Final noncompensatory partnership option rules could affect wide range of arrangements

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In brief

The IRS on February 4 finalized the noncompensatory partnership option (NCPO) regulations (T.D. 9612) regarding the issuance, lapse, exercise, and accounting of an NCPO. The IRS also issued proposed regulations that address "closing transactions" and would expand the recharacterization measurement events to include certain transfers of interests in the issuing partnership and other look-through entities (REG-106918-08). The regulations provide guidance on the key issues that arise when options or convertible partnership interests are issued to investors.

The final regulations are effective for NCPOs issued on or after February 5, 2013. The proposed regulations are proposed to be effective for the same date.

In detail

Definitions

An NCPO is any option issued by a partnership used to acquire a partnership interest, except options issued in connection with the performance of services. For this purpose, the term “option” is defined as any call option, warrant, or the conversion feature of convertible equity or debt.

The final regulations define convertible equity as “equity in a partnership that is convertible into a different equity interest in the partnership that issued the convertible equity.” The final regulations permit the IRS to treat other contractual agreements, such as forward and futures contracts and notional principal contracts, as NCPOs. The final regulations do not extend nonrecognition treatment to options issued by disregarded entities that would convert to partnerships upon the exercise of the option.

Issuance of NCPO

The issuance of an NCPO by a partnership is determined under “open-transaction” principles. Therefore, neither the partnership nor the NCPO holder generally recognizes gain or loss on issuance of the option, unless the NCPO holder transfers appreciated or depreciated property to the partnership in exchange for the NCPO.

Lapse or repurchase of an NCPO

The lapse of an NCPO generally results in recognition of income by the partnership and loss by the holder of the lapsed option. The proposed regulations treat a partnership interest as a security for purposes of Section 1234(b). As a result, gain or loss from any closing transaction (that is, any termination of the NCPO other than exercise) or lapse with respect to the option for the grantor of the NCPO generally is treated as gain or loss from the sale or exchange of a capital asset held for not more than one year.

With respect to the NCPO holder, Section 1234(a) treats the character of gain or loss recognized on the sale, exchange, loss, or failure to exercise an option as gain or loss from the sale or exchange of property that has the same character as the property to which the option relates in the hands of the taxpayer. Thus, generally an NCPO would be treated as a capital asset.

Exercise of an NCPO

Generally, upon the exercise of an NCPO, the NCPO holder is viewed as contributing property in the form of the option premium, the exercise price, and the option privilege to the partnership in exchange for the partnership interest. On exercise of the NCPO, the partnership revalues its property immediately after the exercise of the option. To the extent necessary to reflect the NCPO holder's right to share in partnership capital under the partnership agreement, the partnership must allocate the unrealized income, gain, or loss in partnership property from the revaluation to the NCPO holder until the NCPO holder's capital account equals the value of his partnership interest.

If there is insufficient unrealized appreciation or depreciation in the partnership assets to reflect the NCPO holder's value in the holder's partnership interest, the partnership must reallocate capital between the existing partners and the exercising NCPO holder. Following a capital account reallocation, the regulations require "corrective allocations" to account for any shift that occurs as a result of the capital account reallocation. Corrective allocations are gross allocations of partnership income and loss that are used to account for any capital shift that occurs as a result of the exercise of the option. Thus, if there is not sufficient unrealized appreciation to allocate to the NCPO holder, the conversion will be partially taxable.

Accounting of an NCPO

The final regulations add the issuance of an NCPO as a permissible revaluation event for purposes of maintaining partner's capital accounts. In addition, any revaluation of the partner's capital accounts during the period in which an NCPO is outstanding must take into account the outstanding NCPO. If the fair market value of the outstanding NCPO on the date of the revaluation is greater than the consideration to be paid to acquire the option, the value of the partnership property is reduced by such value to provide "headroom."

Characterization rule

In general, the regulations respect NCPOs and do not recharacterize an NCPO as partnership equity. However, the regulations provide for a "characterization rule" that treats the NCPO holder as a partner in certain circumstances.

The characterization rule provides that if on the date of certain measurement events, an NCPO provides the holder with rights substantially similar to the rights afforded to a partner, then the holder should be treated as a partner and the option should be taken into account in allocating partnership income. This rule applies only if, at the time of measurement, there is a strong likelihood that the failure to treat the holder of the NCPO as a partner would result in a substantial reduction in the present value of the partners' and the holder's aggregate tax liabilities.

The final regulations provide guidance on what facts and circumstances will be taken into consideration in determining whether an NCPO provides its holder with rights that are "substantially similar" to the rights afforded to a partner at the time of a measurement event. If the NCPO is "reasonably certain to be exercised" or if the NCPO holder possesses "partner attributes," the NCPO will be deemed to be exercised at the time of the measurement event.

The regulations specify which events will be treated as a measurement event and certain events that will not. The issuance, modification, and transfer of an NCPO if the option may be exercised more than 12 months after its issuance are measurement events. In addition, issuance, transfer, or modification of an interest in (1) the issuing partnership; (2) any look-through entity that directly or indirectly owns the NCPO; and (3) any look-through entity that directly or indirectly owns an interest in the issuing partnership are measurement events under the proposed regulations. The proposed regulations limit the application of testing under these additional events to events that are pursuant to a plan in existence at the time of the issuance or modification of the NCPO that has a principal purpose of reducing the US federal income tax liabilities of the partners and NCPO holder.

In addition, the final regulations include two safe harbors under the characterization rule to assist taxpayers in determining whether an option is "reasonably certain to be exercised":

- The first safe harbor provides that an NCPO 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.

- The second safe harbor provides that an NCPO is not considered reasonably certain to be exercised if the terms of the option provide that the strike price of the option is equal to or greater than the fair market value of the underlying partnership interest on the exercise date.

The determination of whether an NCPO holder possesses "partner attributes" is based on a facts-and-circumstances test. The final regulations clarify the economic benefits and burdens relevant to satisfying the partner attributes test, including that any other arrangements affecting, or undertaken with a principal purpose of affecting, the likelihood that the NCPO will be exercised will be considered a factor and that general principles of law will continue to apply.

The takeaway

As the use of these instruments has grown along with the growth of partnerships generally, the finalization of these long-awaited regulations will add clarity for taxpayers on the federal income tax treatment of these instruments.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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