the picture, but does not create any additional risk (beyond what already existed) for noncompensatory options structured in the same manner as they were before the Regulations were adopted.

c. <u>Consequence</u>.

i. If a noncompensatory option is treated as a partnership interest, the holder is to receive a distributive share of the partnership's income, gain, loss, deduction and credit in accordance with the holder's interest in the partnership.

ii. **OBSERVATION:** *This may not result in significant allocations to an option holder if the price for the option reflected its value and the partnership is in an income earning mode and distributes amounts equal to its income to its official partners, but will likely result in allocations of income to the option holder if profits are used to pay principal on debt or are retained. Even de minimis allocations will present problems if the partnership is conducting a trade or business and the option holder is a pass-through entity with tax-exempt or foreign members.*

d. <u>Measurement Events</u>.

i. Issuance of a noncompensatory option.

ii. Modification of the terms of the option or the underlying partnership interest.

iii. Transfer of the option if the option can be exercised more than 12 months after issue or transfer is pursuant to a tax avoidance plan.

iv. Proposed regulations included in the NPRM would include three additional measurement events. The events would apply only if they are pursuant to a plan in existence at the time of the issuance or modification of the option that "has a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder."

a) Issuance, transfer or modification of an interest in, or liquidation of, the issuing partnership.

b) Issuance, transfer or modification of an interest in a look-through entity that owns the option (either directly or indirectly through another look-through entity).

c) Issuance, transfer or modification of an interest in any look-through entity that owns an interest in the issuing partnership (either directly or indirectly through another look-through entity).

v. Non-measurement events:

a) Transfers at death or between spouses,

b) Modification that neither materially increases likelihood of exercise nor provides the holder with partner attributes, or

c) A change in strike price or in the interests in the issuing partner made pursuant to a formula to prevent dilution.

3. Consequences of an Acquisition of Noncompensatory Options.

a. Transfer of Property. In the case of the transfer of appreciated or depreciated property to a partnership in exchange for a noncompensatory option, the transferor generally will recognize gain or loss (subject to other provisions of the Code) on the transfer. The partnership will not recognize income for receipt of the property while the option is outstanding.[3]

b. Satisfaction of a Partnership Obligation. If the holder receives the option in satisfaction of a partnership obligation, the holder should recognize income to the same extent as it would have recognized income if it had received the lesser of the amount due or the fair market value of the noncompensatory option.

c. Consequence to a Partnership. The partnership will not recognize income for the receipt of property while the option is outstanding.

d. **OBSERVATION:** *These rules should not present new issues in the case of a lender that receives a noncompensatory option in connection with a loan. The lender should be treated as paying cash for the option. The amount transferred to the borrower will continue to have to be allocated between the loan and the option based on the fair market value of the option. The amount allocated to the option generally becomes OID under the loan.*

4. Cash Settled Options; Sale of Options.

a. Cash settlement of a noncompensatory option should be treated as the sale or exchange of the option and taxed under section 1234 rather than as a contribution to the partnership followed by an immediate redemption. Section 721 does not apply.

[3] A different rule applies in the case of a transfer for convertible equity.

b. The preamble to the Regulations indicates that general tax principles apply in the event that an option is exercised and the interest immediately redeemed. Such a transaction could be recharacterized as a cash settlement of the option.

c. The NPRM seeks comments on the character of gain or loss on the lapse, repurchase, sale or exchange of a noncompensatory option and suggests the possibility that the "hot asset" rules of section 751 apply to a gain on the sale of a noncompensatory option.

d. **OBSERVATION:** *If section 751 applies and causes a portion of the gain to be ordinary income from a trade or business, a new final rule could present great trouble for funds with tax-exempt or foreign investors. They may not be able to hold directly (as opposed to through a blocker corporation) noncompensatory options in partnerships with the expectation that they can sell the options without triggering UBTI or causing foreign investors to be treated as engaged in a U.S. trade or business.*

5. Consequences of the Exercise of a Noncompensatory Option.

a. Capital Account. An exercising option holder's initial capital account before adjustment described below is the amount paid for the option plus the amount paid to exercise it. In the case of converted convertible debt, the initial capital account equals the adjusted issue price of the debt plus the accrued unpaid qualified stated interest on the debt immediately before conversion.

b. Book Adjustments.

i. Upon exercise of an option, the partnership first allocates unrecognized income, gain or loss (i.e., not previously reflected in capital accounts) in the assets of the partnership to the exercising partner to the extent necessary to reflect the partner's right to share in the partnership capital under the partnership agreement. Then, any remaining unrecognized gain or loss is allocated to the historic partners to reflect how such income, gain or loss would be allocated among them if the property had been disposed of in a taxable disposition for fair market value. Section 704(c) rules will apply to the portion of the book adjustments addressed through unrecognized gain.

ii. **OBSERVATION:** *If the option holder is allocated book income under this step, the recognition of taxable income is likely to be deferred until the relevant assets are sold.*

c. Capital Account Reallocation.

i. To the extent that book adjustments are not sufficient to cause the exercising partner's capital account to reflect that partner's right to share in partnership capital under the partnership agreement, the Regulations call for a capital account reallocation. Capital account reallocations are effected through "corrective allocations." If the capital account reallocation is from the historic partners to the exercising option holder, the corrective allocations are first made with gross income and gain. If that is not sufficient, then corrective allocations are made through allocations of gross loss and deduction. (The ordering is reversed if the allocation is from the exercising option holder to the historic partners.)

ii. **OBSERVATIONS:**

a) *A capital account reallocation generally will result in phantom income to the exercising option holder. (A capital account reallocation will result in a loss if the partner's right to share in partnership capital is less than the sum of the amount paid to acquire the option and the exercise price.)*

b) *A capital account reallocation is most likely to be required in situations in which the partnership has done a relatively recent revaluation and has not taken into account (as now required by the Regulations) outstanding noncompensatory options or if the option was acquired for a bargain amount and there has been little increase in the value of the partnership's assets and relatively little tax depreciation.*

c) *Option holders that expect to exercise should encourage the partnership to comply with the capital account revaluation rules in the Regulations.*

d. Required Terms in a Partnership Agreement.

i. If a partnership agreement grants a partner the right to share in partnership capital upon the exercise of noncompensatory options, the Regulations indicate capital accounts will be considered to be determined and maintained in accordance with regulations only if the partnership agreement requires corrective allocations to take into account capital account reallocations.

ii. OBSERVATION**:** *Some partnership agreements (including those with "targeted capital account" allocations) rely on a substantial equivalence test for their allocations to be honored. In such case, it may not be necessary for the partnership agreement to actually reflect the requirements relating to corrective allocations, but the partnership may nonetheless need to make the corrective allocations.*[4]

[4] See observation below about targeted capital account allocations.

e. The General Nonrecognition Rule is Not Applicable in Certain Situations.

i. The general nonrecognition rule does not apply to the extent that the exercise price is satisfied with the partnership's obligation to pay the holder for unpaid rent, royalties, or interest (including OID).

ii. The section 721 nonrecognition rules do not apply to the transfer of a partnership interest upon the conversion of convertible debt in the partnership to the extent that the transfer is in satisfaction of the partnership's indebtedness for unpaid interest (including accrued OID) on convertible debt that accrued on or after the beginning of the convertible debt holder's holding period for the debt. A similar rule applies to the extent that the exercise price is satisfied with the partnership's obligation to the option holder for unpaid rent, royalties, or interest (including accrued OID) that accrued on or after the beginning of the option holder's holding period for the obligation.

iii. The preamble indicates that section 721(b) (which provides that the general nonrecognition rule of section 721(a) does not apply to gain realized on the transfer of property to an "investment company") applies to the exercise of noncompensatory options. (Thus, gain could be recognized if the partnership is an investment company and the strike price is paid with appreciated property.)

6. Lapse of Option.

a. Gain or Loss. Lapse of a noncompensatory option generally results in the recognition of income by the partnership and loss by the holder in an amount equal to the option premium.

b. Character of Gain or Loss to Partnership. The NPRM would treat partnership interests as securities for purposes of section 1234(b). As a result, if the proposed regulation is adopted, in the case of the grantor of an option (i.e., the partnership), gain or loss from any closing transaction with respect to, and gain on lapse of, the option is generally treated as resulting from the sale or exchange of a short-term capital asset.

c. Character of Gain or Loss to the Option Holder. In the case of option holders, any gain or loss resulting from an option transaction maintains the same character as the property to which it relates had that property remained in the hands of the taxpayer. Proposed regulations seek comments on the character of gain or loss to the option holder on the sale or exchange of, or loss on failure to exercise, an option and, in particular, whether the hot asset rules of section 751 apply.

7. Revaluations (Book-Ups) of Capital Accounts.

a. Permissive "Revaluation Event". The Regulations make issuance of a noncompensatory option a "permissible revaluation event." Thus, the partnership can elect to revalue capital accounts at such time.

b. Revaluations While Options are Outstanding. Revaluations while options are outstanding must take into account the fair market value of outstanding noncompensatory options. If the fair market value of outstanding options exceeds the consideration paid by the option holders, the value of the partnership property reflected on the partnership's books must be reduced by that excess to the extent of unrealized gain in partnership property. If the fair market value of the outstanding options exceeds the premiums paid, the value of the assets on the partnership's books is adjusted upwards. The Regulations provide guidance on how to make these adjustments. (How the adjustments are made will have relevance in subsequent applications of section 704(c).)

c. **OBSERVATION:** *The revaluation rules should be taken into account in partnerships with "targeted capital account" allocation provisions. Standard partnership "targeted capital account" allocation language does not take this rule into account. Under this rule, a portion of the hypothetical liquidating distribution should be treated as being made to option holders.*

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