

A Borrowing Deal Worthy of a Billionaire

By Allan Sloan

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So you think that five-year, no-interest car loans are the greatest deal ever? If so, you're one of the little people. If you were Warren Buffett, you'd sneer at "zero percent." Instead, you'd want investors to pay you for the right to lend you money. And for the Internal Revenue Service to come across with some juicy tax breaks.

That's the deal that Buffett got on a five-year, \$400 million loan that Wall Street investors have made to his conglomerate, Berkshire Hathaway Inc. We mere mortals leap at the chance to borrow money for no interest. But Buffett got paid to borrow -- and I'm not even counting what he'll make by investing the borrowings.

In the spirit of Tax Day, which is almost upon us, let's examine Buffett's deal, which was widely publicized last May but whose tax aspects haven't been discussed. I found them by accident last week when, prompted by the arrival of Berkshire's annual report, I trolled through Berkshire's Securities and Exchange Commission filings.

Before we proceed, two things. First, this transaction seems to be not only perfectly legal, but also not immoral. Berkshire uses normal tax-efficiency techniques in an unusual combination, but he isn't being slimy like tax-dodging weasel corporations that move to Bermuda but claim to be American or people who buy sleazy tax shelters of dubious legality and nonexistent morality. Second, I have multiple conflicts. Buffett is on The Washington Post Co.'s board of directors, Berkshire owns 18 percent of Post Co. stock, I own Berkshire stock through the Post Co.'s 401(k) plan, and the Post Co. has a significant holding of Berkshire stock.

Now, back to the deal. My analysis is based entirely on my reading of Berkshire's documents, because Buffett wouldn't talk to me and neither would Goldman Sachs, which concocted this transaction.

And what a transaction it is. Buffett boasted about being involved with the first-ever "negative-coupon" security -- but didn't mention Berkshire's tax break.

What's even better than getting paid more by your lenders than they're charging you in interest? Watch. Investors lent Berkshire \$400 million at 3 percent interest but are paying Berkshire 3.75 percent in annual "installment payments" on stock-purchase warrants that were part of the deal. Those warrants give holders the right to buy \$400 million of Berkshire stock at a fixed price of about \$89,600 a share, some 15 percent above what Berkshire shares fetched at the time.

The interest that Berkshire pays is tax-deductible, but the "installment payments" that it gets on the warrants aren't taxable. That's because those payments are considered part of the price of the warrants, and a company's dealings involving its own stock don't produce taxable income.

The math: Berkshire pays \$60 million in tax-deductible interest over five years and receives \$75 million in nontaxable "installment payments" over the same period. If you assume that Berkshire has a combined 40 percent federal and state income tax rate, Berkshire's after-tax proceeds are more than double its after-tax borrowing costs.

What's more, Buffett doesn't have to worry about getting the "installment payments" from Berkshire's warrant holders. That's because the holders, as part of the deal, were required to purchase \$75 million (face value) of Treasury "strips." Strips are like old-fashioned U.S. savings bonds that pay no cash interest and are redeemed by the government at face value when they mature. The strips cover the payments the warrant holders have to make to Berkshire.

By my estimate, the investors had to pay about \$65 million for the strips, which will pay Berkshire its \$75 million over five years. That \$10 million difference gives the investors taxable interest, but many of the buyers, judging from Berkshire filings, are tax-exempt, such as pension funds.

What I love is that Buffett, quite rightly, has been complaining that derivatives are putting the financial system at risk. But he's selling warrants -- which are derivatives. These are fairly safe for the holders because the worst that happens is that they expire worthless if Berkshire stock isn't worth \$90,000 a share by 2007. By my estimate, the buyers paid an effective cost of about \$75 million for the warrants.

But Buffett's not at risk at all. If the warrants are exercised, he can repay the \$400 million loan with the proceeds. If they're not, he's had the use of \$400 million for five years, and gotten paid handsomely to borrow it. This deal, fans, is an example of why Buffett is a multibillionaire. And why the rest of us have to settle for 60-month, interest-free car loans.

Follow-up: Last year's tax games, today's tax problems. The IRS is after Vivendi, the hard-pressed French conglomerate that has failed so miserably in its pursuit of media moguldom. The taxman says that the 1995 deal in which Vivendi's predecessor, Seagram, got \$8.4 billion for a big block of DuPont stock was a taxable sale rather than the tax-advantaged dividend that Seagram said it was. The IRS wants \$2.7 billion of taxes and interest. Vivendi says "non."

Pas de problème for Vivendi, says Lehman Brothers tax expert Robert Willens. "It's curious that the IRS would challenge this," he told me, "because Congress changed the law only after the transaction. I'm sure Vivendi will prevail."

So, in the spirits of Seagram and Berkshire, a merry Tax Day to all of you. Many happy returns. May you survive April 15 and come out smiling.