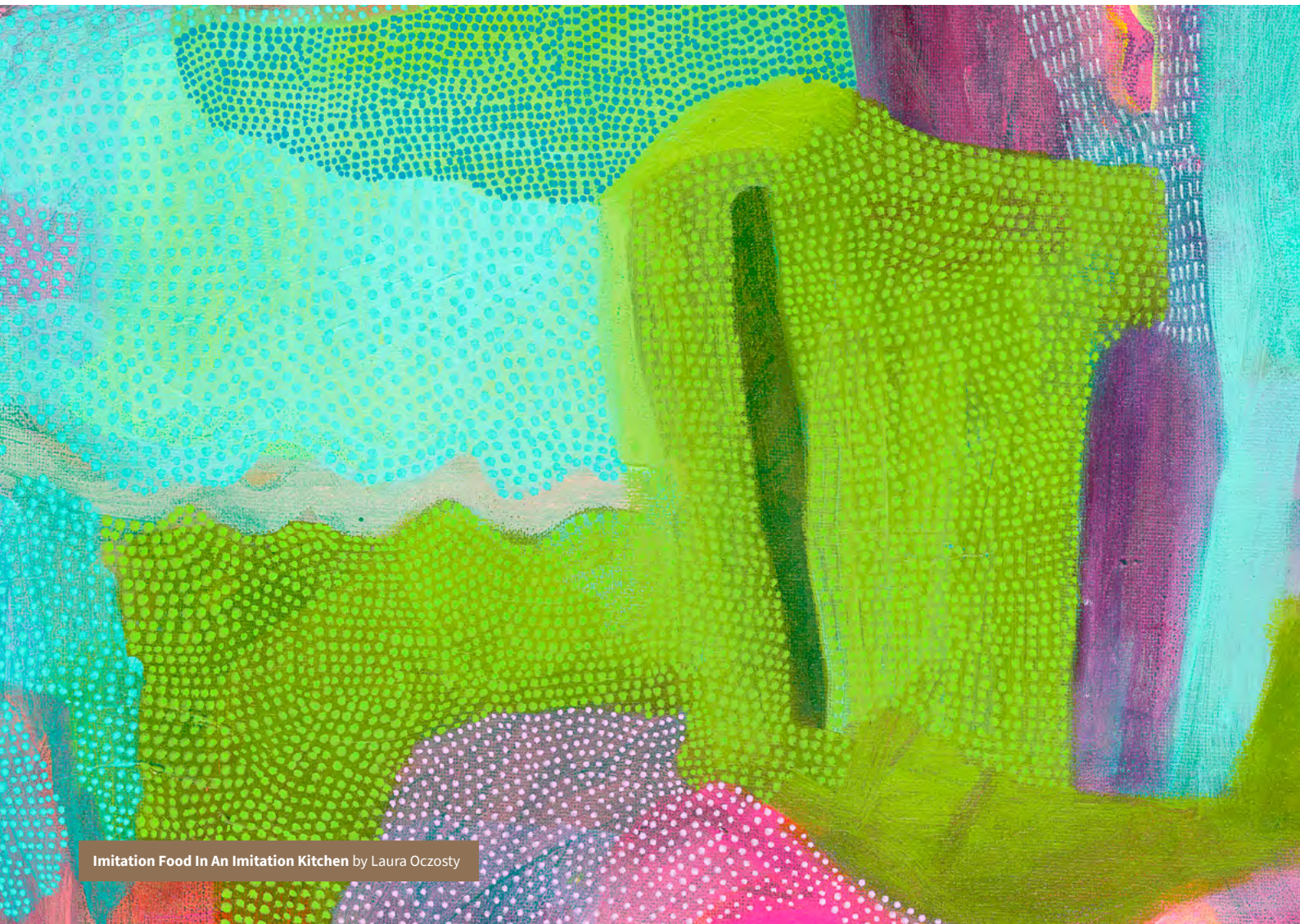


# IN PRIVATE

KWM M&A INSIGHTS | OCTOBER 2025



# DIV RECAPS: HAVE YOUR CAKE AND EAT YOUR PORTCO TOO

**A div recap (or 'dividend recapitalisation' for those people who don't like shorthand) is where a company borrows to fund a distribution to its shareholders. This is a re-gearing event that leaves the company with more net debt on its balance sheet, allowing the sponsor to realise some of its equity value ahead of a full exit.**

## DRIVERS

In our [Leveraged Finance Year in Review](#) we typically have a word or phrase of the year. In 2025, there's a good case for 'DPI' being the winner two years in a row.

Distributed to paid-in capital ('DPI') measures how much money investors have put in vs what they've received back – but over the last couple of years, it has been used as fancy lingo for 'still not exiting yet'.

Sponsors remain under pressure to return funds to investors and, where exit conditions are challenging, are looking at other options to boost DPI.

Div recaps have been the most popular DPI tool this year, in particular as:

- Borrowing conditions in 2025 have been very favourable to borrowers. Falling base rates have been accompanied by a real compression in margins (particularly from private capital lenders). This has been partly driven by competition between an increasing number of lenders who have sought to deploy capital into a limited number of transactions. That lower cost of debt capital makes div recaps an attractive option.
- Many of the portfolio companies that are candidates for a div recap are currently at a natural refinancing point. Australian leveraged loans usually have a tenor of 5 years (or 6 years for private credit). The wave of deals done in 2021 (post-COVID with favourable borrowing conditions and healthy private equity activity) have looming maturities, meaning those portfolio companies will be back in the market to refinance anyway. And, more generally, a few recent years of more difficult borrowing conditions means there is a backlog of refinancings now coming to market.

Those factors, coupled with sponsor messaging that the real exit is coming soon, sees the 'refi + div recap' proposal often coupled with a request for portability – to allow the new debt package to survive a potential change of control transaction.

## COMPLEXITIES

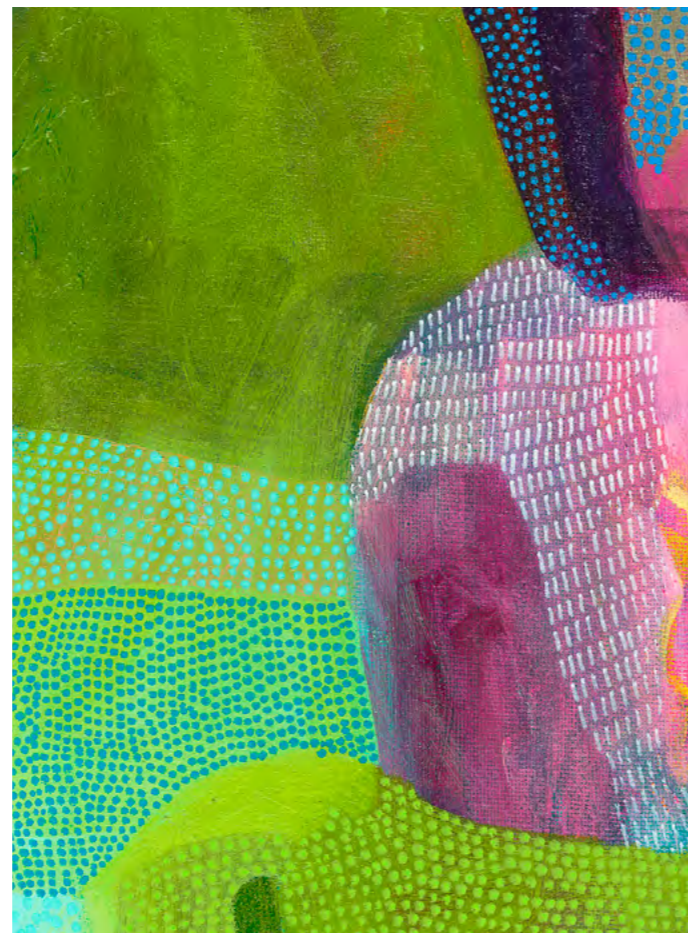
For a relatively simple proposition, div recaps involve some complexity in implementation which needs to be carefully considered for each deal.

## METHOD OF UPSTREAMING

Notwithstanding the name 'div recap', not every deal involves a dividend. The key decision point is the appropriate method of upstreaming funds - dividend, buy-back or return of capital.

Relevant factors to the decision include:

- Whether the company has sufficient current year profits (or retained earnings) to pay a dividend and meets the other requirements of section 254T of the *Corporations Act 2001* (Cth).
- The company's share-capital account balance
- What approvals (if any) may be required from shareholders and the board under the relevant governing documents and/or the *Corporations Act*.



The chosen structure can have very different tax outcomes for shareholders. For example:

### GENERALLY A DIVIDEND:

- is assessable as income
- is subject to dividend withholding tax for offshore holders if not franked
- may attach franking credits

VS

A capital return may reduce the cost base of shares – rather than giving rise to a taxable gain (provided the capital return does not exceed the cost base)

VS

An off-market share buy-back's proceeds may be a combination of capital and dividend; there is a degree of complexity in determining the components and care needs to be taken to ensure various integrity rules do not apply

## DIVIDEND SUBSTITUTION RULES

Because it may be beneficial from a tax perspective for a shareholder to receive a capital return rather than a dividend, an integrity rule exists which can be applied by the ATO to declare all or part of a capital return to be an unfranked dividend. The ATO can do this if there is 'more than an incidental purpose' to confer a 'capital benefit' on shareholders.

To provide certainty, portfolio companies will generally obtain tax advice and may engage with the ATO for a tax ruling in relation to the proposed return of capital prior to undertaking it.

## FRANKING CREDITS

If all or part of the div recap is implemented via a dividend, the next consideration is whether franking credits are available and can be allocated to the dividend.

## THIN CAPITALISATION

For those lucky enough to have avoided thinking about thin capitalisation since the new laws generally came into effect from 1 July 2023, here is a quick primer:

- Under the new rules, deductions for interest expense are generally capped at 30% of 'tax EBITDA' (which is very different to adjusted pro forma financing EBITDA) for most taxpayers. For many leveraged borrowers, this can result in denied deductions.
- Certain taxpayers may be eligible to apply the 'third party debt test' (TPDT) as an alternative to the tax EBITDA test.
- One of the conditions for the TPDT (among others) is for the relevant debt to fund 'commercial activities in connection with Australia'.

Taxation Ruling 2025/2, published by the ATO in early October 2025, indicates that 'commercial activities in connection with Australia' does not include the payment or distribution of dividends or capital returns.

If the ATO's view is correct, borrowers relying on the TPDT will need to consider the impact on deductibility of interest for any div recap transaction.

Where the lender under a div recap is connected to the borrower, additional limitations on interest deductibility may apply.

## THE CASE FOR DIV RECAPS

None of this is to suggest that div recaps should be relegated to the 'too hard basket'. Div recaps are clearly an effective tool for sponsors to manage DPI pressure and generally for capital management – and there are many successful transactions in the market. However, each transaction requires careful and quality advice.



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