**RSM**

**IRS rules warrants issued by taxpayer are expense when exercised**

TAX ALERT|  March 07, 2016

The IRS ruled in [private letter ruling 201610006](https://www.irs.gov/pub/irs-wd/201610006.pdf) (PLR) that **a taxpayer may recognize the tax consequences of warrants issued for services when the warrants are exercised, rather than when they become exercisable.**

**The taxpayer entered into multiple service contracts with three companies**: Company A, a domestic corporation; Company B, a foreign corporation; and Company C, a foreign corporation owned by Company A and B. As part of the service agreement, **the taxpayer issued contingent equity rights, or warrants to Company A and Company B** when the parties entered into a contract for Company C to provide the services to the taxpayer or the taxpayer’s subsidiary. The warrants were issued to provide long term incentives for Company C to meet the performance requirements under the service agreements. If Company C failed to meet the terms of the agreements, the taxpayer had the right to terminate the agreements and cancel the warrants granted to Company A and Company B. However, if Company C met the terms of the agreement, the **warrants provided Companies A and B the right to purchase shares in taxpayer during certain periods for a stated price.**

At the time of issuance, the warrants did not have an ascertainable fair market value as defined in Reg. section 1.83-7(b) as they were not actively traded on an established market and were not exercisable immediately in full by the recipient. Upon exercise of the warrants, the shares purchased would not be subject to a substantial risk of forfeiture and, thus, would be substantially vested within the meaning of Reg. section 1.83-3(b).

The taxpayer and subsidiary use the accrual method of accounting for federal income tax purposes and the PLR first reviewed the principles of the section 461 regulations to determine whether the all events test and economic performance requirement were met when the warrants became exercisable or when the warrants were actually exercised. In determining when the taxpayer met the requirements of Reg. section 1.461-1 to recognize the liability, the IRS reviewed the warrant agreements and determined that economic performance would be met as the services were provided. The IRS then reviewed whether the all events test was met and determined that this test was met when the contingencies lapsed. **Because the warrants were provided for services, they were subject to section 83, and section 83 determined when the contingencies lapsed.**

In its analysis of section 83 and the regulations thereunder, the IRS concluded the following:

1. Section 83(e)(3) provides that section 83 does not apply to a warrant at the time of the grant that does not have a readily ascertainable fair market value
2. Reg. section 1.83-7(a) provides that section 83 does not apply at the time of the grant or when options become exercisable, but will apply on the transfer of property for services *at the time of exercise*
3. Under section 83(h) and Reg. section 1.83-6(a)(3), the service recipient may take a deduction in the amount of the service income realized by the person who performed the services at the time of exercise

Because section 83 applies at the time of exercise, the all events test is met at exercise, not when the options become exercisable. **This results in the deduction occurring later than the time that services are provided.**

**Implications**

The application and provisions of section 83 and the regulations thereunder, as they apply to options and warrants issued for services, can be a source of confusion for taxpayers. **This PLR provides guidance as to how the mechanics of section 83 work in such cases. Taxpayers that currently have warrants or options outstanding or that are contemplating the issuance of such instruments should discuss the tax implications with their tax advisors.**