

has rights that are substantially similar to the rights afforded to a partner. Partner attributes include the extent to which the option holder shares in the economic benefit and detriment of partnership income and loss and the extent to which the option holder has the right to participate in the management of the partnership.

If the holder of a noncompensatory option is treated as a partner under the proposed regulations, then the holder's distributive share of the partnership's income, gain, loss, deduction, or credit (or items thereof) generally must be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances) as determined under § 1.704-1(b)(3). For this purpose, the partner's interest in the partnership generally must reflect the economic differences between holding an option to acquire a partnership interest and holding the partnership interest itself. For example, unlike a partner, a noncompensatory option holder is not required initially to contribute to the partnership the full amount of the purchase price for the partnership interest. Instead, the noncompensatory option holder generally pays an option premium that is considerably smaller than the purchase price and may wait until the option is about to expire to decide whether to exercise the option and pay the exercise price. The computation of the noncompensatory option holder's share of partnership items should reflect this lesser amount of capital investment to the extent appropriate in a particular case. In addition, a noncompensatory option holder's cumulative distributive share of partnership losses and deductions may be limited under sections 704(b) and (d) to the amount paid by the holder to the partnership for the option.

5. Original Issue Discount Provisions

The final regulations under the original issue discount (OID) provisions provide special rules for debt instruments convertible into the stock of the issuer. See §§ 1.1272-1(e), 1.1273-2(j), and 1.1275-4(a)(4). In response to Notice 2000-29, commentators requested that these special rules be extended to apply to debt instruments convertible into partnership interests. Treasury and the IRS agree with the commentators. Treating convertible debt issued by partnerships and corporations differently for purposes of these special rules could create unjustified distinctions between the taxation of instruments that are economically equivalent. Accordingly, the proposed regulations amend the OID provisions to

treat partnership interests as stock for purposes of the special rules for convertible debt instruments.

Proposed Effective Date

These regulations are proposed to apply to noncompensatory options that are issued on or after the date final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight copies) that are submitted timely to the IRS. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at www.irs.gov/reg. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 20, 2003, beginning at 10 a.m. in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written comments and an outline of the

topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by April 29, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Audrey W. Ellis of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

2. Section 1.704-1 is amended as follows:

1. Paragraph (b)(0) is amended by adding entries for 1.704-1(b)(2)(iv)(d)(4), 1.704-1(b)(2)(iv)(h)(1), 1.704-1(b)(2)(iv)(h)(2), 1.704-1(b)(2)(iv)(s), 1.704-1(b)(4)(ix), and 1.704-1(b)(4)(x).

2. Paragraph (b)(1)(ii) is amended by adding a sentence at the end of the paragraph.

3. Paragraph (b)(2)(iv)(d)(4) is added.

4. Paragraph (b)(2)(iv)(f)(1) is revised.

5. Paragraphs (b)(2)(iv)(h)(1), and (2) are redesignated as paragraphs (b)(2)(iv)(h)(1)(i) and (ii), respectively; the text of paragraph (b)(2)(iv)(h) is redesignated paragraph (b)(2)(iv)(h)(1); a heading is added to new paragraph (b)(2)(iv)(h)(1); and paragraph (b)(2)(iv)(h)(2) is added.

6. Paragraph (b)(2)(iv)(s) is added immediately after the undesignated paragraph that follows paragraph (b)(2)(iv)(r)(2).

7. Paragraphs (b)(r)(ix) and (b)(4)(x) are added.

8. Paragraph (b)(5) is amended by adding *Example 20*, *Example 21*, *Example 22*, *Example 23*, and *Example 24*.

The additions and revisions read as follows: