Rochester Business Journal
RBJ
VOLUME 30, NUMBER 34 WWW.RBJDAILY.COM NOVEMBER 21, 2014

Businesses of all sizes can use Buffett's Duracell strategy

TAXING MATTERS
Josh Gewolb

Warren Buffett has two strong opinions about taxes: First, that the rich pay too little and second, that no one should pay more than they owe under the letter of the law. This second principle—that "we won't pay a dime more of corporate taxes than we owe"—is in evidence in the acquisition of Duracell battery that Buffett announced last week.

Variants of that deal, a so-called cash-rich split off, provide a useful tax-saving strategy applicable to businesses of all sizes—and present intriguing policy questions.

One of the key questions that the tax code grapples with is when a taxpayer should pay tax on the appreciation in value of an investment asset. When a taxpayer sells an asset for cash, the answer is simple: Clearly, tax should be due as the investment has come to an end.

However, there are other situations where the tax code, as a policy matter, does not require recognition of gain in order to facilitate different types of business activity. For example, in order to encourage people to start businesses, the code doesn't impose tax when people contribute appreciated assets to newly formed entities. Similarly, when two businesses merge, with the stockholders of each receiving shares in the combined entity, the code doesn't impose tax if technical requirements are met. The idea is to encourage business combinations that generate efficiencies and stimulate economic activity.

The policy considerations get a bit trickier when it comes to divestitures.

Say, for example, that you're Ebay, and you want to sell off Paypal. If Paypal were sold, billions of dollars in tax would be due. What if (as announced in September) Ebay instead "spun off" Paypal, giving shares in the newly separate entity to its shareholders pro rata?

The current code says that if certain technical requirements are met, such a transaction will be tax free. The idea is that shareholders basically own the same thing after the transaction—just in two packages instead of one—and accordingly should not be subject to tax.

For a spinoff to be respected as tax free, it must meet specific rules designed to make sure that there is really only a change in the form of ownership. Ebay easily meets the applicable technical rules as it is in control of Paypal, Paypal is an active trade or business, and all of its shares in Paypal will be distributed. Additionally, the deal isn't a "device for distribution of earnings and profits"—really a disguised dividend. Because these requirements are met, the Paypal deal will be tax free both for Ebay and its shareholders.

Spinoffs are relatively easy from a policy perspective—everyone still owns the same thing, just in a different way. What about the situation where there's one investor, say an octogenarian from Omaha, who wants to exchange his shares in a company for a particular business unit?

In a so-called split off, the parent corporation distributes stock in a subsidiary to one or more specific investors in exchange for their shares in the parent. The rest of the shareholders retain their original shares and beneficial ownership of the remaining business.

Applying the general rules for split offs to the Duracell deal announced last week shows how questionable the result under current law is from a policy perspective.

Buffett's Berkshire Hathaway paid $336 million for its shares in Procter & Gamble Co., which are now worth $4.7 billion, and was looking to sell. At the same time, P&G has been shedding non-core brands and was apparently looking to dispose of its Duracell battery unit—which Buffett "as a consumer and as a long-term investor" has admired. If the unit were sold, P&G would also face substantial corporate taxes.

In the deal announced last week, Buffett will trade in his stock in P&G in exchange for Duracell. Because the transaction qualifies as a split off, both parties will avoid any taxable gain.

Is this the kind of divisive transaction that the code ought to allow to be tax free? On the one hand, maybe it is: each shareholder still owns something that they owned at least a part of before. However, it's pretty different to own a small percentage of P&G's portfolio of thousands of brands, than to own a single brand with a value equal to 1 percent of P&G's market cap. If Buffett has sold his P&G stock to buy stock in another battery maker, he would have owed $1 billion in taxes.

This isn't the end of the story, however. Duracell isn't quite worth as much as Buffett's holding in P&G, so prior to the split off, the unit will be infused with $1.7 billion in cash. Though Buffett will effectively be receiving cash for a substantial portion of his P&G shares, the transaction is still tax free. The code provides that if more than one-third of the value is in the operating business, the deal qualifies. Even though Buffett is effectively cashing out a large portion of his holding in P&G, he is not, to use his words, paying a dime in taxes.

Of course, Buffett is bound by his fiduciary duty to his shareholders to minimize taxes for Berkshire, even while at the same time he may advocate for the reduction of corporate loopholes. Spinoffs and split offs may—at least in the extreme variety of the cash-free split off where only a small portion of the value is in the operating company—be characterized as a loophole. However, under the current code, they provide a very tax-efficient manner of exiting from a business. The benefits of this strategy are available to all taxpayers, not just the Oracle of Omaha.

Josh Gewolb is a tax attorney at Harter Secrest & Emery LLP.