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What's the Option Worth?

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When a lender makes a high-risk loan, it typically wants to be compensated for the high risk by an increased yield. That increased yield often takes the form of an increase in the rate of stated interest on the loan. In some cases, though, the borrower may issue an "investment unit" consisting of a debt instrument and an option, security, or other property to the lender. The lender will accept such an investment unit in the expectation that the amount to be realized from the other property will be sufficient to raise the lender's yield to (or above) a level comparable to that which would be achieved from the receipt of only a debt instrument with a higher stated interest rate.

Original Issue Discount

In the case of the issuance of an investment unit, the borrower achieves tax deductions roughly equivalent to those which would be available through raising the stated interest rate by means of the "original issue discount" (or "OID") mechanism. OID on a debt instrument, which is generally deductible by the borrower and includible in income by the lender over the term of the debt instrument, is equal to the excess of the "stated redemption price at maturity" of the debt instrument over its "issue price." Thus, the lower the issue price of a debt instrument, the greater the amount of OID that it bears. When a debt instrument is issued as part of an investment unit, the determination of the amount of OID starts with the "issue price" for the investment unit, which is generally the amount paid by the lender to the borrower. This overall issue price must then be allocated to each element of the investment unit on the basis of the relationship of the value of that element to the value of all elements in the investment unit.

Allocating Issue Price

For example, if a lender lends $100 (the issue price for the investment unit) and receives, in consideration for its loan, a note with a face amount of $100 and an option to acquire stock in the borrower, the fair market value of the note and of the option must be ascertained and the $100 issue price allocated between them based on their relative values. The effect of this allocation is that OID is created with respect to the note. (If each of (a) the face amount of the debt instrument, (b) the issue price of the investment unit (i.e., the total amount advanced by the lender), and (c) the sum of the values of all of the elements of the investment unit is the same number, the amount of OID will be equal to the value of all elements of the investment unit, other than the debt instrument.)

The determination of the value of each element of an investment unit is thus a critical factual inquiry in determining the amount of OID. Although the Treasury Regulations now provide, with respect to investment units issued after April 4, 1994, that the borrower's allocation of the issue price among an investment unit's elements is binding on the lender (unless the lender explicitly discloses to the IRS that its allocation is different from the borrower's allocation),[1] the borrower's allocation is *not* binding on the IRS.

Valuing Options

In a recent case, the Court of Appeals for the Ninth Circuit had occasion to address the proper method for valuing options that were issued as part of an investment unit. Since the Court of Appeals reversed and remanded the decision of the Tax Court, the case provides a good illustration of differing approaches to this question. *Custom Chrome, Inc. v. Commissioner*, ___ F.3d ___, 2000 U.S. App. LEXIS 15827 (July 10, 2000), *rev'g* 1998 RIA TC Memo Para. 98,317.

In August 1989, in connection with a leveraged buyout transaction ("LBO") in which the stock of Custom Chrome, Inc. ("CCI") was acquired by Custom Chrome Holdings, Inc. ("Holdings"), CCI obtained a $26,000,000 loan from First National Bank of Boston ("FNBB"). The loan matured in tranches over periods of 5 to 7 years, bore interest at 150 to 200 "basis points" over the prime rate, and was only partially secured. FNBB also received options to acquire up to 125 shares, representing 12.5% of the stock, of Holdings. The options were exercisable over a period ending in 1999, at a price of $500 per share, and were provided to FNBB in recognition of the risks that it was taking in making the loan. The terms of the options were hotly negotiated between Holdings and FNBB, whose loan officers estimated that the options might have a value of $5,000,000 by 1994. On their tax returns for the periods from the issuance of the options through January 31, 1994, CCI did not deduct and FNBB did not include in income any OID with respect to the loan. FNBB booked the options as an asset with a nominal value of $1,000.

As part of the LBO, the former sole shareholder of CCI and other members of its senior management purchased stock in Holdings at a price of $500 per share. The IRS and CCI agreed that $500 per share was, in fact, the fair market value of Holdings stock at the time of the LBO.

On November 5, 1991, Holdings was merged into CCI, an initial public offering ("IPO") of the stock of CCI was effected, and FNBB exercised its options, receiving, in exchange for the $62,500 exercise price, stock in CCI having a value of $3,131,250 (based on the price received for CCI stock in the IPO).

As noted above, CCI did not deduct any OID with respect to the loan on its tax returns. However, when the IRS audited its returns for the year which included the November 5, 1991, exercise date of the options and subsequent years, CCI contended that it was entitled to additional deductions, based on amortization of OID over the term of the loan.

The Tax Court held that CCI had not demonstrated that it was entitled to any deduction with respect to the options, because they lacked any "ascertainable value" at the date that they were issued. In support of this conclusion, the Tax Court pointed to the fact that the options were issued "at the money," i.e., with a strike price equal to the value of the stock at the time that the options were issued, and to the way that the options had originally been reported by CCI and FNBB for tax and financial accounting purposes. Based on a 1980 case in the Tenth Circuit,[2] CCI had argued that the value of the options should be derived mathematically from a comparison of the yield on the loan with what would have been the yield on a similar obligation not issued as part of an investment unit. The Tax Court rejected that argument, on the basis that the evidence did not establish that the parties had actually negotiated and agreed to a discounted, or "below-market," interest rate. The Tax Court stated that "any value that might attach to the options would be speculative" and found that the "evidence does not establish that any OID was incurred in the year of issuance."

The Court of Appeals reversed the decision of the Tax Court, pointing out that the fact that an option may be "at the money" does not render it valueless. Even an "at the money" option has a "time value" that "reflects the expectation that, prior to expiration, the price of ... [the] stock will increase." Thus, although the Tax Court may have been correct that the options had only a "speculative value," that speculative value was very real and had to be determined. The Court of Appeals also rejected the notion that either FNBB's tax or financial reporting or even CCI's own financial reporting should be held against CCI in determining whether the options had a value.

Turning then to how the value of the options should be determined, the Court of Appeals noted the existence of a "combination of the general speculative nature of options and the related difficulty of determining precisely what effect options granted for OID have on a core loan transaction." In view of this valuation problem, the Court held that a factfinder could adopt "any well-established and reliable method for determining the value of the options." One such reasonable approach in the Court's view would be similar to that used in the 1980 case – a court would look at the differ-ance between the interest rate actually charged and the rate of return (effective interest rate) required by the lender for the entire loan transaction to take place. In a footnote, the Court of Appeals also listed other "well-established and reliable methods," including the so-called "Black-Scholes method," that could be used by a factfinder in appropriate cases.

Regardless of the method to be used, the Court of Appeals found, contrary to the Tax Court's view, that, under any well-established and reliable financial method, there was no evidence to support the conclusion that the loan was not a below-market loan (and that conclusion's corollary that the options had no value). First, the IRS's own expert had testified that, under two alternative methods of valuation (including the Black-Scholes method), the options would have a positive value. Second, the heated negotiations regarding the terms of the options suggested that the parties thought that they were fighting over something worthwhile. Finally, the Court was impressed by the fact that FNBB's documents indicated that it thought that the value of the warrant would grow in the 5 years from issuance to $5,000,000 and that that rate of growth was needed for FNBB to achieve its desired "internal rate of return" of 22% (on a loan that bore stated interest at only 150-200 basis points over prime). The case was remanded to the Tax Court for a determination of the value of the options at the time of their issuance.

The differing approaches of the Tax Court and the Court of Appeals, as well as the latter court's endorsement of "any well-established and reliable method," present a challenge to lawyers, investment bankers, and appraisers in structuring loan transactions involving investment units and defending their tax consequences before the IRS and in the courts. Careful planning and documentation and creative thought can go far in meeting that challenge.

[1] Treasury Regulation section 1.1273-2(h)(2).

[2] *Monarch Cement Co. v. United States*, 634 F.2d 484 (10th Cir. 1980).