The Flap Continues Over Seagrams and DuPont

by Robert W. Wood • San Francisco

One of the more talked about transactions so far this year—at least from a tax perspective—was the sale by Seagram of a huge chunk of its DuPont stock, a highly publicized transaction that was itself accomplished in order than an even more high profile transaction—Seagram's purchase of MCA, Inc. from Matsushita Electric Industrial Co.—could occur. The basic transaction and its effects were summarized in a recent issue (See Wood, "All the Flap Over Seagrams and DuPont," Vol. 3, No. 11, *M&A Tax Report*, June 1995, p. 1).

The core of the strategy, of course, was

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manipulating the DuPont buyback of its own stock from Seagram so that Seagram was treated as receiving a dividend rather than making a sale of shares. The dividend would qualify for the dividends received deduction, making the tax savings (compared to the sale of stock) enormous. The feat was accomplished through the issuance of DuPont warrants to Seagram.

Aside from the details of these warrants, under the attribution rules of Section 318(a)(4), an option to acquire shares is equated with actual ownership of the optioned stock. Since outstanding options are effectively treated as exercised in determining whether the standards of Section 302 have been met, Seagram neatly (at least from all *appearances*) avoided the buyback being treated as a redemption. Thus, the dividends received deduction made most of the proceeds tax-free.

Overreaction?

The bipartisan legislation introduced May 3, 1995 (H.R. 1551) that would reverse the result in the DuPont/Seagram transaction at least prospectively has been widely criticized as overreaching. At the same time, it should not be surprising—after the publicity that the DuPont/Seagram transaction garnered, and the enormous tax savings there realized—that Congress should be looking at more ways to make big taxpayers pay their due. Under the proposal, Section 302(b)(5) will, in effect, trigger Section 1059(e)(1) so that, for redemptions occurring after May 3, 1995—the date the proposed legislation was introduced—sale treatment will apply where a stock buyback from a corporate shareholder (that would otherwise be eligible for the dividends received deduction) is: (1) part of a partial liquidation; or (2) not pro rata as to all shareholders.

If this proposal is enacted, it can be said that both corporate and noncorporate shareholders alike will face an uncomfortable situation. If a stock buyback is essentially pro rata, it will give rise to dividend treatment to the noncorporate shareholders, who obviously will have to pay ordinary income tax. Conversely, the corporate shareholders who will be seeking dividend treatment will be saddled with capital gain treatment, so that the "sins" of Seagram are not repeated.

Still, Section 302(b)(5) is likely to be turned around by some taxpayers, resulting in sale or exchange treatment in some cases that will be favorable to the corporation whose shares are being redeemed. For example, sale or exchange treatment may well be desirable if there are expiring capital losses that can be offset through the capital gain income generated on the redemption.

Quick Fix?

One possibility that seems less Draconian than the proposal contained in H.R. 1551 would simply be to amend Section 1059(a)(2). If this provision prohibited the deferral of any unabsorbed dividends received deduction that results from an extraordinary dividend, the situation would presumably be corrected. It remains to be seen how H.R. 1551 will fare. Stay tuned. ■