DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS:FI&P

SUBJECT: Warrants

This Field Service Advice responds to your memorandum dated August 5, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer	=
Guarantor	=
Agreement	=
Board	=
Company	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Date 1	=
Date 2	=
Date 3	=
A	=
B	=

C	=
D	=
E	=
F	=
G	=
H	=
I	=
J	=
K	=
L	=
M	=
N	=
0	=
P	=
Q	=
R	=
S	=
T	=
U	=
V	=
W	=
X	=
Y	=

ISSUES:

1: What is the proper treatment of the issuance and reacquisition by Taxpayer of warrants to its lenders ("lender warrants")?

(a) At issuance, are the lender warrants a cost associated with the restructuring of the underlying lender loans or a cost of securing the Guarantor's loan guarantees?

(b) If the lender warrants are a cost of restructuring the lender loans, what are the tax implications upon the later conversion of those loans to preferred stock?

(i) How does the fact that a significant amount of debt was forgiven in connection with the debt-to-stock conversion affect the analysis?

(c) Is the reacquisition of L percent of the lender warrants in Year 3 in exchange for common stock a capital transaction and, if so, is I.R.C. § 1234 applicable?

(i) Does the "open transaction" doctrine apply to "below the line" deductions?

(ii) How does the fact that the lender warrants were reacquired by issuing common stock and in furtherance of a recapitalization in Year 3 affect the analysis?

(iii) Is the "reacquisition" a "closing transaction" within the meaning of section 1234?

2: What is the proper treatment of the issuance and reacquisition of the Company warrants?

CONCLUSIONS:

1(a). Under the origin of claim doctrine, the lender warrants should be treated as a cost of restructuring the underlying lender loans.

1(b). As concluded above, the lender warrants in this case should be treated as a cost of restructuring the lender loans. Therefore, the amount equal to the value of lender warrants at the time of issuance was amortizable over the terms of the lender loans. The lender loans were discharged in two installments in Year 2, pursuant to the agreement of Date 2, in exchange for cash and preferred stock. The agreement provided that Taxpayer would exchange preferred stock for $E of debt, and had the option to pay G percent for the remaining $H in full satisfaction of that debt amount. The terms of this agreement were implemented in two installments in Year 2, with Taxpayer exercising its option to pay G percent of $H in full satisfaction of the portion not converted to preferred stock. After the second installment, Taxpayer owed no further debt obligations to the lenders on the $A debt. As a result, Taxpayer's liability on the loans terminated in Year 2 upon the conversion of the $E portion of the loans to preferred stock and the cash payment in satisfaction of the remaining $H portion. At that time, any unamortized amount of the costs attributable to the issuance of the lender warrants should be allocated between (i) the portion of the loans converted to preferred stock and (ii) the portion satisfied by the cash payment. The first allocated amount would be treated as a cost of issuing the preferred stock (i.e., a capital expenditure), and Taxpayer would not be entitled to a deduction for that unamortized amount. The second allocated amount (with respect to the portion satisfied by the cash payment) would be deductible by Taxpayer in Year 2.

1(b)(i). The terms of the Year 1 agreement and its implementation in Year 2 raise a substantial issue concerning whether Taxpayer had COD income. The facts indicated that Taxpayer gave the lenders preferred stock with a redemption value of $F in exchange for $E of the debt and a cash payment equal to G percent of the remaining $H debt in satisfaction of the latter debt amount. Because the preferred stock had a redemption value that was greater than the amount of debt for which it was exchanged, the limitation of Rev. Rul. 90-87, 1990-2 C.B. 32, on the stock-for-debt exception would not be triggered. Accordingly, Taxpayer would not recognize any income on cancellation of the $E debt exchanged for the preferred stock. However, while Taxpayer paid only G percent for the remaining $H of debt (or $I) owed to the lenders, the full amount of the $H debt was discharged. Inasmuch as the preferred stock was exchanged only for $E of the debt to the lenders and was not given in exchange for any portion of the remaining $H of debt, the stock-for-debt exception would not apply to the J percent of the $H (or $ K) debt that was discharged without any consideration. Accordingly, Taxpayer should recognize COD income for that amount.

1(c)(i). In the event the value of the lender warrants is not ascertainable at the date of issuance, the cost of the lender warrants could become deductible or capitalizable as a cost of issuing preferred stock in a subsequent year when the all events test is met. [redacted]

1(c)(ii). Taxpayer's obligation under the lender warrants was to issue a share of its common stock to the lender warrant holder if the holder tendered the lender warrant and a cash payment of $D. This represented an equity obligation by Taxpayer. In Year 3, when Taxpayer gave the lender warrant holders common stock in exchange for the lender warrants, it merely substituted a "capital stock liability" for the lender warrant obligation. Although the lender warrant obligation terminated, there was no realization of income or deduction from issuing the common stock for the lender warrants. Accordingly, Taxpayer did not realize a loss on the Year 3 stock-for-warrants exchange.

In addition, the facts of this case are similar to those in Jim Walter Corp. v. United States, 498 F.2d 631 (5th Cir. 1974). In our view, the holding of Jim Walter applies in this case. Taxpayer exchanged its common stock for the lender warrants in Year 3 as part of a recapitalization, i.e., a restructuring of its equity capital. Under the Fifth Circuit's rationale in Jim Walter, the costs associated with the recapitalization are not deductible. Therefore, Taxpayer is not entitled to any deduction with respect to the value of the common stock given to the lenders in exchange for the lender warrants.

1(c)(iii). The Year 3 reacquisition of the lender warrants by Taxpayer in exchange for common stock terminated Taxpayer's obligations under the terms of the lender warrants. Therefore, under the facts submitted, since the termination of Taxpayer's obligation under the lender warrants was other than through the exercise or lapse of the lender warrants, the stock-for-warrant exchange is a closing transaction within the meaning of section 1234(b).

2. The stock-for-debt exception applies to the Year 1 transaction with Company because Taxpayer issued preferred stock and warrants for common stock as part of the package that Company received. The stock-for-debt exception applies to the amount of debt that is not satisfied by cash or other property. We understand that the parties treated the preferred stock as satisfying $T of the debt, with the remaining portion of the debt treated as discharged in exchange for the cash and warrants. If the redemption price of the preferred stock was at least equal to $T, the stock-for-debt exception would apply to preclude any COD income on that part of the debt discharge. Because the warrants constitute an equity interest with respect to common stock, the stock-for-debt exception would arguably apply to the issuance of the warrants. Thus, Taxpayer would not have any COD income on the $Y portion of the debt remaining after the $U cash payment. In short, there would be no COD income on the Year 1 conversion of the Company debt. Unlike the lender warrants, the warrants that Taxpayer gave to Company in Year 1 were issued in consideration for a portion of the debt. Accordingly, the cost of the Company warrants was not an amortizable loan cost. However, the Year 3 exchange of the common stock for the Company warrants would be subject to the same analysis as discussed above with respect to the lender warrants.

Issue 1: What is the proper treatment of the issuance and reacquisition by Taxpayer of warrants to its lenders ("lender warrants")?

FACTS

Prior to the years in issue, Taxpayer experienced severe financial troubles. In those years, Taxpayer needed to raise capital in order to comply with federal standards imposed on its industry. Primarily because of Taxpayer's poor financial condition, lending institutions were unwilling to lend Taxpayer the necessary funds. Taxpayer therefore sought financial assistance from the Guarantor.

In order to qualify for the Guarantor's loan guarantees under the Agreement, Taxpayer restructured approximately $A of its debt on Date 1. Under the restructuring, Taxpayer's lenders deferred the payment of principal and most interest for about B years. A portion of the lenders agreed to the Preferred Stock Option ("PSO") under which, subject to certain conditions, Taxpayer or the Board could require the lenders to convert up to $C of deferred interest to preferred stock. Lenders who agreed to the PSO received lender warrants (expiring on Date 3) to purchase Taxpayer stock at an exercise price of $D per share, which could be paid through cancellation or reduction of the pre-existing debt.

Subsequently, on Date 2, the lenders who had agreed to the PSO agreed to convert (in two installments) $E of debt (including some interest covered by the PSO) to preferred stock having a redemption value of $F. Those lenders also agreed to accept payment of G percent of the remaining $H of debt as full payment thereof.

(a) At issuance, are the lender warrants a cost associated with the restructuring of the underlying lender loans or a cost of securing the Guarantor's loan guarantees?

LAW AND ANALYSIS:

The origin of claim doctrine originated in United States v. Gilmore, 372 U.S. 39 (1963). The question in Gilmore was whether a husband's litigation expenses in his divorce proceedings were deductible as a business expense, rather than nondeductible as a personal expense, when they were attributable to protecting his income-producing stock.

In Gilmore, the Supreme Court established that the "controlling basic test of whether the expense was 'business' or 'personal' and hence, whether it is deductible or not" is determined by the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortune of the taxpayer. 372 U.S. at 49. In Gilmore, the court found that the origin of Gilmore's expenses was in the divorce proceedings, and therefore the expenses were personal and nondeductible, even though they had been incurred for a business purpose.

Besides being the "controlling basic test of whether an expense is 'business' or 'personal' and hence, whether it is deductible or not", the origin of claim doctrine has been applied to determine whether certain payments were capital expenditures or deductible expenses. Woodward v. Commissioner, 397 U.S. 572. (1970).

In Woodward, the Supreme Court applied the "origin of claim" doctrine to determine whether the expenses incurred by majority shareholders in acquiring stock owned by minority shareholders were deductible business expenses, or nondeductible capital expenditures. Significantly, the Court specifically rejected the "primary purpose" test (i.e., looking for the business purpose for which the expenditure was incurred) in favor of the origin of claim test.

The issue in the instant case is whether the lender warrants are a cost associated with the restructuring of the underlying lender loans or a cost of securing the Guarantor's loan guarantees.

In Gilmore, the court held that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was "business" or "personal" and hence whether or not it is deductible.

[redacted] These lender warrants were given to the lenders in exchange for the lenders agreement to allow Taxpayer to require the lenders to convert up to $C in deferred interest to preferred stock. This exchange was a component of the loan restructuring plan with Taxpayer's lenders. If Taxpayer had not entered into the restructuring agreements with the lenders, it would have faced the consequence of not being able to receive Guarantor's guarantees of to-be-issued debt.

Even though Taxpayer's purpose of entering into the restructuring agreements may have been to receive Guarantor's guarantees of to-be-issued debt, the origin of the claim doctrine does not look at purpose. In Woodward v. Commissioner, 397 U.S. 572 (1970), the Court specifically rejected the "primary purpose" test (i.e., looking for the business purpose for which the expenditure was incurred), in favor of the origin of claim test. The Court noted that the "primary purpose" test was "uncertain and difficult" and that any test relying on the purpose of the transaction "would encourage resort to formalism and artificial distinctions." 397 U.S. at 577. Therefore, any purpose for issuing the lender warrants should be ignored. The origin of Taxpayer's lender warrant costs is the lender loans to Taxpayer. Therefore, under the origin of claim doctrine, the lender warrants should be treated as a cost of restructuring the underlying lender loans.

(b) If the lender warrants are a cost of restructuring the lender loans, what are the tax implications upon the later conversion of those loans to preferred stock?

LAW AND ANALYSIS:

Costs incurred in connection with a loan are capitalized and amortized over the life of the loan. See Enoch v. Commissioner, 57 T.C. 781, 794-795 (1972), acq., 1974-1 C.B. 1; Rev. Rul. 81-161, 1981-1 C.B. 313. In general, when the borrower's obligation to repay the loan is extinguished, a deduction is allowed for any unamortized loan costs. See S. & L. Building Corp. v. Commissioner, 19 B.T.A. 788, 796 (1930), acq., X-1 C.B. 60 (1931); Rev. Rul. 86-67, 1986-1 C.B. 238. However, whenever debt is converted into stock, any unamortized expense incurred in connection with the debt assumes the character of a capital expenditure in connection with the issuance of the stock and is not deductible. See Chicago, Milwaukee, St. Paul & Pacific R.R. v. United States, 404 F.2d 960 (Ct. Cl. 1969) (no deduction for unamortized expenses related to bonds exchanged for common stock); Rev. Rul. 72-348, 1972-2 C.B. 97.

As discussed above, the lender warrants in this case should be treated as a cost of restructuring the lender loans. Therefore, the amount equal to the value of lender warrants at the time of issuance was amortizable over the terms of the lender loans. The lender loans were discharged in two installments in Year 2, pursuant to the agreement of Date 2, in exchange for cash and preferred stock. The agreement provided that Taxpayer would exchange preferred stock for $ E of debt, and had the option to pay G percent for the remaining $H in full satisfaction of that debt amount. The terms of this agreement were implemented in two installments in Year 2, with

Taxpayer exercising its option to pay G percent of $H in full satisfaction of the portion not converted to preferred stock. After the second installment, Taxpayer owed no further debt obligations to the lenders on the $A debt.

As a result, Taxpayer's liability on the loans terminated in Year 2 upon the conversion of the $E portion of the loans to preferred stock and the cash payment in satisfaction of the remaining $H portion. At that time, any unamortized amount of the costs attributable to the issuance of the lender warrants should be allocated between (i) the portion of the loans converted to preferred stock and (ii) the portion satisfied by the cash payment. The first allocated amount would be treated as a cost of issuing the preferred stock (i.e., a capital expenditure), and Taxpayer would not be entitled to a deduction for that unamortized amount. See Chicago, Milwaukee, St. Paul & Pacific R.R., supra; Rev. Rul. 72-348, supra. The second allocated amount (with respect to the portion satisfied by the cash payment) would be deductible by Taxpayer in Year 2. See S. & L. Building Corp., supra.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

(i) How does the fact that a significant amount of debt was forgiven in connection with the debt-to-stock conversion affect the analysis?

LAW AND ANALYSIS:

It is a settled principle of tax law that a taxpayer recognizes income when its indebtedness is forgiven or otherwise canceled. See United States v. Kirby Lumber Co., 284 U.S. 1 (1931); see also I.R.C. § 61(a)(12); Treas. Reg. § 1.61-12. A judicially created exception to this rule permitted a corporate taxpayer to issue its stock to a creditor in satisfaction of a debt owed to the creditor without having to recognize cancellation of indebtedness ("COD") income.[1] One of the earliest cases to adopt this stock-for-debt exception was Capento Securities Corp. v. Commissioner, 47 B.T.A. 691

[1] The stock-for-debt exception was eliminated by the adoption of current section 108(e)(8), which generally applies to a corporation's transfer of stock after December 31, 1994, in satisfaction of any indebtedness.

(1942), aff’d, 140 F.2d 382 (1st Cir. 1944), in which Raytheon Production Corp. ("Production") issued bonds with a face value of $500,000 in 1929. In 1933, Capento Securities Corporation (“Capento”), which was owned by Production’s parent, paid $15,150 to acquire the bonds. In order to obtain bank financing in 1935, Production issued preferred stock having a par value of $500,000 and a fair market value of $50,000 to Capento in exchange for the bonds.

The Service determined that Production realized gain of $450,000 on the exchange, but the Board of Tax Appeals held that the substitution of the preferred stock for the bonds and the cancellation of the bonds constituted a recapitalization and was therefore a nontaxable reorganization under the predecessor of section 368(a)(1). As a second ground for not taxing Production on the transaction, the Board concluded that the exchange of the corporation's stock for its debt was not a realization event because the corporation had not been relieved of a liability but merely substituted a capital stock liability for a bonded indebtedness. The Board explained this rationale as follows:

> To substitute a capital stock liability for a bonded indebtedness may have its advantages, as this case illustrates, but it can not be called a present realization of gain. The assets are not thereby freed from obligation. They become the subscription price contributed by the shareholder. . . . Gain is not realized by a corporation in the receipt of the subscription price of its shares, . . . and this would seem to be no less true when the subscription price, instead of being newly paid, is the amount which has already been paid in as the principal of a bond loan. While the bond loan has been terminated, the amount borrowed is now committed to capital stock liability instead of to the liability of a fixed indebtedness.

47 B.T.A. at 695. On appeal, the First Circuit cited this ground as the basis for affirming the Board’s decision.

The Tax Court applied the rationale of Capento in a number of cases that arose in connection with bankruptcy proceedings under the Chandler Act. See Tower Building Corp. v. Commissioner, 6 T.C. 125 (1946), acq. 1947-1 C.B. 4; Motor Mart Trust v. Commissioner, 4 T.C. 931 (1945), aff'd, 156 F.2d 122 (1st Cir. 1946); Alcazar Hotel, Inc. v. Commissioner, 1 T.C. 872 (1943), acq. 1947-1 C.B. 1. Although a corporation undergoing a bankruptcy reorganization was not taxable on any discharge of indebtedness income that it realized, the Chandler Act required the reorganized corporation to reduce its tax basis in its assets by an amount equal to the discharged debt. The cases following Capento found that the issuance of stock for debt is not a realization event giving rise to "income" and thus required no basis reduction under the Chandler Act. The stated rationale for this holding was that the exchange of stock for debt merely represents a continuation of the existing liability in a different form, and therefore does not affect a true discharge of the debt. Motor Mart Trust, supra, 4 T.C. at 937 ("mere substitution of common stock for bonds"); see Tower Building Corp., supra, 6 T.C. at 135; Alcazar Hotel, supra, 1 T.C. at 879.

In Rev. Rul. 90-87, 1990-2 C.B. 32, the Service considered a situation where Z, a corporation under the jurisdiction of the bankruptcy court in a title 11 proceeding, issues preferred stock with a redemption price of $300,000 in exchange for indebtedness of $500,000. The revenue ruling concludes that the stock-for-debt exception applies, but only to the extent of the redemption price and liquidation preference (i.e., $300,000) of the preferred stock.

In the instant case, on Date 2, Taxpayer agreed to exchange preferred stock for $ E of debt. At the same time, the lenders also agreed to accept a payment of G percent for the remaining $ H in full satisfaction of that debt amount. The terms of this agreement were implemented in two installments in Year 2. After the second installment, Taxpayer owed no further debt obligations to the lenders on the $A debt. Taxpayer reported no COD income with respect to the discharge of the lender debt on its Year 2 return.

As discussed above, the satisfaction of the $A debt to the lenders in Year 2 entitled Taxpayer to a deduction in Year 2 of a portion of the remaining amount of the unamortized cost of the lender warrants -- i.e., the amount allocated to the $H portion of the debt satisfied by the cash payment. The fact that the stock-for-debt exception applies to the conversion of $E of the debt to preferred stock does not alter that treatment. However, as concluded above, the conversion of that portion of the debt to preferred stock does mean that Taxpayer would not be entitled to deduct any unamortized amount of the lender warrant cost allocable to $E of the debt.

In any event, the terms of the Year 1 agreement and its implementation in Year 2 raise a substantial issue concerning whether Taxpayer had COD income. The facts indicated that Taxpayer gave the lenders preferred stock with a redemption value of $F in exchange for $E of the debt and a cash payment equal to G percent of the remaining $H debt in satisfaction of the latter debt amount.

Because the preferred stock had a redemption value that was greater than the amount of debt for which it was exchanged, the limitation of Rev. Rul. 90-87 on the stock-for-debt exception would not be triggered. Accordingly, Taxpayer would not recognize any income on cancellation of the $E debt exchanged for the preferred stock. However, while Taxpayer paid only G percent for the remaining $H of debt (or $I) owed to the lenders, the full amount of the $H debt was discharged. Inasmuch as the preferred stock was exchanged only for $E of the debt to the lenders and was not given in exchange for any portion of the remaining $H of debt, the stock-for-debt exception would not apply to the J percent of the $H (or $ K) debt that was discharged without any consideration. Accordingly, Taxpayer should recognize COD income for that amount.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

(c) Is the reacquisition of L percent of lender warrants in Year 3 in exchange for common stock a capital transaction and, if so, is section 1234 applicable?

FACTS:

In Year 3, Taxpayer undertook a recapitalization in which the preferred stock issued to the lenders in Year 2 was converted to common stock and L percent of the lender warrants issued to the lenders in Year 1 were exchanged for common stock (M lender warrants for each share of common stock) having a value of $N. A total of O shares were issued to the lenders. In connection with the recapitalization, P shares were also offered to the public. The shares were sold after the recapitalization plan was proposed but before the shareholders approved it. The registration statement filed in connection with this issuance stated that if the plan was approved, the shares would be considered sold on behalf of the lenders and the sale proceeds would be paid to the lenders. If the recapitalization plan was not approved, the registration statement indicated that the shares would be considered sold on behalf of Taxpayer, who would receive the proceeds.

In Year 4, Taxpayer purchased the remaining Q percent of the lender warrants for $R in cash.

(i) Does the "open transaction" doctrine apply to "below the line" deductions?

[redacted]

The "open transaction" doctrine was first applied in Burnett v. Logan, 283 U.S. 404 (1931). In Burnett, taxpayer held shares in one of several steel companies. These steel companies were owners of the stock of a company engaged in mining ore under a long term lease. By agreement among themselves, the steel companies were entitled to share the ore extracted in proportion to their stock holdings in the mining company. The taxpayer and her co-shareholders sold their shares to another steel company, which thus became entitled to participate in the ores thereafter taken from the leased mine. The consideration for the sale was part cash and in part, the purchaser's agreement to pay annually thereafter, for distribution among the selling shareholders, 60 cents for each ton of ore apportioned to the purchaser. The court held that the fair market value of the contract had not been established, that the sale of taxpayer's stock was an open transaction, and that no part of the annual receipts from the contract was income, because taxpayer had not recovered the basis of her stock.

The standard for determining whether an accrual basis taxpayer has incurred a deductible expense for Federal income tax purposes is governed by the "all events" test, not the open transaction doctrine. Treas. Reg. § 1.461-1(a)(2). (For tax years after 1983, section 461(h)(4) also governs.) This test essentially incorporates for deductions a similar notion to the "open transaction" doctrine.

Under Treas. Reg. § 1.461-1(a)(2), the "all events" test has two elements, each of which must be satisfied before accrual of an expense is proper. First, all the events which establish the fact of the liability must have occurred. Second, the amount must be capable of being determined "with reasonable accuracy."

The requirement that the amount of the liability must be determined with reasonable accuracy is set forth in Treas. Reg. § 1.461-1(a)(2) as follows: While no accrual shall be made in any case in which all the events have not yet occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy, and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

The following cases illustrate this point. In Restore Inc. v. Commissioner, T.C. Memo. 1997-571, the taxpayer wanted to accrue and deduct royalties computed but not yet paid under an agreement. Under the agreement, taxpayer's liability to pay the accrued royalties was subject to the contingency that profits must first be realized before the taxpayer was required to pay the royalties. The court held that the "all events" test was not met.

Because of the contingency that profits must first be realized, the court held that the fact of a liability had not yet occurred under the "all events" test. The taxpayer has not realized any profits, and may never realize any profits. The court further held that no royalty deduction would be allowed until the subsequent year in which profits were indeed realized. At that time, the "all events test" will be met. Because the marketing agreement required taxpayer to pay a royalty fee of ten percent of net sales, the court determined that the royalty deduction could be determined with reasonable accuracy. This case supports the proposition that a deduction will be allowed in a subsequent year when the "all events" test is met.

Therefore, in the instant case, in the event that the value of the lender warrants is not ascertainable at the date of issuance, the lender warrants could become deductible in a subsequent year when the "all events" test is met.

In Spitzer Columbus, Inc. v. Commissioner, T.C. Memo. 1995-397, the issue before the court was whether taxpayer properly accrued an expense under section 461(h)(4) for coupons issued by the taxpayer pursuant to a consent judgment. Each coupon was valid at any of the Spitzer car dealerships. The taxpayer owned one of these dealerships. The coupons could be used to purchase auto parts at taxpayer's dealership. Taxpayer offered no evidence as to how a coupon issued by taxpayer, but redeemed at another Spitzer dealership was treated. The court determined that the amount of taxpayer's liability could not be determined with reasonable accuracy, and that therefore, the "all events" test, under section 461(h)(4) was not met. However, in subsequent years, when the coupons were redeemed for parts, the taxpayer was allowed a deduction for those years, because the value of the coupons could then be determined with reasonable accuracy.

Therefore, in the instant case, in the event that the value of the lender warrants is not ascertainable at issuance, Taxpayer's cost of the lender warrants could become deductible in a year subsequent to their issuance (the year that the cost of the lender warrants became determinable with reasonable accuracy). In other words, Taxpayer would be entitled to deductions for the cost of the lender warrants in the year the "all events" test is met.

The purpose behind the "all events" test and the open transaction doctrine are similar in nature. The purpose of both of them is to hold open a transaction until the amount of income or expense can be properly determined.

In the event the value of the lender warrants is not ascertainable at the date of issuance, the cost of the lender warrants could become deductible or capitalizable as a cost of issuing preferred stock in a subsequent year when the all events test is met. [redacted]

(ii) How does the fact that the lender warrants were reacquired by issuing common stock and in furtherance of a recapitalization in Year 3 affect the analysis?

LAW AND ANALYSIS:

Taxpayer exchanged its common stock for the lender warrants in Year 3. This transaction involved the exchange of Taxpayer's indefinite obligation under the lender warrants to issue its common stock for another indefinite obligation (i.e., its common stock). Although the obligation was an equity obligation since it concerned an obligation to issue stock, the exchange of the common stock for the lender warrants is analogous to the exchange of stock for debt. As previously discussed, the judicially created doctrine of the stock-for-debt exception to the recognition of COD income was generally applicable in Year 3 when Taxpayer effected the stock-for-warrants exchange. Although the stock-for-debt exception was subsequently repealed, effective for exchanges occurring after 1994, its applicability was acknowledged by Congress in the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, which imposed certain de minimis limitations on the exception in section 108(e)(8). As noted above, Taxpayer apparently relied on the stock-for-debt exception as the basis for not reporting COD income on the Year 2 transactions in which it satisfied the lender loans with cash and preferred stock.

As discussed above, the rationale for the stock-for-debt exception to the general rule on COD income, as set forth in the Capento line of cases, is that the issuance of stock for debt does not represent a realization of gain but is merely a continuation of the existing liability in a different form. On that ground, the courts held that the substitution of stock for debt did not result in COD income. As the Board explained in Capento, "[w]hile the bond loan has been terminated, the amount borrowed is now committed to capital stock liability instead of to the liability of a fixed indebtedness." 47 B.T.A. at 695.

In the instant case, Taxpayer's obligation under the lender warrants was to issue a share of its common stock to the lender warrant holder if the holder tendered the lender warrant and a cash payment of $D. This represented an equity obligation by Taxpayer. In Year 3, when Taxpayer gave the lender warrant holders common stock in exchange for the lender warrants, it merely substituted a "capital stock liability" (as in Capento) for the lender warrant obligation. Although the lender warrant obligation terminated, just as the bond loan terminated in Capento, there was no realization of income or deduction from issuing the common stock for the lender warrants. Accordingly, Taxpayer did not realize a loss on the Year 3 stock-for-warrants exchange.

In addition, the facts of this case are similar to those in Jim Walter Corp. v. United States, 498 F.2d 631 (5th Cir. 1974). In that case, the Fifth Circuit addressed a situation in which a corporation issued its warrants in exchange for cash. Each warrant entitled the warrant holder to receive one share of the corporation's common stock and two subordinated unsecured bonds for a specified price. The corporation repurchased some of the warrants immediately prior to a public offering of its stock on the advice of the underwriters, who were concerned that potential dilution resulting from the exercise of the warrants would jeopardize the success of the public offering. The taxpayer deducted the difference between the amount paid to repurchase the warrants and the amount received when they were issued.

The Fifth Circuit disallowed the claimed deduction in Jim Walter on two grounds. First, it held that the repurchase of the warrants was required by the underwriters in connection with the public offering and thus costs of the repurchase were nondeductible expenses of a recapitalization, citing United States v. Hilton Hotels, 397 U.S. 580 (1970); Woodward v. Commissioner, 397 U.S. 572 (1970); and lower court cases. Second, the court held that the repurchase of the warrants essentially extinguished the corporation's obligation to issue stock under the warrants and thus extinguished the holder's right to the corporation's stock. In essence, the court viewed the cost of repurchasing the warrants as akin to a cost of redeeming stock. Thus, under the second ground, the court viewed the payment to repurchase the warrants as resulting in an alteration of the corporation's capital structure, the costs of which are nondeductible. 498 F.2d at 638.

In our view, the holding of Jim Walter applies in this case. Taxpayer exchanged its common stock for the lender warrants in Year 3 as part of a recapitalization, i.e., a restructuring of its equity capital.[2] Under the Fifth Circuit's rationale in Jim Walter, the costs associated with the recapitalization are not deductible. Therefore, Taxpayer is not entitled to any deduction with respect to the value of the common stock given to the lenders in exchange for the lender warrants.

We recognize that, as discussed below, the Year 3 exchange of common stock for lender warrants constitutes a closing transaction for purposes of section 1234(b). However, while that provision governs the timing and character of gain or loss on certain transactions involving options, it does not determine whether any gain or loss is realized on such transactions. The recognition of gain or loss on such transactions is governed by other provisions of law. Treas. Reg. § 1.1234-1(f) expressly provides that "Section 1234 does not permit the deduction of any loss which is disallowed under any other provision of the law." As concluded under the above analyses, no gain or loss should be realized on the exchange of Taxpayer's common stock for the lender warrants. Therefore, section 1234(b) is not controlling in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

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[2] The other significant part of the Year 3 recapitalization was Taxpayer's exchange of its common stock for the preferred stock given to the lenders in the Year 2 partial conversion of the debt.

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[redacted]

[redacted][3] [redacted]

[redacted]

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[3] [redacted]

[redacted]

[redacted]

4

[redacted]

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4 [redacted]

[redacted]

(iii) Is the "reacquisition" a "closing transaction" within the meaning of section 1234?

LAW AND ANALYSIS:

Section 1234(b) provides that in the case of the grantor of an option, gain or loss from any closing transaction with respect to, and gain on lapse of, an option in property shall be treated as a gain or loss from the sale or exchange of a capital asset held not more than one year.

Section 1234(b)(2)(A) defines the term "closing transaction" as any termination of the taxpayer's obligation under an option other than through the exercise or lapse of the option.

An exercise occurs where the holder of an option utilizes its right to make the grantor of the option buy or sell property at the agreed upon price. A lapse occurs where the holder does not exercise its option during the option period and the option period expires. See H. Rept. No. 94-1192, 94th Cong. 2d Sess. 3-4 (1976), 1976-3 (Vol. 3) C.B. 19, 21-22.

Rev. Rul. 72-198, 1972-1 C.B. 223, provides, in part, that a stock warrant is an option for purposes of section 1234 if the holder has the right to purchase the stock to which it relates.[5]

In this case, the holders of the lender warrants did not pay Taxpayer the strike price of $D for each share of Taxpayer common stock obtained. The holders gave M lender warrants to Taxpayer for each share of common stock. Thus, the exchange of common stock for lender warrants is not an exercise of the lender warrants. Moreover, the lender warrants were reacquired by Taxpayer prior to the end of the period during which the holders could exercise the lender warrants. Therefore, no lapse occurred.

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[5] As discussed above, Rev. Rul. 72-198 was modified by Rev. Rul. 77-40, 1977-1 C.B. 248, and declared obsolete in Rev. Rul. 86-9, 1986-1 C.B. 290. Since section 1032 was amended in 1984 to cover warrants, Rev. Rul. 86-9 provides that certain rulings (including Rev. Rul. 72-198) are obsolete and are not determinative with respect to stock warrants acquired or lapsing after July 18, 1984.

The Year 3 reacquisition of the lender warrants by Taxpayer in exchange for common stock terminated Taxpayer's obligations under the terms of the lender warrants. Therefore, under the facts submitted, since the termination of Taxpayer's obligation under the lender warrants was other than through the exercise or lapse of the lender warrants, the stock-for-warrant exchange is a closing transaction within the meaning of section 1234(b).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Issue 2: What is the proper treatment of the issuance and reacquisition of the Company warrants?

FACTS:

Unlike the lenders that received warrants in mid-Year 1, Company did not receive warrants until the end of Year 1, after the Guarantor's guarantee of newly issued debt. At that time, Company agreed to convert Taxpayer's $S debt to preferred stock (valued by the parties at $T), a cash payment of $U and V warrants (valued by the Service's expert at $W when issued). Taxpayer reacquired the Company warrants in Year 3 for common stock valued at approximately $X.

LAW AND ANALYSIS:

The stock-for-debt exception, discussed above, applies to the Year 1 transaction with Company because Taxpayer issued preferred stock and warrants for common stock as part of the package that Company received. The stock-for-debt exception applies to the amount of debt that is not satisfied by cash or other property.[6]

We understand that the parties treated the preferred stock as satisfying $T of the debt, with the remaining portion of the debt treated as discharged in exchange for

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[6] This stacking rule is described in the legislative history of the Bankruptcy Tax Act of 1980. See S. Rep. No. 96-1035, at 17 (1980), reprinted in 1980-2 C.B. 620, 629.

the cash and warrants. If the redemption price of the preferred stock was at least equal to $T, the stock-for-debt exception would apply to preclude any COD income on that part of the debt discharge. See Rev. Rul. 90-87, supra. Because the warrants constitute an equity interest with respect to common stock, the stock-for-debt exception would arguably apply to the issuance of the warrants. Thus, Taxpayer would not have any COD income on the $Y portion of the debt remaining after the U cash payment. In short, there would be no COD income on the Year 1 conversion of the Company debt.

Unlike the lender warrants, the warrants that Taxpayer gave to Company in Year 1 were issued in consideration for a portion of the debt. Accordingly, the cost of the Company warrants was not an amortizable loan cost. However, the Year 3 exchange of the common stock for the Company warrants would be subject to the same analysis as discussed above with respect to the lender warrants.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call if you have any further questions.

By: ______________________________
JOEL E. HELKE
Chief, Financial Institutions & Products Branch

cc: Joseph F. Maselli
CC:NER