BusinessManagement DAILY

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Cut company borrowing costs by issuing 'stock warrants'

With interest rates near historic lows, your company may want to take advantage of the low cost of capital by issuing debt.

Advice: To grab an even lower rate, look into issuing stock warrants with this debt. Stock warrants (which are essentially the same as stock options) allow a holder to buy the issuer's stock at an exercise price within a defined period.

Issuing warrants will dilute the ownership interests of existing shareholders. But in some cases, offering equity participation may be the only way you can get a loan at reasonable terms.

For lenders, warrants are an attractive way to possibly increase their return on debt issued at a lower interest rate. For you, as the borrower, warrants lower the cost of capital by helping you obtain debt at a lower rate. You may enjoy tax advantages, too.

Trade lower rate for piece of growth

For example, say your company borrows $100,000 as a straight debt. You'd pay (and deduct) the loan interest, according to the loan's terms.

Instead, say you borrow $100,000 at a lower rate. The lender agrees to the lower rate because you throw in warrants. If your business venture prospers, the warrants allow the lender to participate in the company's growth.

Warrants have some value. Under the tax code, that value is considered original issue discount (OID). When a debt instrument is issued at an amount greater than the amount loaned, the difference is deductible as OID over the life of the loan.

In this case, the face amount of the loan is imputed to be the $100,000 loan plus the value of the warrants, and the value of the warrants is the OID.

The OID, in turn, is deductible over the life of the loan. If the warrants are valued at $50,000, for example, and the term of the loan is 10 years, your company would be entitled to deduct $5,000 per year.

Several methods are appropriate to value such warrants. But you should hire a reputable appraiser to put a justifiable value on them.

End game

If the loan is canceled or repaid early, the remaining OID can be deducted in full that year. Even if the warrants lose value (and, thus, never exercised), it won't affect your tax deduction, as long as you received a valid appraisal upfront.

7600 Leesburg Pike, Suite 300, Falls Church, VA 22043-2004 (800) 543-2002

On the other hand, your company can repurchase the warrants to prevent dilution of ownership. With such a purchase, the company would recognize no capital gain or loss.

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