

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Part 1****[REG-103580-02]****RIN 1545-BA53****Noncompensatory Partnership Options****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership. The proposed regulations generally provide that the exercise of a noncompensatory option does not cause the recognition of immediate income or loss by either the issuing partnership or the option holder. The proposed regulations also modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. Additionally, the proposed regulations contain a characterization rule providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by April 29, 2003. Requests to speak and outlines of oral comments to be discussed at the public hearing scheduled for May 20, 2003, at 10 a.m. must be received by April 29, 2003.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-103580-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:ITA:RU (REG-103580-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS internet site at <http://www.irs.gov/regs>. The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT:

Concerning the regulations, Audrey W. Ellis, (202) 622-3060; concerning submissions, the hearing, and/or to be placed on the building access list to

attend the hearing, Treena Garrett, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:**Background**

In a variety of situations, partnerships issue options or convertible instruments that allow the holder to acquire by purchase or conversion an equity interest in the partnership. On June 5, 2000, Treasury and the IRS issued Notice 2000-29 (2000-1 C.B. 1241) inviting public comment on the Federal income tax treatment of the exercise of an option to acquire a partnership interest, the exchange of convertible debt for a partnership interest, and the exchange of a preferred interest in a partnership for a common interest in that partnership.

In response to Notice 2000-29, Treasury and the IRS received a number of comments. Many commentators requested guidance on the treatment of options and other instruments that are issued by partnerships in connection with the performance of services (compensatory options).

These proposed regulations apply to certain call options, warrants, convertible debt, and convertible preferred equity that are not issued in connection with the performance of services (noncompensatory options). To expedite the issuance of guidance, these regulations do not address compensatory options. Nothing in the proposed regulations should be construed as creating any inference regarding the proper Federal income tax treatment of compensatory options. However, Treasury and the IRS are working on future guidance that will address the Federal income tax consequences of compensatory options and invite comments. In particular, Treasury and the IRS request comments on the proposed amendment to § 1.721-1(b)(1) that was published in the **Federal Register** on June 3, 1971 (36 FR 10787), and, more particularly, on the application of section 83 to the issuance of compensatory options and partnership capital interests in connection with the performance of services. In addition, Treasury and the IRS request comments on how to coordinate the tax treatment of partnership profits interests issued in connection with the performance of services (see Rev. Proc. 93-27 (1993-2 C.B. 343), as clarified in Rev. Proc. 2001-43 (2001-34 I.R.B. 191)) with the tax treatment of options to acquire partnership capital interests issued in connection with the performance of services.

Explanation of Provisions**1. Scope of Proposed Regulations**

The proposed regulations describe certain of the income tax consequences of issuing, transferring, and exercising noncompensatory options. These proposed regulations apply only if the call option, warrant, or conversion right entitles the holder to the right to acquire an interest in the issuer (or to cash or property having a value equal to the value of such an interest).

The proposed regulations generally 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. In addition, the proposed regulations modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. Finally, the proposed regulations contain a characterization rule providing that the holder of a call option, warrant, convertible debt, or convertible preferred equity issued by a partnership (or an eligible entity, as defined in § 301.7701-3(a), that would become a partnership if the option holder were treated as a partner) is treated as a partner under certain circumstances.

The rule providing for nonrecognition of gain or loss on the exercise of a noncompensatory option does not apply to any call option, warrant, or convertible debt issued by an eligible entity, as defined in § 301.7701-3(a), that would become a partnership under § 301.7701-3(f)(2) if the option, warrant, or conversion right were exercised. Treasury and the IRS request comments on whether the nonrecognition rule should be extended to such instruments.

2. Issuance, Exercise, and Lapse of Noncompensatory Options

Section 721(a) and § 1.721-1 provide that, with certain exceptions, no gain or loss is recognized to a partnership or any of its partners on the contribution of property to a partnership in exchange for an interest in the partnership. However, § 1.721-1 does not provide clear guidance as to the tax consequences to the holder of a noncompensatory option and the partnership upon the issuance, lapse, and exercise of a noncompensatory option to acquire a partnership interest. Many taxpayers have requested guidance clarifying the tax consequences of these transactions.

Generally, the proposed regulations do not treat the issuance of a noncompensatory option as a