Session 13 - Capital structure

- Debt v Equity
  - characteristics
    - Priority of claim
    - Fixed v residual claim
  - tax treatment
    - int deductible
    - dividends not, but receive special treatment if received by a corporation

What is debt?

- Debt and equity are the two extremes of a continuum
- Courts have considered a large number of factors in classifying debt and equity
  - Debt-to-equity ratio. No ratio is *too high* or *too low*, but as the risk of the debt increases the debt takes on characteristics of equity
  - Proportion held by shareholders. For example, if shareholders hold debt in proportion to their equity, shareholders receive the benefits of debt without a loss of residual claim.
  - Intent
  - Other factors .....

Section 385

- Enacted in 1969 in response to judicial uncertainty.
- Amended over time to address various concerns such as
  - inconsistent treatment by issuer and holder
  - hybrid securities
  - earnings stripping
  - see section 163
- Instructs Treasury to issue regulations
- Still waiting....

Dividends

- Distributions from corporations are taxed as dividends to the extent that the firm has "earnings and profits"
- Distributions in excess of E&P are a non-taxable return of capital
- Distributions in excess of E&P and basis are capital gains
- Need not be cash:
  - Property
  - Stock

Other ways to get money out of the corporation

- Compensation
- Interest
- Rent
- Royalties
- BUT, attempts to disguise a dividend as some other form could be construed as constructive dividends and taxed accordingly
- Share repurchases

Share repurchases

- Stock repurchases that qualify as “redemptions” are taxed as though the shareholder sold the stock back to the corporation (get to recover basis)
- If the repurchase does not qualify as a redemption *the entire amount* is taxed as a dividend
- To avoid dividend taxation there must be a
  - “disproportionate” reduction in shareholder’s interest, or
  - a complete termination

    Implication: you can’t buy back a flat percentage of all shareholder’s shares

Seagram - DuPont (1995)

- In 1981 Seagram purchased 27.9 million shares of Conoco stock (32.6%) for $2.57 billion as part of a take-over attempt.
- DuPont won the tender offer (over Seagram and Mobil).
- Conoco shares were exchanged for 47.4 million DuPont shares, representing 20% of Dupont.
- Seagram increased its holding of Dupont - by 1995 they held 24% of the company. Total basis in DuPont stock in 1995 was $2.893 billion.

MCA

- On April 9, 1995 Seagram agreed to purchase 80% of MCA from Matsushita for $5.7 billion in cash.
- Transaction was completed on June 5, 1995.

Seagram's problem

- How could it convert its DuPont shares into cash to finance the acquisition?
- One solution: sell the shares

  MV shares ~$10 billion on April 3, book value ~ $2.9 billion

  If sold all, after-tax proceeds

  = 10 - (10-2.9)(.35)

  = 10 - 2.5

  = $7.5 billion

  Would pay tax of ~$2.5 billion

The transaction

- On April 6, 1995 DuPont agreed to redeem 156 million shares of its stock held by Seagram (95%).
- In exchange, Seagram received:
  - $1 billion cash
  - $7.336 billion in 90-day DuPont notes
  - DuPont warrants valued at $440 million, which allowed Seagram to purchase
    - 48 million shares @$89.33 for 60 days
    - 54 million shares @ $101.14 for 60 days
    - 54 million shares @ $113.63 for 60 days

DuPont traded at $61/share on April 3

Rules for a stock redemptions

- Stock redemptions are viewed as preferable to dividends since you get to recover basis and (potentially) pay taxes at the capital gains rate.
- A redemption is a sale if the redemption
  - is not essentially equivalent to a dividend
  - is substantially disproportionate with respect to the shareholder

    post-redemption ownership < 80% of pre-redemption ownership
  - is in complete termination of the shareholder's interest, or
  - results from a partial liquidation of the distributing corporation (noncorporate shareholders only)
- Otherwise the redemption is a dividend.

Seagram

- Was Seagram's redemption a dividend? Some additional information:
  - Options are counted toward ownership. As a result, Seagram's ownership of DuPont is unchanged. There was no disproportionate reduction.
- Payment to Seagram was classified as a $8.776 billion dividend.

Tax consequences of dividend treatment

Seagram received	$ 8.776 billion
Less DRD (.8*8.776)	7.021 billion
Taxable income	1.755 billion
Tax @ 35%	0.614 billion
After tax income	8.162 billion