

HIT OR MISS: THE USE OF WARRANTS, OPTIONS OR STOCK IN LIEU OF CASH

In today's fast paced business environment, many start-up companies are now using various forms of equity as payment for goods or services in order to preserve cash. Increasingly, advisors, landlords and others may be willing to forgo an immediate cash payment in exchange for an equity stake in a start-up company. This equity interest may take the form of preferred stock, common stock, options or warrants to purchase stock at a later date at a fixed price. We are often asked to recommend the best structure to use for these alternative payments and that is the focus of this article.

The opportunity to realize a gain on this type of investment is primarily dependent on a future liquidation event: either the sale of the company or an initial public offering ("IPO"). The timing and availability of a liquidation event is uncertain at best. Thus, there are two primary issues in structuring the acquisition of this type of equity interest: minimizing current tax liability and establishing early liquidation opportunities.

Type of Security and Tax Effect of Receipt

A development stage company may offer any of three types of securities: (1) preferred stock, (2) common stock, or (3) a warrant or option to acquire stock at a fixed price for a specific period of time. Ordinarily, income tax must be paid on the value of property received as payment for the performance of services. However, the type of property received (i.e. cash, tangible property or an equity interest) may make the valuation of that property difficult to ascertain. In certain cases, the Internal Revenue Service has implemented special rules on valuation.

Preferred Stock. Preferred stock is often easy to value, since in many cases there has been a recent, arms-length price negotiated between the company and its investors. In such a case, the recipient of preferred stock would be required to report and pay income tax at ordinary rates on the value of the preferred stock received, based on the most recent sale price. All subsequent appreciation on the preferred stock would be taxed at capital gain rates. Although, nearly all preferred stock is convertible into common stock, preferred stock generally has a higher valuation than common stock. The reason for the higher valuation relates to the liquidation and other preferences usually granted to holders of preferred stock, together with registration and other rights frequently granted.

Common Stock. As with preferred stock, the recipient of common stock would be required to report and pay income tax at ordinary rates for the value of the common stock received. However, common stock may be more difficult to value. In most cases, founders get common stock at the time a company is formed for a nominal consideration and preferred stock is sold to later investors. The value of common stock is usually a fraction of the value of preferred stock in the same company and may be as little as 10% of the value of the preferred stock. Also, as with preferred stock, subsequent appreciation on the common stock would be taxed at capital gain rates.

Warrants or Options. A warrant or option to acquire common stock is very difficult to value (warrants and options each confer the same type of rights to the holder but options are usually held by employees of the issuer). One widely used mathematical model is called the "Black-Scholes" model. It was developed by economists in the 1970s and is now widely used to value a warrant or option to acquire publicly traded stock. However, because use of the model requires knowing the volatility of the underlying security, which is unavailable for privately held stock, certain simplifying assumptions must be made. Nevertheless, we recommend the use of this or some other valuation model to determine the value of warrants or options to be issued in any particular transaction.

However, under tax law, a very stringent set of valuation rules has been adopted. If a warrant or option is not publicly traded, it is virtually impossible to value using those tax rules. Thus, no tax would be due on receipt of the warrant or option received in connection with the performance of services and certain increases in value of the underlying securities would be taxed as ordinary income. The timing and character of income tax payable on the exercise of a warrant or option will depend on the specifics of the transaction.

Summary. As a result of the tax treatment of warrants and options, depending on the stage of development of the company, the prospective recipient of equity may choose to receive common or preferred stock, pay the tax and enjoy capital gain tax rates on subsequent appreciation. There is a risk, however, that the company will never get to a liquidation event and that the tax money paid will be lost (except for the capital loss deduction that may be either short-term or long-term depending on the circumstances). Therefore, the recipient may want to accept a warrant or option to avoid payment of tax on receipt, with the realization that some gain will be taxed at ordinary income tax rates.

Liquidity Issues

Once a company has conducted an IPO, the most frequently used method for early investors to liquidate their holdings is to sell stock into the public market in a Rule 144 transaction. To take advantage of this rule, affiliates (directors, executive officers and significant stockholders) must hold the stock for at least two years and then may sell subject to volume and other limitations, while non-affiliates must hold the stock for at least one year and then may sell subject to similar restrictions. The holding period for common stock commences on the date it is acquired. For preferred stock that is convertible into common stock, the holding period for the common stock commences on the date of acquisition of the preferred stock. For warrants or options pursuant to which common stock may be purchased, the holding period commences when the common stock is purchased unless certain procedures are followed. However, properly structured, the holder may tack (combine) the holding period of the stock and the holding period for the warrant or option used to acquire it.

To tack the holding period of a warrant or option to the holding period for the stock acquired on exercise, the investor must pay at least a nominal consideration (e.g. \$100) for the warrant or option. This will commence the holding period because the investor now has capital "at risk." In addition, the warrant or option must specifically contain the right to effect a "cashless" exercise of the warrant or option. To illustrate a cashless exercise, assume a trading price of \$10.00 per share and a warrant to acquire 10,000 shares at an exercise price of \$1.00 per share. Presumably, the warrant is worth \$90,000 ($10,000 \times \$10 = \$100,000$, less the exercise price of \$10,000). In a cashless exercise, the holder would surrender the warrant in exchange for 9,000 shares (\$90,000 intrinsic value of warrant divided by the \$10 stock price).

Conclusion

Due to the high risk involved in development stage companies, the value of securities received from development stage companies is difficult to assess. Thus, the exact structure to use in any one transaction will depend on many factors. For the potential recipient, the critical factors to analyze include the recipient's financial situation, risk tolerance or aversion, an assessment of the company's prospects, the tax implications of the transaction and the timing and limitations on liquidity. From the company's perspective, factors to evaluate include the company's cash holdings, future financing needs and planned financing sources.

For help with these or any other business or finance questions, David Oswald or any other member of our Strategic Business Planning, Finance and Transactions Group.