Taft/

DID YOU KNOW?

Did you know that if a borrower issues a warrant to a lender that it will create additional interest on the loan?

When a borrower issues warrants with debt, the lender is treated as paying a portion of the loan proceeds to the borrower for the warrant and a portion for the promissory note. For example, if a lender makes a loan of $1000 and receives a promissory note and a warrant worth $100 to buy borrower shares, the lender is treated as loaning $900 to the borrower and requiring repayment of $1000 plus the interest on the loan. That $100 difference between the $900 and the $1000 note amount is treated as additional interest (aka original issue discount or OID). The lender must include the OID (and the borrower will deduct) in income as additional interest over the term of the loan.

For obvious reasons, the lender would like to minimize the value ascribed to warrants. The allocation must be based on the relative fair market values, and under tax regulations, the *borrower's allocation* of value is binding on the lender, unless the lender explicitly discloses in its tax return that its allocation is different from the borrower's. Accordingly, it is advisable that lenders get borrowers to agree in the Note Purchase Agreement or similar document on the value of the warrants (and commensurate OID) and agree to report consistently for tax purposes. The IRS is not bound by these agreements, but they are generally given some deference and it is good for the parties to report consistently.

Bottom Line: When representing a lender who is receiving a warrant in connection with a loan, the best practice is to memorialize the warrant value (and the amount of OID) in the loan documentation.

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"If at first you don't succeed, then skydiving definitely isn't for you." – Steven Wright