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All the Flap Over Seagrams and DuPont

by Robert Wood • San Francisco

Although Seagrams and its well-known controlling Bronfman family are no strangers to the news, the latest flap over the past few months has involved an interesting (and it turns out quite important) tax question. Set against the background of Mr. Bronfman's planned purchase of MCA Inc. from Matsushita Electric Industrial Co., the controversy involves whether the Seagrams transaction with DuPont stock is taxable or not. Since the answer to this question seems to be a resounding "no," perhaps the more troublesome question is whether the transaction *should* be taxable or not.

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Commentators have argued about it, and now the debate reverts to various congressional tax writers who seem to be focusing on the Seagrams/DuPont transaction with myopic intensity.

"Dividend" Is Not A Dirty Word

Aging tax practitioners may understandably have a knee-jerk reaction that a capital gain might be preferred to a dividend. Historically at least, capital gains rates are more favorable. In the peculiar world of the dividends-received deduction, of course, nothing could be further from the truth. Congress has tinkered with the dividends-received deduction over the years, but it remains a permanent and important feature of the corporate tax regime.

Even without a majority share in the dividend-paying company, a corporate taxpayer receives a hefty 80% dividends-received deduction on dividends it receives from corporate payers, as long as the corporate shareholder holds at least 20% of the voting power of the dividend-paying company. Individual taxpayers, of course, do not participate in this scheme. At its heart, the flap over Seagrams involves nothing more sophisticated than the dividends-received deduction, although it does interact notably with the stock redemption rules.

Whether one criticizes the Seagrams plan or not, it must be recognized as a picture of tax ingenuity. In effect, Seagrams turned its gain from the sale of its DuPont stock from a capital gain (which would have been taxable to Seagrams at the normal 35% corporate rate) into dividend income. The latter, because of the 80% dividends-received deduction, is effectively taxed at only a 7% rate. Certainly a home run.

Seagrams accomplished this by no means small feat by DuPont's issuance of warrants to Seagrams. Seagrams turned in to DuPont 156 million shares of DuPont stock in exchange for a package consisting of $8.3 billion in cash and notes, and approximately $500 million in warrants to purchase additional DuPont shares. In fact, Seagrams received one warrant from DuPont for each DuPont share it returned. The strike price for the warrants was set so that the warrants were, at the time of issuance, "out of the money." However, an exercise of the

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warrants would become worthwhile to Seagrams if DuPont shares appreciate approximately 15% each year.

The warrants were issued in three stages, with one group of warrants becoming fully exercisable for a 60-day window 2½ years after their issuance, one group becoming exercisable during a 60-day window 3½ years after issuance, and the last group being exercisable for a 60-day window 4½ years after issuance. Certain major corporate events would accelerate the exercisability of the warrants. The Seagrams/DuPont transaction did result in Seagrams turning in 156 million shares of DuPont (albeit receiving an equivalent number of warrants). Yet, Seagrams did not part with every single share of stock it held in DuPont. Rather, Seagrams retained 8.2 million shares (or 1.2%) of the outstanding DuPont stock.

Before we get to the $64,000 question ("is this a sale or a dividend?"), it bears noting that DuPont and Seagrams executed a standstill agreement covering the retained shares (the 8.2 million shares held by Seagrams that were not turned in) and the shares covered by the warrants. If Seagrams wishes to sell the warrants, it must first offer them to DuPont. Technically, the right of first offer held by DuPont does not affect the ability of Seagrams to exercise the warrants, although DuPont has suggested to analysts that—practically speaking—this first offer right will effectively prevent Seagrams from ever exercising the warrants.

Capital or Dividend?

The question of the hour is whether this transaction, replete with its ingenious warrants, accomplishes a redemption or not. As we are all painfully aware (at least it is *normally* a painful realization), if a stock redemption does not achieve a meaningful reduction in the shareholder's holdings in the company, it is treated as a dividend. Whether there has been a meaningful reduction in the shareholder's stake in the company, of course, depends upon the shares that continue to be held by the shareholder. And, perhaps more obsequiously, it depends on the shares *deemed* held under the Section 318 attribution rules.

Here, then, is the crux of the transaction. Under Section 318(a)(4), an option to acquire shares is equated with actual ownership of the optioned stock. In effect, outstanding options are treated as exercised in determining whether the standards of section 302 have been met.

An Option is an Option

One debate in this drama, although one that seems unproductive, concerns just what is an option. Section 318(a)(4) seems to be absolute in its application. If shares are subject to an option, then the option holder is considered their owner. The regulations under Section 318 shed little light on the issue, not making clear, for example, whether one must distinguish between options and warrants, whether the shares subject to the option must be outstanding for this provision to operate, etc.

There are a few rulings, though, and these seem to give broad expanse to the option concept. Admittedly, this is no surprise, since in the rulings the Revenue Service was typically highly incentivised to find options so that the optioned shares would be caught within the constructive ownership net of Section 318. See Revenue Ruling 68-601, 1968-2 C.B. 124 (warrants and convertible debentures both held to be options for this purpose); and Revenue Ruling 89-64, 1989-1 C.B. 91 (option that was subject to time constraint conditions before it was exercisable was nevertheless viewed as an option subjecting the option holder to constructive ownership of the underlying shares).

The latter of these two rulings (89-64) is particularly relevant, inasmuch as the three groups of Seagram warrants to buy DuPont stock are exercisable only for a relatively limited period of time going out a fair distance into the future. Plus, the first offer provision held by DuPont muddies the water somewhat. These quibblings aside, most observers concluded simply that Seagrams does hold warrants that it can exercise.

The very strict view that the IRS and the courts have accorded the family attribution cases certainly support the Seagrams view. For discussion, see Sheppard, "Can Seagram Bail Out of DuPont Without Capital Gains Tax?", *Tax Notes*, April 17, 1995, page 325. Indeed, to a large extent, the IRS may be hoist by its own petard, since it has generally argued so vociferously in the past that

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Section 318 must be broadly construed to stop taxpayers from both having and eating their cake.

What's Meaningful?

Admittedly, from one perspective the Seagram/DuPont transaction must be painfully cute to pro-tax advocates. The illustrious Lee Sheppard notes that:

- Seagram reduced its voting interest in DuPont from 24.2% to 1.2%;
- Seagram gave up its four DuPont board seats;
- The two DuPont nominees resigned from Seagram's board; and
- Surely this is a meaningful reduction in Seagram's rights as a DuPont shareholder!

(For a full discussion, see Sheppard "Can Seagram Bail Out of DuPont Without Capital Gains Tax?"), *Tax Notes*, April 17, 1995, page 325.

Nevertheless, as *M&A Tax Report* Advisory Board Member and peripatetic author Bob Willens has ably noted in response to Ms. Sheppard, subjective criteria are simply irrelevant to this debate. Since the Section 318 attribution rules *always* apply, subjective musings about whether this transaction *should* be viewed as involving a meaningful reduction in Seagram/DuPont holdings are simply irrelevant. Under section 301, as interpreted in Revenue Ruling 81-289, 1981-2 C.B. 82, dividend distribution treatment is not only clear, but is simply mandatory. See Willens, "You Can't Fight the Facts," *Tax Notes*, May 1, 1995, page 697.

Legislative Fix?

As with many well-publicized transactions, the ever temporal tax writers have now fired up their legislative machine to fix what some may view as a loophole that saved Seagram billions of dollars. On May 3, 1995, House Ways and Means Committee Chair Archer (R - Texas) and representative Gibbons (D - Florida) introduced H.R. 1551. The stated purpose of this bill is to curtail the use of the Seagrams/DuPont type transaction *immediately*, applying an amended version of Section 302 to most redemptions made after May 3, 1995. The bill is neutral on the Seagrams/DuPont transaction, neither blessing nor attacking it, but an IRS attack could still come.

If passed, the bill would amend Section 302 to treat as a sale any non-pro rata redemption or partial liquidation distribution to a corporate shareholder that is eligible for the dividends received deduction. Specifically, the bill would treat a buyback from a corporate shareholder as a sale rather than a dividend where the buyback is part of a partial liquidation, or is not *pro rata* to all shareholders. In other words, sale treatment would result regardless of the effect of the buyback on the shareholder's proportionate interest in the corporation. A corollary change would be made to the basis reduction requirement of current section 1059(e)(1). Perhaps there would be a much easier way to achieve this fix, as some have noted. See "Tax Report," Wall Street Journal, May 17, 1995.

It is certainly too soon to either predict the likely success of this legislative assault, nor even to get clear precisely who should be for it and who against. One Treasury Department spokesman already voiced support for the bill, but others have concern that the age-old question of whose ox is being gored needs to be thought out. After all, some corporate taxpayers will *want* sale treatment (for example, to eat up an existing NOL). Despite the lofty goals of H.R. 1551 to thwart Seagrams-type transactions, it could actually help some taxpayers. See "Taxwriters Go After Corporate Stock Redemption Rules," *Tax Notes*, May 8, 1995, p. 711.

This, it would seem, is one of the hallmarks of our tax system. Anytime a characterization rule is adopted to paint a particular transaction in a particular way, some other taxpayers are likely to get splashed with the same paint—and like it. ■