

USP has a capital account and an adjusted tax basis of \$240 million, CFC1 has a capital account of \$120 million and an adjusted tax basis of \$300 million, and FX has a capital account and an adjusted tax basis of \$40 million.

(iv) *Results: Sale of property in year 16.* PRS1's sale of the IP for cash of \$900 million on January 1 of year 16 results in \$900 million of book and tax gain (\$900 million-\$0). PRS1 allocates the book and tax gain 60 percent to USP (\$540 million), 10 percent to FX (\$90 million), and 30 percent to CFC1 (\$270 million). However, under § 1.704-3(d)(5)(iii)(D)(3), CFC1's tax gain is \$90 million, equal to its share of PRS1's gain (\$270 million), minus the amount of the tax basis adjustment (\$180 million). After the sale, PRS1's only property is cash of \$1.3 billion. With respect to their partnership interests in PRS1, USP has a capital account and an adjusted tax basis of \$780 million, CFC1 has a capital account and an adjusted tax basis of \$390 million, and FX has a capital account and an adjusted tax basis of \$130 million.

[T.D. 9891, 85 FR 3849, Jan. 23, 2020]

#### § 1.721-2 Noncompensatory options.

(a) *Exercise of a noncompensatory option*—(1) *In general.* Notwithstanding § 1.721-1(b)(1), section 721 applies to the exercise (as defined in paragraph (g)(4) of this section) of a noncompensatory option (as defined in paragraph (f) of this section). Except as provided in paragraph (a)(2) of this section, section 721 applies to the exercise of a noncompensatory option when the holder pays the exercise price with either property or cash, regardless of whether the terms of the option require or permit cash payment. However, if the exercise price (as defined in paragraph (g)(5) of this section) of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the option, then general tax principles will apply to determine the tax consequences of the transaction.

(2) *Exception.* Section 721 does not apply to the exercise of a noncompensatory option to the extent that the exercise price is satisfied with the partnership's obligation to the option holder for unpaid rent, royalties, or inter-

est (including accrued original issue discount) that accrued on or after the beginning of the option holder's holding period for the obligation. The issuing partnership will not recognize gain or loss upon the transfer of a partnership interest to an exercising option holder in satisfaction of such unpaid rent, royalties, or interest (including accrued original issue discount).

(b) *Transfer of property or satisfaction of an obligation in exchange for a noncompensatory option*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option, or to the satisfaction of a partnership obligation with a noncompensatory option.

(2) *Exception.* Section 721 does apply to a transfer of property to a partnership in exchange for convertible equity (as defined in paragraph (g)(3) of this section).

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

(d) *Cash settlement of a noncompensatory option.* Section 721 does not apply to the settlement of a noncompensatory option in cash or property other than a partnership interest in the issuing partnership.

(e) *Issuance of a partnership interest in satisfaction of indebtedness for interest on convertible debt.* Section 721 does not apply to the transfer of a partnership interest to a noncompensatory option holder upon conversion of convertible debt in the partnership to the extent that the transfer is in satisfaction of the partnership's indebtedness for unpaid interest (including accrued original issue discount) on the convertible debt that accrued on or after the beginning of the convertible debt holder's holding period for the indebtedness. The debtor partnership will not, however, recognize gain or loss upon such conversion. For rules in determining whether a partnership interest transferred to a creditor is treated as payment of interest or accrued original issue discount, see §§ 1.446-2 and 1.1275-2, respectively.

(f) *Scope.* The provisions of this section apply only to noncompensatory options. For purposes of this section,

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

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

(1) *Option* means a contractual right to acquire an interest in the issuing partnership, including a call option, warrant, or other similar arrangement, the conversion feature of convertible debt (as defined in paragraph (g)(2) of this section), or the conversion feature of convertible equity (as defined in paragraph (g)(3) of this section). To achieve the purposes of this section, the Commissioner can treat other contractual agreements, including a futures contract, a forward contract, or a notional principal contract, as an option. A contract that otherwise constitutes an option will not fail to be treated as an option 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 the partnership that issued the debt.

(3) *Convertible equity* is equity in a partnership that is convertible into a different equity interest in the partnership that issued the convertible equity.

(4) *Exercise* means the exercise of an option in exchange for an interest in the issuing partnership or the conversion of convertible debt or convertible equity into an interest in the issuing partnership.

(5) *Exercise price* means, in the case of a call option, the exercise price of the call option; 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 on the debt and by the fair market value of cash or other

property contributed to the partnership in connection with the conversion.

(h) *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, LM issues an option to N to buy a one-third interest in LM 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 (f) 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 § 1.1001-1, 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 income for the premium (the property received 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. The partnership does not recognize income for the premium (Property E) upon exercise of the option. 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.

(i) *Effective/applicability date.* This section applies to noncompensatory options that are issued on or after February 5, 2013.

[T.D. 9612, 78 FR 8012, Feb. 5, 2013]

**§ 1.722-1 Basis of contributing partner's interest.**

The basis to a partner of a partnership interest acquired by a contribution of property, including money, to the partnership shall be the amount of money contributed plus the adjusted basis at the time of contribution of any property contributed. If the acquisition