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Swallowing the Anti-Seagrams Provisions

by Robert W. Wood • San Francisco

The well-publicized transaction involving Seagrams and DuPont should not happen again. Under provisions enacted in the Taxpayer Relief Act of 1997—one can't help noting the rather curious name for this tax legislation when describing restrictive provisions like the anti-Seagrams provision—this type of transaction has been nixed. When DuPont repurchased the huge block of DuPont stock then held by Seagrams, it did so at a significant discount because Seagrams had a rather significant

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tax advantage. The repurchase was made using a combination of cash and warrants based on the number of shares repurchased.

The result, by a curious use of the constructive ownership rules, was that Seagrams' proportionate interest in DuPont was not diminished, even though as a practical matter it really was. Because a holder of an option to acquire stock is treated as the owner of the underlying stock for many purposes under the tax law, coupling the purchase of shares with an option meant that Seagrams' proportionate interest in DuPont did not diminish. That, in turn, meant that the proceeds of the repurchase were treated as a dividend, eligible for an 80% dividends received deduction in the hands of Seagrams.

Dividend Treatment Preferred

In what tax lawyers must always think of as an Alice in Wonderland reversal, in this transaction Seagrams quite sensibly preferred to receive a "dividend" (a word that on the street might be thought to bear a higher rate of taxation), instead of a "capital gain." While a capital gain normally is considered tantamount to tax nirvana, in the Seagrams/DuPont deal, a capital gain would have borne a 35% tax. On the other hand, the dividends received deduction of 80% yielded an effective tax rate of 35% x 20%, or only 7%.

The dividend was classed as "extraordinary" because it was rooted in a stock repurchase that was non-*pro rata*. Thus, the amount by which the dividends received deduction exceeded Seagrams' basis in the DuPont stock it retained would be taxable capital gain, but only if, as and when that retained stock was sold. Assuming no disposition of the residual stock therefore, Seagrams quite cleverly converted capital gains into dividend income without any downside.

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 into dividend income. Because of the 80% dividends-received deduction, the dividend was taxed at only a 7% rate. Certainly a home run.

Nitty Gritty

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 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,

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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.

(For prior coverage of the Seagrams transaction, see Wood, "All the Flap Over Seagrams and Dupont," Vol. 3, No. 11 *M&A Tax Report* (June 1995), p. 1.)

"Absolut" Tax Relief?

In the Taxpayer Relief Act of 1997, Seagrams' clever strategy was effectively dealt with by Congress. A corporate shareholder that receives an extraordinary dividend must now reduce the basis of stock with respect to which the dividend was received by the nontaxed portion of the dividend, unless the stock was held for more than two years before the dividend was declared. I.R.C. §1059(a). This reduction in basis of stock is treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the deduction relates. In addition, if the nontaxed portion of the dividend exceeds basis, then gain must be recognized.

This gain recognition is immediate, and it is this immediate tax that puts the effective nix on the Seagrams/DuPont type of arrangement. When making the basis reduction on account of an extraordinary dividend, the nontaxed portion of the dividend cannot reduce basis below zero (the old negative basis problem again). Gain must be recognized in the tax year in which the extraordinary dividend is received, to the extent that the nontaxed portion exceeds basis.

In other words, immediate gain recognition is required, as opposed to the old rule which had allowed the gain to be deferred until the tax year in which the stock was sold (or otherwise disposed of) by the corporate shareholder. The gain that is now immediate is treated as gain from the sale or exchange of the stock.

> ***Example:*** Smart Corp. owns 85% of the outstanding stock of Sloth Corp. Smart has a basis of $100,000 in the stock. In 1997, Smart Corp. receives a distribution of $125,000 from Sloth in a non-*pro rata* distribution that is considered to be an extraordinary dividend.
>
> Since Smart owns more than 80% of Sloth, the entire $125,000 is not taxed. However, Smart must reduce its basis in its Sloth stock by the amount of the untaxed extraordinary dividend. In 1997, Smart must recognize gain of $25,000, the amount by which the untaxed distribution exceeds basis ($125,000, less the basis of $100,000).

In this example, bear in mind that it also may not be so easy to determine if the dividends received deduction even applies. That is because another provision of the "Taxpayer Relief" Act ratcheted up the holding period requirements in order for the dividends received deduction to be available. (More on this subject below.)

Reorganizations and Redemptions

Before we look at holding period changes in the dividends received deduction, there are several other aspects of the anti-Seagrams provision that merit attention. The same kind of immediate gain recognition rule was also put in place for reorganizations. Thus, a corporate shareholder must now reduce the basis of stock by the nontaxed portion of any amount treated as a dividend received.

Therefore, the taxpayer must recognize gain immediately, when the nontaxed portion exceeds the basis of the shares surrendered with respect to certain redemptions of stock. In addition to any redemption which is part of a partial liquidation (described in Section 302(e)) or which is not *pro rata* with respect to all the shareholders, the basis reduction and gain recognition rules now apply to any redemption that was treated as a dividend because the holding of options was treated as stock ownership under the constructive stock ownership rules of Section 318(a)(4).

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Taking advantage of this constructive ownership rule was precisely the strategy Seagrams used with respect to DuPont's stock. Basis will be reduced and gain recognized in such cases, whether or not the stock was held for more than two years. Finally, in making this basis reduction for a redemption where options were considered, only the basis in the redeemed stock (as opposed to the other stock or the options) will be taken into account.

The House Committee Report specifically notes (which is hardly a surprise) that these provisions are at least in part (in part?) a response to the Seagrams transaction. Ultimately, what taxpayers must now remember is that the constructive ownership rules respecting options really only work one direction. It would seem that they can only hurt you, not help you.

Reorganizations (or other exchanges involving amounts that are attributed as dividends under Section 356) will be treated as redemptions for purposes of these rules. Where a recapitalization or other transaction involves dividends under Section 356, having the effect of a non-*pro rata* redemption, or if it is treated as a dividend because the options are counted as stock, the basis reduction and gain recognition rules described above would apply.

Old and Cold

Although many of the "Taxpayer Relief" provisions of the 1997 Act that presumably caused Congress to adopt this sappy rubric for the legislation do not kick in until sometime in 1997 or 1998, and some not until 1999!, the anti-Seagrams provision is generally effective for distributions after May 3, 1995. That makes much of this rather old law that corporate taxpayers should now well understand.

Still, there are a couple of transitional rules on the books. The provision does not apply to a distribution made: (1) pursuant to the terms of a binding written contract in effect on May 3, 1995 and so binding at all times thereafter before the distribution; or (2) pursuant to a tender offer that was outstanding on May 3, 1995. Another transitional rule states that in applying the new rules to any distribution that is not a partial liquidation, a non-*pro rata* redemption, or a redemption that is treated as a dividend by reason of the holding of options, September 13, 1995 is substituted for the May 3, 1995 general effective date.

Longer Holding Period for DRD

We should not leave the topic of the dividends received deduction without noting the substantial change to holding periods that was also effected by the 1997 Act. Under prior law, the dividends received deduction was available if the corporate shareholder satisfied a 46 day holding period for the dividend-paying stock. A 91 day holding period was required for dividends on preferred if the dividend was attributable to periods aggregating in excess of 366 days.

However, there was no requirement under prior law that the dividend-paying stock had to be held for the period immediately before (or immediately after) the time the taxpayer became entitled to the dividend.

Now, with varying effective dates described below, a corporation is not entitled to a dividends received deduction if the stock is held less than 46 days during the 90 day period that begins 45 days *before* the stock becomes ex-dividend with respect to the dividends. The holding period for dividends on preferred attributable to a period or periods in excess of 366 days was increased to 91 days during the 180 day period that begins 90 days *before* the stock becomes ex-dividend with respect to the dividends.

Know When to Hold

This change is generally effected for dividends paid or accrued after the 30th day after August 5, 1997 (in other words, September 5, 1997). However, a transitional rule exempts dividends received or accrued during the two-year period beginning on August 5, 1997 provided that the following three requirements are met:

- The dividend is paid with respect to stock held by the taxpayer on June 8, 1997 (and at all times until the dividend is received);
- The stock is continuously subject to a position (*e.g.*, option) that reduces the risk of loss (under Section 246(c)(4)) until the dividend is received; and

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- The stock and position are clearly identified in the taxpayer's records within 30 days after August 5, 1997 (in other words, September 5, 1997).

Finally, this transitional relief is not available if the position is sold, closed or otherwise terminated and re-established. ■

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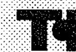

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