

§ 1.704–1 Partner's distributive share.

(b) (0) * * *

* * * * *

Exercise of noncompensatory options	1.704–1(b)(2)(iv)(d)(4)
* * * * *	* *
In general	1.704–1(b)(2)(iv)(h)(1)
Adjustments for noncompensatory options	1.704–(b)(2)(iv)(h)(2)
* * * * *	* *
Adjustments on the exercise of a noncompensatory option	1.704–1(b)(2)(iv)(s)
* * * * *	* *
Allocations with respect to noncompensatory options	1.704–1(b)(4)(ix)
Corrective allocations	1.704–1(b)(4)(x)
* * * * *	* *

(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**.

* * * * *

(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. See *Examples 20* through 24 of paragraph (b)(5) of this section.

* * * * *

(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 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 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 deductions 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.

* * * * *

(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;