

	Assets basis	Value	Option adjustment	1704(c) book
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 (1/4 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 1/4 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	
	Book	Tax	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 DR'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 (1/3 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 1/3 of this