Deal Interrupted: Payments to Modify Stock Purchase Agreements

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A corporation does not recognize gain or loss on the sale of its stock (including Treasury stock) for money, property or services. So says Internal Revenue Code Section ("Code Sec.") 1032(a). It also doesn't recognize gain or loss on the lapse of an option to buy or sell its stock. However, what happens when a corporation pays another party to modify a stock purchase agreement?

The answer is: It depends. A recent CCA 200942040 (June 24, 2009) sheds new light on this issue.

Dealus Interruptus

Two corporations ("Taxpayer" and "Counterparty") formed a subsidiary as a joint venture to provide services. Taxpayer and Counterparty agreed that Counterparty could sell to Taxpayer its subsidiary stock in two tranches during two exercise periods. If Counterparty failed to exercise its rights, however, Taxpayer had the right to buy from Counterparty the subsidiary stock (also in two tranches) for a higher exercise price. In essence, this was a put-and-call arrangement.

Then came the amendments. Counterparty and Taxpayer amended their deal, calling for Taxpayer to pay a minimum amount of the exercise price of Counterparty's first set of put-rights in cash rather than in Taxpayer stock. In consideration for this first amendment, Counterparty paid Taxpayer $X for services.

Then came the second amendment. Under it, the parties changed various terms not affecting the amount or composition of the puts and calls. Finally, in a third amendment, Taxpayer agreed to pay the remainder of the exercise price for Counterparty's first and second puts solely in cash and not in Taxpayer stock. Concurrent with the third amendment, Counterparty paid Taxpayer $Y for additional Taxpayer services. Taxpayer recorded this payment as revenue for financial accounting purposes.

The Complaint

A complaint was filed against Taxpayer, leading to a settlement. Under it, Taxpayer adjusted its accounting for the transaction involving a $Z payment to restate the payment as a reduction in the subsidiary stock. Taxpayer's counsel asserted that the methods of payment under the agreement (including Taxpayer's right to pay the exercise price of the puts in Taxpayer stock) created a put option on Taxpayer stock.

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That put option arguably entitled Taxpayer to sell the Taxpayer stock to Counterparty in exchange for subsidiary stock. Specifically, Taxpayer's counsel argued that the payments were received with respect to the lapse or acquisition of that put option. According to Taxpayer's argument, that made them payments excludible from Taxpayer's income under Code Sec. 1032(a).

The chief counsel advice said, not so fast. According to the Chief Counsel, this transaction was not governed by Code Sec. 1032(a). In fact, the chief counsel advice supported the notion that the payment was a price reduction for the subsidiary stock.

After all, said the IRS, an option is generally a legal contract giving one person (the holder) the right to buy from or sell to another (the grantor) specific property at a fixed price within a certain time. When the holder exercises the option, the exercise is the acceptance of an offer made by the grantor to buy or sell the property at the price stated. An option may be either a put option or a call option.

Option Basics

Generally, the holder of a put option has the right to sell something to the grantor of the put option. The holder of a call option has the right to buy from the grantor of the call option. The holder of a put option is generally treated as accepting the grantor's offer to buy the property at the specified price set forth in the option. Similarly, the holder of a call option is treating as accepting the grantor's offer to sell the property at the price set forth in the option.

Taxpayer here essentially asserted that the ability to pay the exercise price of the puts in cash, Taxpayer stock, or a combination of both, made Taxpayer the holder of a put option to sell its stock to Counterparty for subsidiary stock. After all, Taxpayer argued, the agreement required Counterparty to accept the Taxpayer stock in exchange for subsidiary stock.

Nevertheless, the chief counsel advice concluded that the agreement only required Counterparty to accept Taxpayer stock in exchange for subsidiary stock as one of *three* methods of payment, all relating to Taxpayer's obligation to pay Counterparty the exercise price. Counterparty became obligated to transfer the subsidiary stock to Taxpayer when Counterparty exercised one of its puts. This didn't occur when Taxpayer subsequently decided how to pay the exercise price.

The fact that there were three available methods by which the agreement could have been settled didn't make them separate options, said the IRS. That meant the receipt of cash to forgo one of those methods of payment should not be treated as a lapse or acquisition of an option.

Last Word

As if all this wasn't enough, the IRS went further. The amendments creating Counterparty's obligation to pay Taxpayer $Z were amendments with respect to Counterparty's *put* rights. They were not amendments (said the IRS) to Taxpayer's *call* rights. As a result, the $Z payments weren't paid for any lapse or acquisition of Taxpayer's option to sell its stock.

Under Counterparty's put rights, Taxpayer did not have an option to sell its stock. Under Counterparty's put rights, Taxpayer had an obligation to buy subsidiary stock. Taxpayer had characterized its right to pay for subsidiary stock with Taxpayer stock as an option to *sell* Taxpayer stock. But the Chief Counsel said this simply wasn't supported by the language of the agreement.