

(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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(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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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 non-depreciable 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.

	Basis	Value
Assets:		
Property A	\$20,000	\$35,000
Cash Premium	1,000	1,000
Exercise Price	15,000	15,000
Total	36,000	51,000
Liabilities and Capital:		
TM	10,000	17,000
PK	10,000	17,000
DH	16,000	17,000
Total	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 ($\frac{1}{3}$ 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 $\frac{1}{3}$ 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