

principles, recognize any income or loss attributable to that appreciation or depreciation as the underlying assets are sold, depreciated, or amortized.

In some cases, the built-in gain or loss in the option will exceed the unrealized appreciation or depreciation in the partnership's assets (that has not been reflected in the partners' capital accounts previously). In those cases, even after all of the unrealized appreciation or depreciation in the partnership's assets has been allocated to the option holder, a disparity may remain between the noncompensatory option holder's right to share in partnership capital and the value of money and other property contributed by the partner. Most commentators have recommended and Treasury and the IRS agree that the partnership nevertheless should be allowed to shift capital between the historic partners and the noncompensatory option holder on the exercise of the noncompensatory option.

Some commentators also have suggested that the historic partners and the noncompensatory option holder should be allocated notional tax items over the recovery period for partnership assets similar to the remedial allocations that are permitted, but not required, under the regulations issued under section 704(c)(1)(A). Although the use of section 704(c) notional tax items would ensure that the noncompensatory option holder and the historic partners receive the proper amount of income and loss over time, Treasury and the IRS believe that implementing such a system would be unduly complex where the built-in gain or loss to be allocated to the noncompensatory option holder exceeds the built-in gain or loss in the partnership's assets.

Instead, the proposed regulations require that the partnership make corrective allocations of gross income or loss to the partners in the year in which the option is exercised so as to take into account any shift in the partners' capital accounts that occurs as a result of the exercise of a noncompensatory option. These corrective allocations are allocations of tax items that differ from the partnership's allocations of book items. If there are not sufficient actual partnership items in the year of exercise to conform the partnership's tax allocations to the capital shift, additional corrective allocations are required in succeeding taxable years until the capital shift has been fully taken into account.

The proposed regulations also provide rules for revaluing the partners' capital accounts while a noncompensatory option is outstanding. Section 1.704-1(b)(2)(iv) contains rules for maintaining

a partnership's capital accounts. Section 1.704-1(b)(2)(iv)(f) provides that a partnership may, upon the occurrence of certain events (including the contribution of money to the partnership by a new or existing partner), increase or decrease the partners' capital accounts to reflect a revaluation of partnership property. If one or more options are outstanding when a revaluation occurs, and the revaluation does not account for the value associated with the outstanding options, the partners' capital accounts will not reflect the true economic value of their interests. For example, in partnerships with appreciated property, the historic partners' capital accounts often would overstate the distributions that would be made to the partners if the partnership were liquidated, because a portion of the partnership's assets may ultimately be paid to the option holder. Therefore, the proposed regulations modify § 1.704-1(b)(2)(iv)(f) and (h) to provide that any revaluation during the period in which there are outstanding noncompensatory options generally must take into account the fair market value, if any, of outstanding options.

4. Characterization Rule

Under section 704(b), a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined under the partnership agreement if the allocation under the agreement has substantial economic effect. If the allocation does not have substantial economic effect, or the partnership agreement does not provide for the allocation, then the allocation must be made in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances). Section 1.704-1(b)(2)(ii)(h) provides in part that, for this purpose, the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement, including puts, options, and buy-sell agreements. Currently, there is some uncertainty about the extent to which these rules require a partnership to take into account a noncompensatory option to acquire an interest in a partnership when making its annual allocations.

Treasury and the IRS believe that it is appropriate to clarify these rules with respect to noncompensatory options addressed in this project. As these

proposed regulations are limited to noncompensatory options, nothing in these proposed regulations provides any inference as to the operation of this rule for compensatory options or other types of agreements.

Given the uncertainty of the exercise of most noncompensatory options, Treasury and the IRS believe that noncompensatory options generally should not be treated as entitling the holder to a fixed right to share in partnership income until the option is exercised. However, if a noncompensatory option provides the holder with rights that are 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. At the same time, Treasury and the IRS recognize that treating a noncompensatory option holder as a partner may, in some circumstances, frustrate the intent of the parties without substantially altering their aggregate tax liabilities.

For these reasons, the proposed regulations generally respect noncompensatory options as such and do not characterize them as partnership equity. However, the proposed regulations contain a rule that characterizes the holder of a noncompensatory option as a partner if the option holder's rights are substantially similar to the rights afforded to a partner. This rule applies only if, as of the date that the noncompensatory option is issued, transferred, or modified, there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate tax liabilities.

The proposed regulations use a facts and circumstances test to determine whether a noncompensatory option holder's rights are substantially similar to the rights afforded to a partner, including whether the option is reasonably certain to be exercised and whether the option holder has partner attributes. The proposed regulations list a number of factors that are used to determine whether a noncompensatory option is reasonably certain to be exercised, including the premium paid for the option, the exercise price of the option, the term of the option, the predictability and stability of the value of the underlying partnership interest, and whether the partnership is expected to make distributions during the term of the option. If a noncompensatory option is reasonably certain to be exercised, then the holder of the option ordinarily