

transaction described in section 721. Therefore, the issuance of a noncompensatory option is taxed under general tax principles. Under these principles, the issuance of a noncompensatory call option or warrant (stand-alone option) is generally an open transaction for the issuer. The issuer's income or loss from the noncompensatory stand-alone option does not become fixed and determinable until the lapse, exercise, repurchase, or other termination of the option. For the holder of the noncompensatory stand-alone option, the purchase of the option is merely an investment in the option—a capital expenditure that is neither taxable to nor deductible by the holder. See Rev. Rul 78-182 (1978-1 C.B. 265). However, if the holder uses appreciated or depreciated property (property with a value greater or less than the holder's basis in the property) to acquire the noncompensatory stand-alone option, then the holder recognizes gain or loss in accordance with the provisions of section 1001, subject to the generally applicable rules governing the allowance of losses, such as section 707(b).

The proposed regulations do not change the rules relating to the issuance of convertible debt or convertible equity. Under general tax principles, the conversion right embedded in convertible debt or convertible equity typically is taken into account for tax purposes as part of the underlying instrument.

The proposed regulations also provide guidance on the tax consequences resulting from the exercise of a noncompensatory option. Section 1.721-1(b) provides that, to the extent that a partner gives up his right to be repaid all or a portion of his capital contribution in favor of another partner “as compensation for services (or in satisfaction of an obligation),” section 721 does not apply. Some commentators have expressed a concern that this regulation could be read to exclude from the application of section 721 a shift in partnership capital from the historic partners to the holder of the noncompensatory option in satisfaction of the partnership's option obligation upon exercise of the option. If this were the case, the partnership could be deemed to have sold a portion of each of its assets to the holder in a taxable exchange. Alternatively, the partnership could be deemed to have sold a partnership interest with a \$0 basis to the option holder in a taxable exchange.

Despite these concerns, most commentators believe that § 1.721-1(b)(1) should not cause the issuance of a partnership interest upon exercise of

a noncompensatory option to be taxable. They assert that the exercise of such an option should be nontaxable to the holder and the partnership, both under general tax principles applicable to noncompensatory options and under the policy of section 721 to facilitate business combinations through the pooling of capital.

Treasury and the IRS agree that, in general, the issuance of a partnership interest to the holder of a noncompensatory option should not be taxable to the holder or the partnership. Upon exercise, the option holder may be viewed as contributing property in the form of the premium, the exercise price, and the option privilege to the partnership in exchange for the partnership interest. Generally, this is a transaction to which section 721 should apply—a transaction through which persons join together in order to conduct a business or make investments. Accordingly, the proposed regulations generally provide that section 721 applies to the holder and the partnership upon the exercise of a noncompensatory option issued by the partnership.

The proposed regulations do not describe the tax consequences (to the partnership or the holder) of a right to convert partnership debt into an interest in the issuing partnership to the extent of any accrued but unpaid interest on the debt (including accrued original issue discount). On the one hand, based on *Carman v. Commissioner*, 189 F.2d 363 (2d Cir. 1951), it might be argued that the interest obligation is inseparable from the debt and that both are property for purposes of section 721. On the other hand, it may be appropriate to require a partnership to recognize gain to the extent of the accrued but unpaid interest, because the issuance of the partnership interest satisfies a deductible (or capital) expense of the partnership. As this issue is closely related to the tax treatment of the exercise of compensatory options, Treasury and the IRS have decided to consider this issue in the course of preparing guidance on compensatory options. Treasury and the IRS request comments on the proper treatment of the exercise of convertible debt to the extent of accrued, but unpaid, interest (including original issue discount) on the debt.

The proposed regulations also clarify that section 721 does not apply to the lapse of a noncompensatory option. If a noncompensatory option lapses, the former option holder does not contribute property to the partnership in exchange for an interest in the partnership. Accordingly, consistent

with general tax principles, the lapse of a noncompensatory option generally results in the recognition of income by the partnership and the recognition of loss by the former option holder.

3. Accounting for Noncompensatory Options

The proposed regulations also contain rules to assist partnerships in properly accounting for any shifts in capital that may result from the exercise of noncompensatory options.

Generally, upon the exercise of a noncompensatory option, the option holder receives a partnership interest with a value that is greater or less than the aggregate value of the premium and exercise price that the option holder contributes to the partnership. In other words, the option privilege represents an asset with built-in gain or loss, *i.e.*, an asset to which section 704(c) would apply. However, because the option privilege terminates upon its contribution to the partnership, the partnership cannot allocate gain or loss from the option privilege to the option holder under section 704(c)(1)(A). To address this problem, the proposed regulations generally allow partnerships to substitute built-in gain or loss in the partnership's assets for the built-in gain or loss in the option.

The proposed regulations achieve this result by providing that a noncompensatory option holder's initial capital account is equal to the consideration paid to the partnership to acquire the noncompensatory option and the fair market value of any property (other than the option) contributed to the partnership on the exercise of the noncompensatory option. The proposed regulations then require the partnership to revalue its property immediately following the exercise of the noncompensatory option, when the holder has become a partner. Under the proposed regulations, the partnership must allocate the unrealized income, gain, loss, and deduction from this revaluation, first, to the noncompensatory option holder, to the extent necessary to reflect the holder's right to share in partnership capital under the partnership agreement, and, then, to the historic partners, to reflect the manner in which the unrealized income, gain, loss, or deduction in partnership property would be allocated among those partners if there were a taxable disposition of such property for its fair market value on that date. To the extent that unrealized appreciation or depreciation in the partnership's assets has been allocated to the capital account of the noncompensatory option holder, the holder will, under section 704(c)