Bridge Financings of Emerging Growth Companies – What Lawyers Representing Investors and Companies Need to Know in Structuring Bridge Loans to Fund a Company Before a Series A Round or Bridging From One Series of Preferred to the Next.

Sponsored by the Private Equity and Venture Capital Committee of the Business Law Section

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TAX DISCUSSION*

“It’s a Minefield”

Warren P. Kean
K&L Gates, LLP
Hearst Tower, 47th Floor
214 North Tryon Street
Charlotte, NC 28202
warren.kean@klgates.com
704.331.7413

* This discussion is intended to be general in nature and provide an introduction and overview of the federal income tax issues that are more commonly encountered when structuring convertible bridge financings. It is not intended to be an exhaustive study of all federal income tax issues that may need to be resolved in connection with those financings. For example, this outline does not discuss the possible application of certain anti-abuse rules, the denial of interest deductions for certain acquisition indebtedness (I.R.C. § 279), and the denial or suspension of certain interest deductions under the “applicable high yield debt obligation” (AHYDO) rules of I.R.C. §§ 163(e)(5) and 163(i). Unless otherwise indicated, all section references are to the applicable provisions of the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.
I. BRIDGE NOTES

A. Tax Characterization – Debt or Equity?

1. General Rule. Convertible debt (i.e., debt that is convertible into equity of the issuer) generally will be recognized as debt for federal income tax purposes until it is converted into equity (except to the extent that the holder of that debt instrument may be treated as a shareholder under I.R.C. § 305(d)(2)). Treas. Reg. § 1.1244(c)-1(b) and Rev. Rul. 69-91, 1969-1 C.B. 106. See also the discussion of Section 305 in Part I.D below. No gain or loss is “realized” on the conversion of the debt instrument into equity, except the holder may have to recognize gain with respect to any cash (or property other than the issuer’s stock or securities) that the holder receives in lieu of fractional shares. See Rev. Rul. 66-365, 1966-2 C.B. 116 and Rev. Proc. 77-41, 1977-2 C.B. 574. Upon conversion, the holder’s adjusted tax basis in the debt instrument (reduced by any of that basis that is allocated to a fractional share that is treated as being redeemed in the transaction) becomes the adjusted tax basis of the stock. Treas. Reg. § 1.1001-3(c)(2)(ii); Rev. Rul. 72-265, 1972- C.B. 222. The holding period of the stock (assuming that it is a capital asset) will include the holding period of the debt instrument (at least with respect to the original issue price of debt instrument). I.R.C. § 1223(1). The holding period for that part of the stock received in exchange for accrued interest likely begins on the date that the conversion takes place (because it effectively is at that time that the holder receives payment for the accrued interest instead of accruing the right to receive payment), but there is no authority precisely on point.

2. Recharacterization.

(a) I.R.C. § 385

(b) Rev. Rul. 83-98, 1983-2 C.B. 40. Adjustable rate convertible notes (“ARCNs”) were treated as stock because the IRS determined that there was a “very high probability” that the holders of those notes would exercise their conversion rights and, therefore, the notes did “not in reality represent a promise to pay a sum certain.”

Under the facts, the investors paid $1,000 per ARCN. The ARCN was convertible into shares of stock that on the date of the issuance of the ARCN had a fair market value of $1,000. If the note’s conversion right was not exercised, the investor would be entitled to a payment of only $600 in cancellation of the note. In addition, the issuer had the right to repurchase the ARCN (subject to the holder’s right to exercise the note’s conversion feature) after the second anniversary of its issuance.


B. IRS Responds – Limiting Interest Deductions.

1. Section 385(c). Section 385(c) was adopted and became effective in 1992. It requires the issuer to establish whether an instrument is debt or equity. The issuer will be bound by that characterization but not the IRS. A holder of that instrument also will be bound by that
characterization unless the holder makes disclosure to the contrary on the holder’s federal income tax return.

2. **Section 249.** A corporate issuer of a convertible debt instrument may not deduct any premium (i.e., any amount that exceeds the debt instrument’s adjusted issue price) paid by it or a related party to repurchase the debt, except to the extent that (a) the amount of the premium does not exceed a “normal call premium” on a comparable nonconvertible debt instrument or (b) the issuer demonstrates to the IRS that the premium is attributable to the cost of borrowing and is not attributable to the debt instrument’s conversion feature. See Treas. Reg. 1.249-1.

3. **Section 163(l).**

(a) **“Disqualified Debt Instruments.”** I.R.C. § 163(l) was adopted in 1997 and disallows any interest deduction on “disqualified debt instruments” that are issued by a corporation. Generally, “disqualified debt instruments” are debt instruments that are payable in equity of the issuing corporation or a related party. More specifically, they are debt instruments for which (i) a “substantial amount” of the principal or interest is payable in, or convertible into, equity (or determined by reference to such equity) or is part of an arrangement that is “reasonably expected” to result in such a transaction or (ii) the holder of that instrument may require that it be paid in such manner (i.e., in equity or other consideration that is based on equity) and there is “substantial certainty” that the option will be exercised.

(b) Meaning of “Substantial Certainty”? Is “substantial certainty” a higher standard than “very high probability” that was found to be present in Rev. Rul. 83-98?

(c) **House and Conference Committee Reports.** “[I]t is not expected that the provision will affect debt with a conversion feature where the conversion price is significantly higher [(notice that the standards of “very high probability” and “substantial certainty” were not used)] than the market price of the stock on the issue date of the debt.” H.R. Rept. No. 105-148 (105th Cong. 1st Sess.), at 457, 780, reprinted in 1997-4 C.B. 319, 779, 780 (June 24, 1997); and H.R. Rept. No. 105-220 (105th Cong. 1st Sess.), at 523, 524 (July 30, 1997), reprinted in 1997-4 C.B. 1457, 1993, 1994 (emphasis added). See also, General Explanation of Tax Legislation Enacted in 1997, Staff of the Joint Comm. on Tax’n, at 192, 193 (Dec. 17, 1997), reprinted in 1997-3 C.B. 87, 302, 303.

(d) **Rev. Rul. 2002-31, 2002-1 C.B. 1023.** This revenue ruling primarily concerns the application of the noncontingent bond method under Treas. Reg. § 1.1275-4(b) to a nonconvertible debt instrument issued by a corporation. The IRS failed to use this opportunity to provide guidance as to what constitutes a “significantly high” conversion price, electing instead simply to state in the facts of the ruling that on the date that the debt instrument was issued, the fair market value of the stock for which the instrument could be converted was “significantly less” than the instrument’s issue price.
Rev. Rul. 2003-97, 2003-2 C.B. 380. The ruling concerns the deductibility of interest on the note component of FELINE PRIDES \(^*\) -- an investment unit consisting of a note and a forward purchase contract to purchase stock of the issuer. The purchase contract has a 3-year term and the note has a 5-year term. The interest rate on the note resets shortly before the forward contract’s 3-year settlement date at a rate that makes the note worth slightly more than its stated principal amount (there is no cap on the reset rate). An investment bank is engaged to remarket the notes shortly before the forward contact’s settlement date. If the remarketing is successful, then the holders of the notes will receive more than enough cash to purchase the issuer’s stock under the forward contracts. If the remarketing is not successful, then the holders effectively are allowed to pay for the stock under the forward contracts by surrendering their notes to the issuer. In the facts of the ruling, the IRS stipulates that “[o]n the Issue Date, it is substantially certain that a remarketing of the Notes will succeed” (emphasis added); and therefore, they will not be surrendered to the issuer in exchange for stock. The IRS then ruled that this investment unit was not “reasonably expected” to give the issuer the right to convert or otherwise repay the notes with stock; thus, the IRS ruled that the notes were not disqualified debt instruments under I.R.C. § 163(l).

C. Original Issue Discount (OID) – Economic Accrual of Imputed Interest.


(a) Economic Accrual. The holder must include in income the sum of the daily portions (accrual of the excess of the yield to maturity over the interest paid during the accrual period) of OID (i.e., stated redemption price at maturity over the issue price) with respect to each day that the holder owns the applicable debt instrument. I.R.C. § 1272(a). This treatment causes the holder to recognize increasingly greater amounts of OID in each successive accrual period.

(b) Exceptions to Daily Accrual of OID.

(i) Short-term debt instruments. Debt instruments with a fixed maturity of one-year or less. I.R.C. § 1272(a)(2)(C).

(ii) De minimis OID. Debt instruments with de minimis OID (less than 1/4 of 1% of the stated redemption price multiplied by the number of years to maturity). I.R.C. § 1273(a)(3).

(c) Increase in the Debt Instrument’s Basis to Daily Accrual of OID. The investor’s adjusted tax basis in the debt instrument is increased by the amount of OID included in the holder’s income. I.R.C. § 1272(d)(2).

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\(^*\) Merrill Lynch created PRIDES (“Preferred Redeemable Increased Dividend Equity Securities”) and then reused the acronym for a product that gives the issuer an interest deduction that it called FELINE (Flexible Equity-Linked Exchangeable Securities).
2. **Investment Units.** When a debt instrument is issued with a warrant (or other option), security, or other property, the amount paid for that investment unit must be allocated among its various components based on their relative fair market values. I.R.C. § 1273(c)(2).

3. **Contingent Payment Regulations.** I.R.C. § 1275(d) and Treas. Reg. § 1275-4(b).

   (a) **Noncontingent Bond Method.** The “noncontingent bond method” (“NBM”) is applied to contingent payment debt instruments (“CPDIs”) issued for cash (or publicly-traded property). Under the NBM, interest is deemed to accrue on a CPDI based on the comparable yield (which may not be less than the AFR) on the projected payment schedule of a comparable non-contingent, fixed-rate, nonconvertible debt instrument. Treas. Reg. § 1.1275-4(b)(4)(i).

   (b) **Adjustments.** If the actual amount of a contingent payment differs from the projected payment, the difference generally is taken into account in the year that the actual payment is made (i.e., in the case of a positive adjustment, where an actual payment exceeds the projected payment, the difference is treated as the payment and receipt of additional interest). Treas. Reg. § 1.1275-1(b)(6)(ii). The regulations provide an exception to this characterization if “at the time of the sale, exchange or retirement of the debt instrument, there are no remaining contingent payments due on the debt under the projected payment schedule,” in which case the positive adjustment will be taxed as gain from the sale, exchange or retirement of the debt instrument. Treas. Reg. § 1.1275-4(b)(8)(iii)(A).

   (c) **Accrued Interest Through Date of Conversion.** If the debt documents do not otherwise provide, OID and other interest that accrues from the last accrual period through the date that the note is converted into equity will not be taxed as interest. Boris I. Bittker and James E. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 4.61 (7th ed. 2006); Kevin M. Keyes, *Federal Taxation of Financial Instruments and Transactions*, ¶ 4.02[3][a][ii] (2005); *Tandy Corp. v. U.S.*, 626 F.2d 1186 (5th Cir. 1980); *Ades v. Commissioner*, 38 T.C. 50 (1962), aff’d per curiam 316 F.2d 734 (2d Cir. 1963); Rev. Rul. 72-348, 1972-2 C.B. 97; and Rev. Rul. 68-170, 1968-1 C.B. 71. But if the debt documents provide that such accrued but unpaid interest is to be deemed paid in stock upon conversion, then it will be taxed as interest. See Paul A. Strasen, *The Taxation of Convertible and Other Equity-Flavored Instruments*, 65 *Taxes* 937, 945-46 (1987) and David H. Shapiro, 188 T.M., *Taxation of Equity Derivatives* (Part II.E.2).

   (d) **Exceptions.**

      (i) **Remote and Incidental Contingencies.** Contingencies that are either remote or incidental are not treated as contingent payments requiring the application of NBM. Treas. Reg. §§ 1.1275-4(b)(5) and - 2(h).

      (ii) **Convertible Notes.** The right of the holder of a debt instrument to convert it into “stock” of the issuer (or a related party) alone will not subject the
debt instrument to the CPDI rules. Treas. Reg. § 1.1275-4(a)(4). See also Treas. Reg. §§ 1.1272-1(e) and 1.1273-2(j) (the value of the conversion privilege generally is factored into the computation of OID only by increasing the debt instrument’s issue price by the amount by which that privilege increases the amount paid for that debt instrument). The IRS, however, takes the position that such a conversion right is a contingent payment to be factored into the determination of the instrument’s comparable yield and projected payment schedule (projecting the time and amount of contingent payments) if the debt instrument provides for any other contingent payment that is neither remote nor incidental. Rev. Rul. 2002-31, 2002-1 C.B. 1023. Thus, the stock received upon the conversion of the debt instrument under those circumstances is to be treated as a contingent payment and factored into the projected payment schedule for the debt instrument. Id.

(e) Appreciation in the Value of the Conversion Feature as Interest. By treating the conversion right of a CPDI as a contingent payment, Rev. Rul. 2002-31 causes the appreciation in the value of the conversion right to be treated as interest to be included in the income of the holder (and possibly deductible by the issuer - - see discussion of I.R.C. §§ 163(i) and 249 above) as part of the projected payment schedule and, unless there are no remaining contingent payments at such times, on the sale or conversion of the debt instrument. This is potentially a very bad answer to the holder of the debt instrument. It will (i) accelerate the holder’s recognition of income, by effectively requiring the accrual of the projected appreciation as part of the comparable yield and projected payment schedule; (ii) change the character of the gain recognized on that appreciation from capital gain to ordinary interest income; and (iii) override the otherwise tax-free treatment of the conversion of the debt into equity. See I.R.C. §§ 1271(a)(1) and 1222 for the general rule that the amount paid to an investor to retire a debt instrument will be treated as a capital gain or loss, as applicable, to the extent that the amount differs from the holder’s adjusted tax basis of that debt instrument.

As recognized in Andrew W. Needham and Anita B. Adams, 735 T.M., Private Equity Funds (Part VIII.C): “[T]he mere right of convertible debt to receive dividends on an ‘as-converted’ basis will convert gain on sale or conversion to ordinary income if the likelihood of these payments is not ‘remote or incidental,’ even though they may represent only a small portion of the expected return on the instrument.”

(f) Generally the Issuer’s Determinations Control. Treas. Reg. § 1.1275-4(b)(4)(iv). This regulation requires the issuer to provide the holder with the projected payment schedule. Only if the issuer fails to do so or the schedule prepared by the issuer is “unreasonable,” will the holder prepare the schedule and determine the comparable yield.

D. Convertible Debt Treated as Stock Under I.R.C. § 305(d) – Adjusting (or Failing to Adjust) the Conversion Ratio/Price. The anti-dilution and similar protections and rights (or the absence thereof) of convertible debt instruments issued by a corporation may, under certain circumstances, cause the corporation to be deemed to have paid dividends to the holders of those debt instruments or the actual shareholders of the corporation. This is because I.R.C. § 305(d)
and Treas. Reg. § 1.305-3(b)(5) treat warrants, convertible securities, and other rights to acquire stock of a corporation as “stock” themselves and the holders of those instruments as “shareholders” for purposes of determining whether certain distributions (or deemed distributions) by the corporation to its “shareholders” of additional interests in the equity of the corporation (i.e., an increase in those shareholders’ interests in the corporation’s assets or earnings and profits) are to be taxed as dividends. In this regard, the regulations make it clear that a change in the conversion ratio of a convertible debt instrument (as well as a change in redemption price, a difference between redemption and issue price, a redemption which is treated as a dividend under I.R.C. §302(d), “or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder”) may be treated as a distribution with respect to any shareholder whose interest in the equity of the corporation is increased by that transaction. Treas. Reg. § 1.305-7(a).

Once a distribution is determined to have taken place (or deemed to have taken place), then a determination needs to be made whether that distribution has any of the following results:

1. the receipt of property by some shareholders and an increase in the proportionate equity interests in the corporation by other shareholders (I.R.C. § 305(b)(2));

2. the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders (I.R.C. § 305(b)(3));

3. the distribution is made on (or with respect to) the corporation’s preferred stock (other than by an increase in the conversion ratio to preserve the value of the conversion privilege when a stock dividend or stock split is made in the stock that may be received in exchange for the convertible stock) (I.R.C. § 305(b)(4)); and

4. the distribution is of convertible preferred stock, unless it can be established to the IRS that the distribution will not have the effect of some shareholders receiving property while other shareholders increase their interests in the equity of the corporation (I.R.C. § 305(b)(5)). Treas. Reg. § 1.305-7(a)(2).

The most relevant of the foregoing in the context of early stage bridge financings are distributions made on preferred stock under I.R.C. § 305(b)(4) and disproportionate distributions under I.R.C. § 305(b)(2). In the case of the latter, it is particularly troubling that the two prongs of I.R.C. § 305(b)(2) (i.e., (i) distributions of property to some shareholders and (ii) the increase in the proportionate interests in the corporation’s equity by other shareholders) need not be related to, or even contemporaneous with, each other. See Treas. Reg. § 1.305-3(b)(2), -3(b)(3), -3(b)(4) (only if the two transactions occur more than 3 years apart will they be presumed not to cause those shareholders whose proportionate interests in the corporation’s equity are increased to be treated as receiving dividends under I.R.C. § 305(b)(2)), and Example 1 of Treas. Reg. § 1.305-3(e). Also, the regulations make clear that “the payment of interest” on the corporation’s convertible debt instruments is to be treated as a distribution of property to shareholders for purposes of applying I.R.C. § 305(b)(2). Treas. Reg. § 1.305-3(b)(3). But see Treas. Reg. § 1.305-3(e) Example 15 that finds the accrual of dividends on preferred stock under Section 1272(a) OID principles (so-called “preferred OID”) as being actually distributed for purposes of
determining the Section 305 consequences to other shareholders. Thus, the OID accrual of interest on convertible debt instruments likely also are to be treated as “payments” or “distributions” for this purpose.

The following are some examples of how convertible debtholders (or, conversely, the actual shareholders of the corporation) may be treated as receiving constructive dividends from the corporation.

1. If a dividend (other than a stock dividend or stock split that is not taxable under I.R.C. 305(a) – i.e., a taxable distribution of property under I.R.C. § 305) is made to the corporation’s actual shareholders and an adjustment is made to the conversion ratio/price of the corporation’s convertible debt instruments to account for that dividend, then the holders of the convertible debt instruments will be deemed to have received a dividend in the amount of the value of their increased interests in the corporation’s equity. See Treas. Reg. § 1.305-3(e) Examples 6 and 7. Likewise, if the conversion ratio is reduced (or the conversion price is increased) to account for payments of interest on the convertible debt instruments, then the actual shareholders will be treated as having been paid constructive dividends. See Treas. Reg. § 1.305-1(e) Example 7.

2. If the actual shareholders receive shares of stock as part of a stock dividend or stock split (or receive warrants or other rights to acquire stock) and either no or an inadequate adjustment is made in the conversion ratio/price of the corporation’s outstanding convertible debt instruments (i.e., the convertible debt instruments fail to provide for adequate anti-dilution protection with respect to such issuances of additional shares), then the receipt by the actual shareholders of the additional shares (or rights to acquire additional shares) will be taxed as a dividend. See Treas. Reg. 1.305-3(e) Examples 4, 5, and 15.

3. If the corporation distributes (or is deemed to distribute) property (including cash, stock, rights to acquire stock, etc.), and the conversion ratio/price on the corporation’s outstanding convertible debt instruments is adjusted beyond what is reasonably necessary to prevent the dilution of the corporation’s outstanding convertible debt instruments’ conversion privilege, then each holder of those debt instruments will be deemed to have been paid a dividend. See Treas. Reg. §§ 1-305-7 and 1-1.305-1(e) Example 6.

E. **Taxation of Foreign Investors – Portfolio Interest.**

1. **30% Withholding on FDAP.** Generally, unless the portfolio interest rules (or a tax treaty) applies, a foreign investor is subject to a 30% withholding tax on the interest income earned on a debt instrument issued by a U.S. corporation that is not effectively connected with the foreign investor’s conduct of a U.S. trade or business. I.R.C. §§ 871(a), 881(a), 1441 and 1442

2. **Portfolio Interest.** No U.S. withholding tax is due on “portfolio interest,” which, in general terms, is interest paid to (or accrued by) a foreign investor that does not own 10% or more of the combined voting power of the issuer corporation’s stock (or, if the issuer is a partnership, 10% or more of the capital or profits of the partnership). Generally the attribution rules of I.R.C. § 318(a) apply to determine the extent of a foreign investor’s ownership of the
issuer. I.R.C. § 871(h) and 881(c). See also, Rev. Rul. 68-601, 1968-2 C.B. 124 and Rev. Rul. 89-64, 1989-1 C.B. 91 (convertible debentures and warrants are considered to be “options” under I.R.C. § 318(a)(4) if the holder, at the holder’s election, has the right to acquire the stock either currently or after the lapse of a period of time).

3. **Investment Funds and Other Partnerships.** On April 11, 2007, the IRS published final regulations that make it clear that for partnership investors the determination of whether the above-described 10% ownership thresholds have been breached is to be made at the partner level. Treas. Reg. § 1.871-14(g)(3)(i). Treas. Dec. 9323, 2007-10 I.R.B. 1240.

4. **Contingent Interest Exception to the Portfolio Interest Rules.** “Portfolio interest” does not include any interest that is attributable to certain equity participation features; i.e., that is determined by reference to “(I) any receipts, sales or other cash flow of the debtor or a related person, (II) any income or profits of the debtor or a related person, (III) any change in value of any property of the debtor or a related person, or (IV) any dividend, partnership distributions, or similar payments made by the debtor or a related person.” I.R.C. § 871(h)(4)(A). However, an exception to the denial of “portfolio interest” treatment is provided for interest that is determined by reference to either (a) changes in the value of property (including stock), other than certain U.S. real property interests, that is actively traded, or (b) the yield on such actively-traded property (unless that actively-traded property is either (i) a debt instrument that itself pays the type of contingent interest that is not to be treated as portfolio interest under the general rules of I.R.C. § 871(h)(4)(A) or (ii) “stock or other property that represents a beneficial interest in the debtor or a related person”). I.R.C. § 871(h)(4)(C)(v)(I) and (II) and H.R. Rept. No. 103-111, (103d Cong. 1st Sess.) at 723, 726, reprinted in 1993-3 C.B. 167, 299, 302. Thus, the interest that is determined by reference to the changes in value of the issuer’s actively-traded stock is to be treated as portfolio interest but not interest that is determined by reference to the yield of the issuer’s “actively-traded” stock. Of course, the stock of an emerging growth company will not be actively traded (within the meaning of I.R.C. §1092(d)). Many have argued that this exception to the carve-out from the portfolio interest rule for contingent interest should be extended to interest determined in reference to the value of non-actively traded stock as well as actively-traded stock. See, for example, “Comments Regarding Need for Guidance on Portfolio Interest Rules Under Section 871(h) and 881(c) of the Internal Revenue Code,” submitted by certain members of the Section of Taxation of the American Bar Association on March 18, 2004.

**F. Summary.**

1. Will the conversion privilege be taxed as interest?

   Answer: Generally no, unless the note is a CPDI. The note will be a CPDI if, in addition to the conversion privilege, the holder of the note may be entitled to any other contingent payments that are neither remote nor incidental (or certain other narrow exceptions apply).

2. If the conversion privilege is taxed as interest for federal income tax purposes, will foreign investors for whom that interest is not effectively connected with the conduct of a
U.S. trade or business be subject to U.S. withholding tax on that interest income (ignoring for purposes of this discussion the possible application of a tax treaty)?

Answer: Generally yes because that interest likely will not be treated as “portfolio interest” due to the application of the contingent interest exception to that treatment under I.R.C. § 871(h)(4).

3. If the conversion privilege is treated as interest, when will the amount of that interest be deemed to accrue or be paid?

Answer: Over the projected life of the debt instrument under a fixed, non-contingent, economic accrual schedule with any difference between projected value and actual value being recognized at the time of disposition or conversion.

4. If the conversion privilege is taxed as interest, will the accrual/payment of that interest be deductible by the debtor corporation?

Answer: Likely no. First, any amount paid in excess of the note’s adjusted issue price and, if applicable, a normal call premium, will not be deductible. I.R.C. § 249. Second, the debt instrument likely will be a “disqualified debt instrument” under I.R.C. § 163(l) if (i) the conversion is mandated under the note, (ii) the debtor corporation has the right to require the note to be converted into stock, or (iii) there is a “substantial certainty” that at the time the note is issued the holder of the note will exercise the right to convert it into stock. If the note is a disqualified debt instrument, then none of the note’s interest will be deductible (not just that amount of interest that is attributable to the conversion feature of the note).

5. Even though the note is treated as debt for tax purposes, may the holder be deemed to receive dividends prior to the conversion of the note into stock?

Yes, holders of a corporation’s convertible notes (as well as the corporation’s actual shareholders) may be deemed to receive potentially taxable dividends due to the application of, or adjustments that are made (or not made) with respect to, the note’s conversion ratio/price under circumstances such as those described above.

II. WARRANTS

A. Part of an Investment Unit. When a warrant is received in conjunction with a debt instrument, the amount paid for that investment unit must be allocated between the warrant and the debt instrument based on their relative fair market values. I.R.C. § 1273(d)(2). The allocation usually will generate OID on the debt instrument.

B. Holder’s Income and Loss Recognition. That part of the purchase price of an investment unit that is allocated to the warrant is capitalized and is included in the adjusted tax basis of the property purchased by the exercise of the warrant. Rev. Rul. 78-182, 1978-1 C.B. 265. The holder will recognize a capital gain or loss (assuming the property that the holder had
the right to purchase with the warrant would have been a capital asset in the hands of the holder) upon the sale or other taxable disposition of the warrant, depending on whether the sales price is more or less than the holder’s adjusted tax basis in the warrant (generally what the holder paid for the warrant). Id. If the holder does not sell or exercise the warrant (i.e., allows it to lapse) the tax treatment to the holder will be the same as if the holder had sold it for nothing on the expiration date of the warrant. Rev. Rul. 78-182, 1978-1 C.B. 265 and I.R.C. § 1234(a)(2) and Treas. Reg. § 1.1234-1(b). No gain or loss is recognized upon the exercise of the warrant, except the holder may have to recognize gain to the extent that cash is received in lieu of fractional shares. Rev. Rul. 72-71, 1972-1 C.B. 99.

C. Warrants (and other Stock Rights) Treated as Stock under I.R.C. § 305(d) - - Adjusting or Failing to Adjust) Exercise Price. Warrants and other rights to acquire stock of a corporation are treated as “stock” and their holders as “shareholders” under I.R.C. § 305. I.R.C. § 305(d). See Part I.D above for a discussion of these rules in the context of convertible debt instruments.

D. No Tacking of the Warrant’s Holding Period. The holding period of the stock (or other property) purchased by the exercise of a warrant begins on the day that the warrant is exercised, not when the warrant was acquired. I.R.C. § 1223(5); Treas. Reg. § 1.1223-1(f), and Weir v. Commissioner, 10 T.C. 996 (1948), aff’ed per curiam, 173 F.2d 222 (3rd Cir. 1949) (holding that the holding period for the stock acquired by the exercise of a warrant begins on the day after the date that the warrant is exercised). If instead of exercising warrants, the warrants are exchanged (or treated as being exchanged) for stock (other than nonqualified preferred stock) in a recapitalization or other reorganization (other than a divisive “D” reorganization) under I.R.C. § 368, then, because the warrants are to be treated as “securities” under I.R.C. § 354, their holding periods should be included (tacked on) to the holding period of the stock acquired. See Treas. Dec. 8752, reprinted in 1998-1 C.B. 611 (adding subsection (c) to Treas. Reg. § 1.354-1, treating options and other rights to acquire stock as securities with no principal amount), I.R.C. §354(a)(2) (nonqualified preferred stock is not treated as stock or securities when it is exchanged for stock other than nonqualified preferred stock); and 1223(1) (tacking of holding periods for substituted basis property received in an exchange). Thus, the cashless exercise of a warrant may allow the tacking of the warrant holding period to the holding period of the acquired stock. See Martin D. Ginsburg and Jack S. Levin, MERGERS, ACQUISITIONS, AND BUYOUTS, ¶604.1.2 (Aspen, 2008 ed.) (particularly the discussion of Example 7 and footnote 19 thereof).

E. No Gain or Loss to the Issuing Corporation. A corporation does not recognize gain or loss when it receives money or other property for its stock or when warrants paid to acquire its stock lapse. I.R.C. § 1032(a).

F. “Penny Warrants.” If under the particular facts and circumstances, the purchaser of a warrant in substance acquires the benefits and burdens of ownership of the underlying property, the option will be ignored for federal income tax purposes, and the holder will be treated as purchasing the underlying property. Thus, if a person pays $70 for a warrant giving the holder the right at any time, upon paying an exercise price of $30, to purchase stock that on the date that the warrant is purchased has a fair market value of $100, that person will be treated as owning the stock, not a warrant to purchase that stock. See Rev. Rul. 82-150, 1982-2 C.B. 110. See also Priv. Ltr. Rul. 9747021 (Nov. 21, 1997) in which the IRS had no difficulty in ruling that warrants having a “nominal exercise price” of a penny per share were to be treated as stock. But see Rev.
Rul. 85-87, 1985-1 C.B. 268 (the purchase of an “in-the-money option” to require the issuer to buy stock that on the date that the option was acquired had a fair market value that was “substantially less” than the put price was treated for purposes of the I.R.C. § 1091 wash sale rules as a contract to purchase the stock subject to the put because at the time the put option was sold, there was “no substantial likelihood that the put would not be exercised”).