

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.

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

	Basis	Value
Total	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 ($\frac{1}{3}$ 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 $\frac{1}{3}$ 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 $\frac{1}{2}$ 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	1704(c) book
Property A	\$10,000	\$30,000	(\$1,000)	\$29,000
Property B	10,000	5,000	0	5,000