INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-137396-05

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:

This is in response to your request for technical advice, dated July 13, 2005, concerning § 451 of the Internal Revenue Code.

LEGEND:

Taxpayer	
X Corporation	
Network	
Network X	
Year 1	
Date A	
Date B	
Date C	
$*a*	
Period 1	

Period 2	

ISSUE:

Whether Taxpayer, having received a noncompensatory warrant for shares of common stock of X Corporation, recognized income as of the date the warrant was granted.

CONCLUSION:

The value of the warrant as of the date it was granted is includible in the taxpayer's income since the right to exercise the warrant was not contingent and the value of the warrant could be determined.

FACTS:

Taxpayer is a subchapter S corporation that uses an accrual method of accounting for federal income tax purposes.[1] X Corporation is a publicly traded subchapter C corporation. Both are engaged in the telecommunications business. Prior to Year 1, Taxpayer provided Network telecommunications services to its retail customers under an agreement (tariff) with Network. X Corporation also provided telecommunications services obtained from Network, but generally resold Network's services to third parties who, in turn, serviced retail customers. X Corporation had more favorable rates under its tariff contract with Network than Taxpayer did under its tariff with Network. In Year 1, X Corporation was developing its own telecommunications network, "Network X." In Year 1, Taxpayer and X Corporation entered into an agreement (Services Agreement) whereby Taxpayer would access Network's services under X Corporation's tariff. On Date A, Taxpayer transferred its customers to X Corporation's tariff, and began receiving services from Network under X Corporation's tariff.

The Services Agreement provided that Taxpayer would receive Network's services at the same rate X Corporation paid Network under its tariff with Network. Taxpayer was obligated to move its entire base of customers (Existing Customers) to X Corporation's tariff, and use commercially reasonable efforts to maintain them on the tariff, but Taxpayer would continue to deal directly with Network and with its own customers. The Agreement stated that it was contemplated that Taxpayer's customers would be transitioned to X Corporation's forthcoming Network X. Taxpayer was required to make commercially reasonable efforts to obtain the consent of Existing Customers to move to Network X; Taxpayer had no liability for customers declining to transfer.

[1] There is ambiguity at places in the request for technical advice as to whether it concerns the tax treatment of Taxpayer or Taxpayer's shareholders. Although there are obvious consequences for the shareholders, we view the request as addressed to the tax treatment of Taxpayer.

Under the Services Agreement, Taxpayer had the discretion, but not the obligation, to transfer future customers (New Customers) to X Corporation's tariff. New Customers could be transferred *from* X Corporation's tariff at any time. Taxpayer could transfer Existing Customers from X Corporation’s tariff or from Network X in certain situations, generally at customer request or in circumstances resulting in the inability of X Corporation to provide the required services at all, or at a level of quality comparable to Network, or at the agreed pricing levels. Additionally, in the event of a change in control of Taxpayer, the new owners could transfer Taxpayer’s customers to another carrier or tariff, but only with Period 1 notice to X Corporation.

The Services Agreement provided that Taxpayer would also receive a warrant to purchase X Corporation’s stock (the Warrant), under terms provided in a separate agreement (the Warrant Agreement). The section of the Services Agreement relating to the Warrant provided that default or termination of the Services Agreement would not result in forfeiture: "The Warrant shall be an independent agreement, and no default or termination of the Agreement shall in any manner whatsoever affect or restrict the rights of the holders … of the Warrant … ." The one exception (the "change of control contingency") was that the Warrant (or shares obtained through its exercise) would be forfeited, retroactively, if there were a change of control of Taxpayer and customers were moved, in violation of the Period 1 notice provision, and not replaced within Period 2. The Services Agreement recited that the Warrant was acquired by Taxpayer “for its own account for investment and not for the account of others or with a view to the distribution or resale of such warrant or shares of stock issuable upon exercise thereof.”

Taxpayer’s ability to transfer the Warrant, which was unregistered, was limited to its successors, in certain circumstances, or to its shareholders (to whom the Warrant was in fact distributed). Transfer of the shares obtained through exercise was also limited in accordance with their unregistered status. For the duration of the exercise period (ending Date C) the shares received, and any proceeds, were subject to a right of first refusal retained by X Corporation, and forfeiture for violation of the change-of-control contingency. Under the Warrant Agreement, X Corporation was required to file a "shelf registration" statement with respect to the resale of at least shares of the securities.

Around this time, X Corporation distributed warrants to several other telecommunications companies with which X Corporation did business, in arrangements that placed additional contingencies on the exercise of the warrants. For example, other warrant recipients were generally required to transfer certain numbers of customers to X Corporation’s forthcoming Network X before the warrants could be exercised. These other warrant recipients did not deal directly with Network and paid X Corporation a markup over X Corporation’s tariff rate with Network. The customers transferred to X Corporation’s network by these other warrant recipients generally became the direct customers of X Corporation, not Network.

The Warrant, which was effective as of Date A, was exercisable between Date B and Date C. The Warrant was granted "at the money," meaning that the exercise price was the market price of the stock on Date A. Taxpayer and the field office agree that the value of the Warrant when granted was determinable and, although relatively nominal on a per-share basis, totaled $*a* as of Date A. After receipt, Taxpayer immediately distributed the Warrant to its shareholders, who subsequently exercised the Warrant pursuant to a "cashless exercise" provision. (The tax consequences of this distribution have not been raised and are not addressed in this memorandum.)

The value of X Corporation's stock increased significantly between Date A and Date B, when the Warrant became exercisable and was exercised by the shareholders. As required by the Warrant Agreement, registration statements were filed whereby the shareholders of Taxpayer offered for resale their X Corporation stock to be acquired on exercise of the Warrant. Some of the shareholders immediately sold their stock; some continued to hold X Corporation shares.

Although the field office tentatively agrees with Taxpayer that the value of the Warrant as of Date A, the date it was granted, was includible in Taxpayer's gross income, they have requested technical advice because of uncertainty in the law in this area.

LAW AND ANALYSIS:

Generally, the receipt of property results in gross income. Section 1.61-1(a) of the Income Tax Regulations. And, as a general rule, gains, profits and income are includible in gross income for the taxable year in which they are actually or constructively received by the taxpayer, unless includible for a different year in accordance with the taxpayer's method of accounting. § 1.451-1(a).

Stock warrants are a contractual option to purchase stock, and, like all options, are themselves property. Helvering v. San Joaquin Fruit & Inv. Co., 297 U.S. 496 (1936); Rev. Rul. 77-250, 1977-2 C.B. 309. Like the writing of an option, the purchase of an option generally does not result in immediate tax consequences; instead, if the option is exercised, the cost of the option is added to the basis of the property acquired. See Rev. Rul. 58-234, 1958-1 C.B. 279; Rev. Rul. 78-182, 1978-1 C.B. 265. However, in appropriate circumstances the issuance of an option, including a stock warrant, is treated as a payment of the value of the option to the optionee, coupled with a purchase of the option by the optionee. See, e.g., Redding v. United States, 630 F.2d 1169 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981). Taxpayer did not purchase the Warrant for cash, and the parties agree that the value of the Warrant on Date A was $*a*. Therefore, unless an exception applies that would prevent the realization or recognition of income at that date, this amount is includible in Taxpayer's gross income on Date A under §§ 61 and 451. We conclude that no exception applies.[2]

Under an accrual method of accounting, income is includible in gross income when (1) all the events have occurred fixing the right to receive the income and (2) the amount of the income can be determined with reasonable accuracy. § 1.451-1(a); see also Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-185 (1934); Schlude v. Commissioner, 372 U.S. 128, 133, 136-37 (1963).

Applying the first prong of this "all-events test" under § 451, to the extent the issuance of the Warrant was connected to Taxpayer's transfer of its existing retail customers to X Corporation's tariff, this transfer had occurred by Date A. Taxpayer's right to the Warrant or to exercise of the Warrant was not conditioned on any other performance, under the Services Agreement or otherwise. The right to the Warrant was subject only to the contingency that the Warrant would be forfeited in the event of a change in control of Taxpayer, coupled with failure to comply with the notice/replacement requirements in the Services Agreement. No change of control was contemplated when the Warrant was granted and none occurred. We agree with the taxpayer and the field office that this change-of-control contingency was a condition subsequent that would not prevent the accrual of income. Accordingly, on Date A Taxpayer had a fixed right to the warrant.

With respect to the second prong of the all-events test, the question is whether the value of the Warrant could be determined with reasonable accuracy on Date A. The Warrant was exercisable in exchange for publicly-traded stock, subject only to the passage of time and the change-of-control contingency. The value of the X Corporation stock was known, and the value of the Warrant could be, and was, determined by accepted valuation methods.[3] The taxpayer and the field office agree that the value of the Warrant on Date A was $*a*. Accordingly, that value was determinable with reasonable accuracy. See Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932).

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[2] The tax treatment of certain "compensatory" options—options provided in exchange for services—is governed by § 83 (or, in the case of certain employee plans, § 421). As discussed further below, the parties in the present case agree that the warrants are not compensatory options, and that § 83 does not apply.

[3] As discussed by the court in Custom Chrome, Inc. v. Commissioner, 217 F.3d 1117, 1125 (9th Cir. 2000):

> [T]hat an option is 'at the money' does not render the option valueless. An option has two values: an intrinsic value and a time value. … The intrinsic value of an option is the difference between the actual value of a share [at the date of grant] and the exercise price of the option … The time value 'reflects the expectation that prior to expiration, the price of … [the] stock will increase … .'.

This conclusion with respect to the all-events test is consistent with judicial and administrative precedent.

In Simmonds Precision Products v. Commissioner, 75 T.C. 103 (1980), the issue concerned the depreciable basis of certain patents the taxpayer acquired in exchange for issuing both unregistered shares of its stocks and options to purchase additional shares at the public offering price. The court held that under the "open transaction doctrine," derived from Burnet v. Logan, 283 U.S. 404 (1931), the options had no ascertainable value on the date of the exchange and that the transaction was therefore open until the options were exercised, at which point the taxpayer's depreciable basis in the acquired patents was ascertainable. See also Baumer v. United States, 580 F.2d 863 (5th Cir. 1978), related proceeding at 685 F.2d 1318 (11th Cir. 1982).

A series of Tax Court memorandum decisions (in this memorandum, "the workstation cases") have considered the treatment of stock warrants issued in connection with the sale of computer workstations.

In the first, Sun Microsystems, Inc. v. Commissioner, T.C. Memo. 1993-467, the taxpayer, a manufacturer of computer workstations, entered into a long-term agreement with Computervision Corporation for the sale of workstations. As part of the agreement, Sun granted Computervision stock warrants. The right to exercise each warrant was contingent on the purchase of a certain number of workstations. The court concluded that the warrants were issued to induce the purchase of the workstations and constituted a reduction of their selling price, excludible from Sun's gross sales, not a capital expenditure.[4] The issue of timing was not before the court; the parties agreed that the all-events test was not met until the requisite workstations were purchased.

Computervision International Corp. v. Commissioner, T.C. Memo 1996-131, vacated and remanded on other grounds, 164 F.3d 73 (1st Cir. 1999), addressed the tax consequences of the receipt of Sun Microsystem’s warrants. The court was asked to determine the character of the proceeds Computervision received when it sold the warrants. As in Sun, the court held that, under the facts and circumstances, the purpose and intent of the parties was to adjust the sales price of the workstations, and the amount received on sale was therefore a reduction in Computervision's cost of goods sold, not capital gain. In reaching this conclusion, the court cited, among other

[4] The court applied the test in Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707, 716-17 (1956), nonacq. 1959-2 C.B. 8-9, nonacq. withdrawn and acq., 1962-2 C.B. 5-6, acq. withdrawn and nonacq., 1976-2 C.B. 3-4, nonacq. withdrawn in part and acq. in part, 1982-2 C.B. 2. See Rev. Rul. 2005-28, 2005-19 I.R.B. 997 (under Pittsburgh Milk, an amount is a purchase-price adjustment if "made with the purpose and intent of reaching an agreed upon a net selling price, and is negotiated and agreed to before the sale takes place.")

factors, the fact that Computervision never exercised the warrants, but sold them, and the fact that the warrants were exercisable only upon the transaction of a certain dollar volume of sales. As in Sun, the timing of the adjustment was not at issue.

Finally, in Convergent Technologies, Inc. v. Commissioner, T.C. Memo. 1995-320, a case factually similar to Sun, the taxpayer, a publicly traded corporation, issued stock warrants to two of its customers. As in Sun, the exercise of the warrants was contingent on the volume of purchases. The Service argued that the warrants had an "investment aura" and represented a capital expense. The court held that the taxpayer's use of the warrants represented a reduction in the selling price of the workstations and thus reduced Convergent's gross income. As factors leading to this conclusion, the court noted that (1) the warrants were tied to sales volume; (2) the recipient did not intend to hold them for investment; and (3) the terms of the warrant agreements were more favorable the more workstations the recipient agreed to buy.

Unlike the opinions in Sun and Computervision, the opinion in Convergent addressed the timing of the offset to gross income. The court held that—under the "all-events test" for accrual of liabilities in § 1.461-1(a), which generally mirrors the corresponding test for income under § 451—the warrants represented a fixed liability when the sales volumes were reached; however, their value could not be ascertained with reasonable accuracy until the warrants were exercised.[5] The court stated that even though both the exercise price of the warrant and the value of the stock were known, "the value we are seeking is the actual cost to petitioner of issuing the stock upon the exercise of the warrants, and this value can only be determined on the date of exercise."[6]

Regardless of the correctness or precedential effect of these opinions, they are distinguishable from the present case and do not require deferral of income from Taxpayer's receipt of the X Corporation Warrant. The context in which warrants are issued and received may have a bearing on the tax consequences. In the present case, there are several possible characterizations of the transaction; however, they all lead to the same result.

First, the parties agree that the Warrant was not issued in return for past or future services. When stock options or warrants are issued in return for services, there is a

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[5] The warrants were sold to underwriters who simultaneously exercised them.

[6] In Custom Chrome, Inc. v. Commissioner, 217 F.3d 1117 (9th Cir. 2000), aff'g T.C. Memo 1998-317, the taxpayer, in connection with a borrowing, issued warrants in its stock to the lender. Both courts held that the warrants constituted original issue discount, in the amount of their value on the grant date. The courts rejected the taxpayer's argument that the warrants should be valued on the exercise date, holding that treatment as a closed transaction was mandated by § 1273, and distinguishing the three "workstation cases" on this basis.

specific statutory scheme that governs the timing and character of income, under § 83 (or, in some circumstances, § 421) and the corresponding regulations, which set forth a specific definition of "readily ascertainable fair market value" for that purpose. See § 1.83-7; Pagel v. Commissioner, 91 T.C. 200 (1988), aff'd, 905 F.2d 1190 (8th Cir. 1990). See also §§ 421, 1.421-6 ("statutory" employee options); Weigl v. Commissioner, 84 T.C. 1192, 1208-12 (1985) (Issues 1 and 2).

The parties agree, however, that the warrant in the present case was not compensatory and that § 83 does not apply. Although the phrase "in connection with the performance of services" in § 83 is broadly interpreted, it does not extend to all cases in which property is transferred in a business setting. See § 1.83-3(f); Alves v. Commissioner, 79 T.C. 864 (1982), aff'd, 734 F.2d 478 (9th Cir. 1984); Centel Communications Co., Inc. v. Commissioner, 92 T.C. 612, 637 (1989), aff'd, 920 F.2d 1335 (7th Cir. 1990). Signing the Services Agreement with X Corporation was not the performance of a service by Taxpayer, and Taxpayer was a customer of X Corporation that provided no significant service to X Corporation. The specific rules under § 83 or § 421 do not necessarily apply outside the context of compensatory options. See, e.g., Custom Chrome (value of warrants as OID); Moore v. Commissioner, 425 F.2d 713 (9th Cir. 1970) (value of options as basis); cf. Rev. Rul. 77-250 (value of warrants for § 1232 purposes).

The taxpayer asserts that the transaction was an exchange of a zero-basis intangible asset (the customer traffic) for the Warrant. This possible characterization brings into play the open transaction doctrine under § 1001. As the Tax Court in Simmonds recognized, however, it is settled that only in rare and extraordinary circumstances will property be considered not to have an ascertainable fair market value. See 75 T.C. at 117, citing § 1.1001-1(a); McShain v. Commissioner, 71 T.C. 998, 1004 (1979); Rev. Rul. 58-402, 1958-2 C.B. 15. See also Moore (basis includes value of option on issuance, not exercise; open transaction doctrine inapplicable); cf. Rev. Rul. 80-186, 1980-2 C.B. 280 (value of gifted option on grant date subject to gift tax). In Simmonds, the court found as a fact that the options in question could not be valued on issuance. In the present case, by contrast, the value of the Warrant on Date A has been established; accordingly, the open transaction doctrine does not apply.

Other possible characterizations of the transaction are that the grant of the Warrant was an incentive for Taxpayer to enter into the overall agreement with X Corporation, or to encourage Taxpayer not to transfer customers *off* X Corporation's tariff; or that X Corporation wished to gain indirect access to Taxpayer's customers to pursue its own network (that is, whether or not that access was a "customer-based intangible" within the meaning of § 197, an issue we do not decide); or that X Corporation wished to increase its traffic volume, though not its immediate profit, to obtain volume discounts from Network or for other reasons. However, none of these possible characterizations, in our view, would permit Taxpayer to exclude or defer the recognition of income from the grant of a warrant with a determined value.

The final possibility is that the Warrant represented an additional discount on the tariff rate for telecommunication services that X Corporation had already agreed to provide Taxpayer at cost. The memorandum opinions in the "workstation cases" discussed above—Sun, Computervision, and Convergent—suggest that in such a case the tax consequences might be deferred until the Warrant was exercised.[7]

We are satisfied, however, that based on the facts in this particular case, and looking primarily at objective factors, the transfer of the Warrant was not a sales discount. It was not made with the purpose and intent of reaching an agreed upon a net selling price, see Pittsburgh Milk and Rev. Rul. 2005-28, and, in several significant respects, the "workstation cases" are distinguishable.

First, under the Services Agreement Taxpayer was provided with the same services as before, from Network, at a lower rate—a rate equal to the rate Network charged X Corporation. While sellers sometimes sell below cost, this fact suggests that the Warrant was not needed or intended to induce Taxpayer to purchase specific services from X Corporation.

Second, one factor found to be significant in the "workstation cases" was the fact that the warrants were sold by the recipients, not exercised. In the present case, the Services Agreement provided that Taxpayer was "acquiring the warrant for its own account or investment and not for the account of others or with a view to the distribution or resale of such warrant or shares of stock issuable upon exercise thereof." The Warrant was not generally transferable, except to a successor or shareholder of Taxpayer and, except for certain gift transactions, for a period of years X Corporation had a right of first refusal for any shares issued on exercise. The parties' actions were generally consistent with these recitals and restrictions: the Warrant was not immediately sold but was distributed to Taxpayer's shareholders, who first held and then exercised the Warrant, becoming shareholders of X Corporation. Although some sold their X Corporation shares, there is evidence of a general intent on the part of Taxpayer

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[7] Even if the Warrant were issued as a discount, it is not clear how that would affect the result in this case. Of the "workstation cases," only Computervision addressed the treatment of the warrant recipient, and the issue of timing was not before the court. Moreover, as discussed in the text, the facts in Computervision were distinguishable from the present case. Finally, none of the "workstation cases" focused on whether the recipient of a warrant (in this case, Taxpayer) can make an adjustment based on the warrant's value on the exercise date, when exercise occurs in the hands of transferees (in this case, Taxpayer's shareholders) some time after the warrants were transferred. Since we conclude that the Warrant was not issued as a sales discount, we do not need to resolve these questions.

and its owners to invest in X Corporation, rather than to liquidate warrants received as a sales discount.

Finally, the relevant documents did not describe the arrangement as involving a sales discount: the Services Agreement stated that the warrant was issued "in order to induce [Taxpayer] to enter into the ongoing business relationship represented by this Agreement." More significantly, as a substantive matter the agreement expressly disavowed any more specific linkage between the Warrant and the agreement: "The Warrant shall be an independent agreement, and no default or termination of the Agreement shall in any manner whatsoever affect or restrict the rights of the [Warrant] holders … ." The courts in the "workstation cases" stressed the fact that exercise of the warrants was conditioned on performance under the sales agreements between the parties. In Convergent, the terms of the warrant agreements also varied with expected purchase volumes. In the present case, by contrast, not only were there no such preconditions to exercise of the Warrant, the Warrant would remain valid even if the agreement were terminated completely, and there is evidence that in this respect the Warrant issued to Taxpayer differed from warrants issued by X Corporation to other customers.[8]

In some cases, the distinction between a sales discount and an incentive or other expenditure may be a fine one, but in this case we agree with the tentative conclusion of the field office that, taking all the facts and circumstances into account, the issuance of the warrant was not a sales discount.

We conclude that the value of the Warrant on Date A was includible in Taxpayer's gross income as ordinary income. Taxpayer is treated as having acquired the Warrant for, and having a basis in the Warrant equal to, the value of the Warrant on Date A. See, e.g., Moore.

This memorandum does not address the tax consequences of the distribution of the Warrant to Taxpayer's shareholders, or their subsequent exercise of the Warrant.

CAVEATS:

A copy of this technical advice memorandum is to be given to the taxpayers. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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[8] It is true that the Warrant would be ineffective if Taxpayer transferred existing customers from X Corporation's tariff after a change of control; but, as discussed earlier, the change-of-control contingency was a condition subsequent that would not apply so long as Taxpayer observed the notice period before making the transfer.