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M&A Tax Talk

Leveraged distributions

Leveraged distributions: Uses, potential implications,and tax considerations

Investors and shareholders have several options available for early monetization of a partial exit from their investments. One such option is to recapitalize their investment with a leveraged distribution, through either a cash distribution/dividend or a share buy-back.

What is a "leveraged distribution"?

A leveraged distribution occurs when a company borrows proceeds to make a debt-financed distribution to shareholders and investors. Alternatively, the distribution could be structured as a share buy-back redemption.

If a company borrows additional proceeds from an existing lender, the incremental loan typically is one of the most senior tranches on a company's balance sheet and will generally require additional collateral to back the debt. There are a few commercial factors to consider:

- Whether there is capacity to take on this debt based on existing financial obligations (This will depend on the solvency of the company as well as amount of debt currently on the books.)
- Consistent, predictable cash flows to meet debt servicing needs
- Whether existing lenders will allow a distribution of borrowed funds to shareholders

Another option to finance a distribution is through the use of preferred shares, with the company bringing on one or more additional investors.

Considerations when pursuing a leveraged distribution by a corporation

Under section 301, a leveraged distribution through a corporation could result in either (i) dividends to the extent the corporation has earnings and profits (E&P), (ii) basis recovery, or (iii) capital gain to the extent the distribution exceeds stock basis.

While US investors may be subject to the same rate of tax on dividends from a US corporation as long-term capital gain (i.e., if such dividends were treated as qualified dividends), the amount of dividend income could be more or less depending on the amount of the corporation's E&P, and the overall taxable income to the stockholder may also be dependent on the share basis. In certain instances, to the extent there is basis to absorb the amount distributed (after the amount that may first be treated as a dividend), no gain may be recognized in the transaction if the distribution does not exceed the basis. For dividends, note that the dividends may be treated as qualified dividends and subject to capital gains rates if the holding period is met (generally, for common stock more than 60 days in a 121-day period beginning 60 days before the ex-dividend date).

However, for non-US investors, the results may be different; for example, such investors may be subject to withholding tax, which would decrease the overall distribution received (as investors usually are not grossed up on the distribution for the amount of the withholding tax imposed). Additionally, note that the obligation to withhold for dividends would fall on the payor (or the entity/individual who would have control of the payment), which generally would be the entity that is making the distribution.

For illustrative purposes, assume Shareholders A and B collectively own 100% of the shares of Corporation Y with a stock basis of $200 million. Both shareholders contributed cash into the corporation upon formation and have held the corporate stock since inception. With current-year earnings and profits of $300 million for the calendar year and no accumulated earnings and profits from prior years, Corporation Y makes a leveraged distribution of $1.1 billion to the shareholders. In this example, the $1.1 billion distribution from the corporation would be characterized as $300 million in dividends, $200 million return of capital, and a $600 million capital gain, based on the ordering rule in section 301(c) (and assuming the shareholders have uniform basis per share).

Example 1		**USD millions**
Shareholder A's and B's share basis in Corporation Y	$	200
Corporation Y's earnings and profits	$	300
Leveraged distribution from Corporation Y	$	1,100
Characterization of distribution		
Amount as dividend	$	300
Amount as return of basis	$	200
Amount of gain at corporation	$	600
Total distribution	**$**	**1,100**

A distribution structured as a share buy-back/redemption may be taxed under US U.S. federal income tax rules in certain cases as received in a sale or exchange for the shares bought back or redeemed under section 302(a) (e.g., depending on the investors' pre- and post-redemption ownership, proportionality of distribution), resulting in basis offset for calculating the capital gain (or loss), which may qualify for the lower long-term capital gains rate (as discussed above).

The Inflation Reduction Act that was signed into law on August 16, 2022, may impose a 1% excise tax on share buy-backs after December 31, 2022, subject to certain conditions, including the buy-back of shares of a public company, the buy-back is in excess of $1 million (taking into account any new share reissuances), and repurchase is not part of a plan of reorganization in which no gain or loss was recognized. Furthermore, such excise tax is non-deductible for US federal income tax purposes.

It should be noted that a leveraged distribution may increase the amount of interest expense. However, the interest expense may be deducted for US federal income tax purposes, subject to section 163(j).

If preferred equity is used instead of debt, consideration should be given to, among other things, a potentially longer holding period for qualified dividend income (QDI) and the application of section 305(b), which, depending on the preferred terms, may generate phantom income to the investor. Refer to the recent M&A Tax Talk on PIPEs for further discussion.

Considerations when a leveraged distribution is made by a corporation to a partnership

If a partnership owns 100% of the stock of a corporate parent, there are additional considerations when the parent corporation makes a leveraged distribution to its partnership owner and the partnership makes a subsequent distribution to its partners (i.e., a corporation takes on debt and makes a distribution to its sole partnership shareholder, which then further distributes to its partner(s)). The allocation of the income or gain by the partnership to its partners (or recovery of tax basis by the partnership and its partners) may be different than the income or gain recognized (or basis recovered) by the shareholders if the shareholders owned the corporation directly. Additionally, if certain partners purchased interests in the partnership after the partnership acquired stock, the partners may have or may have had a section 743(b) adjustment with respect to the stock, and the section 743(b) adjustment may result in more or less tax being paid on the transaction. Furthermore, to the extent that a partner receives a distribution of the proceeds in excess of its tax basis in the partnership, the distribution will be taxable to the partner. Lastly, there may be differences in the holding period between the partner's interest in the partnership and the partnership's interest in the corporation that may result in differences in short-term versus long-term capital gain rates.

Finally, there are other potential issues that need to be considered, including greater difficulty in qualifying a buy-back or redemption for sale or exchange treatment under section 302(a); tax withholding (i.e., a partnership may change the entity responsible for withholding); disguised sales; different partners wanting to sell at different times; and future rollover transactions, which would require additional reporting requirements at the partnership level. While a partnership may provide additional benefits in these structures (e.g., profits interests for key service providers), upon a leveraged distribution, a partnership may create additional complexity and traps for the unwary.

Want to learn more?
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