

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.

	Basis	Value
Assets:		
Property Z Undistributed Income	\$26,000 7,000	\$38,000 7,000
Total	33,000	45,000

	Basis	Value
Liabilities and Capital:		
MS	11,500	15,000
VH	11,500	15,000
SR	10,000	15,000
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	.....	.....
Years 2 net income	\$1,000	1,000	\$1,000	1,000	.....	.....
Years 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 1/3 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 (1/3 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 1/3 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.

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