

Nonrecognition of Warrants Exchanged in a Corporate Reorganization

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With stock prices beginning to rise again, the use of warrants to purchase stock may be an attractive option for an acquirer in a corporate reorganization. If the reorganization is properly structured, the use of warrants will not trigger gain or loss in the transaction. Many M&A TAX REPORT readers may already be familiar with these rules. For some, this refresher may warrant your consideration.

Code Sec. 354 Nonrecognition Rule for Stock or Securities

Code Sec. 368 is, of course, the definitional provision governing various corporate reorganizations. Other Code sections elaborate on whether gain or loss will be recognized in a reorganization. Code Sec. 354(a)(1) provides a general rule that no gain or loss is recognized if stock or securities in a corporation that is a party to a reorganization are, in pursuance of the plan

of reorganization, exchanged solely for stock or securities in that corporation or in another corporation that is a party to the reorganization.

Code Sec. 354(a)(2) limits this nonrecognition rule in certain circumstances. For example, Code Sec. 354(a)(1) does not apply:

- if the principal amount of any such securities received exceeds the principal amount of any such securities surrendered; or
- if any such securities are received and no such securities are surrendered. [Code Sec. 354(a)(2)(A).]

Code Sec. 356 Additional Consideration Rule

Code Sec. 356(a)(1) considers what happens when additional consideration—other than stock or securities—is added to the exchange. Specifically, Code Sec. 356(a)(1) applies to exchanges to which Code Sec. 354 would apply,

but for the fact that the property received in the exchange consists *not only* of stock or securities, but also of “other property or money.” In that case, Code Sec. 356(a)(1) requires that the recipient recognizes gain to the extent of the excess of the sum of the money and the fair market value of the other property. That is, gain is recognized to the extent of the boot, but not the Code Sec. 354 nonrecognition property.

Old Rule Regarding Warrants

Neither Code Sec. 354 nor Code Sec. 356 specifically address whether warrants are considered stock, securities or boot. Warrants are similar to stock options. A warrant holder may purchase a specified number of stock shares at a specified time for a specified price.

Normally, stock options are granted to employees. Warrants, on the other hand, are normally granted to the general public. Warrants typically give options to purchase stock over a longer period and are freely transferable instruments. [See generally *K.B. Kimberlin*, 128 TC 163, 165, at note 3, Dec. 56,928 (2007).]

In an old Tax Court case, *W.H. Bateman*, 40 TC 408, Dec. 26,143 (1963), the Tax Court considered a merger of two corporations. Mr. Bateman exchanged his stock in one corporation for stock as well as stock purchase warrants in the surviving corporation. The merger qualified as tax-free. The Tax Court held the warrants were not stock within the meaning of Code Sec. 354(a)(1)’s nonrecognition rule. Instead, the Tax Court viewed the warrants as “other property” that would produce gain.

New Rules Regarding Warrants

In a later publication, the Service included the *Bateman* decision in a list of decisions to which the IRS did not acquiesce. [See 1965-2 CB 7.] More importantly, under Treasury regulations issued in later years, if a shareholder in a reorganization exchanges stock for a combination of stock and warrants, the Code Sec. 354(a)(1) nonrecognition rule applies. That means the shareholder will not recognize gain or loss in the exchange.

Remember that Code Sec. 354(a)(1) speaks in terms of exchanges of “stock or securities.” Reg. §1.354-1(e) states that the term “securities” includes rights issued by a party to the

reorganization to acquire its stock. Those rights include warrants. [See, e.g., Reg. §1.356-3(c).] Reg. §1.354-1(e) further provides that “a right to acquire stock has no principal amount.”

Reg. §1.356-3(a) explains that for purposes of Code Sec. 356, the general rule is that other property includes securities. Of course, this general rule does not extend to include securities that qualify for nonrecognition of gain or loss under Code Sec. 354. The other property taint does not apply to securities received that have a principal amount that does not exceed the principal amount of securities surrendered in the transaction. [Reg. § 1.356-3(a).]

Caution

Here is where warrants can come into play in a big way. A right to acquire stock that is treated as a security for purposes of Code Sec. 354 has no principal amount. [Reg. § 1.356-3(b).] A right to acquire stock *such as a warrant* is not *other property* when it is received in a transaction to which Code Sec. 356 applies.

The regulations provide some examples that help to illustrate how exchanges with warrants are treated. In one, an individual exchanged stock for stock and a warrant. The warrant had no principal amount. Thus, the individual received no excess principal amount within the meaning of Code Sec. 356(d) (which governs when securities constitute other property). [Reg. § 1.356-3(c), Example 7.]

In another example, an individual exchanged a warrant for stock and a warrant. Again, the warrants had no principal amount, and the individual received no excess principal amount within the meaning of Code Sec. 356(d). [Reg. § 1.356-3(c), Example 8.]

Conclusion

Keep in mind that this provision applies to an exchange that includes both stock and securities as well as *other property* or money. The foregoing examples involved exchanges of stock for stock and warrants, or warrants for stock and warrants. An exchange of *only* stock for warrants would not be affected by Code Sec. 356 or Reg. §1.356-3(b).

Instead, under Code Sec. 1001, a shareholder would realize gain to the extent the value of the warrants exceeds the adjusted basis of the surrendered stock.