

Proposal for Rationalizing the Treatment of Options and Warrants in Reorganizations

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Summary of Proposal

Under current law, gain or loss is generally not recognized by holders of employee stock options in a reorganization.¹ The treatment of options and warrants which are not employment related is rapidly becoming less clear.

This proposal will address three issues raised by non-employee options and warrants in the reorganization context: (i) to what extent such options and warrants (whether unexercised or exercised immediately prior to a reorganization) should be considered for purposes of determining continuity of interest; (ii) whether the acquisition of such options or warrants in a reorganization should be considered analogous to the acquisition of stock for purposes of determining whether there is "boot" in the transaction; and (iii) to what extent is exchange treatment appropriate for options or warrants which have not been exercised?

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In general, the proposal suggests that options which are substantially certain of being exercised be treated differently than options which are not substantially certain of being exercised. Thus, stock acquired upon exercise of an option which was substantially certain of being exercised would be considered owned by an historic shareholder, if the option were owned by the historic optionholder. Similarly, acquisition of such an option for cash or other nonqualifying consideration would be taken into account in determining the qualification of the transaction under the various "solely for voting stock" reorganizations. Finally, and more generally, the proposal suggests that the treatment of options or warrants in a reorganization should be clarified, we believe, to comply more closely with the "exchange" requirements of Section 1001.

Description of Current Law

It is unclear how holders who exercise their warrants for stock immediately prior to a reorganization are treated for continuity of interest purposes.² Such stock can be ignored, treated as held by an historic shareholder, or treated as held by a non-historic shareholder. Each of these different positions appears to have some support.³ This confusing treatment seems to be due to the fact that there is continuing uncertainty over whether principles of economic equivalence or underlying corporate law should control the taxation of such instruments.

For example, a deep in the money option or warrant can in certain situations be considered economically equivalent to an equity interest in a company. See, e.g., Treas. Reg. § 1.382-4(d) (deemed exercise rules); Rev. Rul. 82-150, 1982-2 C.B. 110 and Rothman, "Transfers to Controlled Corporations: In General," *Tax Management Portfolio*, 347-2d (1995) at A-18, (inference that under Rev. Rul. 82-150, options may be treated as

¹ See Code §§ 422(a) and 424(a) (incentive stock options); Treas. Reg. § 1.83-7(b) (nonstatutory options). These rules generally permit the holder of an employee option to avoid the current recognition of gain or loss in a reorganization when options in the target company are replaced by similar options in the acquiring company, although under Treasury Regulation section 1.83-7(b), an employee option that has a "readily ascertainable fair market value" is subject to current recognition of gain or loss.

² See PLR 9105028 (shares issued on exercise of option apparently are not considered for purposes of continuity representation); PLR 9136027 (same); *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995) (Tax Court ignored direct issuance of shares to acquiring corporation on option exercise when determining continuity of interest); compare PLR 9102037 (shares issued pursuant to option apparently are considered in the continuity representation); PLR 9008028 (same); see also Ginsburg & Levin, *Mergers, Acquisitions & Buyouts* at § 610.3.2 (Little Brown, 1996).

³ See note 2, *supra*.

stock for purposes of Section 351); see also PLR 9605015 (discussed in more detail below). In this regard, courts and the Service have determined that in certain situations the relevant “owners” of a corporation for continuity of interest purposes may be persons other than nominal equity holders. See, e.g., *Helvering v. Alabama Asphaltic*, 315 U.S. 179 (1942) (debtors of deeply insolvent company were in substance the “owners” for continuity of interest purposes); Rev. Rul. 59-222, 1959-1 C.B. 80 (similar); see also Code §§ 368(a)(2)(H), 354(b), 304(c)(3) and 318(a)(4) (taking options into account for purposes of determining “control” in certain “D” reorganizations).

On the other hand long-standing authority in the reorganization context holds that options and warrants are merely contractual rights and not “stock” for purposes of the reorganization provisions. Thus, in *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942) the Supreme Court noted that the receipt of a warrant did not constitute the receipt of voting stock.⁴ Similarly, the regulations under Section 354 provide that “for purposes of Section 354, stock rights or stock warrants are not included in the term ‘stock or securities.’”⁵ See Treas. Reg. § 1.354-1(e). However, both the *Southwest Consolidated* case and Treasury Regulation Section 1.354-1(e) relate only to the receipt of warrants or options in a reorganization, not to whether a warrant or option may be considered to impart some degree of pre-existing “ownership” of the target corporation for continuity purposes.⁶

Although the purchase of unexercised warrants by an acquiring corporation (for cash or other property) is generally considered irrelevant for purposes of determining continuity of interest and the presence of boot in a transaction, it appears that the current state of the law is that unexercised warrants of a company undergoing a reorganization are treated as having been received in a taxable exchange by the holder. See GCM 39225 (1984) (formation of holding company in a Section 351 or 368(a)(2)(E) transaction results in a taxable exchange of Target options for Parent options); see also Rev. Rul. 69-91, 1969-1 C.B. 106 (purchase by acquiring

corporation of deep-in-the-money options does not affect otherwise valid Section 368(a)(1)(B) reorganization); GCM 34004 (1968) (same). However, warrants in a company which undergoes a Section 368(a)(1)(F) reorganization generally do not appear to be subject to these taxable exchange rules. See PLR 8930030 (publicly traded warrants in an Section 368(a)(1)(F) reorganization not considered exchanged under Section 1001, and accordingly no gain or loss is recognized on the reorganization).

Recent Developments

Certain recent developments have made reliance on the existing precedent in the warrant and option area even more problematic. Thus, a recent private ruling, PLR 9539020, held that the receipt of replacement options in a Section 368(a)(1)(A) reorganization did not require gain or loss to be recognized with respect to such options. The basis for the ruling appears to be that there was no exchange of the options for purposes of Section 1001, a rationale which is similar to the reasoning of PLR 8930030, *supra*, involving an “F” reorganization. There is little clear guidance on this issue, however. In addition, as discussed in more detail below, the *Cottage Savings* decision and its reliance on certain pre-“F” reorganization cases casts some doubt on the continuing validity of the position that there is no exchange of options in an “F” reorganization, a situation which should be clarified.

Another recent ruling, PLR 9605015, held that stock of certain professional corporations owned of record by a physician were “directly owned” for purposes of Section 1504 by a health insurance company, based in large part on the existence of an option to acquire control of the stock of such professional corporations for a nominal exercise price. As with other areas of the tax law, such as President Clinton’s proposal relating to “short against the box” and similar transactions (and the remarks of various commentators who have noted that, even under existing law, such transactions may raise continuity of interest concerns), there appears to be a growing trend to treat owners of options, warrants and other such instruments

⁴ See also *William Bateman v. Commissioner*, 40 T.C. 408 (1963) (holding that warrants do not constitute stock).

⁵ The statement that options are not “securities” appears to be inconsistent with the holding in *Raymond v. Commissioner*, 37 B.T.A. 423 (1938).

⁶ For example, although the Supreme Court in *Alabama Asphaltic* held that the relevant “owners” of a company were its debt holders, receipt of solely debt instruments in a transaction would result in the transaction failing to qualify as a reorganization under the holding in *Southwest Consolidated*, decided by the Supreme Court in the same year. See also Henderson & Goldring, *Failing and Failed Businesses*, § 510.1 (Little Brown, 1995)

as if they were owners of the underlying equity instruments. See, e.g., Faber “Post-Reorganization Sales and Continuity of Interest,” 68 *Tax Notes* 863 (August 14, 1995); Treas. Reg. §§ 1.1504-4 and 1.382-4(d) (relating to deemed option exercise rules); see also Rev. Rul. 77-85, 1977-1 C.B. 12; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11 and *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1984) (treating the assets of certain insurance company separate accounts as being in substance owned by policyholders). We believe that this trend will continue and will create confusion about the proper treatment of warrants and options in reorganizations in the near term.

Reasons for Change

As noted above, current law appears to provide that the formation of a holding company results in a taxable exchange of options of the operating company for options of the holding company (and, e.g., regardless of whether the option provided for such assumption so that no change of terms or physical reissuance is required). See GCM 39225. This seems to conflict with the rationale underlying the tax treatment of convertible debt, which permits the conversions of such instruments pursuant to their terms without the recognition of gain or loss. See, e.g., Fleischer & Cary, “The Taxation of Convertible Bonds and Stock,” 74 *Harv. L. Rev.* 473 (1961). Arguably, the assumption of an option pursuant to its own terms is not a change in a legal right, but merely the exercise of such a right. Compare *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991) (exchange treatment determined by reference to change in underlying legal rights). The basis for the position taken in GCM 39225, however, appears to be based on the fact that the holding company would only have shareholder-type rights with respect to the operating company, and accordingly that the option would be an option to acquire shares of a “shareholder” rather than an operating company. Thus, although from an economic perspective (and most practical perspectives) the holder of an option would be in a virtually identical position, the GCM takes the position that there would be an “exchange” of the options for purposes of Section 1001.

The holding in the GCM focuses on an analysis of the underlying stock and its rights, rather than the contractual rights provided for in the option itself. As indicated above, under the holding in *Southwest Consolidated*, an option is a contractual right separate and apart from any underlying stock. Accordingly it would seem that the proper analysis in such a situation would be

to focus not on whether the stock underwent a significant enough change to constitute an exchange for Section 1001 purposes, but on whether the contractual rights which comprise the option underwent such a change. For the reasons discussed herein, it would seem that no material change in such contractual rights would occur as a result of such a transaction.

For example, the holder of an option on the stock of a company may be holding such option as a hedge, or as a separate and distinct investment in a company, and especially where the option is publicly traded, may have no intention whatsoever to exercise the option and acquire stock of the company. To such a holder, the value of the option is based not on its ability to be converted into stock of the underlying company (although this forms the basis for determining its value), but on the market for such an option which exists independently of the market for the underlying stock. In this regard, such an option is not materially different than any other derivative. Accordingly, minor changes in the rights of the underlying stock or the rights of the company under the laws of a different state are largely irrelevant to the holder of such an option.

The positions taken in GCM 39225 and in PLR 8930030 are somewhat inconsistent. The GCM takes a rather strict view of the existing law under Section 1001 (generally consistent with that applied in *Cottage Savings*) to the effect that any change in a legal right of a stockholder results in a taxable exchange. The private letter ruling, however, seems inconsistent with the holdings in *United States v. Phellis*, 257 U.S. 156 (1921) and *Marr v. United States*, 268 U.S. 536 (1925), both of which were relied upon heavily in *Cottage Savings*, to the effect that stock in a company which has changed its state of incorporation has been “exchanged” for purposes of Section 1001, because such a change results in a variation of a shareholder’s legal rights with respect to the corporation. In either situation, however, from a practical as well as an economic view, no material change has happened to the contractual rights which comprise the option.

It is also interesting to note that, of all of the types of contracts a company may have, options appear to be peculiarly singled out for taxation in reorganizations. Thus, a party to a supply agreement which becomes materially more valuable as a result of a counterparty’s merger with another company that has, for example, a significantly better credit rating, is not generally required to recognize gain or loss on such agreement. Similarly, the proposed regulations relating to exchanges of debt instruments provide a specific exception for

reorganizations as material modifications. See Prop. Treas. Reg. § 1.1001-3(e)(3)(i)(A). In such a case, the value of the debt instrument might be materially impacted by a merger into an entity with a materially worse credit rating than the target company. However, an option in an operating company which is converted into an option in a new holding company (representing no change in value in such option and, if appropriately drafted, no change in any of the contractual terms of such option) apparently is subject to gain or loss recognition. See, *e.g.*, GCM 39225, *supra*.

In addition, it is now fairly common for start-up companies to issue warrants in connection with early non-public financings, and to issue substantial amounts of employee options. In some instances the amount of shares exercisable by option and warrant holders may exceed the amount of outstanding shares outstanding. In such situations, the treatment of option or warrant holders as “historic” or non-historic shareholders may have a material impact on whether continuity of interest will be maintained, especially if the transaction is a cash election merger or other, similar, type of transaction in which continuity of interest is a material consideration. Likewise, the ability of an acquiring corporation to purchase options of the company for cash (which may represent a large portion of the stock of the company on a fully diluted basis), while simultaneously engaging in a tax-free reorganization, would seem to present certain opportunities for abuse.

Explanation of Proposal

Continuity Issues. We propose that shares received upon the exercise of an option that is “substantially certain” of being exercised should be treated as owned by the historic owner of such option, and accordingly, such an historic owner would be treated as an historic shareholder with respect to the stock acquired upon the exercise of such option.⁷ Stock acquired on the exercise of any option which is not “substantially certain” of being exercised would be ignored (*e.g.*, such shares would be excluded from both the denominator and the numerator) for

purposes of determining continuity of interest. Options which are not exercised in connection with a reorganization would also be ignored for purposes of determining continuity of interest unless such options are substantially certain of being exercised and are acquired by the acquiring company (or persons acting in concert with the acquiring company) in connection with the transaction for non-qualifying consideration (consideration other than a replacement option or stock).⁸ We suggest that replacement options be considered qualifying replacement property for these purposes, so that an acquiring corporation not be required to issue voting stock to option holders in “solely for voting stock” reorganizations.

For purposes of this proposal, we believe that “substantial certainty” should be determined based on a facts and circumstances test, with a presumption that an option whose exercise price is forty percent (40%) or less of the average trading price of the stock of the target company immediately prior to date of the reorganization agreement is substantially certain of being exercised, and a presumption that an option whose exercise price is seventy percent (70%) or more of such average trading price is not substantially certain of being exercised. A test based on the “substantial certainty” of exercise would appear to have some support under the reasoning of, *e.g.*, Rev. Rul. 82-150 and PLR 9605015. Other factors which might be considered include whether such options are publicly traded, the exercise price of the option in absolute dollar terms, and the total cost of the option (option premium and exercise price) to the holder of such option, and whether the option or warrant holder is also a shareholder or other interested party in the transaction.

Boot Issues. We propose two alternatives for purposes of determining whether transactions involving options may result in “boot” being present. Under one alternative, options which are “substantially certain” of being exercised and which are acquired for non-qualifying consideration (something other than stock or a replacement option) by the acquiring company in a reorganization would be treated the same as outstanding stock. Options which were

⁷ For these purposes, the “historic owner” would be determined in the same manner as under the existing continuity of interest doctrine, and an option holder would only be considered an “historic” shareholder if such option holder qualified as an “historic” option holder at the time the option was exercised.

⁸ As discussed below, we propose that replacement options in a merger not be subject to current gain or loss recognition. Accordingly, this rule would generally only apply where an Acquiring corporation pays cash for deep-in-the-money options of the Target corporation. We believe this result is appropriate (although contrary to existing law), and will maintain the integrity of the reorganization provisions.

not substantially certain of being exercised would be ignored. The alternative is to clarify the existing treatment provided for under Rev. Rul. 69-91, 1969-1 C.B. 106 and GCM 34004 (1968), to the effect that the acquisition of options always should be ignored for purposes of determining whether there is “boot” present in a reorganization.

Exchange Issues. The proposal suggests two alternatives for determining exchange treatment in reorganizations. Under one alternative, options would be treated as equity securities having a principal amount, for purposes of Section 356(d), of zero. See note 6, *supra*; Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, at ¶ 12.41[4] (with the result that the exchange of options or warrants in a reorganization would not result in any gain or loss being recognized by the holder).

Under the other alternative, the determination of whether a warrant is exchanged, for purposes of Section 1001, would be based on a facts and circumstances approach which would consider whether the various rights comprising the warrant itself (and not the underlying stock) had been modified to such an extent that exchange treatment is appropriate. In general, we believe that a safe harbor should exist for transactions such as “F” reorganizations and holding company transactions, but that the determination of whether an acquisitive reorganization results in an “exchange” of options should be based on factors similar to those under Proposed Treasury Regulation section 1.1001-3 (relating to exchanges of debt instruments). Accordingly, relevant

factors would include changes in the term of the option, its exercise price, and whether a change in the terms of the option (anticipating a reorganization) was provided for in the original option agreement. Other provisions which appear to be relevant would include changing the instrument into which the option may convert from common to preferred stock, the percentage of assets of the new entity which the assets of the target company represents, and changes or modifications of other terms or features which affect the value of the option. See, e.g., PLR 9539020, *supra*. We recognize that this approach seems somewhat inconsistent with the more general view that contractual rights such as warrants and options should generally not be subject to gain or loss recognition as a result of a reorganization under any circumstances, but believe that a general rule providing that no gain or loss would be recognized as a result of a reorganization might lead to abuses.

Simple Alternative. A simple, bright-line alternative to all of the foregoing would be to treat all options which are substantially certain of being exercised as equivalent to stock. This approach may raise certain additional problems, such as whether the receipt of such an option would be treated the same as the receipt of stock (contrary to the holding in *Southwest Consolidated*, *supra*), and generally resulting in a requirement that in any “solely for voting stock” transaction that the options and warrants be acquired for stock in the transaction, both of which the present proposal tries to avoid. On the other hand, it would be somewhat easier to administer such a bright-line rule.