Notice of Proposed Rulemaking and Notice of Public Hearing

Noncompensatory Partnership Options

REG–103580–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership. The proposed regulations generally provide that the exercise of a noncompensatory option does not cause the recognition of immediate income or loss by either the issuing partnership or the option holder. The proposed regulations also modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. Additionally, the proposed regulations contain a characterization rule providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by April 29, 2003. Requests to speak and outlines of oral comments to be discussed at the public hearing scheduled for May 20, 2003, at 10 a.m. must be received by April 29, 2003.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–103580–02), room 5226, Internal Revenue Service, POB 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:ITA:RU (REG–103580–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS internet site at *www.irs.gov/regs*. The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Audrey W. Ellis, (202) 622–3060; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

In a variety of situations, partnerships issue options or convertible instruments that allow the holder to acquire by purchase or conversion an equity interest in the partnership. On June 5, 2000, Treasury and the IRS issued Notice 2000–29, 2000–1 C.B. 1241, inviting public comment on the federal income tax treatment of the exercise of an option to acquire a partnership interest, the exchange of convertible debt for a partnership interest, and the exchange of a preferred interest in a partnership for a common interest in that partnership.

In response to Notice 2000–29, Treasury and the IRS received a number of comments. Many commentators requested guidance on the treatment of options and other instruments that are issued by partnerships in connection with the performance of services (compensatory options).

These proposed regulations apply to certain call options, warrants, convertible debt, and convertible preferred equity that are not issued in connection with the performance of services (noncompensatory options). To expedite the issuance of guidance, these regulations do not address compensatory options. Nothing in the proposed regulations should be construed as creating any inference regarding the proper federal income tax treatment of compensatory options. However, Treasury and the IRS are working on future guidance that will address the federal income tax consequences of compensatory options and invite comments. In particular, Treasury and the IRS request comments on the proposed amendment to §1.721–1(b)(1) that was published in the **Federal Register** on June 3, 1971 (36 FR 10787), and, more particularly, on the application of section 83 to the issuance of compensatory options and partnership capital interests in connection with the performance of services. In addition, Treasury and the IRS request comments on how to coordinate the tax treatment of partnership profits interests issued in connection with the performance of services (see Rev. Proc. 93–27, 1993–2 C.B. 343, as clarified in Rev. Proc. 2001–43, 2001–2 C.B. 191) with the tax treatment of options to acquire partnership capital interests issued in connection with the performance of services.

Explanation of Provisions

1. Scope of Proposed Regulations

The proposed regulations describe certain of the income tax consequences of issuing, transferring, and exercising noncompensatory options. These proposed regulations apply only if the call option, warrant, or conversion right entitles the holder to the right to acquire an interest in the issuer (or to cash or property having a value equal to the value of such an interest).

The proposed regulations generally provide that the exercise of a noncompensatory option does not cause recognition of gain or loss to either the issuing partnership or the option holder. In addition, the proposed regulations modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. Finally, the proposed regulations contain a characterization rule providing that the holder of a call option, warrant, convertible debt, or convertible preferred equity issued by a partnership (or an eligible entity, as defined in §301.7701–3(a), that would become a partnership if the option holder were treated as a partner) is treated as a partner under certain circumstances.

The rule providing for nonrecognition of gain or loss on the exercise of a noncompensatory option does not apply to any call option, warrant, or convertible debt issued by an eligible entity, as defined in §301.7701–3(a), that would become a partnership under §301.7701–3(f)(2) if the option, warrant, or conversion right were exercised. Treasury and the IRS request comments on whether the nonrecognition rule should be extended to such instruments.

2. Issuance, Exercise, and Lapse of Noncompensatory Options

Section 721(a) and §1.721–1 provide that, with certain exceptions, no gain or loss is recognized to a partnership or any of its partners on the contribution of property to a partnership in exchange for an interest in the partnership. However, §1.721–1 does not provide clear guidance as to the tax consequences to the holder of a noncompensatory option and the partnership upon the issuance, lapse, and exercise of a noncompensatory option to acquire a partnership interest. Many taxpayers have requested guidance clarifying the tax consequences of these transactions.

Generally, the proposed regulations do not treat the issuance of a noncompensatory option as a 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) 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 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 (8) copies) that are submitted timely to the IRS. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*. 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.

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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 1.704–1 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 as 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)(4)(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:

§1.704–1 Partner's distributive share.

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(b) (0) * * *

Exercise of noncompensatory options	1.704–1(b)(2)(iv)(*d*)(*4*)

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In general	1.704–1(b)(2)(iv)(*h*)(*1*)

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Adjustments for noncompensatory options	1.704–1(b)(2)(iv)(*h*)(*2*)

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Adjustments on the exercise of a noncompensatory option	1.704–1(b)(2)(iv)(*s*)

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Allocations with respect to noncompensatory options	1.704–1(b)(4)(ix)
Corrective allocations	1.704–1(b)(4)(x)

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(1) * * *

(ii) * * * In addition, paragraph (b)(2)(iv)(*d*)(*4*), paragraph (b)(2)(iv)(*h*)(*2*), paragraph (b)(2)(iv)(*s*), paragraph (b)(4)(ix), paragraph (b)(4)(x), and *Examples 20* through *24* in paragraph (b)(5) of this section apply to noncompensatory options (as defined in §1.721–2(d)) that are issued on or after the date final regulations are published in the **Federal Register**.

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(2) * * *

(iv) * * *

(*d*) * * *

(*4*) *Exercise of noncompensatory options*. For purposes of paragraph (b)(2)(iv)(*b*)(*2*) of this section, the fair market value of the property contributed on the exercise of a noncompensatory option (as defined in §1.721–2(d)) does not include the fair market value of the option privilege, but does include the consideration paid to the partnership to acquire the option and the fair market value of any property (other than the option) contributed to the partnership on the exercise of the option. With respect to convertible equity, the fair market value of the property contributed to the partnership on the exercise of the option includes the converting partner's capital account immediately before the conversion. With respect to convertible debt, the fair market value of the property contributed on the exercise of the option includes the adjusted basis and the accrued but unpaid qualified stated interest on the debt immediately before the conversion. See *Examples 20* through *24* of paragraph (b)(5) of this section.

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(*f*) * * *

(*1*) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, as determined under paragraph (b)(2)(iv)(h) of this section, reduced by the consideration paid to the partnership to acquire any outstanding noncompensatory options (as defined in §1.721–2(d)) that are issued on or after the date final regulations are published in the **Federal Register**. See *Example 22* of paragraph (b)(5) of this section. * * * * *

(*h*) *Determinations of fair market value*—(*1*) *In general*. * * *

(*2*) *Adjustments for noncompensatory options*. The fair market value of partnership property must be adjusted to account for any outstanding noncompensatory options (as defined in §1.721–2(d)) at the time of a revaluation of partnership property under paragraph (b)(2)(iv)(*f*) or (*s*) of this section. If the fair market value of outstanding noncompensatory options (as defined in §1.721–2(d)) as of the date of the adjustment exceeds the consideration paid by the option holders to acquire the options, then the fair market value of partnership property must be reduced by that excess to the extent of the unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. If the price paid by the option holders to acquire the outstanding noncompensatory options (as defined in §1.721–2(d)) exceeds the fair market value of such options as of the date of the adjustment, then the value of partnership property must be increased by that excess to the extent of the unrealized deduction or loss in partnership property (that has not been reflected in the capital accounts previously). This increase is allocated only to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation.

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(*s*) *Adjustments on the exercise of a noncompensatory option*. A partnership agreement may grant a partner, on the exercise of a noncompensatory option (as defined in §1.721–2(d)), a right to share in partnership capital that exceeds (or is less than) the sum of the consideration paid by the partner to acquire and exercise such option. Where such an agreement exists, capital accounts will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless—

(*1*) In lieu of revaluing partnership property under paragraph (b)(2)(iv)(*f*) of this section immediately before the exercise of the option, the partnership revalues partnership property in accordance with the provisions of paragraphs (b)(2)(iv)(*f*)(*1*) through (*4*) of this section immediately after the exercise of the option;

(*2*) In determining the capital accounts of the partners (including the exercising partner) under paragraph (b)(2)(iv)(*s*)(*1*) of this section, the partnership first allocates any unrealized income, gain, loss, or deduction in partnership assets (that has not been reflected in the capital accounts previously) to the exercising partner to the extent necessary to reflect that partner's right to share in partnership capital under the partnership agreement, and then allocates any remaining unrealized income gain, loss, or deduction (that has not been reflected in the capital accounts previously) to the existing 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;

(*3*) If, after making the allocations described in paragraph (b)(2)(iv)(*s*)(*2*) of this section, the exercising partner's capital account still does not reflect that partner's right to share in partnership capital under the partnership agreement, then the partnership reallocates partnership capital between the existing partners and the exercising partner so that the exercising partner's capital account does reflect the exercising partner's right to share in partnership capital under the partnership agreement (a capital account reallocation). Any increase or reduction in the capital accounts of existing partners that occurs as a result of a capital account reallocation under this paragraph (b)(2)(iv)(*s*)(*3*) must be allocated among the existing partners in accordance with the principles of this section; and

(*4*) The partnership agreement requires corrective allocations so as to take into account all capital account reallocations made under paragraph (b)(2)(iv)(*s*)(*3*) of this section (see paragraph (b)(4)(x) of this section). See *Examples 20* through *24* of paragraph (b)(5) of this section.

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(4) * * *

(ix) *Allocations with respect to noncompensatory options*. A partnership agreement may grant to a partner that exercises a noncompensatory option a right to share in partnership capital that exceeds (or is less than) the sum of the amounts paid by the partner to acquire and exercise such option. In such a case, allocations of income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding cannot have economic effect, because, if the noncompensatory option is exercised, the exercising partner, rather than the existing partners, may receive the economic benefit or bear the economic detriment associated with that income, gain, loss, or deduction. Allocations of partnership income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding will be deemed to be in accordance with the partners' interests in the partnership only if —

(*a*) The holder of the noncompensatory option is not treated as a partner under §1.761–3;

(*b*) The partnership agreement requires that, on the exercise of the noncompensatory option, the partnership comply with the rules of paragraph (b)(2)(iv)(*s*) of this section; and

(*c*) All material allocations and capital account adjustments under the partnership agreement not pertaining to noncompensatory options are recognized under section 704(b). See *Examples 20* through *24* of paragraph (b)(5) of this section.

(x) *Corrective allocations*. If partnership capital is reallocated between existing partners and a partner exercising a noncompensatory option under paragraph (b)(2)(iv)(*s*)(*3*) of this section (a capital account reallocation), the partnership must, beginning with the taxable year of the exercise and in all succeeding taxable years until the allocations required are fully taken into account, make corrective allocations so as to take into account the capital account reallocation. A corrective allocation is an allocation (consisting of a *pro rata* portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the partnership's allocation of the corresponding book item. See *Example 21* of paragraph (b)(5) of this section.

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(5) * * *

Example 20. (i) In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company, classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a nondepreciable property, Property A, for $20,000. Also in Year 1, at a time when Property A is still valued at $20,000, LLC issues an option to DH. The option allows DH to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DH pays $1,000 to the LLC for the issuance of the option. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to noncompensatory options are recognized under section 704(b). Also assume that DH's option is a noncompensatory option under §1.721–2(d), and that DH is not treated as a partner with respect to the option. In Year 2, DH exercises the option, contributing the $15,000 exercise price to the partnership. At the time the option is exercised, the value of Property A is $35,000.

Assets	*Basis*	*Value*	Liabilities and Capital	*Basis*	*Value*
Property A	$20,000	$35,000	TM	$10,000	$17,000
Cash			PK	$10,000	$17,000
Premium	$ 1,000	$ 1,000	DH	$16,000	$17,000
Exercise Price	$15,000	$15,000			
Total	$36,000	$51,000		$36,000	$51,000

(ii) Under paragraphs (b)(2)(iv)(*b*)(*2*) and (b)(2)(iv)(*d*)(*4*) of this section, DH's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, DH is entitled to LLC capital corresponding to 100 units of LLC (⅓ of LLC's capital). Immediately after the exercise of the option, LLC's assets are cash of $16,000 ($1,000 premium and $15,000 exercise price contributed by DH) and Property A, which has a value of $35,000. Thus, the total value of LLC's assets is $51,000. DH is entitled to LLC capital equal to ⅓ of this value, or $17,000. As DH is entitled to $1,000 more LLC capital than DH's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

(iii) Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase DH's capital account from $16,000 to $17,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section and allocating the first $1,000 of book gain to DH. The net gain in LLC's assets (Property A) is $15,000 ($35,000 value less $20,000 basis). The first $1,000 of this gain must be allocated to DH, and the remaining $14,000 of this gain is allocated equally to TM and PK in accordance with the LLC agreement. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases DH's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	TM		PK		DH	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise	$10,000	$10,000	$10,000	$10,000	$16,000	$16,000
Revaluation amount	----------	$ 7,000	----------	$ 7,000	----------	$ 1,000
Capital account after revaluation	$10,000	$17,000	$10,000	$17,000	$16,000	$17,000

Example 21. (i) Assume the same facts as in *Example 20*, except that, in Year 1, LLC sells Property A for $40,000, recognizing gain of $20,000. LLC does not distribute the sale proceeds to its partners and it has no other earnings in Year 1. With the proceeds ($40,000), LLC purchases Property B, a nondepreciable property. Also assume that DH exercises the noncompensatory option at the beginning of Year 2 and that, at the time DH exercises the option, the value of Property B is $41,000. In Year 2, LLC has gross income of $3,000 and deductions of $1,500.

	Assets			Liabilities and Capital	
	Basis	*Value*		*Basis*	*Value*
Property B	$40,000	$41,000	TM	$20,000	$19,000
Cash	$16,000	$16,000	PK	$20,000	$19,000
			DH	$16,000	$19,000
Total	$56,000	$57,000		$56,000	$57,000

(ii) Under paragraphs (b)(2)(iv)(*b*)(*2*) and (b)(2)(iv)(*d*)(*4*) of this section, DH's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, DH is entitled to LLC capital corresponding to 100 units of LLC (⅓ of LLC's capital). Immediately after the exercise of the option, LLC's assets are $16,000 cash ($1,000 option premium and $15,000 exercise price contributed by DH) and Property B, which has a value of $41,000. Thus, the total value of LLC's assets is $57,000. DH is entitled to LLC capital equal to ⅓ of this amount, or $19,000. As DH is entitled to $3,000 more LLC capital than DH's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

(iii) Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase DH's capital account from $16,000 to $19,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section, and allocating the $1,000 of book gain from the revaluation to DH. This brings DH's capital account to $17,000. Second, under paragraph (b)(2)(iv)(*s*)(*3*) of this section, LLC must reallocate $2,000 of capital from the existing partners (TM and PK) to DH to bring DH's capital account to $19,000 (the capital account reallocation). As TM and PK share equally in all items of income, gain, loss, and deduction of LLC, each member's capital account is reduced by ½ of the $2,000 reduction ($1,000).

(iv) Under paragraph (b)(2)(iv)(*s*)(*4*) of this section, beginning in the year in which the option is exercised, LLC must make corrective allocations so as to take into account the capital account reallocation. In Year 2, LLC has gross income of $3,000 and deductions of $1,500. The book gross income of $3,000 is shared equally by TM, PK, and DH. For tax purposes, however, LLC must allocate all of its gross income ($3,000) to DH. LLC's deductions ($1,500) must be allocated equally among TM, PK, and DH. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from Property B must be allocated in accordance with section 704(c) principles.

	TM		PK		DH	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise	$20,000	$20,000	$20,000	$20,000	$16,000	$16,000
Revaluation	----------	----------	----------	----------	----------	$ 1,000
Capital account after revaluation	$20,000	$20,000	$20,000	$20,000	$16,000	$17,000
Capital account reallocation	----------	($1,000)	----------	($1,000)	----------	$ 2,000
Capital account after capital account reallocation	$20,000	$19,000	$20,000	$19,000	$16,000	$19,000
Income allocation (Yr. 2)	----------	$ 1,000	----------	$ 1,000	$ 3,000	$ 1,000
Deduction allocation (Yr. 2)	($ 500)	($ 500)	($ 500)	($ 500)	($ 500)	($ 500)
Capital account at end of year 2	$19,500	$19,500	$19,500	$19,500	$18,500	$19,500

Example 22. (i) In Year 1, AC and NE each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to DR. The option allows DR to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DR pays $1,000 to LLC for the issuance of the option. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to noncompensatory options are recognized under section 704(b). Also assume that DR's option is a noncompensatory option under §1.721–2(d), and that DR is not treated as a partner with respect to the option.

(ii) Prior to the exercise of DR's option, ML contributes $17,000 to LLC for 100 units in LLC. At the time of ML's contribution, Property A has a value of $30,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of DR's option is $2,000.

(iii) Upon ML's admission to the partnership, the capital accounts of AC and NE (which were $10,000 each prior to ML's admission) are, in accordance with paragraph (b)(2)(iv)(*f*) of this section, adjusted upward to reflect their shares of the unrealized appreciation in the partnership's assets. Under paragraph (b)(2)(iv)(*f*)(*1*) of this section, those adjustments must be based on the fair market value of LLC property (taking section 7701(g) into account) on the date of the adjustment. The fair market value of partnership property ($36,000) must be reduced by the consideration paid by DR to the partnership to acquire the option ($1,000) (under paragraph (b)(2)(iv)(*f*)(*1*) of this section), and the excess of the fair market value of the option as of the date of the adjustment over the consideration paid by DR to acquire the option ($1,000) (under paragraph (b)(2)(iv)(*h*)(*2*) of this section), but only to the extent of the unrealized appreciation in LLC property ($15,000). Therefore, the revaluation adjustments must be based on a value of $34,000. Accordingly, AC and NE's capital accounts must be increased to $17,000. This $1,000 reduction is allocated entirely to Property A, the only asset having unrealized appreciation. Therefore, the book value of Property A is $29,000. The $19,000 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between AC and NE in accordance with section 704(c) principles.

Assets	Basis	Value	Option Adjustment	704(c) Book
Property A	$10,000	$30,000	($1,000)	$29,000
Property B	$10,000	$ 5,000	0	$ 5,000
Cash	$ 1,000	$ 1,000	0	$ 1,000
Subtotal	$21,000	$36,000	($1,000)	$35,000
Cash contributed by ML	$17,000	$17,000	0	$17,000
Total	$38,000	$53,000	($1,000)	$52,000

Liabilities and Capital	Tax	Value
AC	$10,000	$17,000
NE	$10,000	$17,000
ML	$17,000	$17,000
Option	$ 1,000	$ 2,000
Total	$38,000	$53,000

(iv) After the admission of ML, when Property A still has a value of $30,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, DR exercises the option. On the exercise of the option, DR's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, DR is entitled to LLC capital corresponding to 100 units of LLC (¼ of LLC's capital). Immediately after the exercise of the option, LLC's assets are worth $68,000 ($15,000 contributed by DR, plus the value of LLC assets prior to the exercise of the option, $53,000). DR is entitled to LLC capital equal to ¼ of this value, or $17,000. As DR is entitled to $1,000 more LLC capital than DR's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

(v) Under paragraph (b)(2)(iv)(*s*) of this section, the LLC must increase DR's capital account from $16,000 to $17,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section and allocating the first $1,000 of book gain to DR. The net increase in the value of LLC properties since the previous revaluation is $1,000 (the difference between the actual value of Property A, $30,000, and the book value of Property A, $29,000). The entire $1,000 of book gain is allocated to DR. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases DR's capital account to the amount agreed on by the members, the LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from Properties A and B must be allocated in accordance with section 704(c) principles.

	AC		NE		ML		DR	
	Tax	Book	Tax	Book	Tax	Book	Tax	Book
Capital account after admission of ML	$10,000	$17,000	$10,000	$17,000	$17,000	$17,000	----------	----------
Capital account after exercise of DH's option	$10,000	$17,000	$10,000	$17,000	$17,000	$17,000	$16,000	$16,000
Revaluation	----------	----------	----------	----------	----------	----------	----------	$ 1,000
Capital account after revaluation	$10,000	$17,000	$10,000	$17,000	$17,000	$17,000	$16,000	$17,000

Example 23. (i) On the first day of Year 1, MS, VH, and SR form LLC, a limited liability company classified as a partnership for federal tax purposes. MS and VH each contribute $10,000 cash to LLC for 100 units of common interest in LLC. SR contributes $10,000 cash for a convertible preferred interest in LLC. SR's convertible preferred interest entitles SR to receive an annual allocation and distribution of cumulative LLC net profits in an amount equal to 10 percent of SR's unreturned capital. SR's convertible preferred interest also entitles SR to convert, in year 3, SR's preferred interest into 100 units of common interest. If SR converts, SR has the right to the same share of LLC capital as SR would have had if SR had held the 100 units of common interest since the formation of LLC. Under the LLC agreement, each unit of common interest has an equal right to share in any LLC net profits that remains after payment of the preferred return. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to noncompensatory options are recognized under section 704(b). Also assume that SR's right to convert the preferred interest into a common interest qualifies as a noncompensatory option under §1.721–2(d), and that, prior to the exercise of the conversion right, SR is not treated as a partner with respect to the conversion right.

(ii) LLC uses the $30,000 to purchase Property Z, a property that is depreciable on a straight-line basis over 15 years. In each of Years 1 and 2, LLC has net income of $2,500, comprised of $4,500 of gross receipts and $2,000 of depreciation. It allocates and distributes $1,000 of this net income to SR in each year. LLC allocates, but does not distribute, the remaining $1,500 of net income equally to MS and VH in each year.

	MS		VH		SR	
	Tax	Book	Tax	Book	Tax	Book
Capital account upon formation	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
Allocation of income Years 1 and 2	$ 1,500	$ 1,500	$ 1,500	$ 1,500	$ 2,000	$ 2,000
Distributions Years 1 and 2	-	-	-	-	($2,000)	($2,000)
Capital account end of Year 2	$11,500	$11,500	$11,500	$11,500	$10,000	$10,000

(iii) At the beginning of Year 3, when Property Z has a value of $38,000 and a basis of $26,000 ($30,000 original basis less $4,000 of depreciation) and LLC has accumulated undistributed cash of $7,000 ($9,000 gross receipts less $2,000 distributions), SR converts SR's preferred interest into a common interest. Under paragraphs (b)(2)(iv)(*b*)(*2*) and (b)(2)(iv)(*d*)(*4*) of this section, SR's capital account after the conversion equals SR's capital account before the conversion, $10,000. On the conversion of the preferred interest, however, SR is entitled to LLC capital corresponding to 100 units of common interest in LLC (⅓ of LLC's capital). At the time of the conversion, the total value of LLC assets is $45,000. SR is entitled to LLC capital equal to ⅓ of this value, or $15,000. As SR is entitled to $5,000 more LLC capital than SR's capital account immediately after the conversion, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

Assets	*Basis*	*Value*	Liabilities and Capital	*Basis*	*Value*
Property Z	$26,000	$38,000	MS	$11,500	$15,000
Undistributed Income	$ 7,000	$ 7,000	VH	$11,500	$15,000
			SR	$10,000	$15,000
Total	$33,000	$45,000	Total	$33,000	$45,000

(iv) Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase SR's capital account from $10,000 to $15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section, and allocating the first $5,000 of book gain from that revaluation to SR. The net unrealized gain in LLC's assets (Property Z) is $12,000 ($38,000 value less $26,000 basis). The first $5,000 of this gain must be allocated to SR. The remaining $7,000 of that gain must be allocated equally to MS and VH in accordance with the LLC agreement. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases SR's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	MS		VH		SR	
	Tax	Book	Tax	Book	Tax	Book
Capital account prior to conversion	$11,500	$11,500	$11,500	$11,500	$10,000	$10,000
Revaluation on conversion	----------	$ 3,500	----------	$ 3,500	----------	$ 5,000
Capital account after conversion	$11,500	$15,000	$11,500	$15,000	$10,000	$15,000

Example 24. (i) On the first day of Year 1, AK and JP each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Immediately after its formation, LLC borrows $10,000 from JS. Under the terms of the debt instrument, interest of $1,000 is payable annually and principal is repayable in five years. Throughout the term of the indebtedness, JS has the right to convert the debt instrument into 100 units in LLC. If JS converts, JS has the right to the same share of LLC capital as JS would have had if JS had held 100 units in LLC since the formation of LLC. Under the LLC agreement, each unit participates equally in the profits and losses of LLC and has an equal right to share in LLC capital. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section, and that all material allocations and capital account adjustments not pertaining to noncompensatory options are recognized under section 704(b). Also assume that JS's right to convert the debt into an interest in LLC qualifies as a noncompensatory option under §1.721–2(d), and that, prior to the exercise of the conversion right, JS is not treated as a partner with respect to the convertible debt.

(ii) LLC uses the $30,000 to purchase Property D, property that is depreciable on a straight-line basis over 15 years. In each of Years 1, 2, and 3, LLC has net income of $2,000, comprised of $5,000 of gross receipts, $2,000 of depreciation, and interest expense (representing payments of interest on the loan from JS) of $1,000. LLC allocates, but does not distribute, this income equally to AK and JP.

	AK		JP		JS	
	Tax	Book	Tax	Book	Tax	Book
Initial capital account	$10,000	$10,000	$10,000	$10,000	----------	----------
Year 1 net income	$ 1,000	$ 1,000	$ 1,000	$ 1,000	----------	----------
Year 2 net income	$ 1,000	$ 1,000	$ 1,000	$ 1,000	----------	----------
Year 3 net income	$ 1,000	$ 1,000	$ 1,000	$ 1,000	----------	----------
Year 4 initial capital account	$13,000	$13,000	$13,000	$13,000	0	0

(iii) At the beginning of year 4, at a time when Property D, the LLC's only asset, has a value of $33,000 and basis of $24,000 ($30,000 original basis less $6,000 depreciation in Years 1 through 3), and LLC has accumulated undistributed cash of $12,000 ($15,000 gross receipts less $3,000 of interest payments) in LLC, JS converts the debt into a ⅓ interest in LLC. Under paragraphs (b)(2)(iv)(*b*)(*2*) and (b)(2)(iv)(*d*)(*4*) of this section, JS's capital account after the conversion is the adjusted basis of the debt immediately before JS's conversion of the debt, $10,000, plus any accrued but unpaid qualified stated interest on the debt, $0. On the conversion of the debt, however, JS is entitled to receive LLC capital corresponding to 100 units of LLC (⅓ of LLC's capital). At the time of the conversion, the total value of LLC's assets is $45,000. JS is entitled to LLC capital equal to ⅓ of this value, or $15,000. As JS is entitled to $5,000 more LLC capital than JS's capital contribution to LLC ($10,000), the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

	Assets			Liabilities and Capital	
	Basis	*Value*		*Basis*	*Value*
Property D	$24,000	$33,000	AK	$13,000	$15,000
Cash	$12,000	$12,000	JP	$13,000	$15,000
			JS	$10,000	$15,000
Total	$36,000	$45,000		$36,000	$45,000

(iv) Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase JS's capital account from $10,000 to $15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section, and allocating the first $5,000 of book gain from that revaluation to JS. The net unrealized gain in LLC's assets (Property D) is $9,000 ($33,000 value less $24,000 basis). The first $5,000 of this gain must be allocated to JS, and the remaining $4,000 of that gain must be allocated equally to AK and JP in accordance with the LLC agreement. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases JS's capital account to the amount agreed upon by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	AK		JP		JS	
	Tax	Book	Tax	Book	Tax	Book
Year 4 capital account prior to exercise	$13,000	$13,000	$13,000	$13,000	0	0
Capital account after exercise	$13,000	$13,000	$13,000	$13,000	$10,000	$10,000
Revaluation	----------	$ 2,000	----------	$ 2,000	----------	$ 5,000
Capital account after revaluation	$13,000	$15,000	$13,000	$15,000	$10,000	$15,000

Par. 3. Section 1.704–3 is amended by revising the first sentence of paragraph (a)(6)(i) to read as follows:

§1.704–3 Contributed property.

(a) * * *

(6) *Other applications of section 704(c) principles—*(*i*) *Revaluations under section 704(b).* The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704–1(b)(2)(iv)(*f*) or 1.704–1(b)(2)(iv)(*s*) (reverse section 704(c) allocations). * * *

* * * * *

Par. 4. Section 1.721–2 is added to read as follows:

§1.721–2 Noncompensatory options.

(a) *Exercise of a noncompensatory option.* Notwithstanding §1.721–1(b)(1), section 721 applies to the exercise (as defined in paragraph (e)(4) of this section) of a noncompensatory option (as defined in paragraph (d) of this section). However, if the exercise price (as defined in paragraph (e)(5) of this section) of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the noncompensatory option, the transaction will be given tax effect in accordance with its true nature.

(b) *Transfer of property in exchange for a noncompensatory option.* Section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option. For example, if a person purchases a noncompensatory option with appreciated property, the person recognizes income or gain to the extent that the fair market value of the noncompensatory option exceeds the person's basis in the surrendered property.

(c) *Lapse of a noncompensatory option.* Section 721 does not apply to the lapse of a noncompensatory option.

(d) *Scope.* The provisions of this section apply only to noncompensatory options and do not apply to any interest on convertible debt that has been accrued by the partnership (including accrued original issue discount). For purposes of this section, the term noncompensatory option means an option (as defined in paragraph (e)(1) of this section) issued by a partnership (the issuing partnership), other than an option issued in connection with the performance of services.

(e) *Definitions.* The following definitions apply for the purposes of this section.

(1) *Option* means a call option or warrant to acquire an interest in the issuing partnership, the conversion feature of convertible debt (as defined in paragraph (e)(2) of this section), or the conversion feature of convertible equity (as defined in paragraph (e)(3) 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.

(2) *Convertible debt* is any indebtedness of a partnership that is convertible into an interest in that partnership.

(3) *Convertible equity* is preferred equity in a partnership that is convertible into common equity in that partnership. For this purpose, preferred equity is any interest in the issuing partnership that entitles the partner to a preferential return on capital and common equity is any interest in the issuing partnership that is not preferred equity.

(4) *Exercise* means the exercise of an option or warrant or the conversion of convertible debt or convertible equity.

(5) *Exercise price* means, in the case of a call option or warrant, the exercise price of the call option or warrant; in the case of convertible equity, the converting partner's capital account with respect to that convertible equity, increased by the fair market value of cash or other property contributed to the partnership in connection with the conversion; and, in the case of convertible debt, the adjusted issue price (within the meaning of §1.1275–1(b)) of the debt converted, increased by accrued but unpaid qualified stated interest and by the fair market value of cash or other property contributed to the partnership in connection with the conversion.

(f) *Example.* The following example illustrates the provisions of this section:

Example. In Year 1, L and M form general partnership LM with cash contributions of $5,000 each, which are used to purchase land, Property D, for $10,000. In that same year, the partnership issues an option to N to buy a one-third interest in the partnership at any time before the end of Year 3. The exercise price of the option is $5,000, payable in either cash or property. N transfers Property E with a basis of $600 and a value of $1,000 to the partnership in exchange for the option. N provides no other consideration for the option. Assume that N's option is a noncompensatory option under paragraph (d) of this section and that N is not treated as a partner with respect to the option. Under paragraph (b) of this section, section 721(a) does not apply to N's transfer of Property E to LM in exchange for the option. In accordance with § 1.1001–2, upon N's transfer of Property E to the partnership in exchange for the option, N recognizes $400 of gain. Under open transaction principles applicable to noncompensatory options, the partnership does not recognize any gain upon receipt of appreciated property in exchange for the option. The partnership has a basis of $1,000 in Property E. In Year 3, when the partnership property is valued at $16,000, N exercises the option, contributing Property F with a basis of $3,000 and a fair market value of $5,000 to the partnership. Under paragraph (a) of this section, neither the partnership nor N recognizes gain upon N's contribution of property to the partnership upon the exercise of the option. Under section 723, the partnership has a basis of $3,000 in Property F. See §1.704–1(b)(2)(iv)(*d*)(*4*) and (*s*) for special rules applicable to capital account adjustments on the exercise of a noncompensatory option.

(g) *Effective Date.* This section applies to noncompensatory options that are issued on or after the date final regulations are published in the **Federal Register**.

Par. 5. Section 1.761–3 is added to read as follows.

§1.761–3 Certain option holders treated as partners.

(a) *In general.* A noncompensatory option (as defined in paragraph (b) of this section) is treated as a partnership interest if the option (and any rights associated with it) provides the holder with rights that are substantially similar to the rights afforded to a partner. This paragraph 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 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).

Example 3. Deep in the money options. (i) LP is a limited partnership engaged in an internet start-up venture. In exchange for a premium of $14x, LP issues a noncompensatory option to C to acquire a 5 percent interest in LP for $6x at any time during a 10-year period commencing on the date on which the option is issued. At the time of the issuance of the option, a 5 percent interest in LP has a fair market value of $15x. Because of the riskiness of LP's business, the option is not reasonably certain to be exercised. Nevertheless, because C has paid a $14x premium for a partnership interest that has a fair market value of $15x, C has substantially the same economic benefits and detriments as a result of purchasing the option as C would have had if C had purchased a partnership interest. Therefore, the option provides C with rights that are substantially similar to the rights afforded to a partner (partner attributes). See paragraph (c)(3) of this section. If there is a strong likelihood that failure to treat C as a partner would result in a substantial reduction in the partners' and C's aggregate tax liabilities, C will be treated as a partner. In such a case, C's distributive share of LP's income, gain, loss, deduction, or credit (or items thereof) is determined in accordance with C's interest in the partnership (taking into account all facts and circumstances) in accordance with §1.704–1(b)(3).

(ii) The facts are the same as in paragraph (i) of this *Example 3*, except that C transfers $150x to LP in exchange for a note from LP that matures 10 years from the date of issuance and a warrant to acquire a 5 percent interest in LP for an exercise price of $6x. The warrant issued with the debt is exercisable at any time during the 10-year term of the debt. The debt instrument and the warrant comprise an investment unit with the meaning of section 1273(c)(2). Under §1.1273–2(h), the issue price of the investment unit, $150x, is allocated $136x to the debt instrument and $14x to the warrant. As in paragraph (i), C has substantially the same economic benefits and detriments as a result of purchasing the warrant as C would have had if C had purchased a partnership interest. Therefore, the warrant provides C with rights that are substantially similar to the rights afforded to a partner. If there is a strong likelihood that failure to treat C as a partner would result in a substantial reduction in the partners' and C's aggregate tax liabilities, then C will be treated as a partner. In such a case, C's distributive share of LP's income, gain, loss, deduction, or credit (or items thereof) is determined in accordance with C's interest in the partnership (taking into account all facts and circumstances) in accordance with §1.704–1(b)(3).

(e) *Effective Date*. This section applies to noncompensatory options that are issued on or after the date final regulations are published in the **Federal Register**.

Par. 6. Section 1.1272–1 is amended by adding a sentence at the end of paragraph (e) to read as follows:

§1.1272–1 Current inclusion of OID in income.

* * * * *

(e) * * * For debt instruments issued on or after the date final regulations are published in the **Federal Register**, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for federal tax purposes, as either a partnership or a corporation.

* * * * *

Par. 7. Section 1.1273–2 is amended by adding a sentence at the end of paragraph (j) to read as follows:

§1.1273–2 Determination of issue price and issue date.

* * * * *

(j) * * * For debt instruments issued on or after the date final regulations are published in the **federal Register**, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for federal tax purposes, as either a partnership or a corporation.

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Par. 8. Section 1.1275–4 is amended by adding a sentence at the end of paragraph (a)(4) to read as follows:

§1.1275–4 Contingent payment debt instruments.

(a) * * *

(4) * * * For debt instruments issued on or after the date final regulations are published in the **Federal Register**, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for federal tax purposes, as either a partnership or a corporation.

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David A. Mader,
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(Filed by the Office of the Federal Register on January 21, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 22, 2003, 68 F.R. 2930)