Why you should consider a dividend recap today

In his first address to Congress on April 28, President Joe Biden rolled out his vision for the American Jobs Plan and American Families Plan. While only in proposal form, one thing is very likely: major changes to the U.S. tax code are on the horizon.

As outlined by Biden, numerous components of these proposals could have significant impacts to business owners—both at the corporate and the personal level. While the timing of any potential tax changes is not yet known, there are strategies that exist today that can be considered to help minimize their impact. One such opportunity that has reemerged in recent months is the dividend recapitalization, or dividend recap.

In a dividend recap, a business assumes new debt and distributes the proceeds to shareholders in the form of a dividend. Given the potential changes to the tax code, utilizing this strategy today could prove beneficial for business owners.

What could change in the tax law?

For those earning more than $1 million, Biden has proposed an increase on long-term capital gains taxes to the ordinary income rate of 39.6%. Taxpayers in this bracket would also have to pay an additional 3.8% Medicare investment income tax. Since distributions are taxed at the capital gains rate today, this change would approximately double what business owners pay in taxes, making it attractive to take money out of the business today through a dividend recap.

Article update: In late May 2021, the Biden administration indicated they would like to see the changes to the capital gains tax rates to be effective as of the announcement of the proposed changes, rather than taking effect in 2022. As the legislation has not yet been passed, it is still uncertain what the timing for the changes will be.

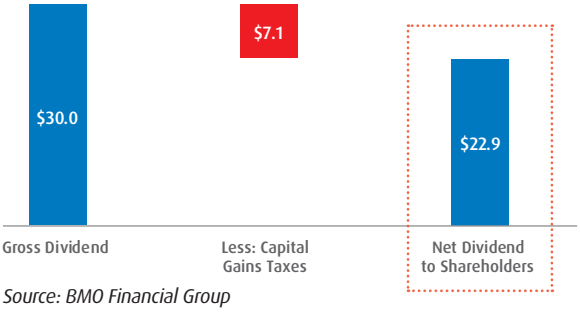
Why should a business owner consider a dividend recap today?

Undergoing a dividend recap today can benefit the owner's or shareholder's personal wealth planning objectives through the following:

- **Today's lower capital gains rate.** Doing a dividend this year with capital gains taxes of 20% versus the proposed rate of 39.6% will result in a tax payment of roughly 50% less than what a shareholder may have to pay in the future.
- **Liquidity without ownership change.** Dividend recaps are an effective way of providing shareholders with liquidity without impacting the ownership of the business. When a dividend is issued, the proceeds are distributed on a pro rata basis without impacting equity ownership.
- **Diversification of wealth.** We often see most of a business owner's wealth tied up in their business. The dividend received can be invested in other strategies (stocks, bonds, real estate, etc.) to diversify wealth so it is not overly reliant on the performance of the business.
- **Wealth transfer benefits.** For those looking at intrafamily succession of their business, assuming debt for a dividend recap prior to transfer of the business interest will decrease the business' equity value. This allows for a greater percentage of the business to be transferred without using additional lifetime exemptions.

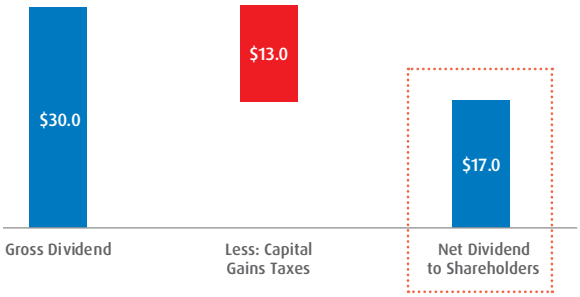
Continued

Dividend recap summary at today's capital gains rates
$ in millions



Source: BMO Financial Group

Dividend recap summary at proposed capital gains rates
$ in millions



1) Rates for those earnings above $1.0 million, based on President Biden's "American Families Plan" proposal.

2) Any income previously taxed but not distributed would be tax-free.

Source: BMO Financial Group

What are the potential impacts to the business?

Taking on incremental debt to pursue a divided recap is likely to impact your business. In today's market, however, the impact may not be as severe as you expect given:

- **Today's low interest rate environment.** Interest rates remain at low levels today, making it relatively inexpensive to take on additional debt to pursue strategies like a dividend recap. If there is an increase in the rate of inflation, this could cause interest rates to increase to help offset it.
- **Interest may be tax deductible.** Interest payments on debt may be tax deductible at the company level. This helps to alleviate concerns that a company might have about incurring incremental debt to provide liquidity to shareholders versus investing in the business.
- **Risk-return threshold may be lowered.** Using debt in a prudent manner can lower a company's cost of capital, which is a proxy for its risk-return threshold. Cost of capital is composed of debt and equity. Debt is almost always less expensive than equity. By decreasing the amount of equity that a company has—and increasing its debt—you lower your cost of capital and economic return threshold, reducing the risk-return profile of the business.
- **Valuation not required.** Dividends can be issued without requiring the company receive a valuation, which can be time consuming and costly. Additionally, given how businesses have performed over the last year—some having record years for the better, others for the worse—receiving a valuation could have unintended consequences. A dividend relies upon the ability of the company to take on additional leverage based on the company's overall debt relative to its earnings.

Is my business a candidate for a dividend recap?

The following are key indicators that a business may be optimal for a dividend recap:

- A proven track record of consistent cash flow and strong EBITDA post-transaction.
- Stable end-markets and the ability to weather market cycles.
- Low leverage with the ability to incur incremental additional debt and remain at a comfortable leverage level.

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