

	AK		JP		JS	
	Tax	Book	Tax	Book	Tax	Book
Year 4 capital account prior to exercise .....	\$13,000	\$13,000	\$13,000	\$13,000	0	0
Capital account after exercise .....	13,000	13,000	13,000	13,000	10,000	10,000
Revaluation .....	.....	2,000	.....	2,000	.....	5,000
Capital account after revaluation .....	13,000	15,000	13,000	15,000	10,000	15,000

3. Section 1.704-3 is amended by revising the first sentence of paragraph (a)(6)(i) to read as follows:

**§ 1.704-3 Contributed property.**

(a) \* \* \*

(6) *Other applications of section 704(c) principles—(i) Revaluations under section 704(b).* The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to § 1.704-1(b)(2)(iv)(f) or 1.704-1(b)(2)(iv)(s) (reverse section 704(c) allocations).

\* \* \*

\* \* \* \* \*

4. Section 1.721-2 is added to read as follows:

**§ 1.721-2 Noncompensatory options.**

(a) *Exercise of a noncompensatory option.* Notwithstanding § 1.721-1(b)(1), section 721 applies to the exercise (as defined in paragraph (e)(4) of this section) of a noncompensatory option (as defined in paragraph (d) of this section). However, if the exercise price (as defined in paragraph (e)(5) of this section) of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the noncompensatory option, the transaction will be given tax effect in accordance with its true nature.

(b) *Transfer of property in exchange for a noncompensatory option.* Section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option. For example, if a person purchases a noncompensatory option with appreciated property, the person recognizes income or gain to the extent that the fair market value of the noncompensatory option exceeds the person's basis in the surrendered property.

(c) *Lapse of a noncompensatory option.* Section 721 does not apply to the lapse of a noncompensatory option.

(d) *Scope.* The provisions of this section apply only to noncompensatory options and do not apply to any interest on convertible debt that has been accrued by the partnership (including accrued original issue discount). For

purposes of this section, the term noncompensatory option means an option (as defined in paragraph (e)(1) of this section) issued by a partnership (the issuing partnership), other than an option issued in connection with the performance of services.

(e) *Definitions.* The following definitions apply for the purposes of this section.

(1) *Option* means a call option or warrant to acquire an interest in the issuing partnership, the conversion feature of convertible debt (as defined in paragraph (e)(2) of this section), or the conversion feature of convertible equity (as defined in paragraph (e)(3) of this section). A contract that otherwise constitutes an option shall not fail to be treated as such for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(2) *Convertible debt* is any indebtedness of a partnership that is convertible into an interest in that partnership.

(3) *Convertible equity* is preferred equity in a partnership that is convertible into common equity in that partnership. For this purpose, preferred equity is any interest in the issuing partnership that entitles the partner to a preferential return on capital and common equity is any interest in the issuing partnership that is not preferred equity.

(4) *Exercise* means the exercise of an option or warrant or the conversion of convertible debt or convertible equity.

(5) *Exercise price* means, in the case of a call option or warrant, the exercise price of the call option or warrant; in the case of convertible equity, the converting partner's capital account with respect to that convertible equity, increased by the fair market value of cash or other property contributed to the partnership in connection with the conversion; and, in the case of convertible debt, the adjusted issue price (within the meaning of § 1.1275-1(b)) of the debt converted, increased by accrued but unpaid qualified stated interest and by the fair market value of cash or other property contributed to the partnership in connection with the conversion.

(f) *Example.* The following example illustrates the provisions of this section:

*Example.* In Year 1, L and M form general partnership LM with cash contributions of \$5,000 each, which are used to purchase land, Property D, for \$10,000. In that same year, the partnership issues an option to N to buy a one-third interest in the partnership at any time before the end of Year 3. The exercise price of the option is \$5,000, payable in either cash or property. N transfers Property E with a basis of \$600 and a value of \$1,000 to the partnership in exchange for the option. N provides no other consideration for the option. Assume that N's option is a noncompensatory option under paragraph (d) of this section and that N is not treated as a partner with respect to the option. Under paragraph (b) of this section, section 721(a) does not apply to N's transfer of Property E to LM in exchange for the option. In accordance with § 1.1001-2, upon N's transfer of Property E to the partnership in exchange for the option, N recognizes \$400 of gain. Under open transaction principles applicable to noncompensatory options, the partnership does not recognize any gain upon receipt of appreciated property in exchange for the option. The partnership has a basis of \$1,000 in Property E. In Year 3, when the partnership property is valued at \$16,000, N exercises the option, contributing Property F with a basis of \$3,000 and a fair market value of \$5,000 to the partnership. Under paragraph (a) of this section, neither the partnership nor N recognizes gain upon N's contribution of property to the partnership upon the exercise of the option. Under section 723, the partnership has a basis of \$3,000 in Property F. See § 1.704-1(b)(2)(iv)(d)(4) and (s) for special rules applicable to capital account adjustments on the exercise of a noncompensatory option.

(g) *Effective Date.* This section applies to noncompensatory options that are issued on or after the date final regulations are published in the **Federal Register**.

5. Section 1.761-3 is added to read as follows.

**§ 1.761-3 Certain option holders treated as partners.**

(a) *In general.* A noncompensatory option (as defined in paragraph (b) of this section) is treated as a partnership interest if the option (and any rights associated with it) provides the holder with rights that are substantially similar to the rights afforded to a partner. This paragraph applies only if, as of the date that the noncompensatory option is