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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106918-08]

RIN 1545-BH89

Treatment of Grantor of an Option on a Partnership Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership.

Specifically, the proposed regulations expand the characterization rule measurement events to include certain transfers of interests in the issuing partnership and other look-through entities, and provide additional guidance in determining the character of the grantor's gain or loss as a result of a closing transaction with respect to, or a lapse of, an option on a partnership interest. The proposed regulations will affect partnerships that issue noncompensatory options, the partners of such partnerships, and the holders of such options.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE THAT IS 90 DAYS AFTER THE DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-106918-08), room 5203, Internal Revenue Service, PO Box 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:PA:LPD:PR (REG-106918-08), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-106918-08).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under § 1.761-3, Benjamin Weaver at (202) 622-3050; concerning the proposed regulations under § 1.1234-3, Shawn Tetelman at (202) 622-3930; concerning submissions of comments and requests for a public hearing, Oluwafunmilayo (Funmi) Taylor, (202) 622-7180 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under sections 761 and 1234 of the Internal Revenue Code (Code). On January 22, 2003, proposed regulations (REG-103580-02) relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership (noncompensatory partnership option regulations) were published in the **Federal Register** (68 FR 2930). Final regulations in the Rules and Regulations section of this issue of the **Federal Register** contain amendments to the Income Tax Regulations (26 CFR Part 1), which finalize the proposed regulations. However, the Treasury Department and the IRS have decided to propose amendments to the regulations expanding the characterization rule measurement events to include certain transfers of interests in the issuing partnership and other look-through entities.

Additionally, the Treasury Department and the IRS received comments on the proposed regulations expressing uncertainty as to whether section 1234(b) applies to the grantor of an option on a partnership interest on the lapse or repurchase of the option. The comments indicated that it was unclear whether the term “securities,” as used in section 1234(b)(2)(B), includes partnership interests. After consideration of all comments received, the IRS and Treasury Department believe that it is appropriate to propose an amendment to the regulations under section 1234(b) to expressly treat partnership interests as securities for purposes of section 1234(b).

Explanation of Provisions

1. Proposed Additions to the Noncompensatory Partnership Option Characterization Rule Measurement Events

The final regulations being published elsewhere in this issue of the **Federal Register**, relating to the tax treatment of noncompensatory partnership options, contain a characterization rule providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. Under the characterization rule, a noncompensatory option is treated as a partnership interest if, on the date of a measurement event (1) the noncompensatory option provides the option holder with rights that are substantially similar to the rights afforded a partner, and (2) 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 noncompensatory option holder’s aggregate Federal tax liabilities. The final regulations define a measurement event as: (1) issuance of the noncompensatory option; (2) an adjustment of the terms (modification) of the noncompensatory option or of the underlying partnership interest (including an adjustment pursuant to the terms of the

noncompensatory option or the underlying partnership interest); or (3) transfer of the noncompensatory option if either (A) the option may be exercised (or settled) more than 12 months after its issuance, or (B) the transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder.

The Treasury Department and the IRS believe it is appropriate to expand the list of measurement events to include certain transfers of interests in the issuing partnership and look-through entities. The proposed regulations add three measurement events to the list above, but apply only if those measurement events are pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder. The three additional measurement events are: (1) issuance, transfer, or modification of an interest in, or liquidation of, the issuing partnership; (2) issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns the noncompensatory option; and (3) issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership. The Treasury Department and the IRS believe that the first of these measurement events is necessary because it is inconsistent to test a noncompensatory option under the characterization rule upon transfer of the noncompensatory option, but not upon transfer of an interest in the

issuing partnership, because either type of transfer may change the analysis of whether 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 option holder's aggregate tax liabilities. The Treasury Department and the IRS believe that the second and third measurement events are necessary to prevent avoidance of the characterization rule through the use of look-through entities.

Like the measurement events in the final regulations, the three measurement events in the proposed regulations are subject to exceptions in §1.761-3(c)(2). The Treasury Department and the IRS believe that the limitations on these measurement events will reduce the administrative burden associated with testing under the characterization rule upon these events.

The Treasury Department and the IRS request comments on the appropriate procedures for notifying the partners and the partnership upon the occurrence of a measurement event.

2. Character of Gain or Loss on Lapse, Sale, or Exchange of Partnership Options

A. Character of gain or loss to the grantor of the option

In response to comments, the proposed regulations address the application of section 1234(b) to the grantor of an option on a partnership interest on the lapse or repurchase of the option. Section 1234(b) provides that, in the case of the grantor of an option, gain or loss from any closing transaction with respect to, and gain on lapse of, an option in property shall be treated as gain or loss from the sale or exchange of a capital asset held not more than one year. Section 1234(b)(2)(B) defines the term property to mean stock and securities (including stocks and securities dealt with on a

when issued basis), commodities, and commodity futures. Accordingly, for section 1234(b) to apply to a closing transaction with respect to, or lapse of, an option on a partnership interest, a partnership interest would have to be a security and, thus, property within the meaning of section 1234(b)(2)(B). The proposed regulations provide that the term “securities” as used in section 1234(b)(2)(B) includes partnership interests. As a result, in the case of the grantor of an option on a partnership interest, gain or loss from any closing transaction with respect to, and gain on lapse of, the option is generally treated under the proposed regulations as gain or loss from the sale or exchange of a capital asset held not more than 1 year.

B. Character of gain or loss to the option holder

With respect to an option holder, under section 1234(a), gain or loss on the sale or exchange of, or loss on failure to exercise, an option is considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates would have in the hands of the taxpayer. Although a partnership interest is generally considered a capital asset, section 751(a) may apply to recharacterize a portion of a partner’s gain on the sale or exchange of a partnership interest as ordinary. A number of commenters on the noncompensatory partnership option proposed regulations questioned whether section 751 applies to the lapse, repurchase, sale, exchange, or other termination of a noncompensatory option.

The Treasury Department and the IRS continue to study this issue and request comments on (1) if section 751(a) applies to the lapse, repurchase, sale, or exchange of a noncompensatory option, (a) how the option holder’s share of income or loss from section 751 property would be determined under §1.751-1(a)(2), and (b) how a partner

in the issuing partnership that transfers its partnership interest while the option is outstanding would determine its share of income or loss from section 751 property under §1.751-1(a)(2) (that is, should it be reduced by the amount of income or loss from section 751 property attributable to the option holder); and (2) if section 751(a) does not apply to the lapse, repurchase, sale, or exchange of a noncompensatory option, what measures, if any, should be taken to ensure that ordinary income is not permanently eliminated.

Effective/Applicability Date

To coordinate the proposed regulations with the final noncompensatory partnership option regulations, the proposed regulations are proposed to have the same effective date as the final noncompensatory partnership option regulations. Therefore, the proposed regulations are proposed to apply to options issued on or after **INSERT DATE THIS DOCUMENT IS 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, as supplemented by Executive Order 13563. 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 this regulation, and because the regulation does not impose a collection of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments are available at www.regulations.gov or upon request. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Benjamin Weaver of the Office of Associate Chief Counsel (Passthroughs and Special Industries) and Shawn Tetelman of the Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department 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

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

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

Par. 2. Section 1.761-3 is amended by adding paragraph (c)(1)(iv) to read as follows:

§1.761-3 Certain option holders treated as partners.

* * * * *

(c) * * *

(1) * * *

(iv) An event described in paragraphs (c)(1)(iv)(A), (B), or (C) of this section, provided the event is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder (under paragraph (a)(1)(ii) of this section):

(A) Issuance, transfer, or modification of an interest in, or liquidation of, the issuing partnership;

(B) Issuance, transfer, or modification of an interest in any look-through entity (as defined in paragraph (b)(1) of this section) that directly, or indirectly through one or more look-through entities, owns the noncompensatory option;

(C) Issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership.

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Par. 3. Section 1.1234-3 is amended by adding a sentence at the end of paragraph (b)(2) to read as follows:

§1.1234-3 Special rules for the treatment of grantors of certain options granted after September 1, 1976.

* * * * *

(b) * * *

(2) * * * For purposes of the preceding sentence, for options granted on or after

[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL

REGISTER], the term securities includes partnership interests.

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Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

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