

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date: April 8, 1999

Legend:

Taxpayer =

Lessor Company =

Lessee Company =

Date 1 =

Date 2 =

Date 3 =

Class 1 Stock =

Class 2 Stock =

A =

B =

Dear Sir or Madam:

This responds to a letter of July 7, 1998, submitted on your behalf by your authorized representatives requesting rulings (1) that Taxpayer's receipt from Lessee Company of a warrant to purchase Lessee Company Class 2 stock was a closed transaction, rather than an open transaction, and (2) that Taxpayer did not receive rental income at the time of its exercise of the warrant when the fair market value of the Lessee Company Class 2 stock acquired exceeded the price paid for the stock. Although the second ruling requested concerns the receipt of rental income, we have expanded the scope of our reply by considering whether Taxpayer recognized income of any kind as a result of its exercise of the warrant.

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ISSUES

(1) Was Taxpayer's receipt from Lessee Company of a warrant to purchase Lessee Company Class 2 stock a closed transaction or an open transaction?

(2) Did Taxpayer recognize income when it exercised the warrant because the then fair market value of the Lessee Company Class 2 stock acquired on exercise exceeded the price paid for the stock?

CONCLUSIONS

(1) Taxpayer's receipt from Lessee Company of a warrant to purchase Lessee Company Class 2 stock was a closed transaction.

(2) Taxpayer did not recognize income when it exercised the warrant even though the then fair market value of the acquired Lessee Company Class 2 stock exceeded the warrant's exercise price.

FACTS

Taxpayer represents that it is a venture capital fund the primary purposes of which are to provide lease financing to, and purchase equity interests in, emerging growth companies. Taxpayer represents that Lessor Company assists Taxpayer in these activities and that the transactions in which it and Lessor Company together participate are generally structured as follows:

Lessor Company enters into an agreement with a company (the "lessee") that Taxpayer and Lessor Company believe is an emerging growth company. Pursuant to the agreement, Lessor Company becomes obligated to lease property having a specified value to the lessee. Lessor Company's obligations under the agreement are then assigned to and assumed by Taxpayer. Taxpayer receives, purportedly in exchange for a stated cash consideration, a warrant from the lessee entitling it to purchase stock in the lessee. Taxpayer may also invest in subsequent private equity offerings by the lessee.

Taxpayer represents that it engages in these activities in order to earn yields that exceed average lease yields.

Taxpayer represents that Lessor Company and Lessee Company, a company unrelated to either Taxpayer or Lessor Company, entered into a term sheet on Date 1 pursuant to which Lessor Company offered to provide to Lessee Company lease financing for tangible personal property having a value of up to \$A. The term sheet also stated that as an incentive to Lessor Company "to enter into the lease agreement,"

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Lessee Company would grant to Lessor Company a warrant to purchase a specified number of shares of Lessee Company's Class 1 stock at its initial offering price. The term sheet also provided that if the amount of financing provided to Lessee Company by Lessor Company exceeded a specified amount that was less than \$A, the number of shares of Class 1 stock that could be purchased at that price under the warrant would increase proportionately up to a specified maximum amount.

Approximately 2.5 months later, on Date 2, Lessor Company and Lessee Company entered into a "master lease agreement" pursuant to which Lessor Company committed to provide to Lessee Company lease financing, at predetermined rentals based on the nature and cost of the property to be leased, for tangible personal property having a value of up to \$A. The master lease agreement provided that

"Lessee acknowledges that it is Lessor's intention to assign this Lease . . . and the related [tangible personal property] to [Taxpayer] and agrees that upon such assignment the sole liability for performance of Lessor's obligations hereunder shall fall upon [Taxpayer] which shall assume such obligations and Lessor shall be fully released from such liabilities"

Thereafter, Lessor Company assigned to Taxpayer, and Taxpayer assumed, Lessor Company's obligations under the master lease agreement. Taxpayer represents that the master lease agreement provided for an arm's length return.

Also on Date 2, Taxpayer and Lessee Company entered into a warrant purchase agreement which provided that Taxpayer agreed to purchase from Lessee Company and Lessee Company agreed to sell to Taxpayer the warrant described therein for "an aggregate [cash] purchase price of \$B." The warrant so acquired by Taxpayer from Lessee Company entitled taxpayer to purchase a specified number of shares of Lessee Company's Class 2 stock at a specified price and further provided that if the amount of lease financing provided to Lessee Company under the master lease agreement exceeded a specified amount that was less than \$A, the number of shares of Class 2 stock that could be purchased at that price under the warrant would increase proportionately up to a specified maximum amount. Taxpayer represents that Lessee Company requested that the warrant contain this contingency because Lessee Company did not want Taxpayer to fully benefit from the warrant in the event Lessee Company determined not to fully use the lease financing available to it under the master lease agreement. The warrant was exercisable by Taxpayer until the earlier of a specified date or the fifth anniversary of the first (if any) initial public offering of Lessee Company's common stock yielding aggregate gross proceeds in excess of a specified amount. At the time of the warrant's issuance, the fair market value of a share of Lessee Company's Class 2 stock was less than the warrant's per share exercise price. Taxpayer represents that the warrant was not issued to it in connection with its performance of services within the meaning of § 83 of the Internal Revenue Code.

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The amount of the lease financing made available by Lessor Company (\$A) to Lessee Company was approximately 2,500 times as large as the cash purchase price (\$B) recited in the warrant purchase agreement.

Taxpayer represents that, pursuant to the master lease agreement, Lessee Company leased property from Taxpayer having an aggregate value of approximately 96% of \$A. Taxpayer represents that Lessee Company and Taxpayer considered this to fully satisfy the contingency contained in the warrant so that Taxpayer became entitled to purchase the maximum number of shares permitted under the warrant. On Date 3, soon after Lessee Company's successful initial public offering of stock, Taxpayer fully exercised its right under the warrant to purchase Lessee Company Class 2 stock for the price specified in the warrant. At the time of the warrant's exercise, the fair market value of a share of Lessee Company's Class 2 stock greatly exceeded the warrant's per share exercise price.

ANALYSIS

Taxpayer has not requested a ruling as to whether the transaction described above in which it purported to lease tangible personal property to Lessee Company was for federal tax purposes a true lease. Taxpayer has not requested a ruling as to the fair market value of the warrant as of its issuance to Taxpayer. Taxpayer has also not requested a ruling as to whether it received the warrant from Lessee Company (1) solely for \$B cash, as stated in the warrant purchase agreement, (2) in part for \$B cash and in part as rent paid by Lessee Company (in the event the transaction is a true lease), or (3) in part for \$B cash and in part as something else (such as additional purchase price for the property sold to Lessee Company in the event the transaction is instead a sale). Rather, Taxpayer seeks rulings (1) that its receipt of the warrant, whether it was just in exchange for \$B or was part in exchange for \$B and in part for something else, was a closed transaction as of the date of its receipt, rather than an open transaction, and (2) that it did not recognize additional income of any kind on Date 3 as a result of its exercise the warrant at a time when the fair market value of the Lessee Company Class 2 stock acquired greatly exceeded the price paid for it.

Section 1.1001-1(a) of the Income Tax Regulations and Rev. Rul. 58-402, 1958-2 C.B. 15, provide that a property's fair market value is a question of fact and that only in rare and extraordinary cases will property be considered to have no fair market value.

Taxpayer's receipt of the warrant on Date 2 was a closed transaction because the warrant had an ascertainable fair market value at that time. In accordance with Rev. Rul. 77-250, 1977-2 C.B. 309, and Rev. Rul. 68-601, 1968-2 C.B. 124, the warrant was an option to purchase the stock subject to the warrant. Accordingly, upon its receipt of the warrant, Taxpayer had a basis in the warrant equal to the amount deemed exchanged for the warrant. Rev. Rul. 58-234, 1958-1 C.B. 279. The amount exchanged for the warrant may be either (1) \$B, if the warrant's then fair market value

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did not exceed \$B so that Taxpayer would be deemed to have received the warrant solely in exchange for \$B cash, or (2) the warrant's then fair market value, if it exceeded \$B so that Taxpayer would be deemed to have received the warrant for something in addition to \$B cash. Further, in accordance with Helvering v. San Joaquin Fruit & Investment Co., 297 U.S. 496 (1936); Rev. Rul. 78-182, 1978-1 C.B. 265, Rev. Rul. 58-234, 1958-1 C.B. 279, Taxpayer was not required to recognize income as a result of its exercise of the warrant even though the fair market value of the Lessee Company Class 2 stock acquired greatly exceeded the exercise price under the warrant. Rather, Taxpayer's basis for the shares acquired on exercise of the warrant equaled the sum of its basis for the warrant plus the price paid on exercise. Moore v. Commissioner, 425 F.2d 713 (9th Cir. 1970); Rev. Rul. 84-121, 1984-2 C.B. 168. That basis would be taken into account in determining the tax consequences of a subsequent transfer of the shares by Taxpayer.

Accordingly, based on the facts submitted and the representations made, we rule (1) that Taxpayer's receipt from Lessee Company of the warrant was a closed transaction, rather than an open transaction, and (2) that Taxpayer did not recognize income when it exercised the warrant even though the then fair market value of the acquired Lessee Company Class 2 stock exceeded the warrant's exercise price.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter under any other provision of the Code and no opinion is expressed or implied herein as to the fair market value of the warrant as of the time of its issuance to Taxpayer, the amount Taxpayer exchanged for the warrant, or as to whether the transaction between Taxpayer and Lessee Company was a true lease for federal tax purposes.

This letter ruling is directed only to Taxpayer. Section 6110(k)(3) of the Code provides that this letter ruling may not be cited or used as precedent. Taxpayer must attach a copy of this letter to any of its income tax returns to which it is relevant.

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

By _____
Christopher F. Kane
Assistant to the Branch Chief, Branch 3