

Setting up Share Structure

In general, there are two kinds of shares: common and preferred. Preferred shares are like bonds: they usually have a set value, and pay a set dividend per year. Common shares are normally the "residual equity" shares: you get what's left after paying the company's debts and preferred shareholders.

You can attach many different rights and restrictions to shares, including:

- voting rights
- dividend rights: these can be a fixed percentage, or else at the discretion of the directors
- rights to redeem the shares for a fixed amount
- company rights to buy back the shares for a fixed amount
- the right to convert the shares into shares of another class at a set formula
- restrictions on ownership of the shares

Shares can have a "par value" or not. Ones with "no par value" have no assigned face value. While the historic reasons for the distinction are no longer that relevant, par value shares can be useful for corporate and tax planning in specific situations. Your lawyer can advise you whether these would be beneficial to set up in your case.

You should plan the share structure of the company to provide for future flexibility as well as your present needs. Consult your tax advisor to choose the best kinds of shares.

Definitions

Common Shares

Common stock, also referred to as **common shares**, are, as the name implies, the most usual and commonly held form of [stock](#) in a [corporation](#). The other type of shares that the public can hold in a corporation is known as [preferred stock](#). Common stock that has been re-purchased by the corporation is known as [treasury stock](#) and is available for a variety of corporate uses.

Common stock typically has voting rights in corporate decision matters, though perhaps different rights from preferred stock. In order of priority in a [liquidation](#) of a corporation, the owners of common stock are near the last. Dividends paid to the stockholders must be paid to preferred shares before being paid to common stock shareholders.

Preferred Shares

A **preferred stock**, also known as a **preferred share** or simply a **preferred**, is a [share](#) of [stock](#) carrying additional [rights](#) above and beyond those conferred by [common stock](#).

Such rights may include:

- a [dividend](#) amount that never changes, if the dividend is paid at all. The dividend is usually specified as a percentage of the initial investment and/or a [stock symbol](#) letter, such as Pacific Gas & Electric 6% Preferred A. Variable preferreds are rare exceptions: their changing dividends depend on prevailing interest rates, or nowadays on ratings.
- precedence over shares of common stock when it comes to the distribution of [profits](#) and the [liquidation](#) proceeds of a [stock corporation](#)
- superior voting [rights](#) generally, or special voting [rights](#) to approve certain extraordinary events (such as the issuance of new [shares](#) or the approval of the acquisition of the company) or to elect directors, but many preferred shares provide no voting rights
- anti-dilution provisions that prevent the issuance of additional shares at prices below those of the preferred shares
- right of first refusal with respect to the issuance of new shares
- dividend rights or cumulative dividend rights (cumulative dividend rights accumulate during periods when they are not paid).
- when a company goes bankrupt and has to liquidate assets the preferred stockholders get paid first, if possible.

The above list, although including several customary rights, is far from comprehensive. Preferred shares, like other legal arrangements, may specify nearly any right conceivable.

Dividends

A **dividend** is the distribution or sharing of parts of profits to a company's [shareholders](#).

Why companies pay dividends

The primary purpose of any [business](#) is to create [profit](#) for its owners, and the dividend is the most important way the business fulfills this mission. When a company earns a profit, some of this money is typically reinvested in the business and called [retained earnings](#), and some of it can be paid to its shareholders as a dividend. Paying dividends reduces the amount of cash available to the business, but the distribution of profit to the owners is, after all, the purpose of the business.

How dividend is determined

The amount of the dividend is determined every year at the company's annual general meeting, and declared as either a cash amount or a percentage of the company's profit.

The dividend is determined mainly on the basis of the company's unappropriated [profit](#) and its business prospects for the coming year (see [The dividend decision](#)). It is then proposed by the [Executive Board](#) and the [Supervisory Board](#) to the annual general meeting.

The dividend is the same for all shares of a given class (that is, [preferred shares](#) or [common stock](#) shares). Once declared, a dividend becomes a liability of the firm.

For most companies, the amount of the dividend remains constant. This is to reassure investors, especially during phases when earnings are low, and sends the message that the company is optimistic with respect to its future performance.

Cum-dividend

Cum Dividend means "with dividend". A stock trades cum-dividend up until the ex-dividend date. Before this date, a stock buyer is still entitled the dividend rights (ie to receive a dividend that has been declared, but not paid). However, on or after this date, the stock buyer is no longer entitled to the dividend rights.

Ex-dividend

Ex-dividend means "exclude dividends. When a share is sold shortly before the dividend is to be paid, the seller rather than the buyer is entitled to the dividend. At the point at which the buyer is not entitled to the dividend if the share is sold, the share is said to go *ex-dividend*. This is usually two business days before the dividend is to be paid, depending on the rules of the stock exchange. When a share goes ex-dividend, its price will generally fall by the amount of the dividend.

Type of dividends

The methods of sharing profits are as follows:

1. **Cash dividends** (most common) are those paid out in form of "**real cash**". It is a form of investment interest/income and are taxable in the year they are paid. It is the most common method of sharing corporate profits.
2. **Stock dividends** (common) are those paid out in form of **additional stock shares** of the issuing corporation, or other corporation (eg its

- subsidiary corporation). They are usually issued in proportion to shares owned (eg for every 100 shares of stock owned, 5% stock dividend will yield 5 extra shares).
- When the company distributes these new shares to investors, the price of each share decreases to account for the new shares. This is a recalculation of cost basis. It means that the stock dividends will not be taxed when distributed.
 - Stock dividends benefit the **corporation** in that they don't need to pay out in "real cash", reducing the financial burdens and saving money for other business operations (eg business expansion).
 - Stock dividends also benefit the **shareholder** by increasing his/her number of shares of the company.
3. **Property dividends** (rare) are those paid out in form of **assets** from the issuing corporation, or other corporation (eg its subsidiary corporation). Property dividends are usually paid in the form of products or services provided by the corporation. When paying property dividends, the corporation will often use securities of other companies owned by the issuer.

Dividend-reinvestment plans

Some companies have dividend-reinvestment plans. These plans allow shareholders to use dividends to systematically buy small amounts of stock often at no commission. Dividends are not yet paid in gold certificates although this idea has been discussed by mining companies such as Goldcorp.

Reasons why companies avoid paying cash dividends

Companies have often avoid paying cash dividends for several reasons:

1. Company management and the board believe that it is important for the company to take advantage of opportunities before it, and reinvest its recent profits in order to grow, which will ultimately benefit investors more than a dividend payout at present. This reasoning is sometimes right, but is often wrong, and opponents of this reasoning (such as [Benjamin Graham](#) and [David Dodd](#), who complained about the practice in the classic 1934 reference [Security Analysis](#)) usually note that this comprises company management dictating to the business's owners how to invest their own money (i.e. the profit of the business).
2. When dividends are paid, shareholders in many countries, including the United States, suffer from [double taxation](#) of those dividends: the company pays income tax to the government when it earns any income, and then when the dividend is paid, the individual shareholder pays income tax to the government on the dividend payment. This is often used as justification for retaining earnings, or for performing a [stock buyback](#), in which the company buys back stock, thereby increasing the value of the

stock left outstanding. The shareholder pays no income tax on this transaction. In addition, certain types of specialized investment companies (such as a [REIT](#) in the U.S.) allow the shareholder to partially or fully avoid double taxation of dividends.

[Microsoft](#) is an example of a company who has historically been a proponent of retaining earnings; it did so from its [IPO](#) in 1986 until 2003, when it declared it would start paying dividends. By this point Microsoft had accumulated over [US\\$43 billion](#) in [cash](#), and there had been increasing irritation from stockholders who believed this large pile of cash should lie in their hands and not in the company's. Originally, the official reason to amass this large sum was to create a reserve for Microsoft's legal battles; since then, Microsoft appears to have changed tactics such that the reserve is not as necessary.