REPORT #881

TAX SECTION

New York State Bar Association

Report of Ad Hoc Committee
of New York State Bar Association Tax Section
Concerning Treatment of Exchanges
of Warrants in Reorganization Transactions

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TAX SECTION
New York State Bar Association

July 26, 1996

Hon. Donald C. Lubick,
Acting Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D-C- 20220

Hon. Margaret M. Richardson,
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N-W.
Washington, D-C. 20224

Re: Report on Warrant Exchanges in Reorganizations

Dear Secretary Lubick and Commissioner Richardson:

I am pleased to enclose a report by an ad hoc committee of the New York State Bar Association Tax Section dealing with the treatment of warrants in reorganization transactions. The principal drafter of the report was Lewis R- Steinberg.

As discussed in the report, we believe that holders of warrants should be allowed to exchange such warrants for acquirer stock or warrants on a tax-free basis in reorganization transactions. We believe this result is consistent with the principles underlying the reorganization provisions and generally affords no potential for abuse. Accordingly, we recommend that:

1. subject to exceptions for certain types of warrants that may present abuse

potential, conventional warrants (i.e., those that are settled solely in issuer stock) should be t treated as zero principal amount securities for purposes of the reorganization provisions of the Internal Revenue Code;

2. cash settled warrants should not be treated as stock or securities for purposes of the reorganization provisions; And

3. further study should be accorded to whether some or all warrants should be treated like stock for purposes of the continuity of shareholder proprietary interest doctrine.

Please let me know if we can be of any further assistance in addressing these issues.

Respectfully submitted,

Richard L. Reinhold
Chair

[Enclosure]

Report of Ad Hoc Committee of New York State Bar Association Tax Section Concerning Treatment of Exchanges of Warrants in Reorganization Transactions

This report by an ad hoc committee [1]/ (the "Committee") of the New York State Bar Association Tax Section updates and amplifies a July 29, 1968 report by the Tax Section [2]/ concerning the treatment of exchanges of warrants [3]/ in reorganization transactions [4]/ under Section 368. [5]/ We focus on two situations: (1) the circumstance where a taxpayer holding a warrant of an acquired corporation exchanges the warrant for a warrant of an acquiring corporation (or the acquiring corporation's parent) in a reorganization (a "Warrant-for-Warrant Exchange") and (2) the circumstance where a taxpayer holding a warrant of an acquired corporation exchanges the warrant for stock of an acquiring

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[1]/ The members of the committee were Andrew Berg, Peter C. Canellos, William G. Cavanagh, Benjamin J. Cohen, Stuart Finkelstein, John C. Hart, Robert A. Jacobs, Michael Hirschfeld, Richard L. Reinhold, Barnet Phillips IV, David R. Sicular and Lewis R. Steinberg. The principal drafter of the report was Lewis R. Steinberg. Helpful comments were received from Richard O. Loengard, Jr., Eric Solomon and Linda Z. Swartz.

[2]/ See Report on "Stock Warrants in Corporate Organizations and Reorganizations, " New York State Bar Association, Tax Section, Special Committee on Reorganization Problems, a copy of which is attached hereto.

[3]/ The term warrant denotes any warrant, option or right to acquire stock of the corporation that issued such warrant, option or right. It does not include compensatory stock options subject to the rules of Section 83 or 422 of the Internal Revenue Code of 1986, as amended (the "Code").

[4]/ While this report focuses on the treatment of warrants in reorganization transactions, similar considerations would apply to the treatment of warrants in spinoff, splitoff and splitup transactions under Section 355 of the Code.

[5]/ Unless otherwise indicated, all Section references are to Sections of the Code.

corporation (or its parent) in a reorganization (a “Warrant-for-Stock Exchange”). [6]/

In general and as discussed more fully below, the Committee believes that both types of exchanges should be treated as tax-free pursuant to Sections 354 and 356. [7]/ Accordingly, the Committee's principal recommendations are that:

> (1) the Treasury Department and the Internal Revenue Service (the “Service”) amend current Treasury Regulation Section 1.354-1 (e) to provide that, in the case of Warrant-for-Warrant and Warrant-for-Stock Exchanges and with certain exceptions, physically- settled warrants will be treated as “zero principal amount” securities;
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> (2) cash-settled warrants not be treated as stock or securities for purposes of the reorganization provisions; and
>
> (3) further study be accorded to whether all (or certain types) of warrants should be treated like stock for purposes of the continuity of shareholder proprietary interest doctrine.

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[6]/ The Committee also examined a third situation, one in which a taxpayer holding stock of a target corporation exchanges such stock for warrants (or warrants and stock) of an acquiring corporation or its parent (a “Stock-for-Warrant Exchange”). In general, the Committee believes that, consistent with the tax policy analysis of Warrant-for-Warrant and Warrant-for-Stock Exchanges discussed below, Stock-for-Warrant Exchanges should generally be accorded non-recognition treatment in reorganization transactions. Nevertheless, it is unclear whether such a result can be achieved under the literal language of Sections 354(a)(2)(A)(ii) and 356(d)(2)(B) (flush language) which, in circumstances where solely stock is given up in exchange (in whole or part) for securities, treats the fair market value of the “entire principal amount” of the securities received as taxable boot. This might be interpreted to make the entire fair market value of warrants received in a Stock-for-Warrant Exchange taxable to the exchanging shareholder even if, as proposed in this report, warrants were generally treated as “zero principal amount” securities for purposes of Section 356(d)(2)(B).

[7]/ While this report focuses on exchanges involving warrants and stock, similar arguments could be adduced for treating the receipt in a reorganization of warrants in exchange for debt securities as generally tax-free. Of course, even after implementation of the proposals we recommend, a transaction in which the taxpayer receives debt securities in exchange for warrants would generally be taxable under the excess principal amount rule of Section 356(d)(2)(B).

Legal Authorities

Treasury Regulation Section 1.354-1(e) states that "[f]or the purpose of section 354, stock rights or stock warrants are not included in the term 'stock or securities'". [8]/ While this regulation has been in effect for over forty years, the genesis and policy justification of the provision remain murky. In particular, while the Supreme Court in 1942 held in Helvering v. Southwest Consolidated Corp. [9]/ that warrants to acquire voting stock of an acquirer did not constitute voting stock for purposes of the reorganization provisions, [10]/ the Court did not decide or discuss whether warrants could constitute "securities" for that purpose.

In E.P. Raymond, [11]/ the Board of Tax Appeals held that warrants were securities for purposes of the predecessor provision to Section 354. [12]/ The Board of Tax Appeals reasoned that:

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[8]/ See also Treas. Reg. Sec. 1.355-1(b) (same rule for purposes of Section 355).

[9]/ 315 U.S. 194 (1942).

[10]/ The Southwest Consolidated Corp. decision turned on whether warrants constituted voting stock for purposes of the predecessor provision to Section 368(a)(1)(C).

[11]/ 37 B.T.A. 423 (1938).

[12]/ In Raymond, the taxpayer claimed that a warrant received in exchange for stock did not constitute a security for purposes of Section 112(b)(3) of the 1932 Act in order to recognize a loss with respect to the stock. The Board of Tax Appeals sustained the Commissioner's determination that the warrant was a security (thereby resulting in nonrecognition of the loss). See also G.C.M. 2177, VI-2 C.B. 112 (1927), holding that warrants could be received tax-free in a reorganization pursuant to Section 203 of the Revenue Act of 1924 (which allowed for the tax-free exchange of "stock or securities" for "stock or securities" of another party to the reorganization). G.C.M. 2177 is apparently still good authority. See G.C.M. 38906 (October 13, 1982).

> "The word, 'securities' was used [in the reorganization provisions] so as not to defeat the exemption in cases where the interest of the transferor was carried over to the new corporation in some form." The "form" in which this petitioner's right "was carried over to the new corporation" was the right, unlimited as to time, to demand the issuance to him of 100 shares of stock of the new corporation at $115 a share, a right which we have already said yielded him $107 in the following year. [13]/

Subsequent to the issuance of Treasury Regulation Section 1.354-1 (e), the Tax Court, in William H. Bateman v Commissioner, [14]/ held that warrants did not constitute stock for purposes of Section 354, [15]/ but were taxable as boot. The Tax Court found it unnecessary to decide whether the warrants could constitute securities for purposes of Section 354: in its view, since the taxpayer had surrendered only stock in the exchange, even if the warrants were securities they would still constitute boot under former Section 354(a)(2)(B) (now Section 354(a)(2)(A)(ii)).

While more recent cases have cited Bateman for the proposition that warrants do not constitute "stock or securities," in none of the cases did the result actually turn on

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[13]/ Raymond, at 426 (quoting Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932) cert, denied, 288 U.S. 599 (1933)).

[14]/ 40 T.C. 408(1963), nonacq. 1965-2 C.B. 7

[15]/ This conclusion was based, in great part, on the Supreme Court's holding in Southwest Consolidated Corp., although the latter had held merely that warrants were not voting stock.

whether warrants were securities for purposes of Section 354. [16]/

In PLR 9539020 (September 27, 1994), the Service held that warrants could be exchanged tax-free in a Warrant-for-Warrant Exchange where, pursuant to the original terms of the warrants, acquirer stock was substituted for target stock and the terms and conditions of the warrants were otherwise unaltered. The basis of the Service's conclusion is unspecified, but may be premised on the view, analogous to Proposed Treasury Regulation Sections 1.1001-3(c)(2)(i) (alteration in terms of debt instrument occurring pursuant to operation of original terms of instrument does not constitute "modification") and 1.1001-3(e)(3)(i)(A) (substitution of obligor in Section 381(a) transaction does not constitute "significant modification"), that the changes at issue in the private letter ruling did not rise to

[16]/ See Baan v. Commissioner, 51 T.C. 1032, 1038 (1969), aff'd, Gordon v. Commissioner, 424 F.2d 378 (9th Cir. 1970), and aff'd, Baan v. Commissioner, 450 F.2d 198 (9th Cir. 1971) (distribution by parent to its shareholders on two separate occasions and subsequent exercise of rights to purchase stock of subsidiary; transaction held not to constitute "D" or "F" reorganization); Smith v. Commissioner, 63 T.C. 722 (1975), acg. 1976-2 C.B. 2 (warrants held not to be stock; court did not have to reach issue of whether warrants could be securities because taxpayer held not to have realized gain in the transaction); see also Commissioner v. Baan, 382 F.2d 485 (9th Cir. 1967), aff'd, Commissioner v. Gordon, 391 U.S. 83 (1968) (same as Baan; court held that transaction did not qualify under Section 355); Levant v. Commissioner, 45 T.C. 185 (1965) (employee received from employer as compensation option to acquire interest in sole proprietorship; after business was incorporated, employee transferred option to acquirer for acquirer stock as part of overall stock-for-stock acquisition; court held that employee not entitled to nonrecognition treatment); Redding v. Commissioner, 630 F.2d 1169 (1980) (distribution by parent to its shareholders and subsequent exercise of rights to acquire stock in subsidiary; court held overall transaction did not qualify under Section 355); cf. Carlberg v. U.S., 281 F.2d 507 (8th Cir. 1960) ("certificates of contingent interest" held to be equivalent of stock under particular facts of case and therefore accorded non-recognition treatment); James C. Hamrick, 43 T.C. 21 (1964), vacated and remanded, 66-1 U.S.T.C. ¶ 9322 (4th Cir. 1965), acq. in result 1966-2 C.B. 2. (right to receive additional stock held to be equivalent of stock under facts of case and accorded nonrecognition treatment under Section 351).

the level of a realization event. [17]/

Policy Considerations

The Committee believes taxpayers should generally be allowed to exchange physically-settled [18]/ warrants in a reorganization without recognizing gain or loss. As explained more fully below, the statutory basis for that result would be to treat warrants generally as "zero principal amount" securities for purposes of Sections 354 and 356(d)(2)(B). [19]/

As articulated in Treasury Regulation Section 1.368-1(b), the purpose of the reorganization provisions is to provide non-recognition treatment for "readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms." Similarly, Treasury Regulation Section

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[17]/ 57 Fed. Reg. 57034, December 2, 1992. Under recently-finalized Treasury Regulation Section 1.1001-3, the types of changes at issue in the private letter ruling would likely constitute a significant modification and therefore constitute a realization event. See Treas. Reg. Secs. 1.1001-3(c)(2)(i), 1.1001-3(e)(4)(B) and 1.1001-3(e)(4)(E). In any event, as the Preamble makes clear, those Regulations apply solely to debt instruments, with other types of financial instruments being subject to the more stringent "fundamental change" principle of Revenue Ruling 90-109, 1990-2 C.B. 191.

[18]/ Our recommendations herein generally are limited to "physically-settled" warrants. By physically-settled we mean a warrant that, in all circumstances, can only be settled in issuer stock. Although the tax law conforms the tax treatment of cash settled options and physically-settled options for some purposes (see, e.g., Section 1234(c)(2)), extending our recommendations to cash settled warrants would introduce a number of difficult policy and technical issues. We discuss these issues at pp. 13-15, below.

[19]/ The policy justifications for the result suggested in this report would apply equally to warrants received in Section 351 transactions. Nevertheless, the Committee believes that the 1989 amendments to that Section, which limited Section 351 non-recognition treatment to receipt of stock, precludes the tax-free receipt of warrants under Section 351 under current law.

1.368-2(a) states that "[t]he term [reorganization] does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its shareholders in the properties transferred." The Committee believes allowing for tax-free exchanges of physically-settled warrants in reorganization transactions would further these purposes.

This principle is perhaps clearest in the case where a taxpayer exchanges a target company warrant for an acquiring company warrant with economically identical terms [20]/ in a Warrant-for-Warrant Exchange. Nevertheless, even where the terms of the two warrants differ, [21]/ or in the case of Warrant-for-Stock or Stock-for-Warrant Exchanges, the Committee believes the exchanges generally represent nothing more than a "readjustment of continuing interest in property tinder modified corporate forms." [22]/

In particular, the fair market value of a warrant is, in great part, a function of the fair market value of the underlying stock and changes in its value. [23]/ In addition, the rate at which the value of the stock is expected to change (i.e., the

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[20]/ Because the exchange ratio of target stock for acquirer stock may not be 1 for 1, the nominal terms of the new warrant may differ from those of the old warrant even though the two warrants are identical in economic terms.

[21]/ For example, even if the stock exchange ratio were 1 for 1, the target warrantholder might accept a lesser number of acquirer warrants with a reduced strike price or a greater number of warrants with an increased strike price.

[22]/ See also Raymond, at 426 (reasoning that exchange of warrants for stock constituted mere change in form of shareholder's interest in target corporation).

[23]/ See generally John C. Hull, Options. Futures, And Other Derivative Securities (1993), Chapter 7.

volatility of the underlying stock) affects the value of the warrant. [24]/ Thus, a warrant can be viewed simply as a leveraged investment in the underlying stock. Therefore, although warrants may not constitute stock for purposes of the reorganization provisions, they should certainly be viewed as constituting equity-flavored interests in the corporate properties and enterprise generally entitled to tax-free exchange treatment.

Subject to the excess principal amount rule of Sections 354(a)(2) and 356(d)(2)(B), the reorganization provisions have always allowed taxpayers to change the "type" of their interest in the corporation (from common stock to preferred stock [25]/ and vice versa, or from securities to stock, or from one kind of security to another) without recognizing gain or loss. Similarly, exchanges involving warrants are nothing more than a change in the form and type of the taxpayer's continuing equity interest in the corporate enterprise, a change not so substantial as to require the recognition of gain or loss. Indeed, given that warrants (at least those on common stock) provide greater potential for participation in corporate profits and value than non-participating debt securities or preferred stock, it is difficult to see why exchanges incident to reorganizations involving the exchange of debt or preferred stock should be accorded tax-free treatment, while exchanges involving warrants should not.

Because a warrant represents a leveraged investment in the underlying stock, it is frequently possible to alter the

[24]/ Id.

[25]/ The ability to receive preferred stock for common stock tax-free would be adversely impacted by certain proposals recently made by the Clinton Administration. See Proposed Fiscal 1997 Budget, Section 9527 (Tax Analysts Highlights & Documents, Special Supplement, March 21, 1996, at 3496).

structure of a proposed transaction to provide the same economic result as an exchange involving warrants, but without recognizing gain or loss under current law. For example, assume an acquirer wishes to issue warrants and stock in exchange for all the stock of an acquired corporation as part of a tax-free reorganization. Because the receipt of the warrants by the target shareholders would not be tax-free under current law, the acquirer might initially recapitalize its existing stock into preferred stock, representing the bulk of the current value of the corporation's equity, and a small amount of common stock, which represents an "upside play" on the future value of the corporation. [26]/ Common stock and preferred stock could then be issued to the target shareholders in exchange for their target stock.

Because the substantial value attributed to the acquirer's preferred stock would soak up substantially all the acquirer's equity value, the acquirer's common stock would have mainly "option value" and would trade like a warrant on the corporation's (unleveraged) equity. The exchange of the package of preferred and common stock for the acquired corporation's stock thus provides economic results similar to the issuance of warrants and stock in an unleveraged corporation, but without adverse tax consequences to the target corporation's shareholders. Utilizing such a structure is neither abusive nor inconsistent with the purposes of the reorganization provisions. For the same reason, as a pure matter of tax policy, a direct

[26]/ This structure is akin to that commonly used in "estate freeze" transactions.

Although the preferred stock might well be "section 306 stock", that fact would not alter the analysis in the text, since there are many circumstances in which the effect of any Section 306 taint may be avoided in non-abusive transactions.

exchange of acquirer warrants and (unleveraged) stock for the target's shares should also be tax-free. [27]/

The Committee recognizes there may be cases where allowing non-recognition treatment for exchanges involving warrants might be inappropriate. In particular, some cash-settled warrants [28]/ may present the potential for abuse. A deep-in-the-money cash-settled warrant or a warrant having a stated minimum and/or maximum value may, in some cases, be viewed as a surrogate for a debt instrument that, depending on the warrant's terms and by analogy to the rules dealing with the exchange of debt securities in reorganizations, should either be treated as a security having a positive principal amount for purposes of the excess principal amount rule of Sections 354(a)(2) and 356(d)(2)(B) or denied non-recognition treatment entirely as being a "non-security". In other cases, because of the short term of the warrant or other features, a warrant's potential participation in corporate growth and earnings may be viewed as too insubstantial to be accorded nonrecognition treatment; instead, the taxpayer may be viewed as possessing nothing more than a short-term bet on the fortunes of the acquiring company or the target, as the case may be.

Given these concerns, the Committee does not propose that non-recognition treatment be extended to cash- settled warrants at this time. The Committee understands that, to date,

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[27]/ As noted above (see note 6) fully tax-free treatment of a direct exchange of warrants and acquirer stock for target stock may be precluded by the literal language of Sections 354(a)(2)(A)(ii) and 356(d)(2)(B).

[28]/ The Committee would treat as cash-settled any warrant that is either required to be settled in cash or other property (other than the issuer's stock) or that may be settled in cash or other property (other than the issuer's stock), at either the option of the issuer or the holder.

cash-settled warrants have not become a fixture of the corporate finance scene. Moreover, the Committee recognizes that the tax treatment outside the reorganization context of cash-settled warrants, like many other hybrid financial instruments, remains uncertain in some respects. The Committee therefore believes that it would be premature to accord non-recognition treatment to cash-settled warrants at this time. Nevertheless, because, in at least some cases, cash-settled warrants provide the same opportunities for participation in corporate growth without potential for tax abuse as physically-settled warrants, [29]/ the Committee believes that further thought and analysis should be given to extending non-recognition treatment to at least long-dated (e.g., more than five years) "plain vanilla" cash-settled warrants.

Furthermore, the Committee recognizes that, even in the case of physically-settled warrants, there may be certain types of "exotic" warrants that present abuse potential. These might include warrants that provide for minimum payouts at maturity or, because of "caps" on the holder's right to participate in the upside of the underlying stock, provide for a substantially certain amount at maturity. [30]/ These kinds of warrants are similar in many respects to debt instruments, the exchange and receipt of which in reorganizations have traditionally been policed by the requirement that the instrument in question be a

[29]/ For example, a ten-year, at-the-money "plain vanilla" cash-settled warrant on acquirer stock would, from a tax policy point of view, appear to be as deserving of non-recognition treatment as a physically-settled warrant having otherwise identical terms.

[30]/ For example, assume that an acquirer issues a "call spread" warrant with a strike price of $25 and a maximum payoff of $30 at a time when the under lying stock is trading at $100. Depending on the term of the warrant and the volatility of the underlying stock, a payoff at maturity of $30 may be virtually certain.

"security" for tax purposes and by the excess principal amount rule of Sections 354(a)(2) and 356(d)(2)(B).

The Committee believes that these potential abuse cases involving physically-settled warrants are more the exception than the rule in the real world. To provide clear guidelines for tax planning purposes, however, the Committee suggests that the Treasury Department and the Service issue detailed and specific guidance describing the types of transactions involving warrants that will not be granted non-recognition treatment. This issue is discussed further in the following section of the report.

Specific Recommendations

The Committee respectfully suggests the Treasury Department and Service amend existing Treasury Regulation Section 1.354-1(e) to provide that, for purposes of Warrant-for-Warrant and Warrant-for-Stock Exchanges, physically-settled warrants will generally be treated as securities for purposes of Sections 354, 356 and 368 and will generally be treated as having a zero principal amount for purposes of the excess principal amount rule of Sections 354(a)(2) and 356(d)(2)(B). [31]/

To some degree, this suggestion is result-driven: given the policy justifications for according nonrecognition treatment

[31]/ Similarly, the Committee recommends the amendment of the last sentence of Treas. Reg. Sec. 1.355-1(b) in a manner analogous to that described herein.

Theoretically, an amended Regulation under Section 1.354-1(e) could also provide that physically-settled warrants will be treated as zero principal amount securities for purposes of Stock-for-Warrant Exchanges. Because of the technical problem presented by the statutory language of Sections 354(a)(2)(A)(ii) and 356(d)(2)(B), as discussed in note 6 above, we believe that such an amendment would not be advisable.

to warrants outlined above and, based on Southwest Consolidate Corp. and Bateman, the inability to treat warrants as stock, treating warrants as securities achieves the proper result with the least required change to the statutory scheme. [32]/ Treating warrants as securities is also consistent with other areas of the tax law. [33]/ A concern might be expressed about the proposal to treat warrants as having a zero principal amount for purposes of the excess principal amount rules. The legislative history to the provision that is now embodied in Sections 354(a)(2) and

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[32]/ As discussed below, see pages 25-27, exchanges involving warrants in "B" reorganizations may remain taxable even if the Committee's recommendations are implemented. This result, which the Committee believes to be unwarranted as a tax policy matter, is unavoidable absent additional changes to the prevailing legal authority.

The Committee would support legislative amendments to Sections 354-6 and 351 to provide generally for tax-free treatment of warrants. Nevertheless, given the difficulty of enacting tax legislation in the current budgetary environment and the Committee's belief that the Treasury Department and Service are authorized under current law to accord non-recognition treatment to warrants by means of regulations (except in the case of Stock-for-Warrant Exchanges), the Committee does not recommend waiting for legislative action on this issue.

[33]/ See, e.g., Section 475(c)(2)(E)("security" includes option relating to corporate stock); Section 731(c)(2)(A),(C) ("marketable securities" includes actively traded stock options); Section 1236(c) ("security" includes right to subscribe to or purchase a share of corporate stock); Section 6323(h)(4) ("security" includes warrant or right to subscribe to or purchase share of stock); See also Section 165(g) ("security" includes right to subscribe for, or to receive, corporate stock); cf. Section 1091(a) (except as otherwise provided in regulations, "stock or securities" includes options to acquire stock); Treas. Reg. Sec. 1.351- 1(c)(3) ("readily marketable stocks or securities" includes warrants and other stock rights if the underlying stock is readily marketable); Treas. Reg. Sec. 1.543-1(b)(5)(i) ("stock or securities" includes stock rights or warrants: obsolete but applies by analogy to foreign personal holding company provisions); Treas. Reg. Sec. 1.864-2(c)(2) ("effecting of transactions in stocks or securities" includes buying, selling or trading in options to buy or sell stock or securities); Treas. Reg. Sec. 1.1362- 2(c)(4)(ii)(B)(3) ("stock or securities" includes stock rights or warrants). See also Section 305(d)(1) (treating rights to acquire stock as "stock"); Section 306(d)(1) (same); Section 1032 (treating stock and stock rights identically).

356(d)(2)(B) [34]/ makes clear that the provision was animated by the Neustadt's Trust [35]/ and Bazley cases. [36]/ In Neustadt's Trust, the Second Circuit held that a debt- for-debt exchange could be a tax-free recapitalization. In 1952, the Service announced it would follow Neustadt's Trust where the bonds exchanged and the bonds received had the same principal amount. [37]/ In Bazley, the Supreme Court held that the receipt of debt securities in exchange for stock in a purported recapitalization should be taxed as a dividend.

Absent the excess principal amount rule (or case-specific judicial scrutiny), reorganization transactions (and, in particular recapitalizations) could be used to bail out corporate

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[34]/ See Sen. Rep. No. 1622, 83rd Cong., 2d Sess., at 268-69:

> Section 356 corresponds to Section 112(c) and 112(e) of the 1939 Code and retains to a large extent the language of such sections. The treatment of securities is clarified by the adoption of a principle analogous to that found in Commissioner v. Neustadt's Trust (131 F.2d 528 (C.C.A. 2, 1942)).
>
> Subsection (d) contains rules as to the treatment of securities for purposes of Section 356. Paragraph (1) states the general rule that for purposes of Section 356 the term "other property" includes securities. This is a restatement of the principle stated by the Supreme Court in Bazley v. Commissioner, 331 U.S. 737 (1948).

[35]/ 131 F.2d 528 (1942), acq. 1951-1 C.B. 2.

[36]/ 331 U.S. 737 (1947), reh'g denied and prior opinion amended, 332 U.S. 752 (1946).

[37]/ I-T. 4081, 1952-1 C.B. 65.

earnings at preferential capital gains rates. [38]/ The excess principal amount rule functions in tandem with Section 306 to ensure that debt and preferred stock are not used to convert dividend income into capital gain. However, subject to the discussion in the next paragraph, the equity-flavored nature of warrants does not afford taxpayers an analogous opportunity to convert dividends into capital gain. [39]/ Accordingly, the Committee believes that treating warrants as having other than a zero principal amount for purposes of the excess principal amount rule would frustrate the purposes of the reorganization provisions without furthering any anti-abuse goals.

As noted above, the Committee acknowledges that abuse potential might exist in the case of certain warrants, particularly physically-settled warrants that provide for a minimum payout or, because of caps or similar features, provide a substantially certain payout at maturity. [40]/ Consequently, the

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[38]/ For example, assume a corporation has debt securities and appreciated common stock held proportionately by its shareholders. After Neustadt's Trust, an exchange of the existing debt for new debt securities having a greater principal amount would qualify as a reorganization. If the excess principal amount rules did not apply (and absent a Bazley-type analysis), the receipt of the new debt would be tax-free and the gain on the bondholder's sale of the new debt would be taxed at capital gains rates, thereby achieving a bailout of corporate earnings. Thus, the excess principal amount rule is a natural adjunct to the codification of the holding in Neustadt's Trust, as well as a bulwark against the type of debt-for-stock bailout at issue in Bazley.

[39]/ The use of warrants on preferred stock to effect earnings bailouts is already adequately policed by Section 306(d).

[40]/ Bailout concerns are arguably greatest in the case of Stock-for-Warrant Exchanges.

As discussed above, cash-settled warrants would be treated as boot in all cases.

Obviously, to the extent legislative changes are enacted that would treat certain types of preferred stock as boot, see note 25, warrants to acquire such preferred stock should similarly be denied tax-free treatment under Section 354.

Committee suggests the relevant regulations provide that: (a) a warrant guaranteeing a fixed minimum dollar payout [41]/ should be treated as a security only if such warrant has a minimum term of at least five years and should be treated as having a principal amount equal to the amount of such minimum payout for purposes of Sections 354(a)(2) and 356(d)(2)(B), [42]/ and (b) a warrant that provides for a fixed maximum dollar payout [43]/ should be treated as a security only if such warrant has a minimum term of at least five years and should be treated as having a principal amount equal to the fair market value of such warrant at the time of the reorganization. [44]/ Where both rules apply, the amount of the deemed principal amount of the warrant should be determined under whichever rule provides the greatest amount. Notwithstanding the foregoing, the Committee believes that a warrant having a less-than-five year term that is received in a Warrant-for-Warrant Exchange should be treated as a security where the terms of the new warrant are economically identical to those of the old

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[41]/ Because the Committee proposes that non-recognition treatment not be extended to cash-settled warrants or other warrants that settle (or could settle) in property other than the issuer stock, any such fixed dollar minimum payout would have to be payable solely in issuer's stock.

[42]/ Because the amount of boot under Section 356(d)(2)(B) is the fair market value of the excess principal amount of the relevant security, the boot attributable to the receipt of a minimum payout warrant should be the present value of such minimum payout. See also Section 483 (potentially treating a portion of the minimum payout as interest).

[43]/ Again, any such maximum could be payable only in issuer stock.

[44]/ Some may feel that treating the full fair market value of such a warrant as boot is inappropriate under certain circumstances. For example, assume a five-year warrant on a low volatility stock (with a current trading price of $25) that has a strike price of $25 and a maximum payout of $1,000. In such case, the cap on the payout is essentially meaningless. Nevertheless, for reasons of administrative simplicity and because the Committee believes that such capped warrants are relatively rare in practice, we suggest that the rule set forth in the text should apply to all capped warrants.

warrant and the original maturity of the old warrant was greater than five years. [45]/

The Treasury Department and Service would also retain authority to issue future guidance (in the form of amendments to the relevant regulations) defining other types of warrants that, because of their abuse potential, should be exempted from the definition of securities and/or treated as having a positive principal amount for purposes of Sections 354(a)(2) and 356(d)(2)(B). [46]/ This would afford the Treasury Department and the Service flexibility to amend the regulations further as needed to address areas of concern that are discovered in the wake of the amendments to the regulations proposed in this report- Nevertheless, given the Committee's belief that abuse situations will be very limited and the overriding goal of not chilling legitimate business transactions, the Committee recommends any exceptions to the general rule of the regulations be narrowly and precisely drawn.

Lack of Impediments to and Timeliness of Suggested Changes

The Committee believes that there are no impediments to the Treasury Department's and Service's making these salutary changes to the relevant regulations. In particular, there is no

[45]/ This exception is intended to allow for a tax-free rollover of warrants on economically identical terms, even if the remaining term of the warrant is less than five years. The Committee recognizes that this may afford preferential treatment to warrants as compared to debt securities (which generally may not be rolled-over tax free where the remaining term of the debt is less than five years). This is appropriate, however, since debt instruments, particularly those with a term of less than five years, are significantly less equity-flavored than stock warrants.

[46]/ In addition to the specific exceptions contained in the regulation, the Service would of course be free to treat any purported warrant that, under general income tax principles is in fact a debt instrument, under the debt (rather than the warrant) rules.

indication Congress ever explicitly focused on Treasury Regulation Section 1.354-1(e) or the cases applying its principles so as to invoke the legislative reenactment doctrine. Similarly, while the Bateman case held that warrants were boot for purposes of Section 356 under the facts presented, the Court did not have to address the question whether warrants could constitute zero principal amount securities in other contexts. [47]/ Finally, as noted above, while more recent cases have invoked the holding of Bateman, none has actually had to apply that holding in a manner that would have altered the outcome in the case at issue.

The Committee believes the proposed changes to the Regulations are particularly timely given the important changes in corporate finance that have occurred over the last forty years. Especially since the mid-1980s, increased leveraged buyout and merger and acquisition activities, coupled with advances in the area of derivatives and the development of high-yield debt financing, has produced a proliferation of warrant issuance. As a result, taxable treatment of warrant exchanges has become an increasingly significant problem for those desiring to consummate reorganization transactions. The Committee respectfully submits that now is the time for the Treasury Department and the Service to act to modernize this area of Subchapter C of the Code.

[47]/ As noted above, see note 6, the Committee agrees with the court in Bateman that the literal language of Sections 354(a)(2)(A)(ii) and 356(d)(2)(B) may preclude nonrecognition treatment of Stock-for-Warrant Exchanges even if warrants were otherwise treated as securities. The Committee thus agrees with the result in Bateman under the current statutory scheme, although not necessarily with all aspects of the reasoning of that decision.

Collateral Issues

1. Exercise of Warrants. Treating warrants generally as zero principal amount securities would not change, and would be consistent with, the long-standing rule that exercise of a warrant is tax-free to the holder. [48]/ Because of Section 1223(6), a holder's holding period in stock received upon exercise of a warrant would begin on the day after the date of exercise.

2. Impact on “B” and “C” Reorganizations. In Revenue Ruling 68-637, 1968-2 C.B. 158, the Service held that the substitution of acquirer warrants and options for the target's warrants and compensatory stock options in a purported reorganization under Section 368(a)(1)(C) constituted a permitted assumption of liabilities, thereby not disqualifying the overall transaction from reorganization treatment. In Revenue Ruling 78-408, 1978-2 C.B. 203, the Service held that the substitution of the acquirer's warrants for the target's warrants as part of an overall transaction involving the acquisition of all the target's stock in exchange for acquirer voting stock was a separable transaction from the stock-for-stock exchange,- accordingly, the latter qualified as a tax-free exchange pursuant to Section 368(a)(1)(B), while the warrant-for- warrant exchange was taxable by analogy to Revenue Ruling 69-142, 1969-1 C.B. 107 (which held that an exchange of acquirer debentures for target debentures

[48]/ In certain limited circumstances (e.g., where the warrant has a nominal strike price and exercise is subject to the target's attaining certain levels of post-acquistion profits), it might be appropriate to impute interest pursuant to Section 483 with respect to the receipt of stock upon exercise. In such cases, the warrant functions, in essence, as a disguised earnout. Cf. Rev. Rul. 70-300, 1970-1 C.B. 125; Treas. Reg. Sec. 1.483-4, Ex.2 (application of Section 483 to contingent stock “earnouts”.) The Committee believes, however, that such cases are extremely rare in practice.

was not part of a “B” reorganization and therefore taxable).

The Committee's recommendation that warrants be treated as securities, and not stock, for purposes of the reorganization provisions of the Code is consistent with the holdings of those Rulings. Nevertheless, the Committee recognizes that this result, by making Warrant-for-Warrant and Warrant-for-Stock Exchanges taxable in the case of “B” reorganizations, may limit somewhat the practical utility of our recommendations. [49]/ Given the equity-flavored nature of warrants, we believe that such an outcome is incorrect as a purely tax policy matter and, were we writing on a clean slate, would strongly urge that such exchanges generally be treated as tax-free. Nevertheless, given the long-standing precedent of Southwest Consolidated Corp. that warrants are not voting stock, coupled with the Service's position in Revenue Rulings 69-142 and 78-408 that only stock for voting stock exchanges are tax free pursuant to Section 368(a)(1)(B), the Committee believes” that according tax-free treatment to Warrant-for-Warrant and Warrant-for-Stock Exchanges in “B” reorganizations would be inconsistent with the prevailing legal authority. [50]/

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[49]/ Of course, if the transaction in question independently qualifies as a reorganization under Section 368(a)(2)(E), the problem of gain recognition with respect to Warrant-for-Warrant and Warrant-for-Stock Exchanges would be avoided. In any event, even in the case of a “B” reorganization, a warrantholder could avoid gain recognition attributable to a Warrant-for-Stock Exchange by first exercising the warrants (assuming they were currently exercisable), and then exchanging the target stock received upon exercise for acquirer stock as part of the “B” reorganization.

[50]/ The Committee strongly encourages the Service to reexamine the holdings of Revenue Rulings 69-142 and 78-408. In particular, we believe that viewing the exchange of debentures or warrants, respectively, as part of the plan of reorganization is not inconsistent with treating the overall transaction as an acquisition of the target's stock solely in exchange for the acquirer's voting stock. In this way, both the debenture-for-debenture/warrant-for-warrant and the stock-for-stock exchanges would qualify as tax-free under Section 354.

3. Continuity of Shareholder Proprietary Interest. Given the equity-flavored nature of warrants, the Committee believes that warrants generally should be treated as equity interests for purposes of the continuity of shareholder proprietary interest doctrine. For example, an in-the-money or at-the-money "plain vanilla" warrant on acquirer stock certainly affords the holder at least as substantial an equity interest in the acquiring corporation as nonparticipating preferred stock, which is treated as stock for continuity purposes. [51]/

Nevertheless, the Committee recognizes that the considerations for treating warrants as "continuity-giving" may differ, and be more stringent, than those discussed above in support of the proposition that warrant exchanges should generally be tax-free. In particular, like debt securities, warrants may, in at least some cases, afford the holder a sufficiently substantial interest in the acquiring company to make non-recognition treatment appropriate without also making it appropriate to treat the warrant as continuity-giving. Furthermore, the Committee understands that, in the wake of cases like Seagram. [52]/ the Treasury Department and Service are intensively studying at least certain aspects of the continuity of interest doctrine. The Committee therefore suggests that, while the Treasury Department and Service expeditiously amend the relevant Treasury Regulations to provide generally for nonrecognition treatment in warrant exchanges as discussed above, continued study be undertaken as to the advisability of issuing guidance that would treat physically-settled warrants as equity interests for continuity purposes.

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[51]/ See also Bateman, at 413 ("Certainly, the purpose of the statute requiring that the taxpayer have a continuing interest in the surviving corporation is met under the facts here present").

[52]/ J.E. Seagram Corp., 104 T.C. 75 (1995).

Conclusion

The Committee believes treating warrants as zero principal amount securities for purposes of the reorganization provisions of the Code will further the purpose of the reorganization provisions and remove tax- based impediments to consummating bona fide commercial transactions. That treatment of warrants could be accomplished by amending existing Treasury Regulation Section 1.354-1(e) to provide that physically-settled warrants will be treated generally as “zero principal amount” securities. Precise exceptions could be provided for identified warrants that are perceived to create tax abuse potential.

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

July 29, 1968

PETER MILLER, ESQ.
Chairman of Tax Section
New York State Bar Association 3
Hanover Square New York, New York 10005

Dear Mr. Miller:

I enclose herewith a Report of the Special Committee on Reorganization Problems entitled “Stock Warrants in Corporate Organizations and Reorganizations”.

This Report was approved in principle by the Executive Committee of the Tax Section at its meeting on June 5, 1968 and was thereafter revised with the approval of the Administrative Committee.

This Report was drafted by Messrs. Elliott Manning and Walter C. Cliff of the Special Committee on Reorganization Problems. Helpful comments were received from Messrs. Alan N. Cohen, Richard G. Cohen, Mervyn S. Gerson, Richard Loengard, Jerome Rosenberg and Professor George E. Zeitlin.

Respectfully submitted,

JOHN WILCOX
Chairman of Special Committee
on Reorganization Problems

STOCK WARRANTS IN CORPORATE ORGANIZATIONS AND REORGANIZATIONS

BY

SPECIAL COMMITTEE ON REORGANIZATION PROBLEMS

INTRODUCTION

The Special Committee on Reorganization Problems proposes that the Internal Revenue Service amend its Regulations to provide that, in determining the extent to which gain is recognized in a corporate organization or reorganization, stock rights and warrants are to be treated as equity “securities” and not as “other property” (commonly called “boot”). Adoption of the Committee’s proposals would permit stock rights or warrants to be received without immediate tax to their recipients, even in those cases where the recipient of the stock rights or warrants does not surrender stock rights or warrants (or debt securities) in exchange for those received.

1. AUTHORITIES THAT STOCK WARRANTS ARE NOT “SECURITIES”

A. REGULATIONS ON NONRECOGNITION OF GAIN

The Regulations[*] under Sections 351,[**] 354,[***] and 355[****] of the Internal Revenue Code state categorically that "stock rights or stock warrants are not included in the terms 'stock or securities' ".[*] The Regulations under Sections 361[**] and 371[***] are silent as to the meaning of the terms "stock or securities".

Regulations 118, issued under the 1939 Code, did not purport to construe the term "stock or securities" as used in the predcessors to Sections 351 and 354, and thus were silent as to whether that term covered stock rights and warrants.

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[*] Regs. §§ 1-351-1(a)(1); 1.354.1(e); 1.355-1 (a).

[**] Section 351(a) provides that "No gain or loss shall be recognized it property is transferred to a corporation . . . solely in exchange for stock or securities in such corporation . . ."

[***] Section 354(a)(1) provides that "No gain or loss shall be recognized if stock or securities m a corporation a party to a reorganization . . . are . . . exchanged solely for stock or securities in such Corporation or another corporation a party to the reorganization.

[****] Section 355(a)(1) provides that "No gain or loss shall be recognized to . . . [a] shareholder or security holder on the receipt of [certain] stock or securities . . ." in connection with divisive reorganization.

Section 355 was recently construed in Commissioner v. Gordon, —U. S.— (1968). 68-1 U.S.T.C. Para 9383 (Sup. Ct. 1968), involving a distribution by Pacific Telephone & Telegraph Company of rights to subscribe to stock of a second corporation. Pacific Northwest Bell Telephone Company. Accordingly, the Gordon case did not deal with "stock rights or stock warrants" to subscribe to shares of the distributing corporation, which is the subject of this Report.

[*] This Report also does not discuss the tax consequences of the receipt of rights to purchase bonds or other forms of indebtedness.

[**] Section 361 (a) provides that "No gain or loss shall be recognized if a corporation, a party to a reorganization, exchanges property . . . solely for stock or securities in another corporation a party to the reorganization."

[***] Section 371 (b)(1) provides that "Xo (rain or loss shall be recognized on an exchange ... of stock or securities in a corporation [involved in specified insolvency proceedings] . . . tor stock or securities of a corporation . . . made use of to effectuate such plan of reorganization."

In Helvering v. Southwest Consolidated Corp.,[****] the Supreme Court held that warrants to purchase voting common stock were not "voting stock" for purposes of the definition of "reorganization" in the predecessor of Section 368(a)(1)(C). However, the Supreme Court did not indicate whether such warrants are to be classified as "securities", since that issue apparently was not raised before the Court by either of the parties.

B. BATEMAN DECISION

In William H. Bateman,[*****] a case not reviewed by its full membership, the Tax Court held that warrants to Subscribe to voting common stock, which were issued by the acquiring corporation in a statutory merger along with its stock, were not "stock" within the meaning of Section 354(a)(1). Such warrants were held to constitute "boot" under Section 356. Judge Scott considered it unnecessary to decide whether the warrants should be classified as "securities" under Section 354 on the ground that, even if the warrants were classified in this manner, they would nevertheless be taxable as "boot" under Sections 354 and 356 because no securities had been surrendered by the taxpayer in exchange for the warrants.

Our Committee believes that the Bateman case was wrongly decided and should not be followed insofar as it held that warrants are "boot" merely because no securities were surrendered. We submit that stock warrants are equity "securities" and that those provisions of Section 354, 355 and 356, added by the 1954 Code, which compare the face amount of "securities" received with the face amount of "securities"

[****] 315 U.S. 194 (1942).

[*****] 40 T.C. 408 (1963), nonacq. on another issue. 1965-2 Cum. Bull. 7, appeal dismissed pursuant to stipulation (4th Cir. 1964).

surrendered, are to be applied only to debt securities and not to equity securities such as stock warrants. [*]

II. AUTHORITY THAT STOCK WARRANTS ARE “SECURITIES”

A. RAYMOND DECISION

The only authority interpreting Section 112(b)(3) of the 1932 Act, the predecessor of Section 354, held that stock warrants were “securities” which could be received in exchange for stock without recognition of gain.

In E. P. Raymond[**] the taxpayer participated in a reorganization pursuant to which he exchanged 100 shares of common stock in the old corporation for a perpetual warrant to subscribe for 100 shares of common stock of the new corporation at a stipulated price. The exchange was effected in 1933, and the warrant was sold in 1934 for a nominal sum. The taxpayer claimed that he suffered a loss in 1933 on the exchange of his old stock for the warrant, contending that the warrant was not a “security” under Section 112(b)(3) of the Revenue Act of 1932, which was similar to Section 354(a)(1). The Commissioner contended that the warrant issued in the reorganization was a “security”, and was sustained by the Board of Tax Appeals. The Board’s opinion reads in part:

> “. . . we are of the opinion that the right or option which petitioner acquired in exchange for his stock falls squarely within the accepted definition of ‘securities’ and also within the spirit and intendment of the reorganization provisions of the statute.”[*]

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[*] Sec “Interpretation of 1954 Amendments as to 'Principal Amount' of ‘Securities’ “ at pp. 49-52 below.

[**] 37 B.T.A. at 426.

[*] 37 B.T.A. at 426.

The result in Raymond was presaged by G.C.M. 2177,[**] which held warrants to be “stock or securities” (without determining which) within the meaning of Section 203 of the Revenue Act of 1924.

The decision in Bateman, discussed above,[***] accepted the decision in Raymond as support for the proposition that warrants are not “stock”.[****] However, Bateman, also raised the issue of whether 1954 amendments (as to “principal amount” of securities) required recognition of gain upon receipt of stock warrants by a shareholder who surrendered neither other warrants nor debt securities in exchange therefor.[*****]

III. COMMON USAGE CLASSIFIES WARRANTS AS “SECURITIES”

The ordinary meaning of the term “securities” clearly includes stock warrants and at least those types of stock rights which arc freely transferable.

In discussing “Classification of Securities” in their treatise on Security Analysis, Messrs. Graham, Dodd & (Cottle characterize warrants as “securities” as follows:

> “More striking still is the emergence of completely distinctive types of securities so unrelated to the standard bond or stock pattern as to require an entirely different set of names. Of these, the most significant is the option warrant—a device which during the years prior to 1929 developed into a financial instrument of major importance and tremendous mischief making powers. The option warrants issued by a single company—American and Foreign Power Company—attained in 1929 an aggregate market

[**] VI-2 Cum. Bull. 112 (1927).

[***] See text at p. 39, above.

[****] 40 T.C. at 414.

[*****] See “Interpretation of 1954 Amendments as to ‘Principal Amount’ of 'Securities’” at pp. 49-52 below.

> value of more than a billion dollars, a figure exceeding our national debt in 1914." (p. 101; footnotes omitted; emphasis added).

Stock warrants are likewise characterized as "securities" in Dewing, Financial Policy of Corporations*

It would appear, therefore, that there is nothing in the common understanding of the term "stock or securities" which requires exclusion of stock warrants from the category of "securities".

IV. WARRANTS ARE TREATED AS "SECURITIES" IN OTHER TAX CONTEXTS

The Regulations** under Sections 351, 354, and 355 appear to be unique in excluding stock warrants from the scope of the phrase "stock or securities".

By contrast, the Regulations interpreting the old personal holding company provisions,* which included gains from the sale or exchange of "stock or securities" in personal holding company income, provided that "stock or securities" included stock warrants.** Although this Regulation is in one sense obsolete as a result of 1964 amendments to the personal holding company provisions,*** it presumably continues to have validity under the identical statutory language found in Section 553(a)(2) with respect to foreign personal holding companies. Moreover,

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* Vol. I. (5th Ed. 1953) at p. 265.

** See footnote on p. 38 above.

* Section 543(a)(2) (prior to amendment by the Revenue Act «.[1964).

** Reg. § 1.543-1 (b)(5).

*** Section 543(a)(2) as amended and Section 543(b).

it has been incorporated by reference in defining gains from "the sale of stock or securities" for Subchapter S purposes.[****]

The recently-adopted Regulations under Section 351(c), which deal with recognition of gain on transfers to "investment companies", include stock warrants in the category of "readily marketable securities" if the stock to be acquired on exercise of the warrants is readily marketable.[*****]

In Revenue Ruling 56-406,[******] warrants were treated as stock or securities which were held to be "substantially identical" to stock or securities in certain circumstances for purposes of the disallowance of losses from wash sales required by Section 1091. See also Section 1083(f) of the Code which defines "stock or securities" to include "any . . . right to subscribe to or to purchase ..." stock or securities for purposes of nonrecognition of gain or loss in exchanges or distributions in obedience to orders of the Securities and Exchange Commission.[*******]

In Commissioner v. Neustadt's Trust,[*] the Service contended unsuccessfully that a "recapitalization" reorganization under the predecessor of Section 368(a)(1)(E) did not embrace an exchange of debt securities for debt securities. In its opinion, the Second Circuit noted that the first question was whether debentures constituted "securities" within the meaning of Section

[****] Reg. § 1.1372-4(b)(5)(viii).

[*****] Reg. §1.351-1 (c)(3).

[******] 1956-2 Cum. Bull. 523.

[*******] Cf. Rev. Rul. 63-183, 1963-2 Cum. Bull. 285.

[*] 131 F.2d 528 (2d Cir. 1942).

112(b)(3) of the 1939 Code, the predecessor of Section 354. This was answered m the affirmative, the Court stating:

> "The first question is whether the debentures are 'securities' within the meaning of this section. The word is used in contrast to 'stock'; it necessarily refers to bonds of some sort, since bonds are the most usual, if not the only, form of corporate securities to contrast with stock. Conceivably the word might be construed to include mortgage bonds but to exclude debentures. But it is usual financial practice to speak of debentures as 'securities' and the term should be given its ordinary meaning."

We agree that the term "securities" should be given its ordinary meaning, but we disagree that this term necessarily refers to debt instruments of some sort.

V. POLICY CONSIDERATIONS FAVOR CLASSIFICATION OF WARRANTS AS "SECURITIES"

From a policy standpoint, the arguments in favor of treating stock warrants as "securities" for nonrecognition purposes appear to outweigh the arguments for not so classifying them.

The effects of treating stock warrants as "other property" ("boot") are to cause the receipt of warrants to result in recognition of gain in (1) corporate organizations under Section 351 and (2) corporate reorganizations under Sections 368(a)(1)(A),(D) and (E). Such treatment would not affect reorganizations under Sections 368(a)(1)(B) and (C) because the latter require that the consideration received consist "solely" of "voting stock". As noted above, it is clear that stock rights and stock warrants are neither "stock" nor "voting stock".*

* Cf. Rev. Rul. 64-251, 1964-2 Cum. Bull. 338, holding that warrants are not voting: stock for purposes of Section 1504; Rev. Rul. 66-339, 1966-2 Cum. Bull. 274, holding that warrants are not "voting securities" for purposes of Section 851(b).

Accordingly, classification of stock rights and warrants as equity securities would not affect the definition of “control” for purposes of Section 368(c), since that term is defined in terms of ownership of “stock” rather than “securities”.

In issuing private rulings, the Internal Revenue Service is understood to hold that the assumption in reorganizations of outstanding transferable warrants (as well as assumption or substitution of “restricted” or “qualified” employee stock options pursuant to Section 425) does not prevent qualification of the overall transaction as a reorganization under Section 368(a)(1)(C), does not result in treatment of the assumption as “boot” in statutory mergers under Section 368(a)(1)(A), and does not result in gain or loss to warrant holders or optionees. This ruling practice is apparently premised on the view that such assumption or substitution involves the assumption of a “liability” by the surviving corporation.[**]

Our Committee submits that stock warrants provide greater “continuity of interest” in a corporate organization or reorganization than that provided by a debt security. Accordingly, we see no policy objection to treating them as “stock or securities”.

The rules with respect to corporate organizations under Section 351 make it clear that property can be transferred tax-free to a controlled corporation in exchange for its stock

[**] See Rev. Rul. 61-215, 1961-2 Cum. Bull. 110, holding that assumption of outstanding installment debt obligations in a statutory merger is not a “disposition” of the installment obligations within the meaning of Section 453(d).

(common or preferred, voting or non-voting), debt securities with a sufficiently long maturity, and nontransferable contingent rights to receive additional shares to be issued in the future. [*] Moreover, immediately after its organization, the corporation could issue stock rights or warrants to its shareholders without causing them to incur tax, as provided by Section 305. It is therefore hard to see why it should not be possible to issue such stock rights or warrants without tax as part of the initial Section 351 transaction.

Stock warrants are likely to be issued on a non-prorata basis at the time a corporation is organized as a means of providing for future changes in the control of the enterprise. Thus, shares carrying effective control may be issued initially to the persons who supply the money during the first few years of a new corporate endeavor, while warrants are issued to the active participants in the business with a view to enabling them to acquire a larger equity after the enterprise is fully under way.[**] It is hard to see the policy reason for denying nonrecognition treatment in such cases.

Excluding stock warrants from “securities” for Section 351 purposes allows their use by shareholders who wish to recognize a capital gain, typically in order to provide the corporation with a stepped-up basis for assets transferred to it

[*] James C. Hamrick. 43 T.C 21 (1964). vacated and remanded on stipulation 66-1 U.S.T.C. ¶9322 (4th Cir. 1965): Rev. Rul. 66-112, 1966-1 Cum. Bull. 68: Rev. Proc. 66-34. 1966-2 Cum. Bull. 1232; Rev. Proc. 67-13, 1967, 1967 Int. Rev. Bull. 3. at p. 8. These authorities treat as “stock” a nontransferable right to receive additional shares to be issued in the future.

[**] Such use of stock warrants is somewhat equivalent to contractual arrangements for the future issuance of additional shares of stock, often contingent on future events. Of course. to the extent that stock warrants represent compensation for services, they will result in compensation income even if classified as “securities”. Reg. §1.351-1 (a)(i) and (b).

in exchange for the warrants. Although Sections 1239, 1245 and 1250 restrict the circumstances under which this use of warrants may be advantageous, there will often be a substantial tax benefit with respect to the transfer of (i) improved real estate to the extent that Section 1250 is inapplicable and (ii) certain intangibles on which amortization has not been claimed because costs have been expensed. *

Even if, as recommended, stock rights and warrants are classified as “securities”, they will still be excluded for purposes of determining “control” within the meaning of Sections 351 and 368(c). This result stems from the fact that “control” turns on stock ownership, whereas warrants do not constitute “stock”.

Our Committee believes that substantially similar policy considerations apply with respect to the use of stock rights and warrants in connection with corporate reorganizations under Section 368. Thus, under existing law, a corporation can issue stock warrants pro rata without recognition of gain to its shareholders, as provided by Section 305. If a corporation with such outstanding warrants were to be acquired in a statutory merger, it is the practice of the Service, in issuing private rulings, to permit these warrants to be assumed by the surviving corporation without recognition of gain to the disappearing corporation or its shareholders. Moreover, after the merger the surviving company could issue stock warrants pro rata without recognition of gain to its shareholders, old or new. With these considerations in mind, our Committee believes that warrants issued by the surviving corporation in a statutory merger should be permitted to be part of the consideration that can be received

* This step-up in asset basis could, of course, also be achieved by other devices, such as issuance of short-term corporate notes.

tax-free in exchange for stock in the disappearing corporation. Similarly, we believe that, if the acquired corporation has outstanding warrants, the surviving company should be able to issue its stock in exchange for those warrants without recognition of gain to the warrant holders.

The anomalies which result from not treating stock warrants as "securities" may be illustrated by contrasting the position of a bondholder in a reorganization who surrenders a bond in exchange for (a) a convertible debenture of an equal principal amount or (b) a bond of an equal principal amount together with a warrant. Although the economic effects are very similar, such treatment makes the receipt of (b) taxable, notwithstanding the fact that the receipt of (a) is tax-free.

Warrants could be important in a "recapitalization" under Section 368(a)(1)(E), especially one involving insolvency or financial difficulties. In such cases, it may be desirable to give stock warrants to certain creditors or stockholders. This was the situation presented in E. P. Raymond,[*] where the court treated warrants as securities to prevent recognition of loss.

A distribution of stock warrants ought to be permitted to be made tax-free in a "spin-off" under Section 355. Such treatment appears particularly appropriate in the light of Section 355(a)(1)(D) which requires that at least 80 percent of the stock in a controlled corporation be distributed and that, if any stock or securities are retained, the Secretary of the Treasury or his delegate must be satisfied that such retention is

[*] 37 B.T.A. 42.1 (1938).

not for tax avoidance purposes.[**] If stock warrants are not treated as "securities" (or stock), then a corporation could distribute all the stock and securities of a controlled corporation but retain warrants and thereby enable itself to reacquire a substantial equity interest in the spun-off corporation through the exercise of the warrants. Thus, classification of warrants as "securities" would implement the Congressional purpose underlying Section 355(a)(1)(D).

VI. INTERPRETATION OF 1954 AMENDMENTS AS TO "PRINCIPAL AMOUNT" OF "SECURITIES"

Since 1954, Section 354(a) (2) has required that gain or loss be recognized in a reorganization where "securities" are received and

> "(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or
>
> "(B) any such securities are received and no such securities are surrendered."

Similar language is found in Section 355(a)(3) and in Section 356(d)(2)(B).

[**] Section 355(a)(1)(D) requires the distributing corporation to distribute:

> "(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> "(ii) an amount of stock in the controlled corporation constituting: control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax," Notwithstanding its imprecise language, Section 355(a)(1)(D)(ii) appears to have been properly interpreted by the regulations as requiring satisfaction of the Secretary or hi« delegate when "securities" alone are retained. See Reg. § 1.355-2(d): "Where a part of either the stock or securities is retained * * *".

These references to “securities” with a “principal amount” raise a question as to how such rules are to be harmonized with our Committee's view that stock warrants should be treated as “securities.”

Our Committee believes that these provisions were never intended to apply to equity securities, such as stock warrants which had previously been held to be “securities” in the Raymond case*

The legislative history of Section 354(a)(2)(B) and the comparable 1954 changes incorporated in Sections 355 and 356 afford no support for the view that these changes were intended to overrule the interpretation adopted in the Raymond case. On the contrary, that history suggests that these changes were intended to be limited to debt securities. *

The Senate Committee Report on H. R. 8300 discusses the change incorporated in Section 356 as follows:

> “Section 356 corresponds to section 112(c) and 112(e) of the 1939 Code and retains to a large extent the language of such sections. The treatment of securities is clarified by the adoption of a principle analogous to that found in Commissioner v. Neustadt's Trust.”
>
> “Section (d) contains rules as to the treatment of securities for purposes of section 356. Paragraph (1) states the general rule that for purposes of section 356 the term 'other property' includes securities. This is a restatement of the principle stated by the Supreme Court in Bazley v. Commissioner.”**

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* See text at pp. 40-41 above.

* Although an argument that the 1954 Code changes were intended to restrict all “securities” under Section 354 to debt securities could be constructed on the use of the word “such” in Section 354(a)(2)(A), our Committee believes that this argument is not sufficient to support the significant changes which its acceptance would produce.

** Sen. Rep. No. 1622, 83rd Cong., 2d Sess.

The references to the decisions in the Neustadt's Trust and Bazley cases are significant in that both decisions involved the receipt of debt securities in purported reorganizations. As previously noted, Neustadt's Trust[***] posed the question whether a tax-free “recapitalization” could be effected if both the property received and the property surrendered consisted solely of debt securities. The Commissioner contended unsuccessfully that a tax-free recapitalization required the exchange of some stock. After waiting until 1951 to announce his acquiescence,[****] the Commissioner in 1952 issued I.T. 4081,[*****] which stated that the Service -would follow Neustadt's Trust and similar cases involving “an exchange of bonds for the same principal amount of new bonds of the same corporation. . . .” (Emphasis added) This is apparently the principle of Neustadt's Trust to which reference is made in the above quoted portion of the Senate Finance Committee Report.

The decision in the Bazley case[*] involved debt securities issued in the course of a “recapitalization” but held by the Supreme Court to be taxable as a dividend.

Professors Bittker and Eustice[**] conclude that the

[***] 131 F. 2d 528 (C.C.A. 2, 1943).

[****] 1951-1 Cum. Bull. 1.

[*****] 1952-1 Cum. Bull. 65.

[*] 331 U.S. 737 (1948).

[**] Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (26 Ed. 1966) at p. 588. But compare the statement in the same treatise at p. 580, n. 140: “At the very least, warrants and rights would seem to constitute 'securities,' as held in E. P. Raymond”, 37 B.T.A. 423 (1938); note, however, that if only stock is surrendered, the receipt of securities becomes taxable under §354(a)(2)(B). although not under §361(a).”

It is believed that the latter portion of this statement is in error and that the authors did not intend to contradict the above-quoted statement appearing at p. 588.

"securities" referred to in Section 354(a)(2) are debt securities only:

> "The non-recognition rule of §354(a)(1) is applicable only if the exchange is 'solely' for stock or securities of a corporation that is a party to a reorganization. Moreover, $354(a)(2) (enacted in 1054) provides that the general non-recognition rule of §354(a)(1) shall 'not apply' if: (a) the principal amount of securities received exceeds the principal amount of securities surrendered; or (b) securities are received and no securities are surrendered. (For this purpose the term 'securities' means only debt securities.)" (Emphasis added)

These authors describe the purposes of the changes made by the 1954 Code:

> "The purpose of these restrictions is to apply the continuity of interest test (taxpayer-by-taxpayer) to the exchanges in a reorganization. Another purpose of these provisions is to block the 'security bailout' device, whereby debt obligations could be issued prorata to shareholders with a view to their subsequent retirement at capital gain rates, thus effecting a distribution of corporate earnings and profits without dividend consequences." (Id. at p. 589).

We submit that these purposes would not be frustrated by permitting stock rights or warrants to be received tax free under Section 354. Stock rights and warrants cannot be used to effect a "bail-out". And even the Bateman opinion[*] recognized that stock warrants can serve to fulfill the "continuity of interest" requirement.

In summary, the legislative history of the 1954 Code changes does not disclose any intention to change the tax treatment of stock wan ants as equity securities under the Raymond decision.[**] On the contrary, that history suggests that these changes were intended to be limited to debt securities.

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[*] 40 T.C. at p. 413

[**] See text at pp. 40-41 above.

CONCLUSIONS

Our Committee submits that there is no sound policy reason for receipt of stock warrants to give rise to recognition of gain (in the typical case of a shareholder who does not exchange other warrants or debt securities for them). Unlike debt securities, which look toward the ultimate receipt of cash and termination of the holder's economic interest in the company, stock rights and warrants look toward further investment and increased equity participation. In this respect they are more like stock, or at least contingent rights to receive additional shares of stock in the future,[***] and should be accorded similar tax treatment, i.e., as an equity security.[****]

The Committee has therefore concluded that stock rights and stock warrants should be treated as equity “securities” which can be received in corporate organizations and reorganizations (and surrendered in reorganizations) without recognition of gain and without regard to the “principal amount” rules found in Sections 354(a)(2), 335(a)(3) and 356(d). We respectfully recommend that the Regulations be amended to so provide.

The Committee recognizes that the Internal Revenue Service may agree with the substance of this recommendation but hesitate to change existing Regulations in the absence of Congressional or judicial action to require such change. In that event, we respectfully recommend that the Service support legislation to effect such change.

[***] See footnote on p. 46 above.

[****] Unlike debt securities, warrants cannot be disposed of without diluting the holder's equity or potential equity in the Company.

A somewhat similar recommendation has previously been made by the Section of Taxation of the American Bar Association, which has urged that stock warrants be treated as “stock” for all reorganization purposes other than the determination of “control”.* The American Bar Association's proposal goes beyond the recommendation made by our Committee, which would require classification of stock rights and warrants as “securities” rather than “stock”.

* XVIII Bulletin of the Section of Taxation No. 4, at pp. 32. 35 & 37 (July 1965).