INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

June 30, 2000

Number: **200043013**
Release Date: 10/27/2000
Index (UIL) No.: 1273.00-00, 83.00-00
CASE MIS No.: TAM-115700-99/CC:CORP:B4

Taxpayer's Name: =
Taxpayer's Address: =

Taxpayer's Identification No: =
Years Involved: =
Date of Conference: =

LEGEND

Company =

Owner =

Bank =

Month A =

Month B =

Date C =

Date D =

Date E =

Month F =

Date G =

Date H =

Month I =

Date J =

Year K =

a =

b =

c =

d =

e =

f =

g =

h =

ISSUES

1. Whether, for purposes of § 83 of the Internal Revenue Code, certain warrants granted by Company to Bank were granted "in connection with the performance of services."

2. Whether the issuance of warrants by Company to Bank is subject to the investment unit rules of § 1273(c)(2).

FACTS

In Month A, Owner acquired all the stock of Company. In Month B, Company filed for Chapter 11 bankruptcy. On Date C, Bank advised Company that it would arrange credit accommodations for Company when Company became a "reorganized debtor," as defined in Company's Amended Plan of Reorganization (the "Loan Commitment Letter"). The Loan Commitment Letter contained separate sections addressing interest, fees, expenses incurred by the lender, and warrants (the "Warrants"). The Warrants were not mentioned in any other section and the reasons why they were granted were not stated.

On Date D, Company proposed its Debtor's Amended Plan of Reorganization as Modified (Debtor's Plan) to the bankruptcy court (the "Bankruptcy Plan"). Article VI.C., titled "Equity Distributions" provides:

> On the EFFECTIVE DATE, DEBTOR shall issue to OWNER a shares of the NEW COMMON STOCK in exchange for the OWNER GUARANTEE to Bank and the OWNER LOAN. The terms of the WARRANTS granted to Bank in connection with debtor-in-possession financing will remain in

effect upon confirmation of the PLAN and will entitle Bank to purchase up to b shares of NEW COMMON STOCK of the REORGANIZED DEBTOR for $c per share.

On Date E, Company signed a promissory note for advances to be made under a $d line of credit (also executed on Date E) (the "Line of Credit Agreement"). The Line of Credit Agreement provided that Company could request advances from Bank up to $d before confirmation of the Bankruptcy Plan and $e thereafter but not an amount in excess of its "borrowing capacity." Borrowing capacity was defined to be the lesser of $d before confirmation and $e after confirmation, or an amount equal to 75 percent of the receivables borrowing base. The receivables borrowing base was defined to be aggregate receivables less ineligible receivables and any reserves established by Bank. The note was to be paid by the earlier of Month F or confirmation of the Bankruptcy Plan. The interest rate on advances under the line of credit was stated as prime plus f percent with prime having a floor of g percent. Based on the information provided, this interest rate was above the normal rate offered by commercial lenders at the time and was due to the substantial risk that Company represented due to the recent bankruptcy proceedings. In addition, Owner was required to pledge all his stock in Company as collateral for the guarantee of the line of credit.

Under the Line of Credit Agreement, each day Company delivered to Bank a schedule describing the outstanding receivables and an inventory report. Company also was required to submit periodic financial reports and to maintain a minimum net worth. Customers of Company were directed to remit payment to a Bank lockbox. Bank then accounted to Company for collection. As collections were made, they were applied by Bank to reduce the line of credit.

On Date E, Company and Bank executed a Warranty Agreement, and on the same date Company issued Warrants to Bank to purchase b shares of Company stock (approximately 11 percent of the total shares). The exercise period began on Date H and extended through Month I. The exercise price was $c per share.

The terms of the Warrant Agreement gave Bank the right to put the warrants at any time on or after Date H. The put price would be computed by dividing the total number of outstanding shares of common stock into the greater of (i) a multiple of earnings before interest and taxes ("EBIT"), (ii) appraised value, or (iii) book value. The terms of the Warrant Agreement also gave Company the right to call the Warrants at any time on or after Date H. The Call Price is equal to the Put Price multiplied by 105 percent. The Warrants were not transferable and, according to Company, had no readily ascertainable market value. The Warrant Agreement expressed no clear indication of the reasons why the Warrants were granted.

The Loan and Security Agreement signed on Date E did not discuss the Warrants.

The Bankruptcy Plan was confirmed as of Date G. On that date, the $d debtor-in-possession line of credit was paid off from the proceeds of the $e line of credit from Bank to Company. The terms of the $e line of credit were identical to the earlier $d line of credit except for the dollar cap and the maturity date (two years from Date G).

On Date J, Company agreed to buy the Warrants from Bank for $h using a term promissory note that was delivered on Date H. Section 4.1 of the Agreement for Purchase and Sale of Warrants provided as follows:

> Interest Reporting of Purchase Price. Both parties acknowledge and agree (i) that the issuance to Bank of the Warrant was made solely as an inducement to Bank to provide Company with a line of credit and (ii) that any and all amounts payable to Bank by Company for purchase of the Warrant represents additional compensation to Bank for the line of credit and for the amount loaned to Company under the Loan and Security Agreement date Date E, and will be characterized as interest income to Bank for tax purposes.

On its Year K return, Company deducted $h as an interest expense.

Company's senior vice president stated that the Warrants were granted because Bank wanted additional security and an "interest kicker." In contrast, Company's representative stated that the $h should not have been characterized as interest because it was a fee for providing credit, like a loan origination fee, for which he contended § 83 would allow a deduction. Company's position is that the Warrants were given in exchange for services rendered by Bank, and because, at the time they were given, there was not readily ascertainable fair market value, Company is allowed a deduction when the Warrants were disposed of by Bank.

LAW AND ANALYSIS

Issue 1.

Under § 83(a), if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property (determined on the first day that the transferee's rights in the property are not subject to a substantial risk of forfeiture) over the amount paid for the property is included in the service provider's gross income for the taxable year that includes that day.

Under § 83(h), the service recipient is allowed a compensation expense deduction under § 162 for the amount included in the service provider's gross income under § 83(a). The rules governing such deductions are found in § 1.83-6 of the Income Tax Regulations.

Section 83(e)(3) provides that § 83(a) does not apply to the transfer of an option not having a readily ascertainable fair market value. However, § 83(a) does apply to such an option at the time that it is exercised, sold, or otherwise disposed of. If the option is exercised, § 83(a) applies to the transfer of property pursuant to the exercise. If the option is sold or otherwise disposed of in an arm's-length transaction, § 83(a) applies to the transfer of money or other property received in the same manner as it would have applied to the transfer of property pursuant to an exercise of the option. See § 1.83-7(a).

Section 1.83-3(f) provides that property transferred to an employee or an independent contractor (or beneficiary thereof) in recognition of the performance (or the refraining from performance) of services is considered "transferred in connection with the performance of services" within the meaning of § 83.

As a general rule, any time warrants are transferred by a corporation to a banking institution in connection with the giving of credit, they are transferred to compensate the bank for making the loan and not for "services," and if, in the case of a loan to a financially troubled corporation, the bank becomes involved in the corporation's day-to-day operations, "services" are not provided by the bank. Rather, the bank is merely taking precautionary steps to ensure that its loan is repaid.

It is clear that the authorities discussing the phrase "in connection with the performance of services," including § 1.83-3(f), require that it be broadly interpreted to mean more than compensation "for" services rendered. See Alves v. Commissioner, 79 T.C. 864 (1982), aff'd, 734 F.2d 478 (9th Cir. 1984). However, the scope of the word "services" was never intended to be so broad as to cover all transactions in which property is transferred as consideration in a business setting. See Centel Communications Co., Inc. v. Commissioner, 92 T.C. 612 (1989), aff'd, 920 F.2d 1335 (7th Cir. 1990).

The issue of whether warrants issued in consideration for, or in recognition of, an increased risk assumed by two individuals and a corporation were transferred in connection with the performance of services was considered in Centel. The risk was assumed when a company, of which the individuals and corporation were shareholders, experienced financial difficulties to the point where banks required that the shareholders and corporation assume the increased risks as a condition for making loans. In their analyses, the courts noted that the legislative history of § 83 indicates that its purpose is limited to setting comprehensive rules for the tax treatment of deferred compensation arrangements made between employers and employees. In concluding that the warrants were not issued "in connection with the performance of services," it was noted that the assumption of additional risks on behalf of the company was a shareholder/investment action undertaken to protect an investment, and as such, did not constitute the performance of services and did not arise "in connection with the performance of services" within the meaning of § 83.[1]

None of the documents presented by the Company indicate that Company and Bank agreed or intended that the $h was compensation. Additionally, none of the documents indicate what, if any, services were provided by Bank.

Based on the above, we believe the Warrants granted to Bank were not "transferred in connection with the performance of services" within the meaning of § 83. See Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982), aff'g in part and rev'g in part, 47 A.F.T.R.2d (RIA) 652 (Ct. Cl. 1981) (involving the classification of income for purposes of §§ 861 through 863);[2] see also Duncan Industries, Inc., v. Commissioner, 73 T.C. 266 (1979) (a borrower's sale of an equity interest to a lender was not "transferred in connection with the performance of services").

We note that Company's reliance on United States v. Kroy (Europe), Ltd, 27 F.3d 367 (9th Cir. 1994) and Fort Howard v. Commissioner, 103 T.C. 345 (1994), *supplemented by* 107 T.C. 187 (1997), appears misplaced. Both of those cases involve the payment of certain fees to investment bankers for services in connection with the leveraged buyouts. Because Company has failed to show what, if any, services were provided by Bank, those cases are irrelevant to the determination of whether the $h is deductible under § 83.

The Warrants were not granted in connection with the performance of services within the meaning of § 83, and thus the amount paid to Bank by Company to purchase the Warrants is not deductible under § 83.

Issue 2.

Section 1273(a) defines original issue discount ("OID") as the excess of a debt instrument's stated redemption price at maturity over its issue price. The amount of OID is ratably includible in the income of the holder of the debt instrument and deductible from the income of the borrower over the life of the debt instrument. See

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[1] The Tax Court in Centel left open the possibility that, where there are incidental services to providing a loan, the provision of a loan could be "services." Note that the Service disagrees with this portion of the opinion, except to the extent that it is applied to situations in which the property is transferred specifically for the incidental services only.

[2] In Bank of America, the government argued that acceptance and confirmation commissions paid to a bank for (effectively) guaranteeing payments of buyers and foreign banks were for "*services* performed in the United States." However, the court concluded that the transaction involved the lending of credit, and that the commissions, although difficult to characterize, were most analogous to interest.

§§ 163(e) and 1272.

Section 1273(c)(2) provides rules for the treatment of an investment unit for purposes of §§ 1271 through 1275. Section 1273(c)(2) provides that in the case of any debt instrument and an option, security, or other property issued together as an investment unit, the issue price of the entire investment unit is allocated between the two components based on their relative fair market values. For tax purposes, the debt and property components of an investment unit are treated separately.[3]

In this case, Company signed a promissory note for advances to be made under a $d line of credit on Date E. On the same date, Company issued the Warrants to Bank to purchase b shares of common stock at an exercise price of $c per share. Article VI.C. of the Bankruptcy Plan states that the Warrants were granted to Bank in connection with debtor-in-possession financing.

Because the Warrants were issued by Company in connection with the issuance of a debt instrument (the line of credit), the investment unit rules of § 1273(c)(2) are applicable.[4] See the discussion in Monarch Cement Co. v. United States, 634 F.2d 484 (10th Cir. 1980).

Under § 1273(c)(2)(A), the issue price of an investment unit is determined as if the investment unit were a debt instrument. In the case of a debt instrument issued for money, the issue price of the instrument generally is the amount paid for the instrument. See § 1273(b)(2). For example, the issue price of a loan is the amount loaned. Therefore, in the case of an investment unit issued in a cash lending transaction, the issue price of the investment unit is the amount loaned. The determination of the issue price of a debt instrument (investment unit) is made as of the

[3] Proposed regulations under § 1273 were published in the Federal Register on April 4, 1986. The proposed regulations would have provided guidance on how to determine the issue price of a debt instrument issued after 1982, including an investment unit treated as a debt instrument. 51 Fed. Reg.12,022. Under the proposed regulations, rules similar to those under § 1.1232-2(b)(2)(ii)(a) would have applied to allocate an investment unit's issue price to its components as of the issue date. The 1986 proposed regulations were withdrawn in 1992 when new proposed regulations were published in the Federal Register. 57 Fed. Reg. 60,750. The proposed regulations were finalized in 1994. T.D. 8517, 1994-1 C.B. 38. The final regulations generally apply to debt instruments issued on or after April 4, 1994. Neither the 1992 proposed regulations nor the final regulations provide specific rules to determine the fair market value of the components of an investment unit for purposes of making the allocation.

[4] Also see the discussion in Custom Chrome, Inc. v. Commissioner, 1998 T.C.M. ¶ 98,317, appeal docketed, No. 98-71378 (9th Circuit, Nov. 9, 1998).

issue date. See § 1275(a)(2).

Section 1273(c)(2)(B) requires an allocation of the issue price of an investment unit to its components based on their relative fair market values. The amount of OID associated with the debt instrument equals the portion of the value of the investment unit allocated to the property component.

In this case, the issue price of the investment unit is the amount loaned pursuant to the line of credit agreement (the $d advanced to Company on Date E). The investment unit is valued as of the date of issuance. The amount of OID associated with the debt instrument is the portion of the value of the investment unit allocated to the Warrants.[5] Under the investment unit rules of § 1273(c), Company would be entitled to deduct the amount of OID associated with the financing provided by Bank over the life of the loan. The amount of OID is computed as of the date of issuance and equals the portion of the value of the investment unit allocated to the Warrants. If the Warrants have no value as of the date of issuance, then there is no OID associated with the financing provided by Bank.

For tax purposes, the debt and property elements of an investment unit are treated separately. See Rev. Rul. 72-46, 1972-1 C.B. 50 (the lapse of the warrant element of an investment unit does not affect the treatment of the debt element or the amount of OID on the debt element). If the property element is a warrant, the portion of the issue price of the investment unit allocated to the warrant is treated by the issuer (borrower) as an option premium.[6] The option premium is not taxable to the issuer upon receipt. See Rev. Rul. 58-234, 1958-1 C.B. 279, modified by Rev. Rul. 68-151, 1968-1 C.B. 636. Prior to the 1984 amendment to § 1032, the issuer generally would

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[5] Company argues that the Warrants granted to Bank should be valued as of the date the Warrants were repurchased. This would result in OID in the amount of $h, the amount paid to Bank to repurchase the Warrants. However, this approach is inconsistent with the statutory requirement of having the OID taken into account for tax purposes ratably over the life of a debt instrument. Section 1273(c) provides that the issue price of an investment unit is to be determined on the date of issuance in order to determine the issue price of its debt component. The issue price of the investment unit is allocated between the debt component and the Warrants on the basis of relative fair market values. Consequently, the Warrants must be valued as of the date of issuance in order to determine the issue price of the debt component as well as the amount of OID associated with the debt component.

[6] Rev. Rul. 72-198, 1972-1 C.B. 223, provided, in part, that a stock warrant is an option for purposes of § 1234. Rev. Rul. 77-40, 1977-1 C.B. 248, limited the application of Rev. Rul. 72-198 to warrants issued after April 24, 1972. Rev. Rul. 86-9, 1986-1 C.B. 290, obsoleted Rev. Rul. 72-198 because of the 1984 amendment that extended the application of § 1032 to warrants.

recognize any gain or loss realized upon the lapse or termination of the warrant. See § 1234(b) and Rev. Rul. 78-182, 1978-1 C.B. 265. After the 1984 amendment, the issuer generally would not recognize any gain or loss realized upon the lapse or termination (including a repurchase) of the warrant.