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Private Equity

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update

The Dividend Window:

Liquidity Options for Private Equity Investors and Business Owners Created by the New Tax Law

On May 28, 2003, President Bush signed the Jobs and Growth Tax Relief Reconciliation Act of 2003 into law. While the tax relief is less than the tax cut originally sought, the Administration did get Congress to tax dividends and long-term capital gains generally at the same reduced rate of 15%. The equal tax treatment of dividends and capital gains removes the tax bias against transactions that generate dividend income, but the relief is only temporary. The reduced rates are in effect through the end of 2008. At that point, dividends go back to being taxed as ordinary income and long-term capital gains revert to a 20% rate. However, the actual duration of the alignment of tax rates on dividends and long-term capital gains is much more speculative. Several Democratic presidential candidates quickly announced that they would campaign for the 2004 election on a promise to repeal some or all of the new tax cuts.*

This Update highlights:

- Key provisions of the new tax law with respect to the treatment of dividends and long-term capital gains; and
- Implications for:
  - Family-owned and other privately held businesses; and
  - Portfolio companies of private equity funds.

Key Provisions of the New Tax Law

What has changed?

- **Capital Gains:** The new tax law reduces the maximum rate for individual taxpayers on long-term capital gains from 20% to 15%. The rate reduction is in effect through the end of 2008. For taxpayers in low income tax brackets (who have been subject to a maximum 10% rate on long-term capital gains), the reduced rate will be 5% through 2007 and 0% in 2008.
- **Dividends:** The new tax law also generally reduces the maximum individual income tax rate on dividends to 15% through the end of 2008. As in the case of the capital gain rate reduction, taxpayers in low income tax brackets will generally have a maximum rate of 5% (0% in 2008) on dividends. The reduced rate applies to dividends received by individual taxpayers from

* "Some Candidates Quick to Urge Tax-Cut Repeal," *The New York Times*, May 30, 2003, page A 24.

domestic corporations, with certain limited exceptions, and from qualified foreign corporations. As a practical matter, individual U.S. taxpayers holding stock—directly or through a pass-through entity—in a private U.S. corporation will typically not be affected by these exceptions and qualifications and, thus, will be entitled to the reduced rate.

- **Ordinary Income:** The slight reduction in marginal tax rates scheduled to become effective in 2004 and 2006 has been accelerated by the new tax law. The rates have been reduced retroactively to January 1, 2003, as follows:

Old Rate	27.0%	30.0%	35.0%	38.6%
New Rate	25.0%	28.0%	33.0%	35.0%

What has not changed?

- Neither the lower capital gain rate nor the reduced rate on dividends applies to corporate taxpayers. As under prior law, corporations will still generally be able to take a "dividend received deduction" of 70% or more of qualifying dividend income.
- The reduced rate applies to dividends paid to the extent of current and accumulated earnings and profits (E&P) of a corporation. If a dividend exceeds E&P, the shareholder has (1) first, a return of tax basis and, thus, no taxable income but a reduction of tax basis in the stock, and (2) then, to the extent the dividend exceeds both E&P and the stock's tax basis, taxable capital gain.
- The rate reduction for dividends is relevant for C corporations and, in most cases, not applicable to S corporations. As before, (1) an S corporation is usually not taxed on its income at the entity level, (2) the S corporation's profits are reported by its shareholders on their personal tax returns and taxed at regular individual tax rates, and (3) there is no second level of tax on distributions by the S corporation of previously taxed earnings.
- Even though the tax rates have been aligned, there is still a difference between redemptions that may qualify as a sale and dividends. In a qualified redemption, the shareholder recognizes capital gain on the difference between the amount of the distribution and the tax basis in the stock, while in the case of a dividend the full amount of the distribution is taxed (unless the dividend exceeds E&P). Accordingly, the tax provisions determining whether a distribution is a redemption or a dividend are still somewhat relevant.
- Compensation via restricted stock or non-qualified stock options is still taxed at ordinary rates.

Leveraged Recapitalization

The reduction in tax rates comes during a period of historically low interest rates. The current prime rate of 4.25%, which has been in effect since November 2002, is the lowest since 1959. One effect of the low interest environment has been a renaissance of the high-yield market fueled by investors searching for more attractive yields. During the first quarter of 2003, the principal amount of high-yield fixed income securities placed was more than twice the amount placed in all of 2002. Even though the rally may have cooled off recently, the historical experience that the high-yield market offers the best long-term return opportunity at the outset of an economic recovery should result in the continued allocation of capital to the asset class.

The combination of low interest rates, the rebounding high-yield market, and reduced tax rates has created an attractive window for private business owners to obtain partial liquidity through a leveraged recapitalization when other exit options are not available. The basic structure of a leveraged recapitalization is simple: a company borrows money to pay a substantial dividend or redeem stock. The structure has been frequently employed to effect an ownership change yet avoid a step-up in the book value of the target's assets for financial accounting purposes, particularly before the SEC tightened the rules on recap accounting in 2001. However, the focus here is on recapitalizations by the current owners to unlock unrealized value and to obtain partial liquidity without a change of control. The liquidity option made attractive by the new tax law should be of primary interest to two groups: family-owned businesses and portfolio companies of private equity funds.

Family-Owned Businesses

Private owners of C corporations have traditionally been discouraged from recapitalizations because the distributions received in the transactions were generally treated as ordinary income. Even apparent redemptions ran the risk of being treated as dividends, with corresponding adverse tax consequences. The basic rules determining the treatment of a stock redemption as a sale were not changed by the new tax law. A redemption (including a sale of stock in one corporation to a related corporation) qualifies for capital gain treatment as a sale only if the redemption meets the requirements of Section 302 of the Internal Revenue Code. A shareholder receives sale treatment if (1) after a redemption of voting stock the shareholder owns less than 50% of the voting power of the corporation and his or her percentage ownership of all voting stock and all common stock, whether voting or nonvoting, is reduced by more than 20%, (2) all the stock of the shareholder is redeemed, or (3) the redemption brings about a meaningful reduction of interest that makes it unlike a dividend. The latter test does not afford the comfort of a safe harbor. For purposes of the redemption tests, the family stock attribution rules provide that stock owned by certain family members are treated as owned by the shareholder whose stock is redeemed. The attribution rules also cover shares held by partnerships, trusts, estates and related corporations and shares subject to options. The stock attribution frequently precludes shareholders in family-owned corporations from meeting the Section 302 tests.

The new tax law now allows privately owned C corporations to distribute cash proportionately or disproportionately without facing the quandaries of the redemption tests and the stock attribution rules, particularly where the stock basis is low relative to stock value. There is an incentive to go beyond the release of any existing excess cash balances and recapitalize the business with debt. Even in a tight bank lending market, steadily performing private businesses may be able to incur incremental senior debt that stays within a modest leverage ratio of 2-to-2.5 times EBITDA. Larger businesses with stable cash flows will also be able to tap the market for mezzanine capital and obtain higher leverage.

Private Equity Funds

Many private equity funds have held portfolio companies for several years yet do not find the current M&A or IPO market receptive to an exit. Frequently, these companies have grown their cash flow or reduced their debt, or both, and can be re-leveraged accordingly. In addition to the opportunity to lock in an IRR on the equity investment, recapitalizations that refinance high-yield debt also offer the prospect of lowering the overall cost of capital.

Leveraged recapitalizations raise a number of issues under corporate law, the existing debt instruments, and potentially the securities laws, but these are not novel and we will not reiterate them here. Instead, we will discuss some tax-planning aspects of the distribution under two equity structure scenarios.

- **Common Stock:** The tax results in an all common stock structure are straightforward. Proportionate distributions are dividends subject to the reduced tax rate. Disproportionate redemptions that meet the Section 302 tests produce capital gain after basis offset. Redemptions that do not meet these tests constitute dividends. Either way the reduced rates generally apply. However, equity structures involving only common stock are unlikely to exist in private equity financed companies.

- **Preferred Stock/Common Stock:** If a private equity fund holds voting or convertible preferred stock and management holds vested common stock (or common for which an 83(b) election has been made), and it is intended that management participate in the distribution, a dividend on both classes of stock may be the obvious solution to take advantage of the reduced rate, since the private equity fund will probably not accept the shift in voting power required to meet the redemption test. If the private equity fund holds a strip of non-voting, redeemable preferred stock (with basis reflecting the bulk of its equity investment) and common stock, and management only holds common stock, the private equity fund would benefit from a redemption of all or a portion of the preferred stock to recover basis and minimize current taxation. The accruing dividend on the redeemed preferred would then end, conserving future value for the common. However, since the redemption is neither substantially disproportionate (since it is not accompanied by a shift in voting power) nor a complete redemption under Section 302, it would probably not qualify for sale treatment where the fund holds a significant block of common. A potential solution would be for the private equity fund to distribute the preferred stock first to its partners, so that the Section 302 tests can be applied on the partner level (where the redemption may qualify as not essentially equivalent to a dividend). Care must be exercised to minimize the likelihood that the distribution and later redemption would not be respected as separate steps.

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