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September 23, 2008

Re: Request for Formal Guidance on the Tax Consequences of  
Warrant Exercises

Dear Sirs:

We write to suggest that the Internal Revenue Service (the "IRS") publish formal guidance clarifying (i) whether, considering the Tax Court's holding in *Weir v. Commissioner*<sup>1</sup> and section 1223(5),<sup>2</sup> a warrant holder's holding period begins on the date of, or the date after, the exercise of a warrant by payment of the cash exercise price, (ii) whether, notwithstanding the Tax Court's distinctions in *Weir*, a warrant constitutes a "right to acquire" stock for purposes of section 354, and (iii) the tax consequences of a cashless

<sup>1</sup> 10 T.C. 996 (1948), *aff'd*, 173 F.2d 222 (3d Cir. 1949).

<sup>2</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

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exercise transaction (as defined below).<sup>3</sup> We recommend that the IRS confirm that the distinction in *Weir* is not relevant for purposes of section 1223(5) (and that therefore the warrant holder's holding period begins on the date of exercise of a warrant by payment of the cash exercise price) and also confirm that a warrant exercisable in stock or cash at the warrant holder's option constitutes a "right to acquire stock" and, thus, is a security for purposes of section 354. We also recommend that the IRS confirm that the exchange of a warrant for stock in a cashless exercise transaction is a recapitalization.<sup>4</sup>

A warrant holder typically may exercise warrants either by paying the cash exercise price or by exchanging the warrants for stock. In some cases, the terms of the warrant may not anticipate "cashless exercise," or may provide cashless exercise as an issuer option rather than a holder option. Without regard to the terms of a warrant, the holder and the issuer could always agree to a negotiated exchange of warrants for stock. In any of these cases (a "cashless exercise transaction"), the warrant holder typically receives an amount of stock that is reduced by the exercise price of the warrants in lieu of paying the exercise price in cash. To illustrate, assume that (i) the warrant holder has a warrant to acquire 10 shares of Corp. X stock for \$1 per share, (ii) Corp. X stock has a fair market value of \$2 per share on the exercise date, and (iii) the warrant holder may either exercise the warrant by (x) paying \$10 to acquire 10 Corp. X shares, or (y) simply receiving 5 shares of Corp. X stock with a fair market value of \$10. The authority regarding the holding period of stock received on exercise of a warrant for cash is unclear, and no authority directly addresses the tax treatment of a cashless exercise transaction.

In a typical transaction where a warrant holder exercises a warrant for cash, (i) the holder does not recognize taxable income upon the exercise, and (ii) its tax basis in the warrant is added to the tax basis of the acquired stock.<sup>5</sup> The Tax Court held in *Weir* that the warrant holder's holding period in the underlying stock generally begins on the day after the exercise date if the warrant does not constitute a right "arising out of stock ownership".<sup>6</sup> By contrast, if a warrant represents a right "arising out of stock ownership", the holding period for the stock received upon exercise of the warrant would include the warrant's exercise date.<sup>7</sup>

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<sup>3</sup> The principal drafters of this letter are Jodi J. Schwartz, Linda Z. Swartz, and Richard M. Nugent, with substantial assistance from Kathleen L. Ferrell and Catherine P. Tennant. Helpful comments were received from Michael L. Schler and David S. Miller.

<sup>4</sup> This letter does not address the treatment of compensatory stock options. See, e.g., I.R.C. §§ 83, 421.

<sup>5</sup> See Rev. Rul. 78-182, 1978-1 C.B. 265.

<sup>6</sup> See *E.T. Weir v. Comm'r*, 10 T.C. 996 (1948), *aff'd*, 173 F.2d 222 (3d Cir. 1949).

<sup>7</sup> See I.R.C. § 1223(5). Section 1223(5) states that, "[i]n determining the period for which the taxpayer has held stock or securities acquired from a corporation by the exercise of rights to acquire such stock or securities, there shall be included only the period beginning with the date on which the right to acquire was exercised." See also Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions, and Buyouts*, ¶ 604.1.2 (Jan. 2008) (section 1223(5), which provides that holding period includes exercise date, applies only to right to acquire stock that is obtained from corporation in rights distribution, and not when warrant is obtained by purchase).

A section 368(a)(1)(E) reorganization (a “recapitalization”) is generally a “reshuffling of a capital structure within the framework of an existing corporation.”<sup>8</sup> A cashless exercise transaction may qualify as a recapitalization if (i) the warrants qualify as “rights to acquire stock” under section 354, and (ii) the transaction is treated as an exchange of warrants for stock.<sup>9</sup> If a cashless exercise constitutes a recapitalization, the warrant holder’s holding period for the stock received upon exercise generally would include the holding period for the warrants.<sup>10</sup>

The qualification of a cashless exercise as a recapitalization principally depends on whether the warrants constitute “rights to acquire stock” and whether the exchange is pursuant to a plan of reorganization.

As discussed below, it is not entirely clear whether these conditions are satisfied. Current Treasury regulations under section 354 cross reference sections 305 and 317(a) in defining “right to acquire stock”,<sup>11</sup> but neither section 305 nor section 317(a) clarifies whether warrants constitute “rights to acquire stock”.<sup>12</sup> Other Treasury regulations and guidance imply that the term “right to acquire stock” should be read to include warrants.<sup>13</sup> In the examples in the section 356 regulations, the term “warrants” is used to mean “rights to acquire stock”.

The Tax Court, however, has narrowly interpreted the term “right to acquire stock” to mean subscription rights held by or issued to existing shareholders.<sup>14</sup> In *Weir*, the court explained in interpreting the predecessor to section 1223(5): “there is a fundamental distinction

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<sup>8</sup> *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 202 (1942). See also Treas. Reg. § 1.368-2(e) (recapitalization examples).

<sup>9</sup> While a recapitalization, like other reorganizations, must be effected for a valid corporate business purpose, the current Treasury regulations explicitly exclude recapitalizations from the continuity of interest and continuity of business enterprise requirements. See Treas. Reg. § 1.368-1(c); Treas. Reg. § 1.368-1(b); see also *Comm’r v. Neustadt’s Trust*, 131 F.2d 528 (2d Cir. 1942) (exchange of debentures for convertible debentures treated as recapitalization; business purpose was to strengthen issuer’s financial condition); *Lorch v. Comm’r*, 70 T.C. 674 (1978), *aff’d*, 605 F.2d 657 (2d Cir. 1979) (exchange of debentures undertaken to reduce debt and avoid involuntary liquidation was valid business purpose in recapitalization); Rev. Rul. 72-57, 1972-1 C.B. 103 (recapitalization undertaken to simplify capital structure by eliminating minority shareholder was valid business purpose in recapitalization).

<sup>10</sup> See I.R.C. § 1223(1).

<sup>11</sup> See Treas. Reg. § 1.354-1(e).

<sup>12</sup> For purposes of section 305, the term “stock” generally includes “rights or warrants to acquire such stock.” See Treas. Reg. § 1.305-1(d)(1). This definition suggests that “rights to acquire” stock may be different from “warrants to acquire” such stock, because the definition refers to rights and warrants in the alternative. In addition, the definition of “property” in section 317(a) includes any property, such as money, securities and debt of the corporation, other than (i) stock in the corporation making the distribution, and (ii) the rights to acquire such stock.

Prior to its amendment, Treasury regulation section 1.354-1(e) stated: “[f]or the purpose of section 354, stock rights or stock warrants are not included in the term ‘stock or securities,’” and it is not clear whether the omission of warrants in the current regulations is purposeful.

<sup>13</sup> See, e.g., Treas. Reg. § 1.597-3(b) (“debt instruments, stock, warrants, or *other rights to acquire stock*”) (emphasis added); P.L.R. 82-44-113 (Aug. 6, 1982) (“convertible stock, securities, warrants, options or *other rights to acquire its stock*”) (emphasis added).

<sup>14</sup> See *E.T. Weir v. Comm’r*, 10 T.C. 996 (1948), *aff’d*, 173 F.2d 222 (3d Cir. 1949).

between a stock right and an option. The former is an equity inherent in stock ownership as a quality inseparable from the capital interest represented by the old stock. An option to purchase stock is a right in no way based upon the ownership of stock.”<sup>15</sup>

We believe that the Tax Court’s interpretation of a “right to acquire stock” in *Weir* is unduly narrow. In our view, the plain meaning of a “right to acquire stock” includes a warrant that entitles the holder to purchase stock of the issuer.<sup>16</sup> In addition, our approach is consistent with the Treasury regulations and other guidance cited above. We believe that the exchange of warrants in one issuer for warrants in another in connection with a merger that is a tax free reorganization should be tax free. Accordingly, we recommend that the IRS confirm that a warrant entitling the holder to purchase stock of the issuer constitutes a “right to acquire stock” and, thus, is a security under section 354.

Assuming the underlying warrant constitutes a security, treating a cashless warrant exercise as a recapitalization would be consistent with the underlying policy of the reorganization provisions because the exchange of warrants for shares merely represents a change in the form and type of the warrant holder’s continuing interest in the underlying corporate enterprise.<sup>17</sup> In addition, the treatment of convertible stock and convertible debentures provides analogous support for treating a cashless exercise transaction as a recapitalization. In Revenue Ruling 77-238,<sup>18</sup> the IRS ruled that the conversion of common stock into preferred stock of equal value of the same corporation (or vice versa), by operation of a conversion feature in the relevant share of stock, was a recapitalization.<sup>19</sup> The conversions satisfied the business purpose test because they (i) permitted the issuer to use the cash that would otherwise be distributed in the stock redemption for other business purposes, (ii) were pursuant to a continuing plan of reorganization represented by the conversion privilege embodied in the certificate of incorporation, and (iii) allowed for the simplification of the corporate structure.<sup>20</sup> The IRS has also ruled that a convertible debenture holder does not realize taxable income upon the conversion of the debenture into stock of the same issuer pursuant to a conversion feature.<sup>21</sup> A warrant is economically similar to a convertible debenture, and the IRS itself has analogized convertible debentures to warrants.<sup>22</sup> Accordingly, a cashless exercise transaction may constitute a recapitalization.

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<sup>15</sup> *E.T. Weir v. Comm’r*, 10 T.C. 996, 999 (1948), *aff’d*, 173 F.2d 222 (3d Cir. 1949) (citations omitted).

<sup>16</sup> We offer no recommendation on the treatment of cash settled warrants.

<sup>17</sup> *See, e.g.*, Treas. Reg. § 1.368-1(b) (“Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such 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.”).

<sup>18</sup> 1977-2 C.B. 115.

<sup>19</sup> Rev. Rul. 77-238, 1977-2 C.B. 115.

<sup>20</sup> *See* Rev. Rul. 77-238, 1977-2 C.B. 115.

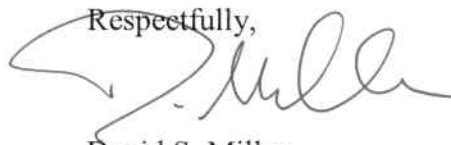
<sup>21</sup> *See* Rev. Rul. 72-265, 1972-1 C.B. 222.

<sup>22</sup> *See* Rev. Rul. 69-91, 1969-1 C.B. 106.

We note that it is possible to have a warrant exercisable for stock and/or cash at either the warrant holder's or the issuer's election. We believe that, if a warrant is in fact settled in stock by cashless exercise (whether or not pursuant to its terms and whether that is an option of the holder or the issuer to use shares), the transaction constitutes a recapitalization.<sup>23</sup> In this regard, we note that we have previously suggested that the terms of certain rights to acquire stock may not fit within the intended scope of the warrant regulations. More specifically, we have recommended "that the definition of stock rights be limited to instruments in the nature of physically-settled call options," and a right to acquire stock should be defined "as a financial instrument in the nature of a 'call option' issued by a party to the reorganization or the distributing or controlled corporation, as the case may be, with respect to its own stock and that can only be settled pursuant to its terms in stock of the issuer."<sup>24</sup> It is less clear to us whether a warrant that may be only cash settled constitutes a right to acquire stock.

In any event, to provide taxpayers with the certainty necessary to properly plan their transactions, we recommend that the IRS publish formal guidance clarifying (i) that the holding period begins on the date of, or the date after, the exercise of a warrant by payment of the cash exercise price, (ii) that a warrant constitutes a "right to acquire" stock and, thus, is a security for purposes of section 354, (iii) whether a warrant's treatment as a security should be limited to an instrument that must be stock settled, and (iv) the tax consequences of a cashless exercise transaction.

We appreciate your consideration of our comments. Please let us know if you would like to discuss this letter or if we can otherwise further assist you.

Respectfully,  
  
David S. Miller

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<sup>23</sup> We have also considered whether a cashless exercise transaction should be viewed as either (i) a taxable exchange of the warrants for the stock, in which case the warrant holder generally would recognize taxable gain to the extent the fair market value of the acquired stock exceeds the holder's tax basis in the warrants, or (ii) an exchange of a portion of the warrants as consideration for the exercise price of the remaining warrants, in which case the warrant holder generally would be taxed on gain equal to the difference between the holder's tax basis in the warrants used as consideration and the fair market value of those warrants. I.R.C. § 1001(a); *see also* Michael J. Kliegman, "Tax Treatment of Cashless Warrant Exercises," 719 *PLI/TAX* 855 (2006) (cashless exercise transaction may be taxable under section 1001). If a cashless exercise is taxable under either characterization, the warrant holder's holding period for the stock would commence on the date after the warrant exercise, assuming the holder purchased the warrant. *See Helvering v. San Joaquin Fruit & Inv. Co.*, 297 U.S. 496 (1936) (holding period of shares acquired on exercise of warrant for cash does not include period during which warrant holder held the warrant); *E.T. Weir v. Comm'r*, 10 T.C. 996 (1948), *aff'd*, 173 F.2d 222 (3d Cir. 1949) (holding period for stock received upon exercise of warrant that is not tied to an existing shareholder's equity interest commences on the date after exercise). We recognize that the holding period treatment in this case would be consistent with the holding period for stock obtained upon the exercise of a warrant in a cash transaction.

<sup>24</sup> NYSBA Tax Section, "Comments on the Proposed Regulations Dealing with the Treatment of Stock Rights under Sections 354, 355 and 356 of the Internal Revenue Code," 97 *TNT* 75-21 ¶ 2, 4 (Apr. 15, 1997). Further, "[w]hether a particular financial instrument constitutes a stock right for this purpose should turn on its substance and not whether it is documented as a stock right, option, warrant or other financial instrument." *Id.*

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