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THE TAX REFORM ACT AND CONVERTIBLE DEBT SECURITIES

LAWRENCE LEE*

INTRODUCTION

The purpose of this paper is to outline the impact of the Tax Reform Act of 1969 upon the use of convertible debt securities as consideration in corporate acquisitions. In addition, recent developments with respect to the use of warrants will also be examined. In discussing this specific and somewhat narrow assignment a brief explanation of the creatures involved will be given by way of background.

USE OF CONVERTIBLE DEBT SECURITIES

The public's interest in convertible debt securities is explained as follows:

"Converts" are regaining favor in Wall Street — at least in that larger segment of the financial community, wherein dwell the institutional buyers — and it won't be long before convertible debentures win back their once popular role as an instrument in the merger game. Behind the expanding interests in "converts" by mutual funds, insurance companies, pension funds, colleges and foundations, and the ever-faithful bank portfolio managers, is the conviction that stock prices will rise this year coupled with the fact that the Fed's tightening of margin requirements has made these securities a more attractive investment medium. The popularity of these so-called "two-way" or "hybrid" securities stems from the fact that they possess the defensive characteristics of a senior security plus the appreciation potential of an equity investment. Says a leading specialist: "If the investor is concerned about inflation, the equity part of a convertible is working for him. If he's worried about the market taking a sharp drop, he can (still) buy converts for their bond values."1

Another viewpoint expresses the advantages in the following terms:

Historically, this form of payment has offered a unique advantage to both the buyer and the seller in a taxable transaction. Debentures afford the seller the ability to elect the installment treatment of reporting his capital gain on the sale, so as to incur only a tax liability when the debentures mature or are converted to cash. As mentioned previously, the ability to use the installment method in this situation is currently under attack in the new Tax Reform Bill. Debentures afford the buyer the ability to record the basis of the assets acquired at fair market value and depreciate the stepped-up basis over future periods. Obviously the economics of this type of transaction does not appeal to the Treasury since the seller could defer the tax on his gain, through the installment

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1 Window on Wall Street, 3 Mergers & Acquisitions 70, 71 (1968).

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method, while the buyer could secure a current tax deduction for the depreciation on the assets acquired.\textsuperscript{2}

Other advantages, such as the expense deduction allowed for interest paid or accrued and the prevention of immediate equity dilution,\textsuperscript{3} are factors to be considered.

The Treasury's dissatisfaction with the use of convertible debt securities by the acquiring company in a corporate acquisition is obvious. But other regulatory agencies are equally dissatisfied. For example, it is reported that:

Mr. Budge spent much of his testimony spelling out the SEC's concern with corporate take-overs financed by the issuance of debt securities, such as convertible debentures and stock-purchase warrants. The major problem, Mr. Budge told the hearing, is that issuing large amounts of these securities often gives an unclear picture of the combined company that most investors aren't knowledgeable enough to interpret properly.

In response to a question, Mr. Budge said one possible approach for dealing with this would be legislation banning the issuance of certain "complex" debt securities in take-overs. The idea, he said later, would be to force the issuance of simpler securities so that investors could better evaluate a take-over proposal. He said that this possibility has been discussed by some SEC staff members but that a specific proposal hasn't been drafted.\textsuperscript{4}

In the same vein, the New York Stock Exchange indicated its concern:

On bonds and debentures, Mr. Haack said the exchange is formulating standards that would preclude listing them when, in the exchange's opinion, the company can't adequately service the interest on the issue. Last April, the exchange said it wouldn't list two such issues because it doubted whether earnings of the companies involved would be sufficient to service the debt.

The companies involved were General Host Corp. and NVF Co., both of which had issued the bonds to acquire interests in other companies.\textsuperscript{5}

Even so, enthusiasm for the use of convertible debt securities has continued,\textsuperscript{6} although apparently the concerted efforts of the Treasury, the Justice

\textsuperscript{2} Brown & Buchholz, Tax Considerations in Mergers and Acquisitions, 47 Taxes 654 (1969). See also S. Rep. at 137-44.

\textsuperscript{3} There are indications that the Accounting Principles Board of The American Institute of Certified Public Accountants may adopt rules requiring that financial reports include "earnings per share" figures reflecting the situation if all the company's convertible securities were converted into additional shares of common stock. See L.A. Times, Oct. 20, 1969, § III, at 12, col. 3. For an accounting approach to convertible debt securities, see Asner, Convertible Debentures—Tax and Financial Accounting Treatment Today, 1 Tax Advisor 9 (1970).


\textsuperscript{5} Id., June 18, 1969, at 6, col. 1.

\textsuperscript{6} Id., July 1, 1969, at 10, col. 2. For examples of the terms of convertible debt securities, see Prospectus, Vail Associates, Inc., 7\textfrac{1}{4} percent Convertible Subordinated Subordinated Debentures Due 1984, Oct. 27, 1969; Prospectus, Commonwealth Telephone Company, 6\textfrac{3}{4} percent convertible Subordinated Debentures Due 1989; U.S. Natural Resources, Inc., 6 percent Convertible Subordinated Debentures Due 1979, appearing in L.A. Times, Nov. 3, 1969, at 14, col. 5; Liberty Loan Corp., 9\textfrac{1}{2} percent debentures plus
Department, the Securities and Exchange Commission, and the Stock Exchanges are having some effect.  

ISSUANCE OR ASSUMPTION OF DEBT SECURITIES AND EXPENSES CONNECTED THEREWITH

Income Tax Regulation section 1.61-12(c) provides: "If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss." Any expense incurred in connection with the issuance of the debt securities are capital expenditures, recoverable proportionately over the term of the securities in the same manner as discount is recoverable. 

If, in the language of the regulations, "bonds are issued by a corporation at a premium . . . the net amount of such premium . . . is income which should be prorated or amortized over the life of the bonds." The holder of corporate bonds purchased at a premium may elect to amortize into income the premium, defined as the "excess of the amount of the basis . . . of the bond over the amount payable at maturity or, in the case of a callable


Whatever the main cause—whether it be the decline in the stock market, record high interest rates, threatened tax legislation or our activities—merger among giants and acquisitions by the giants of leading firms in other industries, are much fewer in number today than they were 10 months ago, . . . .

In addition, Mr. McLaren said he regarded this as a "healthy development." Id. However, McLaren told an institutional investor conference in Los Angeles that the Justice Department does not oppose either conglomerate firms as such or conglomerate mergers as such.

8 These are regulations of long standing. See, e.g., San Joaquin Light & Power Corp. v. McLaughlin, 67 F.2d 677 (9th Cir. 1933). See also Treas. Reg. § 1.61-12(C) (all Treasury Regulations cited herein appear as amended and in effect as of Dec. 1, 1969): "a debenture, note, or certificate or other evidence of indebtedness, issued by a corporation and bearing interest shall be given the same treatment as a bond." If the corporation sells its bonds on time payments and a buyer defaults and forfeits the amounts paid, the forfeiture is income. First Nat'l Bank, 3 B.T.A. 751 (1926).


[u]namortized bond issuance expense remaining when a corporation purchases its bonds is not allowed as a deduction where the corporation elects to have section 108(a) . . . apply to the purchase by filing a consent to the Income Tax Regulations prescribed under section 1017 of the Code. However, the amount not allowed as a deduction is to be taken into account in determining the adjustment to the basis of the corporation's property under section 1017 . . .

10 Treas. Reg. § 1.61-12(c)(2); Nashville, Chattanooga & St. Louis Ry., 24 B.T.A. 856 (1931). Conceptually, this follows the rule that if the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is income for the taxable year. Treas. Reg. § 1.61-12(c)(3). See Asner, supra note 3, at 11-12.
bond, the earlier call date."\textsuperscript{11} "Premium" is defined, from the corporation's viewpoint, as "the excess of the issue price of the bond (as defined in paragraph (b)(2) of section 1.1232-3 over the amount payable at maturity (or in the case of a callable bond, at the earlier call date)."\textsuperscript{12} The fact that the bond is convertible prevents neither the inclusion of premium into income by the issuer nor the deduction of the premium by the holder.\textsuperscript{13} However, the issuer is not required to include into income that part of the issue price and the holder may not deduct that part of the price paid which is attributable to the conversion feature.\textsuperscript{14}

On the other hand, "[i]f bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds."\textsuperscript{15}

If the acquiring corporation assumes the indebtedness of another corporation in a transaction defined in section 381(a), then the acquiring corporation stands in the shoes of the transferor corporation with respect to unamortized premium, discount, or expense originally incurred with respect to the indebtedness assumed.\textsuperscript{16}

**TAX INCIDENTS OF BONDS TO HOLDER**

The holder of the bond includes the discount into income "for the year in which received or accrued (depending on the method of accounting used by the taxpayer),"\textsuperscript{17} unless, in the case of an accrual basis taxpayer, genuine doubt exists as to the collectibility of the interest.\textsuperscript{18} The disposition by the holder of the discount bond prior to its maturity is governed by the original issue discount rules set forth in section 1232.\textsuperscript{19} Since the issue price


\textsuperscript{12} Treas. Reg. § 1.61-12(c)(3).

\textsuperscript{13} Id. §§ 1.61-12(c)(2), 1.171-2(c)(1).

\textsuperscript{14} Id. See Treas. Reg. § 1.171-2(c)(2); cf. id. § 1.1232-5(b) (to determine the amount attributable to the conversion feature). See also H.R. Rep. 782, § 413, at 135.

\textsuperscript{15} Treas. Reg. § 1.163-5(a)(1). This correlates to the rule that if the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted is a deductible expense for the taxable year. Treas. Reg. § 1.163-5(c)(1).

\textsuperscript{16} I.R.C. § 381(c)(9); Treas. Reg. § 1.381(c)(9)-1. Prior to the statute, the continued deduction of these items depended on whether or not the issuing company was the survivor in the reorganization; see, e.g., American Gas & Elec. Co. v. Commissioner, 85 F.2d 527 (2d Cir. 1936). The deduction was apparently disallowed in liquidations. See Metropolitan Edison Co., 35 B.T.A. 1110 (1937), rev’d, 98 F.2d 807 (3d Cir. 1938) (court of appeals treating the liquidations as a de facto merger), aff’d, 306 U.S. 522 (1939). But cf. Anover Realty Corp., 33 T.C. 671 (1960).

\textsuperscript{17} Treas. Reg. § 1.61-7(c). But see S. BILL § 413, amending I.R.C. § 1232 to require the holder to include a ratable portion of the discount into income each year.

\textsuperscript{18} See, e.g., Clifton Mfg. Co. v. Commissioner, 137 F.2d 290 (4th Cir. 1943); Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930).

\textsuperscript{19} Treas. Reg. § 1.1232-1(a):

In general, section 1232(a)(1) provides that the retirement of an obligation . . . is considered to be an exchange and, therefore, is usually subject to capital gain or loss treatment; and section 1232(a)(2) provides that in the case of a gain realized on the sale or exchange of certain obligations issued at a discount . . .
for convertible bonds is deemed to include any amount attributable to the conversion feature, no original issue discount is implied.\textsuperscript{20} Hence, unless the convertible debt security is issued at an actual discount, there is no discount either to the issuer or the holder.

The Tax Reform Act of 1969 cuts back on one advantage of the use of bonds issued at discount by eliminating the existing right of cash basis taxpayers to defer the recognition of the discount income until paid.\textsuperscript{21} In the words of the Senate Report, section 1232 provides that "the bondholder is to be required to include the original issue discount in his income on a ratable basis over the life of the bond."\textsuperscript{22} As the holder of the bond includes the discount into income, the basis of the bond is correspondingly increased.\textsuperscript{23}

If the bond is sold or retired prior to maturity, the gain, \textit{i.e.}, the selling price less the adjusted basis as increased by inclusion of discount into ordinary income, is subject to capital gains treatment.\textsuperscript{24} But if the bond was issued with the intention to call it prior to maturity, then any gain recognized is treated as ordinary income to the extent of the full amount of original issue discount (adjusted for that portion of discount previously included within income).\textsuperscript{25} A purchaser of the bond from the original or prior holder is required to pick-up into his income the remaining discount,\textsuperscript{26} \textit{i.e.}, the balance of the discount not included into the income of prior holders, unless he paid a "premium" for the bond (a price in excess of the previous owner's adjusted basis for the bond), in which case the subsequent holder is allowed to amortize the excess over the remaining life of the bond.\textsuperscript{27} If the original purchaser paid a premium for the bond to the issuer, then ratable inclusion of discount is not required.\textsuperscript{28}

Section 1232(b), however, speaks solely to discount arising from a "package" offering (\textit{e.g.}, bond plus warrants); it does not change the existing rule that the conversion feature does not trigger discount.\textsuperscript{29}

Additionally, the amendments to section 1232 do not apply to government obligations or corporate bonds issued before May 27, 1969;\textsuperscript{30} the existing rules apply to such securities.

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the amount of gain equal to such discount or, under certain circumstances, the amount of gain equal to a specified portion of such discount, constitutes ordinary income.

Section 1232 was amended by Senate Version § 413. The proposed amendment was accepted. H.R. Rep. 782, at 133.

\textsuperscript{20} Treas. Reg. § 1.1232-3(b)(2)(i).

\textsuperscript{21} S. Rep. 552, at 146.

\textsuperscript{22} Id. at 147. \textit{See} Tax Reform Act § 1232(a)(3)(A). H.R. Rep. 782, § 413(c) provides that the exception is effective with respect to indebtedness issued after October 9, 1969.

\textsuperscript{23} Tax Reform Act § 1232(a)(3)(E).

\textsuperscript{24} Id. § 1232(a)(2)(A).

\textsuperscript{25} Id. \textit{But cf.} House Version § 1232(a)(2)(A).

\textsuperscript{26} Tax Reform Act § 1232(a)(3)(A).

\textsuperscript{27} Id. § 1232(a)(3)(B).

\textsuperscript{28} Id. § 1232(a)(3)(D).

\textsuperscript{29} Id. § 1232(b)(2). \textit{Asner, supra note 3, at 15.}

\textsuperscript{30} House Version § 413(c). The Senate version had the same provisions except the date was October 9, 1969, Senate Version § 1232(a)(2)(B).
Additional Discount Factors

If the transaction is in cash, the rules discussed above are relatively simple in application; further complexity is introduced when the debt securities are exchanged for property. Generally speaking, if the exchange is part of a reorganization within the meaning of section 368, the corporation issuing the securities (the “transferee” of the property) takes a “carryover basis” in the property acquired equivalent to the basis of the property in the hands of the transferor corporation. But such basis is increased to the extent that the transferor corporation recognizes gain upon the exchange. Recognition of gain depends on two factors: (1) the existence of “boot” in the transaction and (2) whether the transferor corporation can avoid recognition by distributing the boot to its shareholders as part of the plan of reorganization. The presence of boot in the transaction depends largely on whether the debt securities involved constitute “securities” and not “other property” within the meaning of the Code; and whether the principal amount of any securities distributed exceeds the amounts surrendered, or debt securities are given where none are surrendered.

On the other hand, if a tax-deferred reorganization is not involved, the usual basis rules apply. The basis of the property acquired with debt securities is cost to the acquiring company, which in turn is ordinarily the face value of the bonds. Albeit difficult to demonstrate, it is possible to create discount when exchanging debt securities for property (vis-à-vis cash). This is true even if the “property” being acquired is the issuer’s own stock, although the Internal Revenue Service (IRS) regards this as a change in capital structure.

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31 I.R.C. § 362(b); Treas. Reg. § 1.362-1.
32 I.R.C. § 362(b).
33 Id. § 361(b).
34 Id. § 356(a).
35 Id. § 354(a)(2).
36 Id. § 1012.
37 Treas. Reg. § 1.1012-1(a).
40 Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962); American Smelting & Refining Co. v. United States, 130 F.2d 883 (3d Cir. 1942).

The preferred stock of the corporation which it received in exchange for the debentures and common stock did not constitute property. Instead, the transaction involved merely a readjustment of the corporation’s own securities, in the form of a recapitalization, exclusive of receiving property therefor which can be recognized as assets in the hands of the corporation.
THE TAX REFORM ACT

Section 1232(b)(2) recognizes that discount may arise when a corporation issues its bonds for a price less than its face value, whether it receives cash, stock, or other property (including the assets of another corporation) for the bonds. Where bonds are issued for property (vis-à-vis cash), the issue price of the bonds is the fair market value of the property. To this end the Senate Report contains the following statement:

To provide certainty of tax treatment, where a buyer and seller dealing at arms length have established a price for the property for which the bonds are issued, this price will be presumed to be the fair market value of the property.

This concept, however, is not clearly articulated in the statute.

If stock (rights) as well as debt securities are involved in the taxable acquisition of the property, the price paid (i.e., the package of securities) must be apportioned between the stock and bonds in order to determine that portion of the cost which is attributable to each kind of security. Thus, two elements of discount may be involved: (a) the discount arising by reason of the allocation between relative values as to the securities in the package, and (b) the discount arising from the fact that the property (vis-à-vis cash) received in the exchange is worth less than the face value of the debt securities exchanged. However, granting that a package approach might indicate that the bonds were exchanged at less than face value, it has been held that if the property (vis-à-vis cash) received has a value at least equal to the face value of the bonds alone, no discount is created. Thus it is assumed that the bonds were paid for in full. However, the amendment of section 1232(b)(2), as discussed above, may change the approach. The "package" concept (e.g., debentures and warrants) and recognition of the fact that discount may arise when bonds are issued for property (vis-à-vis cash) are treated in the same paragraph, and neither the House nor the Senate Report gives any indication that discount may not arise from both sources.

Section 1232(b)(2) also comes to grips with "package" discount and

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44 Tax Reform Act § 1232(b)(2).
46 Tax Reform Act § 1232(b)(2) provides that unless it is found in the sentence: "The issue price of the bond or the evidence of indebtedness in such investment unit shall be the portion so allocated to it."
47 Cf. Hummel-Ross Fibre Corp. v. Commissioner, 79 F.2d 474 (4th Cir. 1935); Pierce Oil Corp., 32 B.T.A. 403 (1935). Where more than one asset is involved, the cost must be allocated among the assets acquired; cf. Treas. Reg. § 1.61-6(a).
48 Treas. Reg. §§ 1.1232-3(b) et seq., 1.165-3(a)(2). It should be noted that the "package" allocation is not required where convertible securities are used; original issue discount is not attributed from the value of the conversion feature. Id. §§ 1.1232-3(b) (2)(i), 1.165-3(b) (Example (2)).
50 Tax Reform Act § 1232(b)(2).
provides that where debt securities are issued together with options or warrants, the issue price of each element of the investment unit must be allocated between the elements of the "package" on the basis of their respective fair market values, thus codifying the existing regulations.

In the case of convertible debt securities, as indicated above, the new legislation leaves unchanged the prevailing rule: "In the case of an obligation, the issue price includes any amount paid in respect of the conversion privilege."

**Bond Rights**

Should the corporation issue its bonds by distributing them among its shareholders, the fair market value of the bonds is a dividend to the shareholders according to the usual "in-kind" dividend rules. Presumably it makes no difference that the bonds are convertible into stock. On the other hand, if rights to subscribe to bonds are distributed, different rules may apply. According to the IRS, rights to acquire convertible bonds are treated as stock rights (i.e., tax free upon receipt or exercise, or in some cases, the taxable event, if any, being the exercise), but rights to acquire bonds without the conversion feature are dividends.

The IRS's position, assuming it to be equally valid today, must be considered in the context of the recently enacted tax reform bill. Previously, under section 305 the distribution by the corporation to its shareholders of rights to acquire its stock is not, generally speaking, a taxable event. Assuming that the rights are utilized to acquire the stock of the corporation distributing the rights, the subsequent exercise of the rights is also not taxable. Applying these rules in the bond situation, the rule would seem to be: A distribution of rights to acquire convertible bonds is tax-free upon receipt or exercise. Whether this rule is changed by the Tax Reform Act of 1969 will be considered later in this paper.

**Corporation's Transactions with Its Own Debt Securities**

If outstanding bonds are subsequently purchased by the issuing corporation at a cash price less than the adjusted original price, i.e., the original issue price plus any amount of discount already deducted but minus any amount of premium already returned as income, the difference between the

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52 Tax Reform Act § 1232(b)(2).
54 Id. § 1.1232-3(6)(2)(i).
59 The exceptions presently applicable are found in I.R.C. § 305(b). It makes no difference if the stock distributed or the stock subject to the rights is treasury stock. See Treas. Reg. § 1.305-1.
price paid and the adjusted original issue price is income in the year of purchase. This rule is well established. The year of the cash purchase triggers the incidence of tax regardless of the subsequent handling of the bonds, while the expenses incurred in purchasing the bonds are deductible as ordinary and necessary expenses. Similarly, unamortized discount and expenses incurred with respect to such bonds may be deducted in the year of purchase. The sole exception to the general rule stated above applies where the bonds were originally issued as dividends. There the approach is that because the corporation received no consideration in the issuance, it realizes no income in retiring the bonds at less than face value or, as stated by the Court of Appeals for the Second Circuit:

When certain of the bonds were retired at less than par, all that happened was that the corporation retained a part of the surplus it had expected to distribute, because it paid those shareholders whose bonds were redeemed at a discount, less than it had promised to pay them. Hence, it is apparent that the corporation received no asset which it did not possess prior to the opening and closing of the bond transaction, and it is impossible to see wherein it has realized any taxable income.

Income Tax Regulation section 1.163-3(c), referring generally to the "Deduction for bond discount," provides as follows:

(1) Except as provided in subparagraph (2) of this paragraph, if bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of discount deducted prior to repurchase, or (in the case of bonds issued subsequent to Feb. 28, 1913) minus any amount of premium returned as income prior to repurchase, the excess of the purchase price over the issue price adjusted for amortized premium or discount is a deductible expense for the taxable year.

(2) In the case of a convertible bond (except a bond which the corporation, before September 5, 1968, has obligated itself to repurchase at a specified price), the deduction allowable under subparagraph (1) of this paragraph may not exceed an amount equal to one year's interest at the rate specified in the bond, except to the extent that the corporation can demonstrate to the satisfaction of the Commissioner or his delegate...
that an amount in excess of one year's interest does not include any amount attributable to the conversion feature.\(^6\)

Subparagraph (2), quoted above, is the Service's reaction to such cases as Roberts & Porter, Inc. v. Commissioner\(^6\) and Universal Tractor-Equipment Corp. v. United States,\(^7\) which in general terms permitted the deduction of the full amount of premium (i.e., excess over face value) paid in retiring convertible debt securities. The Service's position was stated in Revenue Ruling 67-409, as follows:

The longstanding position of the Service has been that a deduction for premiums paid by a corporation on the redemption or repurchase of its own bonds, under the provisions of these sections or any other sections of the Code or regulations [reference to section 162 Reg. s1.161-12], is limited to an amount which relates to the cost of borrowing money and, thus, such excess amounts are not deductible. ... Accordingly, the Service does not follow the decision of the Seventh Circuit in the Robert & Porters, Inc. case. ...\(^7\)

The Service's concern, of course, was the expensing of the cost of purchasing the conversion feature. The problem is summarized as follows:

Under present law, there is a question as to whether a corporation which repurchases its convertible indebtedness at a premium may deduct the entire difference between the stated redemption price at maturity and the actual repurchase price. The Internal Revenue Service takes the position that the deduction is limited to an amount which represents a true interest expense (i.e., the cost of borrowing) and does not include the amount of the premium attributable to the conversion feature. This part of the repurchase is viewed by the Revenue Service as a capital transaction analogous to a corporation's repurchase of its own stock for which no deduction is allowable. There are, however, court cases which hold to the contrary and allow the deduction of the entire premium. In addition, other court cases have been filed by taxpayers to test the validity of the Service's position on this matter.\(^7\)

Congress' solution was the enactment of section 249,\(^7\) which provides, in the words of the Senate Report, "that the amount of the premium which may be deducted is to be limited to an amount not in excess of a normal call premium for nonconvertible corporate indebtedness."\(^7\) Note also that proposed section 249 codifies the concept of "adjusted issue price" set forth in Regulation section 1.163-3(c)(1) quoted above.\(^7\) The corporate issuer,

\(^{68}\) Treas. Reg. § 1.163-3(c).
\(^{69}\) 307 F.2d 745 (7th Cir. 1962).
\(^{72}\) S. REP. 552, at 149; see Thrower, Conglomerates and Convertibles, 1 TAX ADVISOR 4, 7 (1970).
\(^{73}\) S. BILL § 414(a); H.R. 13270, at § 414(a); H.R. REP. 782, at 137.
\(^{74}\) S. REP. 552, at 149.
\(^{75}\) Tax Reform Act § 249(b)(1); see Rosen, Final Regulations on options given to lenders answer many longstanding questions, 31 J. TAXATION 2 (1969).
however, may obtain a larger deduction than the rule allows if it can demonstrate to the IRS's satisfaction that the excess paid is related to the cost of borrowing and is not attributable to the conversion feature of the indebtedness.\footnote{Tax Reform Act § 249(a).} The new approach will be effective with respect to convertible debt securities purchased by the issuer after April 22, 1969.\footnote{H.R. Rep. 782, § 414(c).}

There is, however, another alternative. If the company buys in its outstanding bonds with its newly issued bonds, a tax-deferred reorganization\footnote{I.R.C. § 368(a)(1)(E).} may be involved and its recognition of gain or loss at both the corporate and shareholder level may be deferred.\footnote{Commissioner v. Edmonds' Estate, 165 F.2d 715 (3d Cir. 1948); Commissioner v. Neustadt Trust, 131 F.2d 588 (2d Cir. 1942).} This result is obtained even though the interest rate and date of maturity are changed or a conversion feature is added;\footnote{See, e.g., Commissioner v. Neustadt Trust, 131 F.2d 588 (2d Cir. 1942).} but if the principal amount of the indebtedness is increased, "boot" may be involved.\footnote{I.R.C. §§ 354(a)(2)(A), 356(d).}

The expenses of the exchange are handled in the same manner as expenses incurred in any other type of reorganization, \textit{viz.} capitalization and, in the case of debt securities, amortization of such expenses over the term of the new debt.\footnote{Skenandoa Rayon Corp. v. Commissioner, 122 F.2d 268 (2d Cir. 1941), cert. denied, 314 U.S. 696 (1942); Rev. Rul. 387, 1959-2 Cum. Bull. 56.} Unamortized discount and expenses applying with respect to the old bonds (now retired in exchange for the new bonds) are carried over to the new bonds and amortized over the term of such new bonds.\footnote{Great Western Power Co. v. Commissioner, 297 U.S. 543 (1936); Bridgeport Hydraulic Co., 22 T.C. 215 (1954), \textit{aff'd}, 223 F.2d 925 (2d Cir. 1955) (per curiam). Of course, if the new bonds involve a reduction in the principle amount due, the unamortized expense may be lost; see Chicago, Milwaukee, St. Paul & Pac. R.R., 404 F.2d 960 (Cl. Ct. 1968). The unamortized expense, carried over to the new bonds, is deducted when the new bonds are redeemed or the corporation is liquidated; see United States v. Memorial Corp., 244 F.2d 641 (6th Cir. 1957); Chicago, Milwaukee, St. Paul & Pac. R.R., 404 F.2d 960 (Cl. Ct. 1968).} But a "sleight of hand" approach is involved: whether the old issue was in fact retired, albeit from the proceeds of the new issue, or whether the old was exchanged for the new (a recapitalization). If the former, the unamortized items are deductible in the year the bonds are retired.\footnote{Helvering v. California Oregon Power Co., 75 F.2d 644 (D.C. Cir. 1935); Bridgeport Hydraulic Co., 22 T.C. 215 (1954), \textit{aff'd}, 223 F.2d 925 (2d Cir. 1955) (per curiam).} A tax-deferred reorganization may also be involved if the outstanding bonds are exchanged by the holders thereof for common or preferred stock of the debtor corporation.\footnote{Treas. Reg. § 1.368-2(c); Rev. Rule 98, 1959-1 Cum. Bull. 76. But cf. Treas. Reg. § 1.1056-1(a). It is the reverse situation that causes problems, \textit{i.e.}, where the shareholders trade stock for bonds. Bazley v. Commissioner, 331 U.S. 737, \textit{rehearing den}, 332 U.S. 752 (1947). But cf. Berner v. United States, 282 F.2d 720 (Cl. Ct. 1960); Alan O. Hickok, 82 T.C. 80 (1959). See I.R.C. §§ 354(a)(2)(B), 356(a)(1), 356(a)(2), 356(d)(2)(B) which would treat the bonds on such an exchange as "boot," perhaps, subject to dividend treatment.}
Apart from recapitalizations, the nature of the security involved determines whether the reorganization is tax-deferred. Thus, to one degree or another, whether by statute or judicial determination, most reorganizations require stock or equity participation. It therefore becomes important in certain situations to determine whether debt securities are in reality stock. It should be noted here, that proposed section 415 was an attempt by Congress to put in statutory form the criteria used to make the determination. The Senate Report states:

For the above reasons, the committee has added a provision to the House bill which gives the Secretary of the Treasury or his delegate specific statutory authority to promulgate regulatory guidelines, to the extent necessary or appropriate, for determining whether a corporate obligation constitutes stock or indebtedness. The provision specifies that these guidelines are to set forth factors to be taken into account in determining, with respect to a particular factual situation, whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists. The provision also specifies certain factors which may be taken into account in these guidelines. It is not intended that only these factors be included in the guidelines or that, with respect to a particular situation, any of these factors must be included in the guidelines, or that any of the factors which are included by statute must necessarily be given any more weight than other factors added by regulations. The factors specifically listed are as follows:

1. Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;
2. Whether there is subordination to or preference over any indebtedness of the corporation;
3. The ratio of debt to equity of the corporation;
4. Whether there is convertibility into the stock of the corporation; and
5. The relationship between holdings of stock in the corporation and holdings of the interest in question.

Finally, the fact that a debt security is convertible into stock of the issuing corporation does not, until its actual conversion, make the instrument stock.
USE OF CONVERTIBLE DEBT SECURITIES IN ACQUISITIONS

A. Interest Deduction

As indicated at the outset, one feature of using debt securities is the deductibility of the interest paid. The Tax Reform Act of 1969 circumscribes this deduction at least as to large corporations. The House approach was to attack the interest deduction; the Senate targeted two aspects—first, the nature of the instrument itself, and second, the interest deduction.

Section 415 of the Reform Act enacted new section 385, which, in general terms, authorizes the IRS to promulgate regulatory guidelines for determining whether a corporate obligation constitutes stock or indebtedness. The proposed statute lists, only by way of example, some of the factors which may be considered. The Senate Report emphasizes that section 385 is broader than the acquisition context:

An obligation the interest on which is not disallowed under the corporate acquisition section [section 279] nevertheless might be found to constitute equity (and hence the interest disallowed) under the general debt-equity regulatory guidelines. Moreover, unlike the rules provided by the bill in a corporate acquisition context, which deal only with the allowability of the interest deduction, the guidelines to be promulgated by the Secretary of the Treasury are to be applicable for all purposes of the Internal Revenue Code.

Assuming that the factors suggested by the Bill are included in the guidelines, taxpayers can gain little solace, because the Senate stresses that these factors are not conclusive and that the Commissioner may place varying emphasis upon each factor. Thus, for example, the instrument involved might pass four of the tests suggested but find that the fifth test is “more equal” than the other four. In this context it is doubtful whether the Senate’s professed goal —

Rev. Rul. 269, 1967-2 CUM. BULL. 298; Treas. Reg. § 1.1244(c)-1(6); “[N]either securities of the corporation convertible into common stock nor common stock convertible into other securities of the corporation shall be treated as common stock”; id. § 1.1031(a)-1. But cf. Treas. Reg. § 1.544-5.

I.R.C. § 163.

H.R. 13270, at § 411; H.R. REP. 413, pt. 2, at 77-82.

S. BILL § 411; S. REP. 552, at 137-44.

Tax Reform Act § 385 reads:

(b) FACTORS. — The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money’s worth, and to pay a fixed rate of interest,

(2) whether there is subordination to or preference over any indebtedness of the corporation,

(3) the ratio of debt to equity of the corporation,

(4) whether there is convertibility into the stock of the corporation, and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

S. REP. 552, at 139.
In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions, the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. . . .

The point is that even if the taxpayer satisfies the specific tests set forth in section 279 concerning corporate acquisition indebtedness, it must also clear the perhaps more vague tests suggested or to be suggested by section 385.

In general terms, section 279, the second string to the Senate's bow, provides that an interest deduction in excess of $5 million is not allowed with respect to obligations issued for acquisition purposes. To know the plays, it is necessary to know the game rules. Section 279 is aimed at so-called "Corporate Acquisition Indebtedness," defined generally as having these characteristics:

1. The obligation was or is incurred "to provide consideration for the acquisition of the stock or assets of another corporation, provided that in asset acquisitions, at least two-thirds (in value) of all the assets (excluding cash) used in the acquired corporation's business(es) are acquired; And

2. The obligation is either subordinated to trade creditors of the issuer or "expressly subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued, of the issuing corporation"; And

3. The debt instrument is convertible into the stock of the issuer or is an element of an investment unit ("package") which gives an option to acquire stock of the issuer; And

4. On the last day of the issuer's taxable year in which it issues obligations of the kind defined here, the ratio of debt to equity exceeds two to one, or, the projected earnings do not exceed three times annual

95 Id. at 138.
96 S. BILL § 411.
97 Tax Reform Act § 279(b).
100 Tax Reform Act § 279(b)(3).
101 Id. § 279(c)(1).
102 Id. § 279(b)(4)(A). House Version § 279(b)(4)(A) provided for a ratio of 4 to 1. Tax Reform Act § 279(c)(2) defines the ratio as that which the total indebtedness of the issuer bears to the sum of its cash plus the adjusted basis of its assets less the indebtedness. No mention is made for contingent liabilities such as guarantees on loans for subsidiaries, etc. In commenting on the House Version, the Section of Taxation, American Bar Association stated:

The use of the adjusted basis of assets in determining the debt-equity ratio as provided in section 279(c)(2) is unsound in theory and would be inequitable in practice. This standard has been uniformly rejected in the cases. Rapid depreciation on the one hand and inflation on the other have made adjusted basis a poor measure of the capacity of tangible assets to support debt; and intangible values

103 Id. § 279(b)(4)(A).
interest\textsuperscript{103} to be paid or incurred.\textsuperscript{104}

Assuming the presence of "Corporate Acquisition Indebtedness," which refers only to debt incurred after October 9, 1969, then the rule precisely stated is:

No deduction shall be allowed for any interest paid or incurred by a corporation during the taxable year with respect to its corporate acquisition indebtedness to the extent that such interest exceeds —

(1) $5,000,000, reduced by

(2) the amount of interest paid or incurred by such corporation during such year on obligations (A) issued after December 31, 1967, to provide consideration for an acquisition described in paragraph (1) of subsection (b), but (B) which are not corporate acquisition indebtedness.\textsuperscript{105}

\textsuperscript{103} Senate Version \textsection{} 279(c)(3) defines "projected earnings" as follows:

(A) The term "projected earnings" means the "average annual earnings" (as defined in subparagraph (B)) of —

(i) the issuing corporation only, if clause (ii) does not apply, or . . .

acquired corporation, in any case where the issuing corporation has acquired control (as defined in section 368(c)), or has acquired substantially all of the properties, of the acquired corporation.

(B) The average annual earnings referred to in subparagraph (A) is, for any corporation, the amount of its earnings and profits for any 3-year period ending with the last day of a taxable year of the issuing corporation described in paragraph (1), computed without reduction for —

(i) interest paid or incurred,

(ii) liability for tax under this chapter, and

(iii) distributions to which section 301(c)(1) applies (other than such distributions from the acquired to the issuing corporation), and reduced to an annual average for such 3-year period pursuant to regulations prescribed by the Secretary or his delegate. Such regulations shall include rules for cases where any corporation was not in existence for all of such 3-year period or such period includes only a portion of a taxable year of any corporation.

The House and Senate versions of section 279(c)(3) are substantially the same. The Senate version of section 279(b)(4)(B) provided for two times interest coverage; the House, three times interest coverage. The Section of Taxation, American Bar Association, suggests that extraordinary gains and losses be excluded from the earnings. ABA Report at 59. As to the right to include the earnings of affiliates, the Section of Taxations report states:

In the case of acquisition of less than "control" of a corporation as defined in section 368(c), the acquired corporation's earnings under section 279(c)(3)(A) are not considered in testing interest coverage. The control definition of section 368(c) is unduly restrictive, since the required ownership of 80 percent of each class of non-voting preferred stock is hardly relevant to the acquiring corporation's access to the acquired corporation's earnings. Substitution of a control test which excludes non-voting preferred stock would be preferable and would be consistent with section 279(g). Moreover, for accounting purposes, corporations customarily consolidate earnings of 50 percent-owned subsidiaries; and development of an allocation formula to permit inclusion of a proper share of earnings and interest in such cases might prevent some unfair results. Since future interest is to be measured against past earnings, the latter should be as inclusive as possible.

\textsuperscript{104} Tax Reform Act \textsection{} 279(c)(4) defines annual interest as that paid by the issuer, but if affiliate earnings are counted in the interest coverage test, then the interest payable by both the issuer and acquired corporation are included.

\textsuperscript{105} Id. \textsection{} 279(a). The Senate version added the date "December 31, 1967"; see House Version \textsection{} 279(a).
Subsection (2), in simpler terms, reduces the $5 million interest allowance by the amount of interest paid by the issuer on obligations which are issued in connection with acquisitions but which, for one reason or another, are not technically includible as "Corporate Acquisition Indebtedness," as for example, debentures which are not convertible, but only post December 31, 1967 indebtedness will be considered.108

Referring now to each of the characteristics of "Corporate Acquisition Indebtedness," the first criterion is the issuance of debt instruments "to provide consideration for . . ." the acquisition of stock or assets. The problem with this approach was stated by the American Bar Association's Section of Taxation, in commenting on the House proposal as follows:

The definition of corporate acquisition indebtedness in section 279 (b)(1) to mean an obligation "issued to provide consideration for" an acquisition is apparently intended to include securities issued to obtain cash to finance cash acquisitions. The purpose of the borrowing appears to control and the determination of this purpose will give rise to numerous problems of application in situations where cash acquisitions are made by corporations concurrently engaged in borrowing for various purposes:

a. Corporate borrowings are frequently made to raise cash for a number of purposes. The bill leaves it unclear whether the obligation will be acquisition indebtedness only if issued solely to provide consideration for a purchase; whether the principal purpose will determine the status of the entire issue; whether the entire issue will be tainted if any portion is to provide such consideration; or whether the issue will be fragmented and only the portion issued to provide consideration will be acquisition indebtedness.

b. The exact uses of borrowed funds and the amounts to be required for each use are frequently not known at the time the obligation is issued. In such a case, it is difficult to see how the necessary determination could be made, unless there is authority to make it retrospectively by reference to the actual use of funds.

c. Funds may be borrowed for one purpose and used for another. Thus, due to a change of plans, funds borrowed for plant expansion or working capital may be used for an acquisition or vice versa. Is the original purpose or the ultimate use controlling?

d. Obligations whose proceeds are used for other corporate purposes may free internally generated cash for acquisitions. Should these be deemed to have provided such consideration and, if so, will the statute permit it?107

The Senate Report indicates that the "two-thirds" of assets test was expanded over the House version by including only assets used in a trade or business in order to "prevent this test from being avoided where a large proportion of the assets of the acquired company consists of cash or non-operating properties. . . ."108 Banks and lending or finance companies will

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106 S. REP. 552, at 141-42.
107 ABA REPORT at 57-58.
108 S. REP. 552, at 139. As to the meaning of "substantially all," see Rev. Proc. 34, 1966-2 CUM. BULL. 1232.
have their own tests.\textsuperscript{108} The Senate Report also states that an asset used in the business retains its business status although temporarily not used.\textsuperscript{110} Although a de minimis exception is provided in section 279(d)(5) [less than 5 percent], no relief is provided in a situation where a giant acquires say 25 percent of a small supplier using, for example, less than 1 percent of a large issue floated for plant expansion.

The Senate expanded the subordination test to include not only trade creditors but also subordination in payment "to the payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued. . . ."\textsuperscript{111} What "substantial" means is a guess, but presumably, subsequent public offerings of debt instruments which have a superior position will infect existing issues. Note that only "unsecured" debt is involved so mortgages and the like are excepted. An obligation is "expressly" subordinated if so agreed as to principal or interest, but subordination by operation of law, \textit{e.g.}, bankruptcy, is not considered.\textsuperscript{112}

With respect to stock acquisitions, three exceptions are provided: (1) the acquisition of the stock of a foreign corporation is not covered if substantially all of the income of such foreign corporation for the three years prior to its acquisition was from foreign sources;\textsuperscript{113} (2) the tax-deferred acquisition of the stock of a newly formed and controlled (section 386(c)) subsidiary of the issuer or of the stock of an existing 80 percent or more owned subsidiary,\textsuperscript{114} and (3) the acquisition of less than 5 percent of the stock of the acquired corporation (here the test is voting power).\textsuperscript{115}

The other operating rules are as follows:

(1) If the indebtedness involved qualifies as "Corporate Acquisition Indebtedness," the interest disallowance starts with the first taxable year of the issuer as of the last day of which the debt-equity or annual interest coverage test is satisfied.\textsuperscript{116}

(2) With limited exceptions, once the indebtedness qualifies, the interest deduction is disallowed for each succeeding year.\textsuperscript{117}

(3) However, where the issuer acquires 80 percent control of the ac-

\begin{footnotesize}

\textsuperscript{108} Tax Reform Act § 279(c)(5). This exception was added by the Senate.
\textsuperscript{110} S. REP. 552, at 139. \textit{Cf.} Penton v. United States, 259 F.2d 536 (6th Cir. 1958).
\textsuperscript{111} Tax Reform Act § 279(b)(2)(B).
\textsuperscript{112} S. REP. 552, at 139-40.
\textsuperscript{113} Tax Reform Act § 279(f); S. REP. 552, at 143. What is substantial?
\textsuperscript{114} Tax Reform Act § 279(e); S. REP. 552, at 143.
\textsuperscript{115} Tax Reform Act § 279(d)(5); S. REP. 552, at 143. This provision was inserted by the Senate. \textit{Cf.} the ABA's Section of Taxation, commenting on the absence of this exemption in the House version:

The provisions of section 279(b)(1) apparently would apply regardless of how few shares are acquired. Recognizing that ownership of a relatively small percentage of stock may represent effective control, it may nevertheless be desirable to exempt purchases for investment by adding a minimum percentage ownership test, say 5 or 10 percent.

ABA REPORT at 58.
\textsuperscript{116} Tax Reform Act § 279(d)(1); S. REP. 552, at 142.
\textsuperscript{117} Tax Reform Act § 279(d)(2); S. REP. 552, at 142.
\end{footnotesize}
quired corporation or acquires substantially all of the assets of such corporation, and,

as a result, by applying the debt-equity or annual interest coverage test as of the end of the year in which control, or the properties, are acquired and by taking the annual interest expense and projected earnings of both corporations into account for purposes of the annual interest coverage alternative of the test, the limits provided in the test are no longer exceeded, then the interest deduction is to be allowed for the taxable year and subsequent taxable years.\textsuperscript{118}

(4) If the issuer satisfies the debt-equity ratio and the interest coverage tests for each of three consecutive years, then the disallowance of interest rule ceases to apply with respect to previously issued obligations of the corporation commencing with the first taxable year after the three-year period.\textsuperscript{119}

(5) Where the issuer is a member of an affiliated group (as provided in section 1504), section 279 is applied by treating all members of the group as a single issuer, but the acquired corporation is not treated as a member for this purpose unless it would have been a member on the date of acquisition.\textsuperscript{120}

(6) The extension, renewal, or refinancing of an existing obligation is not considered the issuance of a new obligation — the taint continues even if the "Corporate Acquisition Indebtedness" is extended, renewed or refinanced.\textsuperscript{121} The taint lingers even if the indebtedness is assumed by another corporation or if another corporation undertakes to guarantee, endorse, or indemnify with respect to the indebtedness.\textsuperscript{122}

(7) Section 279 applies with respect to indebtedness issued after October 9, 1969, except as to: (a) obligations issued for acquisitions pursuant to a binding contract in effect on October 9, 1969,\textsuperscript{123} or (b) obligations issued to acquire stock to gain 80 percent control if on October 9, 1969, the issuer had at least a 50 percent voting interest in the acquired corporation.\textsuperscript{124} This exception, however, applies only with respect to the 80 percent or less — the difference between the 50 percent or more owned and 80 percent control necessary to obtain control. If obligations are issued to acquire more stock than necessary to gain 80 percent control, only the proportionate part of the obligations related to the acquisition of that part of the stock acquired which is necessary to provide control is excepted.\textsuperscript{125}

\textsuperscript{118} S. REP. 552, at 142; Tax Reform Act § 279(d)(3).
\textsuperscript{119} Tax Reform Act § 279(d)(4); S. REP. 552, at 142-43. This exception was inserted by the Senate.
\textsuperscript{120} Tax Reform Act § 279(g); S. REP. 552, at 143. I.R.C. § 1504(a) applies but not I.R.C. § 1504(b).
\textsuperscript{121} Tax Reform Act § 279(h)(1); S. REP. 552, at 143.
\textsuperscript{122} Tax Reform Act § 279(h)(2).
\textsuperscript{123} Tax Reform Act § 279(i)(1); S. REP. 552, at 143-44. The effective date was changed by the Senate. This exception was also added by the Senate.
\textsuperscript{124} Tax Reform Act § 279(i)(2).
\textsuperscript{125} Tax Reform Act § 279(i)(2).
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Finally, section 279 is to provide no inference as to whether any obligation which the issuer labels debt is, in fact, debt or equity. The Senate, however, carried forward with section 385, mentioned previously, which provides the guidelines not only for "Corporate Acquisition Indebtedness" but for general application under the Code. Even so it is debatable whether section 385, which has problems of its own, satisfies the Section of Taxation.

Section 411 cannot be justified as an attempt to re-define the distinction between debt and equity for tax purposes because of its failure to deal comprehensively with this subject. Its application is restricted not only by the $5,000,000 allowance but also by its confinement to "corporate acquisition indebtedness"; there is no apparent tax policy justification for distinguishing between such indebtedness and debt issued for other purposes. Moreover, the debt-equity distinction is applied only to the deductibility of interest. There is no attempt to deal with the other situations in which the distinction is relevant, such as the relative consequences of a retirement of debt or equity or receipt of securities or stock in a merger, eligibility of payments for the intercorporate dividend deduction, the individual dividend exclusion, and the like.

In spite of its limited coverage, the provision may have unfortunate and unpredictable collateral effects on the state of the tax law as to the distinction between debt and equity. The principles applied in distinguishing debt and equity for these purposes have been developed and refined over the years in a long series of court decisions. Some of these principles are at variance with the standards established in section 279. While the section itself, as well as the House report, part I, p. 107, states that no inference is to be drawn from the provision as to the nature of any instrument for the purpose of any other provision of tax law, the possibility that those charged with administration of the tax laws, as well as the courts, may be influenced by these standards cannot be ignored. It is submitted that the tests of section 279 would not afford a suitable statutory definition of indebtedness for all purposes.126

B. Installment Election

The second feature, previously mentioned, making convertible debentures attractive to the seller is his ability to elect the installment method of reporting gain on the sale of stock, so as to incur a tax liability only when the debentures are sold or mature.127 But even disregarding, for the moment, section 412 of the Reform Act, the use of convertible debt has problems, vis-à-vis the installment method. For example, a debenture usually pays out in one installment — at maturity. In Revenue Ruling 69-462128 the taxpayer sold real estate in exchange for the buyer's negotiable promissory note payable in a lump sum 10 years from the date of sale. The IRS ruled that "[t]he installment method of reporting income is applicable only to those sales of real property that, by their terms and conditions, provide for two or more payments of portions of the purchase price in two or more tax-

126 ABA REPORT at 56-57; Tax Reform Act § 279 (j).
127 Brown & Buchholz, supra note 2, at 659. See also Thrower, supra note 72, at 7.
Another problem is whether the conversion feature must be separately valued to determine whether the 30 percent limit in the year of sale is exceeded. From one point of view, it does not seem so because the regulations issued under section 1232 do not require a separate allocation and section 413 of the Tax Reform Act of 1969 does not change this result. Nevertheless, the Service, in treating amortization of premiums with regard to convertible bonds, finds no difficulty in attributing value to the conversion feature.

Whatever the correct view, the issue is largely mooted by section 412 of the Reform Act. Section 412 amends section 453(b) to provide that indebtedness payable on demand or issued with interest coupons attached, in registered form or in any form which makes the instrument readily tradeable in established markets, is not to be treated as an "evidence of indebtedness." Under section 453(b)(2) if the debt instrument is not so regarded the value of the bond must be included in determining whether the payment in the year of sale exceeds 30 percent of the selling price. And, of course, loss of the right to report on the installment method means that the holder must report the full amount of gain inherent in the transaction in the year that the taxable exchange is made.

According to the Senate Report,

[b]onds or debentures are to be considered designed to be readily tradeable if steps necessary to create a market for the security are taken at the time of issuance (or later, if taken pursuant to an agreement or understanding which existed at the time of issuance) or if the bonds or debentures are part of an issue which will normally be traded through brokers dealing in corporate or government securities.

Three types of bonds are within the purview of the proposed section: those with interest coupons attached, in registered form, or in any form designed to make the bonds readily tradeable. A debt instrument is considered in registered form if it is issued in a series under a trust indenture and if it cannot be transferred without changing the ownership registration on the registration books of the issuer. A bond or debenture which is

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129 Id. at 16. The ruling, if valid, would apply to the convertible debenture situation since I.R.C. § 453(b) covering sales of realty applies as well to casual sales of personalty.

130 Treas. Reg. § 1.1232-3(b)(2)(i).

131 Id. § 1.171-2(c). But see Appert, Installment Reporting As a Substitute for a Tax-Free Reorganization, 22 TAX LAW. 187 (1968).


133 H.R. REP. 413, pt. 2, at 83.

134 S. REP. 552, at 145; see H.R. REP. 413, pt. 1, at 108.

135 Tax Reform Act § 453(b)(5)(A); House Version § 453(b)(4).

136 Id.

137 Tax Reform Act § 453(b)(5)(B); House Version § 453(b)(4).

138 S. REP. 552, at 145; see I.R.C. § 1232(a)(1).
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normally traded through brokers is readily tradeable in an established securities market.\textsuperscript{139}

Section 412 of the Reform Act\textsuperscript{140} provides that bonds in registered form which the taxpayer establishes are not readily tradeable in an established securities market are not to be treated as payments received in the year of sale, "since because of their lack of ready marketability they do not possess the characteristics which would render them essentially similar to cash."\textsuperscript{141} Finally, the Senate Report states: "The committee does not intend that ordinary promissory notes are to be included within the category of indebtedness which is treated as payments received in the year of sale, even though it is possible for these notes to be assigned by one party to another party."\textsuperscript{142}

The Senate approach, which ultimately prevailed, dropped the House requirement that payments of principal or principal and interest be made periodically over the installment period.\textsuperscript{143} The House proposal dictated either (1) payments required to be made at least every two years in relatively even or declining amounts over the installment period, or (2) at least 5 percent of the principal was required to have been paid by the end of the first quarter of the installment period, at least 15 percent of the principal paid by the end of the second quarter and at least 40 percent of the principal paid by the end of the third quarter of the installment period.\textsuperscript{144}

The ABA's Section of Taxation quarrelled with the House proposal in this regard\textsuperscript{145} but found no substantive objection to the provision con-
cerning readily marketable bonds which the House proposed (along with the periodic payments) and the Senate finally adopted.\textsuperscript{146}

Section 412(b) of the Tax Reform Act provides that the proposed amendment applies to sales or other dispositions occurring after May 27, 1969, which are not pursuant to a binding contract entered into on or before such date.

**TAX ATTRIBUTES OF CONVERSION**

Several of the tax attributes of the convertibility feature of debt securities were previously mentioned. For example, that part of the premium paid either by the purchaser of the bond\textsuperscript{147} or by the issuer repurchasing its bonds\textsuperscript{148} is not deductible as an ordinary expense. From the corporation's viewpoint, the price paid for the conversion feature "is similar to an amount paid in a capital transaction. In effect, the corporation is repurchasing the right to convert the bonds into common stock, much as it might purchase its stock."\textsuperscript{149} Presumably the holder of the bond has no separate basis in the conversion feature and measures gain or loss by his adjusted cost in the bond determined by the rules provided in section 1232.\textsuperscript{150}

The conversion of the bond into the stock of the issuing corporation, by long-standing rule, is not a taxable event.\textsuperscript{151} Gain is realized when the stock is subsequently sold;\textsuperscript{152} but the conversion into stock of a corporation in the transaction. (House report, part 1, p. 108). For example, if 20 percent of the purchase price is paid at the time of sale, 10 percent later in the year of sale and the remaining 70 percent in subsequent installments within 4 years of the sale, it is not clear what portion, if any, of the 70 percent must be paid by the first and second anniversary dates. The apparent purpose of the provision is to require regular payments on the total price, which would lead to giving credit for any down payment by making the entire selling price the base for the percentages.

\textsuperscript{146} "Adoption of proposed section 453(b)(4), disqualifying readily marketable corporate securities as installment obligations, would eliminate the only substantial problem which is believed to exist under present law." Id. at 60. But, the Section did comment: The phrase "readily tradable on an established securities market" in section 453(b)(4) will likely leave most taxpayers in considerable uncertainty as to what constitutes "an established securities market" and what conditions must exist before a security can be considered "readily tradable" on it. The House report sheds no light on the question. In view of the time which will doubtless elapse before regulations are promulgated, an explanation of what is meant by the phrase would be helpful.

\textsuperscript{147} Treas. Reg. § 1.171-2(c). If the bond is converted, any unamortized premium is lost, but the holder receives a basis in the stock equal to his remaining cost in the bond. Albert J. Ades, 38 T.C. 501 (1962), aff'd, 316 F.2d 734 (2d Cir. 1963) (per curiam).

\textsuperscript{148} Tax Reform Act § 249.

\textsuperscript{149} S. Rep. 552, at 149; H.R. Rep. 413, pt. 1, at 110-111.

\textsuperscript{150} Cf. I.R.C. § 1234.


different from the issuer of the bond is taxable. One aspect worth noting is that there is authority permitting the accrual and deduction of unpaid interest due on debt securities which are converted. But if the holder of the bond has elected the installment method of reporting gain on the exchange of his stock for the bond, exercising the conversion (as well as a sale or other disposition) is a disposition of the obligation and immediate gain or loss must be recognized.

This aside, the question is how the above rules and the treatment of bond rights (discussed supra) should be viewed in light of section 421 of the Reform Act which amends sections 301 and 305 of the Code.

Section 421 of the Tax Reform Act is deceptively simple in language; nightmarishly complex in its silence. The general rule stated in existing section 305(a) is that it makes no difference whether the stock distributed is common or preferred stock or whether the stock distributed relates to common or preferred stock, although preferred stock issued on common stock or common stock issued on preferred stock may be subject to section 306 taint. This rule is continued, but the exceptions provided in section 305(b) modify it considerably.

The first exception continues present law, and a stock dividend is taxable to the recipients if it is payable at the election of any shareholder in property or stock. This follows existing law as found in section 305(b)(2). Obviously, a right to elect to take convertible debt securities,

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153 The taxable portion is the difference between the fair market value of the stock received and the cost of the bond. I.T. 3056, 1937-1 Cum. Bull. 101, superseded by Rev. Rul. 195, 1969 Int. Rev. Bull. No. 12, at 17. Of course, the result may be different if the change is a part of a tax-deferred reorganization pursuant to I.R.C. § 368.


155 Appert, supra note 151, at 150-58.

156 House Version § 421. The House version's language differs from that found in existing section 305(a) by attempting to limit the general rule of section 305 to distributions on common stock only. The Senate version uses language closer to the general rule.


158 H.R. 13270, at § 421(a) proposed both the House and Senate versions; see Tax Reform Act § 305(b)(1).

159 The ABA Report, in commenting on the House version, made the following comments as to the applicability of the subsection to 306 stock:

Section 305(b)(1) continues the provision of present law that a stock dividend is taxable if it is payable at the election of any shareholder in property or stock. Thus, under existing law, a common shareholder who has an election to receive a dividend in either common stock or cash is currently taxable even though he elects to receive the common stock. Where the election is to receive either common stock or preferred stock, however, under present law the shareholder is not currently taxable since "property" does not include stock in the corporation making the distribution. (Section 317(a)). The preferred stock constitutes section 306 stock and has ordinary income potential upon ultimate disposition.

It is probable that the same result is intended under the bill, since actual distributions of section 306 stock on common stock are not generally taxable. However, the status of common stock received pursuant to such an election is unclear. The rule that a shareholder who has an election to receive either stock or property is currently taxable would be retained; but section 306 stock is treated for this purpose as property which is not stock. On the other hand, under section 306(c)(1)(A), stock is section 306 stock only if it is not includible in gross income by reason of section 305(a). Since includibility in income under section 305(a) is
generally treated as "property" under section 301, will trigger immediate taxation under section 305(b)(1). But recall that a bond right, a right to subscribe to convertible debentures, is treated as a stock right.\textsuperscript{160} Hence, for purposes of section 305(b)(1) there is in theory no choice, for either stock or stock rights are treated as stock. Under existing rules the distribution is tax free and the subsequent exercise of the bond rights is also tax-free. The holder, winding-up with a convertible debenture without immediate tax cost, can also exercise the bond rights without tax incident.

Acceding to the intent expressed both in the House and Senate Reports, the shareholder winds up with a bond—"property"—while retaining the election either to sell or convert to maintain his proportionate interest. The theory is that in an election situation "the stockholder who receives a stock dividend is in the same position as if he received a taxable cash dividend and purchased additional stock with the proceeds."\textsuperscript{161} Is the situation different where the corporation gives a choice between common stock and bond rights? The answer may lie in the second exception found in section 305(b)(2).

The Senate Report gives this explanation of the second exception:

The bill provides (in sec. 305(b)(2)) that if there is a distribution or

\begin{quote}
the point in issue, a circularity would exist, rendering it impossible to determine whether the preferred stock should be treated as property or stock.

This problem can be eliminated by amending the last sentence of section 305(a) to provide that section 306 stock shall be treated as property which is not stock only for purposes of subsection (b)(2).

In the situation described above, although the distribution would presumably not be taxable by reason of section 305(b)(1), if some of the shareholders elect to receive common stock while others elect to receive preferred stock, those electing to receive common stock would be currently taxable under section 305(b)(2) whereas those electing to receive preferred stock would not be currently taxable, but instead, assuming the problem referred to in paragraph 1 above is resolved as suggested, the preferred stock would constitute section 306 stock. It is unclear whether this is the result intended by the bill.

Under current law as well as under the bill, a stockholder who has an election to receive either cash or common stock would be currently taxable even though he elects to receive common stock. Moreover, under current law if a shareholder has an election to receive cash or preferred stock, he is currently taxable even though he elects to receive the preferred stock. Under the bill, however, it is unclear whether the shareholder would be currently taxable when he takes preferred stock because of the circularity referred to above. If the preferred stock constitutes section 306 stock, it would be treated as property which is not stock for purposes of section 305(b)(1). The shareholder would thus have an election to receive two types of property, neither of which would be treated as stock; and the section 305(b)(1) exception would be inapplicable. The test of taxability would, therefore, be under the general rule of section 305(a). Since section 306 stock is treated as property other than stock only for purposes of sections 305(b)(1) and (2), it would presumably still be stock for purposes of section 305(a) and the distribution would be nontaxable. This would appear to be an unintended result.

ABA REPORT at 63-64. The Senate version avoids the problem to a degree by deleting any reference to section 306 stock (House Version § 305(b)(5)) and adding subsections (b)(3), (b)(4), Senate Version §§ 305(b)(3), (b)(4).

\textsuperscript{160} See Tax Reform Act § 305(c)(1): "the term 'stock' includes rights to acquire such stock."

\textsuperscript{161} S. REP. 552, at 150.
series of distributions of stock which has the result of the receipt of cash or other property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation, the shareholders receiving stock are to be taxable (under sec. 301).

For example, if a corporation has two classes of common stock, one paying regular cash dividends and the other paying corresponding stock dividends (whether in common or preferred stock), the stock dividends are to be taxable.

On the other hand, if a corporation has a single class of common stock and a class of preferred stock which pays cash dividends and is not convertible, and it distributes a pro rata common stock dividend with respect to its common stock, the stock distribution is not taxable because the distribution does not have the result of increasing the proportionate interests of any of the stockholders.

In determining whether there is a disproportionate distribution, any security convertible into stock or any right to acquire stock is to be treated as outstanding stock. For example, if a corporation has common stock and convertible debentures outstanding, and it pays interest on the convertible debentures and stock dividends on the common stock, there is a disproportionate distribution, and the stock dividends are to be taxable (under section 301). In addition, in determining whether there is a disproportionate distribution with respect to a shareholder, each class of stock is to be considered separately.162

The criteria under section 305(b)(2) are: (1) the receipt of property by some shareholders, and (2) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. Again bond rights are not property but are in the nature of "stock rights" or stock for the purposes of section 305(b). Again, an election between stock and stock rights is involved.163 Still the test is whether some shareholders have changed their proportionate interest. The shareholders certainly have not, if the rights are exercised and the bonds converted because the existing shareholders will be diluted.

Of course, more alarming is that under the second proposal a corporation which has outstanding convertible debentures upon which it pays interest can never distribute a tax-free stock dividend. Original issue discount is not implied with respect to convertible debentures, and without more, no interest would be paid by the issuer until maturity. Presumably this will foster the birth of the non-interest bearing convertible debenture (a better conversion ratio to compensate for the lack of interest).164

Section 305(b)(3) provides that the shareholders are taxable on stock dividends where the distribution results in "the receipt of preferred stock by some common shareholders and the receipt of common stock by

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162 Id. at 152.
163 It is difficult to see how electing to purchase a bond increases the holder's interests in assets; he puts in money.
164 The Internal Revenue Service may take the view that discount is deemed paid even though not actually paid. See S. Rep. 552, at 152; Tax Reform Act § 305(b)(3). Cf. H.R. 13270, at § 413; S. Bill § 413.
other common shareholders . . ." All stock distributions with respect to preferred stock, under section 305(b)(4) are taxable except increases in the conversion ratio of convertible preferred stock made solely to take into account stock dividends or stock splits (no provision is made for capital changes, e.g., recapitalization, other than those listed) with respect to the stock into which the convertible stock is convertible. The final exception, found in section 305(b)(5), is that a distribution of convertible preferred stock is taxable unless it is established to the satisfaction of the IRS that it does not result in a disproportionate distribution as that term is used in section 305(b)(2).

The final provision, a "catch-all" clause, is found in section 305(c), which, for want of regulations, cannot be thoroughly analyzed. This subsection is designed to authorize the Commissioner to broaden the statutory exceptions by regulations. The examples used in the Senate Report are probably intended to be covered by section 305(b)(2). The Senate Report gives this explanation:

The bill provides (in sec. 305(c)) that under regulations prescribed by the Secretary or his delegate, a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption treated as a section 301 distribution, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder is to be treated as a distribution with respect to each shareholder whose proportionate interest is thereby increased. The purpose of this provision is to give the Secretary authority to deal with transactions that have the effect of distributions, but in which stock is not actually distributed.

The proportionate interest of a shareholder can be increased not only by the payment of a stock dividend not paid to other shareholders, but by such methods as increasing the ratio at which his stock, convertible securities, or rights to stock may be converted into other stock, by decreasing the ratio at which other stock, convertible securities, or rights to stock can be converted into stock of the class he owns, or by the periodic redemption of stock owned by other shareholders. It is not clear under present law to what extent increases of this kind would be considered

165 S. REP. 552, at 152. Tax Reform Act §§ 305(b)(3), (b)(4) are new to the Senate version. If bond rights are treated as in the nature of preferred stock, this exception would apply.

166 Id.

167 S. REP. 552, at 152-53 gives the following example:

For example, if a corporation makes a pro rata distribution on its common stock of preferred stock convertible into common stock at a price slightly higher than the market price of the common stock on the date of distribution, and the period during which the stock must be converted is 4 months, it is likely that a distribution would have the result of a disproportionate distribution. Those stockholders who wish to increase their interests in the corporation would convert their stock into common stock at the end of the 4-month period, and those stockholders who wish to receive cash would sell their stock or have it redeemed. On the other hand, if the stock were convertible for a period of 20 years from the date of issuance, there would be a likelihood that substantially all of the stock would be converted into common stock, and there would be no change in the proportionate interest of the common shareholders.
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distributions of stock or rights to stock. In order to eliminate uncertainty, the committee has authorized the Secretary or his delegate to prescribe regulations governing the extent to which such transactions shall be treated as taxable distributions.

For example, if a corporation has a single class of common stock which pays no dividends and a class of preferred stock which pays regular cash dividends, and which is convertible into the common stock at a conversion ratio that decreases each year to adjust for the payment of the cash dividends on the preferred stock, it is anticipated that the regulations will provide in appropriate circumstances that the holders of the common stock will be treated as receiving stock in a disproportionate distribution (under sec. 305(b)(2)).

It is anticipated that the regulations will establish rules for determining when and to what extent the automatic increase in proportionate interest accruing to stockholders as a result of redemptions under a periodic redemption plan are to be treated as taxable distributions. A periodic redemption plan may exist, for example, where a corporation agrees to redeem a small percentage of each common shareholder's stock annually at the election of the shareholder. The shareholders whose stock is redeemed receive cash, and the shareholders whose stock is not redeemed receive an automatic increase in their proportionate interests. However, the committee does not intend that this regulatory authority is to be used to bring isolated redemptions of stock under the disproportionate distribution rule (of sec. 305(b)(2)). For example, a 30 percent stockholder would not be treated as receiving a constructive dividend because a 70 percent stockholder causes a corporation to redeem 15 percent of its stock from him.

The provision giving the Secretary authority to treat certain transactions as distributions (sec. 305(c)) also applies to distributions on preferred stock. For example, assume that a corporation issues preferred stock convertible into its common stock, and that the preferred stock pays no cash dividends, but the ratio at which it may be converted into common stock increases annually by a specified percentage. It is anticipated that the regulations will provide that the change in conversion ratio in such a case constitutes a taxable distribution of a right to acquire stock. Similarly, a corporation may issue preferred stock which pays no cash dividends, but which may be redeemed after a specified period of time at a price higher than the issue price. It is anticipated that, unless the increase is a reasonable call premium, it will be treated under the regulations as constructively received by the stockholder over the period during which the preferred stock cannot be called for redemption.

It is anticipated that the regulations will provide that if preferred stockholders are given stock in a recapitalization, or an increase in proportionate interest by means of a constructive distribution, as payment of current dividends or dividend arrearages, sec. 305(b)(4) is to apply whether or not the recapitalization or other transaction is an isolated transaction. Thus, if in a recapitalization preferred stockholders are given additional preferred stock in satisfaction of several years dividend arrearages, the distribution of the additional stock will be taxable (under sec. 301).168

168 Id. at 153-54. The comment in the Senate Report was presumably prompted by comments earlier addressed to H.R. 13270 appearing in ABA REPORT at 62, 63.

The Secretary would be given broad authority under sections 305(b)(2) and 305(c) to determine whether various events have the effect of making certain
It remains to be seen if bond rights will be attacked under this provision. Of course, it is under this provision that any tampering with the conversion feature of convertible debt securities will be caught. For example, even if non-interest bearing convertible debentures are used, any stock paid with regard to common stock may be taxable if the conversion ratio of the debentures changes.

Finally, the effective dates provided are complex and reference should be made to the statute for the respective governing dates.169

USE OF WARRANTS

The attraction of warrants has been succinctly stated as follows:

Acquisition-minded corporations have taken a fancy to stock purchase warrants as a useful tool in take-over efforts. Such conglomerates as AMK, National General, Ling-Temco-Vought, Fuqua and Gulf & Western found ways to include these instruments in recent and proposed acquisitions. Another acquisition-active company—Leasco Data Processing— took the same route, issuing nearly 2.8 million warrants in its acquisition of Reliance Insurance Co.

GWI utilized warrants in three 1968 transactions. The conglomerate issued 1.1 million warrants in connection with its acquisition of Consolidated Cigar, and an additional 4.2 million of these options were disbursed as part of the payment under tender offers for stock of Allis-Chalmers and The Brown Co.

When National General moved to acquire additional outstanding shares of Great American Holding Company (it already had been tendered 75 percent of the insurance holding company's stock) it offered a new warrant exercisable at $40 through 1978. It was indicated that at least 6.5 million of these new warrants would be used as part payment for the purchase of the minority stock holdings outstanding.

Why warrants? Conglomerates have found two pluses in including warrants in the package of goodies they dangle in front of shareholders of corporations they are wooing. While a new warrant issue creates a stock distributions taxable. For example, a redemption which is treated as a section 301 distribution may be determined by the Secretary to give rise also to a constructive distribution to any shareholder whose proportionate interest in the earnings and profits or the assets of the corporation is thereby increased. The House report, part 1, p. 114, gives as an example a periodic redemption plan under which each shareholder may annually elect whether to have a small percentage of his stock redeemed. But, the broad language of the statute might permit the Secretary to go much further than an across-the-board election and to determine, for example, that a 40 percent stockholder of a corporation receives a constructive distribution when a 60 percent stockholder causes the corporation to redeem 10 percent of its stock from him. Similarly, under the broad language the Secretary arguably could visit dividend taxation on the continuing shareholders in the case of a non-pro rata spin-off or of an “A” type reorganization wherein some shareholders take stock and others cash. The breadth of his authority and the lack of any standard to guide him or by which to determine the propriety of his action will produce undue uncertainty and risk of administrative overreaching in an area of wide significance to many taxpayers. Moreover the issuance of regulations under such a complex provision of a major revenue revision is frequently long delayed. During this period, it is usually not possible to obtain rulings on proposed transactions. These considerations make it undesirable to give the Secretary such broad regulatory authority.

169 S. BILL § 421(b); H.R. 13270, at § 421(c).
security with tangible value, it poses no threat of immediate dilution of
the common. In the case of a new issue, the warrant holder isn’t likely
to quickly exercise his option because it usually will be some time before
it becomes profitable to do so. Purchasers of existing warrants aren’t likely
to exercise quickly either, since their purpose in the first place was to
obtain a less expensive means of participating in the related common.

Then too, the warrant involves no dividend payments. Thus, by using
these options as part of a package in a tender offer, the conglomerate can
offer the takeover target a corresponding smaller portion of convertible
bonds, convertible preferreds or common, thereby reducing the amount of
additional interest or dividend payments it will face after the acquisi-
tion.170

Again, however, warrants have attracted considerable criticism:

The New York Stock Exchange has two studies under way on so-called
“funny money” securities issued by listed concerns in connection with
mergers and acquisitions, Robert W. Haack, Big Board president, said in
a speech here.

One survey involves long-term warrants to purchase common stock,
while the other concerns listing standards for bonds and debentures, he
told a conference of the American Society of Corporate Secretaries.

On warrants, Mr. Haack said the question is, at what point isn’t a
company’s stock any longer suitable for listing because of the dilution that
would occur if the warrants were to be exercised? There are cases where
prospective dilution of common can be measured at up to 400%, he said.
Mr. Haack added: “In other words, at what point would such warrants rep-
resent a serious threat of relegating the outstanding common stock to such
a minority status that it would no longer be representative of the
company?”

The Big Board chief said a possible solution might be to require a
company’s current stockholders to vote on any issue of warrants that would
bring total warrants outstanding to a point where they would outnumber
the total shares of common outstanding.

The Big Board has a long-standing ban on trading of warrants on its
board. However, warrants of some Big Board-listed concerns are traded on
other exchanges, including the American Stock Exchange.171

ISSUANCE, ACQUISITION AND DISPOSITION OF WARRANTS

Generally speaking the distribution of warrants to shareholders to
purchase stock in the issuing corporation is tax-free.172 If Palmer v. Com-

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170 Window on Wall Street, 4 Mergers & Acquisitions 32, 33 (1969). For a lengthy
discussion of the use of warrants in acquisitions, see Wall Street Journal, May 5, 1969, at
1, col. 6.

171 Wall Street Journal, June 18, 1969, at 6, cols. 1-2. See also id., May 6, 1969, at 17,
col. 1; id., Feb. 24, 1969, at 6, col. 2; id., July 7, 1969, at 26, col. 4. For examples of warrant
offerings, see id., July 23, 1969, at 4, col. 2; Prospectus, City Investing Mortgage Group,
Oct. 30, 1969; Prospectus, Missouri Utilities Co., July 28, 1969; Prospectus, Delmar Power

172 I.R.C. § 305(a). This must be qualified by the two situations mentioned in the
present section 305(b) — arrearages and choice of property or stock — and those suggested
in S. Bill § 421 and H.R. 13270, at § 421. For the effect of distributing warrants on the
earnings and profits of the corporation, see Treas. Reg. §§ 1.312-1(d),11(b). For holding
is still good law, the distribution of warrants to buy stock of a corporation other than the distributing company is also tax-free; the tax incident, if any, being the exercise of the warrant. The exercise of warrants distributed on a tax-free basis under section 305(a) is not a taxable event. If, of course, the stock dividend falls under section 305(b), then the tax incident was the distribution and the exercise became irrelevant for this purpose. Apparently the lapse of a tax-free warrant results in no gain or loss, but presumably the expiration of taxable warrants should give rise to a capital loss. The sale of a tax-free warrant would be treated in the manner of any stock sale; the sale of a warrant held tax-free upon receipt under Palmer would presumably give rise to ordinary income, but a right taxable under section 305(b) would seemingly give rise to a capital gain or loss upon subsequent sale.

If tax-free warrants are exercised, the basis of the stock acquired is the allocated basis of the warrants plus the subscription price paid. If a warrant, taxable upon distribution, is exercised, the basis of the stock received is the subscription price plus the basis of the warrants (already taxed to the shareholder) at the time of exercise. If the warrant, tax-free upon distribution under Palmer, but taxable upon exercise, is exercised, the basis of the stock is the subscription price plus the fair market value of the warrants (taxed upon exercise) at the time of exercise.

While the immediately preceding discussion states the apparent tax results in issuing and disposing of warrants, in point of fact the rules are vague. One problem has always been whether section 305 of the Internal Revenue Code, as enacted in 1954, really affected the Palmer approach. The area is even more unsettled with the enactment of the amendments to section 305 (section 421 of the Reform Act). Most certainly, rights to subscribe to the stock of another corporation other than the issuer is "property" whether it is immediately taxed, and this certainly will have an effect on the proportionate position of shareholders in assets of the issuer. Presumably, therefore, the Service will reach a distribution of Palmer rights to one class.
of shareholders, and stock or rights in the issuer to another class. Still, the area remains confused, suggesting that the subject is in need of further clarification.

If the warrants are purchased, no tax incident is involved and the basis of the warrant is its cost.183 If the warrant is an element of an investment unit, a “package,” then several tax results follow: (1) if the package is of stock and warrants, the basis of the respective elements must be allocated according to relative fair market values;184 (2) if the package is a debt instrument plus warrants, then original issue discount may be involved185 and if so, the basis of the warrants is the excess of the issue price of the package over the portion allocated to debt.186

Turning to the discount issue, section 413 of the Reform Act requires the holder to include the discount as income on a periodic basis. Nevertheless, in determining the discount to be reported, it codifies the concept of finding discount.187 The formula, following that of the regulations,188 is:

Such issue price attributable to each element of the investment unit shall be that portion thereof which the fair market value of such element bears to the total fair market value of all the elements in the investment unit.

The issue price of the bond or other evidence of indebtedness included in such investment unit shall be the portion so allocated to it.189

Warrants are specifically mentioned for this purpose in the legislative history.190

USE OF WARRANTS IN ACQUISITIONS

It is now well established that warrants are not “stock” for the purpose of the reorganization provisions of the Code;191 they are merely boot in the exchange.192 An acquisition contemplating the generous use of warrants is not feasible if a tax-deferred result is sought.193 A tender of warrants to the

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183 I.R.C. § 1012.
184 Cf. Collin v. Commissioner, 32 F.2d 753 (6th Cir. 1929).
185 Treas. Reg. § 1.1232-3(b)(2)(ii).
186 Id. §§ 1.1232-3(c), 1.1012-1(d). But see Tax Reform Act § 1232(a)(3)(F) which indicates that as discount is returned as income, it increases the taxpayer’s basis in the bond. For a discussion, see Rosen, Final Regulations on options given lenders answer many long-standing questions, 31 J. Tax. 2, 3 (1969).
187 S. BILL § 415(b); H.R. 13270, at § 415(b). Tax Reform Act § 1232(b)(2).
188 Treas. Reg. § 1.1232-3(b)(2)(ii).
189 Tax Reform Act § 1232(b)(2).
190 S. REP. 552, at 148.
193 The presence of boot may destroy a “B” reorganization. (I.R.C. § 368(a)(1)(B)).
194 The warrants would be boot in an “A,” “C” or “D” reorganization. The use of warrants without stock would not qualify as a reorganization. Presumably an exchange of stock for warrants to acquire stock in the same corporation would be taxable, cf. Rev. Rul. 65,
shareholders in exchange for the stock of the corporation to be acquired is a taxable transaction. An offer to exchange debt securities plus warrants for stock of the corporation to be acquired is likewise a taxable transaction to the exchanging shareholders.

Naturally, inventive counsel have sought ways and means of achieving the tax-deferred result usually desired by the selling stockholder while retaining for the corporation the benefits of the warrants. It is understood that the IRS has ruled favorably upon the following transactions. The basic transaction was a stock for assets exchange provided by section 368(a)(1)(C). The acquiring corporation proposed to acquire substantially all of the assets of the transferor corporation in exchange for shares of series C convertible preferred stock and $1.25 series D convertible preferred. The series C convertible preferred stock possessed these characteristics: (1) a dividend rate of $0.05 per year cumulative, (2) one-half vote per share, (3) the right to convert into one share of common stock of the acquiring corporation upon payment of $37.00 or surrender of fifteen additional shares of series C stock, if converted during the ten-year period beginning six months after issuance, and (4) the right to convert after ten years into one share of common only upon the surrender of 15 additional shares of series C stock.

Admittedly the IRS had no leeway; the series C stock had stock attributes, as per the headnote:

A share of stock is one of the proportionate integers or units of the capital stock, and is the interest or right which the owner or holder thereof has in the management of the corporation and to share in the profits thereof.

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1954-1 Cum. Bull. 101; warrants would be boot if stock was exchanged for stock and warrants. See Treas. Reg. § 1.1036-1(b).

194 I.R.C. § 1031(a). This assumes that the warrants are not part of a stock exchange which would be tax-deferred as a reorganization with the warrants as boot. The transaction would presumably be tax-free to the corporation, section 1032, assuming that for this purpose at least the warrants qualified as stock.


If a company issues bonds to owners of a company it buys, it incurs debt on which it must pay interest. If it issues stock, it dilutes the ownership interest of its old shareholders. But if it issues warrants, it gives the recipients nothing except a chance to benefit from future increases in the price of its stock (a warrant to buy Speculative Industries at $15 will be highly valuable if the price rises to, say, $30). Eventually, of course, the acquiring company may have to issue new stock to people who exercise their warrants, but that day may be long postponed.

Security experts don't know of any company that has bought another by issuing warrants alone. But it has become commonplace for an acquiring company to pay for the company it buys by issuing a package of securities including some bonds, some stock and a batch of warrants. Loew's Inc., for instance, included 6,477,357 warrants in the securities package it successfully offered recently to shareholders of P. Lorillard Co., the cigar maker. Each warrant entitled the recipient to buy one share of Loew's at prices ranging from $35 to $10 a share until late 1980 (Loew's common closed Friday at $47).

"Warrants are a valuable acquisition tool that enables a merger-minded company to sweeten the package given to shareholders of a new subsidiary without giving away too much equity (stock) at once," comments Jacob Stillman, Loew's treasurer.
and in the property and assets thereof on dissolution, after the payment of the corporate debts and obligations.\textsuperscript{197}

The same text defines "Options, rights and warrants to subscribe to stock," as:

An option is but a continuing offer; and, when the offer is accepted, it is merged in the contract which results. The term "warrant" may broadly include a "right to subscribe" to the capital stock of a corporation at a fixed price either for a limited period or perpetually.\textsuperscript{198}

Yet to be practical the series C stock was a voting warrant.\textsuperscript{199} Nevertheless, treatment as "stock" allowed it to be qualified consideration for a tax-deferred reorganization, in this case a type "C" which requires voting stock.

The question remains on how far the IRS will permit this approach to be stretched. No doubt counsel who follow will push it to the extremes,\textsuperscript{200} but it is doubtful that the Service has much tolerance for this approach.

\textsuperscript{197} 11 W. \textsc{Fletcher}, \textit{Private Corporations} § 5083, at 36 (perm ed. rev. repl. 1958).

\textsuperscript{198} \textit{id.} § 1370, at 28 (perm. ed. rev. repl. 1965).

\textsuperscript{199} One national accounting firm suggests that the market place treats the series C stock as warrants.

Investment bankers in valuing warrants of this type use a rule of thumb — 40 percent of exercise price less 50 percent of difference between that and the market price. In this case the exercise price is $37.00 and market price of the stock is $24.00. Therefore, $14.80 (40 percent of $37.00) less $6.50 (50 percent of $37-$24) = $8.00 (rounded). The warrant has been trading between $7.00 and $7.50 and, therefore, it is apparent that the market considers this security to be a warrant.

The valuation of warrants from the investor's viewpoint is explained in the Wall Street Journal, May 5, 1969, at 1, col. 6, as follows:

Warrants intrigue investors for another reason: They offer dramatic "leverage." That is, their price tends to fluctuate by much greater percentages than the price of the stock they can be used to buy, raising the possibility of a big profit — or a big loss. A hypothetical example illustrates the workings of warrants:

At a time when the stock of XYZ Corp. is selling for $10 a share, it issues 10-year warrants with an exercise price of $12 (exercise prices are commonly set 20\% to 30\% above market prices). But by the time trading starts in the warrants, the price of XYZ stock rises to $14.

The first warrants to trade, therefore, sell for $4 each. Half that price represents the immediate profit a warrant holder can make buying XYZ stock for $12 and selling it for $14. The other $2 of the warrant price is a "premium," a variable amount paid for the chance XYZ stock will go much higher before the warrants expire.

Some months later, XYZ stock rises to $24 a share. The warrant price jumps to $14 — the $2 premium plus the $12 profit a warrant holder can now make exercising his option to buy XYZ stock at $12. Though stock and warrant have risen by $10 each, the warrant price started much lower so its percentage rise has been much greater; 10 shares of XYZ stock bought initially for $140 are now worth $240, but 35 warrants bought (at the initial price of $4 each) for $140 are worth $490.

\textsuperscript{200} Recall the Citizens Utilities Co. situation with regard to stock dividends. \textit{See 2 Research Institute America, Tax Coordinator} F-1406, at 22,049.