

issued, transferred, or modified, there is a strong likelihood that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners' and the holder's aggregate tax liabilities. If the holder of a noncompensatory option is treated as a partner under this section, such partner's distributive share of the partnership's income, gain, loss, deduction or credit (or items thereof) is determined in accordance with that partner's interest in the partnership (taking into account all facts and circumstances) in accordance with § 1.704-1(b)(3).

(b) *Definitions*—(1) *Noncompensatory option*. For purposes of this section, a noncompensatory option means an option (as defined in paragraph (b)(2) of this section) issued by a partnership, other than an option issued in connection with the performance of services. A noncompensatory option issued by an eligible entity (as defined in § 301.7701-3(a)) that would become a partnership under § 301.7701-3(f)(2) of this chapter if the option holder were treated as a partner under this section is also a noncompensatory option for purposes of this section. If a noncompensatory option is issued by such an eligible entity, then the eligible entity is treated as a partnership for purposes of applying this section.

(2) *Option*. For purposes of this section, a call option or warrant to acquire an interest in the issuing partnership is an option. In addition, convertible debt (as defined in § 1.721-2(e)(2)) and convertible equity (as defined in § 1.721-2(e)(3)) are options for purposes of this section. A contract that otherwise constitutes an option shall not fail to be treated as such for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(c) *Rights taken into account*. (1) In determining whether a noncompensatory option provides the holder with rights that are substantially similar to the rights afforded to a partner, all facts and circumstances are considered, including whether the option is reasonably certain to be exercised (as of the time that the option is issued, transferred or modified) and whether the option holder possesses partner attributes. For purposes of this section, if a noncompensatory option is reasonably certain to be exercised, then the holder of the option ordinarily has rights that are substantially similar to the rights afforded to a partner.

(2) *Reasonable certainty of exercise*. The following factors are relevant in

determining whether a noncompensatory option is reasonably certain to be exercised (as of the time that the noncompensatory option is issued, transferred, or modified)—

(i) The fair market value of the partnership interest that is the subject of the option;

(ii) The exercise price of the option;

(iii) The term of the option;

(iv) The volatility, or riskiness, of the partnership interest that is the subject of the option;

(v) The fact that the option premium and, if the option is exercised, the option exercise price, will become assets of the partnership;

(vi) Anticipated distributions by the partnership during the term of the option;

(vii) Any other special option features, such as an exercise price that declines over time or declines contingent on the happening of specific events;

(viii) The existence of related options, including reciprocal options; and

(ix) Any other arrangements (express or implied) affecting the likelihood that the option will be exercised.

(3) *Partner attributes*. Partner attributes include the extent to which the holder of the option will share in the economic benefit of partnership profits (including distributed profits) and in the economic detriment associated with partnership losses. Partner attributes also include the existence of any arrangement (either within the option agreement or in a related agreement) that, directly or indirectly, allows the holder of a noncompensatory option to control or restrict the activities of the partnership. For this purpose, rights in the partnership possessed by the option holder solely by virtue of owning a partnership interest and not by virtue of holding a noncompensatory option are not taken into account, provided that those rights are no greater than rights granted to other partners owning similar interests in the partnership.

(d) *Examples*. The following examples illustrate the provisions of this section. For the following examples, assume that:

(1) Each option agreement provides that the partnership cannot make distributions to its partners while the option remains outstanding; and

(2) The option holders do not have any significant rights to control or restrict the activities of the partnership (other than restricting distributions and dilutive issuances of partnership equity).

Example 1. Active trade or business. PRS is a partnership engaged in a

telecommunications business. In exchange for a premium of \$8x, PRS issues a noncompensatory option to A to acquire a 10 percent interest in PRS for \$17x at any time during a 7-year period commencing on the date on which the option is issued. At the time of the issuance of the option, a 10 percent interest in PRS has a fair market value of \$16x. Due to the riskiness of PRS's business, the value of a 10 percent PRS interest in 7 years is not reasonably predictable as of the time the option is issued. Therefore, it is not reasonably certain that A's option will be exercised. Furthermore, although the option provides A with substantially the same economic benefit of partnership profits as would a direct investment in PRS, A does not share in substantially the same economic detriment of partnership losses as would a partner in PRS. Given these facts, the option to acquire a PRS interest does not provide A with rights that are substantially similar to the rights afforded to a partner. Therefore, A is not treated as a partner under this section.

Example 2. Option issued by partnership with reasonably predictable earnings. PRS owns rental real property. The property is 95 percent rented to corporate tenants with a mid-investment grade bond rating or better and is expected to remain so for the next 20 years. The tenants of the building are responsible for paying all real estate taxes, insurance, and maintenance expenses relating to the property. Occupancy rates in properties of a similar character are high in the geographic area in which the property is located, and it is reasonably predictable that properties in that area will retain their value during the next 10 years. In exchange for a premium of \$6.5x, PRS issues a noncompensatory option to B to acquire a 10 percent interest in PRS for \$17x at the end of a 7-year period commencing on the date of the issuance of the option. At the time the option is issued, a 10 percent interest in PRS has a fair market value of \$16.5x. Given the stability of PRS's rental property, PRS can reasonably predict that its net cash flow for each of the 7 years during which the option is outstanding will be \$10x (\$70x over the 7 years), and that there will be no decline in the value of the property during that time. In light of the reasonably predictable earnings of PRS and the fact that PRS will make no distributions to its partners during the 7 years that the option is outstanding, it is reasonably certain that the value of a 10 percent interest in PRS at the end of the option's 7-year term will significantly exceed the exercise price of the option. Therefore, the option is reasonably certain to be exercised. Because the option is reasonably certain to be exercised, under these facts, B has rights that are substantially similar to the rights afforded to a partner. Therefore, if there is a strong likelihood that failure to treat B as a partner would result in a substantial reduction in the partners' and B's aggregate tax liabilities, B will be treated as a partner. In such a case, B's distributive share of PRS's income, gain, loss, deduction, or credit (or items thereof) is determined in accordance with B's interest in the partnership (taking into account all facts and circumstances) in accordance with § 1.704-1(b)(3).