Warrants: The Tax Story

By Dan Wright and Joe Wallin

Warrants are interesting and can be confusing from a tax point of view because they come in a couple of different varieties.

Warrants: What is a Warrant Anyway?

A warrant is an agreement with a comany that entitles the holder of the warrant to purchase shares of the company, typically at a fixed price, over a set period of time (e.g., 2, 5, 7 or 10 years).

Thus, a warrant is simply an option to purchase shares, just like an employee stock option. However, warrants are not issued under a stock option or equity incentive plan. They are stand alone contracts, typically 5-10 pages in length.

Despite the fact that warrants are at some fundamental level the same thing as an employe option does not mean that the tax consequences of a warrant track the tax consequences of an employee stock option. The tax consequences can and do track if the warrant is a compensatory warrant issued for services. But if the warrant was received in connection with an investment transaction, the consequences are different.

The Taxation of the Investment Warrant

The investment warrant is a warrant received in connection with an investment into a company. The most typical example of this type of warrant is the warrant received in connection with the purchase of a convertible note. This warrant entitles the holder to purchase additional securities of the issuer. The "warrant coverage" is typically a percent of the amount invested. For example, the warrant coverage might be 25%. Meaning, that for every dollar invested, an additional $0.25 is available for the investor to purchase, pursuant to the warrant. The warrant typically has a 2 or 5 year term. So, if you invested $100,000 in a convertible note round, you would be entitled to purchase an additional $25,000 in the round, at the round's ultimate price, at any time during the term of the warrant.

The taxation of an investment warrant is favorable. If you ultimately exercise the warrant when the underlying stock has appreciated, you do not have to pay tax on the spread on exercise. The reason is that you purchased the warrant when you bought the underlying securities. It was a purchase transaction, not a compensatory transaction

The Taxation of the Compensatory Warrant

The compensatory warrant is a warrant issued for services. Warrants issued for services are taxed just like compensatory stock options. If you receive a compensatory warrant, you are not taxed on the receipt of the warrant as long as the warrant is priced at fair market value. When you exercise, however, any spread is taxable as ordinary income.

The labeling of rights to purchase shares issued in the compensatory context as "warrants" rather than options can cause confusion regarding the tax treatment.

Does labeling the instrument as a warrant rather than an option change its tax treatment? No. The US federal income tax tax law doesn't care what you call a thing. What matters is the character of the payment. If the payment is compensatory in nature, then the tax consequences follow the compensatory pattern.

The IRS recently issued a Letter Ruling that relates to this issue.

Letter Ruling 201610006 describes a situation where warrants were issued in exchange for services. The warrants entitled the service provider recipient to acquire a fixed amount of shares on two future dates. The warrants did not have an “ascertainable value” upon issuance. The warrants could be canceled if the service provider failed to perform. This contingency lapsed once the warrants were exercised.

The IRS concluded that the income associated with the warrants (i.e., the excess of the FMV over the purchase price) was not required to be recognized when the warrants were issued or when the contingency lapsed (i.e., when the services were performed). Instead, the income should be recognized when the warrant rights were exercised.

While Letter Rulings cannot generally be relied upon for audit protection, the Letter Ruling provides insight into Treasury’s thinking regarding how warrants should be treated when issued to a service provider.

Don't let the label of a thing lead you to believe it has one tax result over another.

(This blog doesn't constitute tax or legal advice. Always consult a tax or legal advisor with respect to your particular circumstances.)