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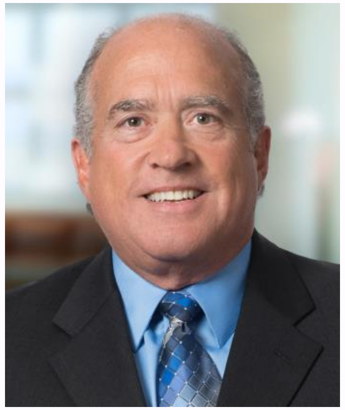
The COVID Stimulus Hangover and Other Economic Issues Facing Portfolio Companies

September 2, 2020



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Polsinelli COVID-19 Resources

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For COVID-19 legal advice across a spectrum of issues impacting an array of industries and legal areas, our team is available and connected nationally and in the communities in which you operate.

Contact us with questions at:
COVID19webinars@Polsinelli.com

Blog + Resources

Polsinelli's cross-disciplinary COVID-19 blog provides companies tools and information needed to effectively and lawfully protect their employees and business.

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Introduction

Phil Feigen, Office Managing Partner

Phil Feigen is a shareholder in Polsinelli's Business Department, chair of the Financial Institutions Practice Group and managing partner of the firm's Washington, DC office. With over 25 years of experience, Mr. Feigen brings a unique perspective to providing general corporate advice, as well as complex business counsel to clients in ever-changing regulatory environments. His practice focuses on representing financial institutions, Small Business Investment Companies and other entities before the Small Business Administration, other private investment funds, federal and state banks and other financial services related companies. Mr. Feigen has represented clients complying with complex federal/state licensing and regulatory requirements.

Bill Sanders, Shareholder

Through over 30 years of practicing law concentrated on tax matters, Bill Sanders has developed broad tax experience in corporate, partnership, limited liability company, complex business transactions, and workout and bankruptcy issues. As chairman of the firm's tax practice group for the last 15 years and a licensed CPA in Missouri, Bill's clients range from Fortune 100 companies to family-owned and tax-exempt organizations. He regularly represents clients nationwide before the Internal Revenue Service at all levels including audits, the Appeals Division and in tax court.

Sara Ainsworth, Associate

As an associate in the Securities & Corporate Finance practice, clients rely on Sara Ainsworth to work with Polsinelli's team of attorneys to analyze each transaction matter to develop a strategic approach to representation based on the client's immediate and long-term business and operational goals. Working closely with seasoned Polsinelli attorneys in the Securities & Corporate Finance practice, Sara helps deliver a range of legal services during the life cycle of the client's business—from selecting the appropriate choice of entity through to exit strategy, and assisting with the nuts and bolts of fund formation and fund transactions.

Topics Covered

- PPP
- CARES Act tax considerations
- Funding sources:
  - Volcker Rule amendment
  - SEC definitional changes
- Carried Interest
- Payroll Tax Holiday
- Main Street Lending Program

PPP - Issues to Flag

M&A Transactions - Consents

- M&A transactions are likely an event of default under the PPP
  - ***You will need bank consent***
- Changes of ownership within 12 months of disbursement require SBA consent
  - ***Depending on the transaction, you may also need SBA consent***
- The SBA has not taken a position on how a change of control impacts eligibility for forgiveness

M&A Transactions – Lender Consent

- Check promissory note or loan agreement for events of default
  - ***The applicable provision will likely reference "reorganizations, merges, consolidates, change of ownership, change of structure."***
  - ***Be careful on cross defaults***
- Some lenders have given consent if the forgivable amount is escrowed until such time as either (a) the SBA consents to the transaction or (b) forgiveness is obtained.

M&A Transactions – When Do You Need SBA Approval?

Transaction	SBA Approval Required?
Borrower selling substantially all of the assets	Yes
Borrower selling majority of its equity	Yes
Parent of Borrower selling substantially all of the assets of another subsidiary	No
HoldCo (above Parent) of Borrower selling all of its equity	No
Borrower selling some equity, but not a change of control	*It is unclear*

From the SBA's Servicing and Liquidations 7(a) Servicing Matrix and SOP 50 10 5(J)

M&A Transactions – Timing the Closing

- Timing the closing during the covered period can impact forgiveness
  - Reductions
    - If the buyer is taking on the PPP loan but not the employees, there could be a reduction due to a reduced FTE count
    - If the buyer is not taking the PPP loan but is taking the employees, the borrower could face a reduction in forgiveness due to a reduced FTE count
  - Using the proceeds
    - If the borrower no longer has employees due to the transaction, it may not be able to use all of the loan proceeds

M&A Transactions – Practical Issues

- Due diligence
  - Eligibility (including affiliation analysis)
  - Use of proceeds
- Buyer and seller should discuss any PPP loans early on to ensure that the appropriate consents are obtained or the loan is paid off
- Indemnification in the event of audit
- Potential solutions
  - Signing subject to regulatory approval
  - Transition services agreement for employees

Audit Risk

- The SBA will audit all PPP loans of over $2 million, and likely all PPP loans in which an affiliate group has loans of more than $2 million
- Audits can occur at any time in a the six years following the end of the covered period
- Make sure to have ***all*** documentation now, especially if the portfolio company is planning an exit

Forgiveness Denials

- Lenders or the SBA can deny forgiveness
- There is a process for appeal – if you are planning an exit, this should be included in the documentation
  - If Lender denies the Borrower, the Borrower can request that the SBA review the Lender’s decision

PPP and CARES Act Tax Considerations

Loan Forgiveness Taxation

- Loan forgiveness does not create a taxable “debt forgiveness” event under the CARES Act
- However, the IRS has indicated in Notice 2020-32 that despite the CARES Act provision, a deduction will not be allowed for the expenses that give rise to loan forgiveness (e.g., payroll, interest, utility, etc.)
- Congressional action pending to counter the position taken by the IRS

Loan Forgiveness – Timing of Deduction Denial

- In many cases, forgiveness will not occur until after the tax year when the expenses are incurred
- For a number of reasons, it may be more beneficial to have deductions reduced in the year the loan is forgiven than in the year(s) the expenses are incurred (e.g., CARES Act NOL carryback rules)
- Application of the “Annual Accounting Tax Principal” may be justification for reducing deductions in year of forgiveness.

Other CARES Act Tax Considerations

- Employer Retention Payroll Tax Credit
  - Very fact-specific and subject to IRS scrutiny/dispute
- Employer's Share of Social Security Deferral
  - Planning important for the very significant obligation due 50% on each of 12/31/2021 and 12/31/2022
- NOL revised carryback rule provides some targets the opportunity to request refunds of taxes paid as long ago as 2013

Due Diligence Considerations – Tax Matters

- Absent a legislative fix, confirm expenses giving rise to the loan forgiveness have not been deducted in computing taxable income
- Scrutinize records for qualification and computation inherent in Employer Retention Tax Credit
  - Backup documentation for number of hours worked most susceptible to error/abuse
- Confirm calculation of Employer's share of Social Security deferred and determine potential exposure to Employee’s share
- Investigate net income/losses incurred from 2013 through closing date for availability of refunds of taxes previously paid

Funding Sources – Regulatory Changes

Funding Sources – Regulatory Changes

- There have been two changes that could impact, in a positive way, the funding sources available:
  - The Federal Reserve, OCC, FDIC, SEC and CFTC amended the Volcker Rule to expand exclusions to the definition of "covered fund"
  - The SEC adopted rule changes that expand the scope of the definition of "accredited investor" in Rule 501(a) of Regulation D and "qualified institutional buyer" in Rule 144A

Volcker Rule Amendment

- The Volcker Rule was amended to permit banking entities to engage in an expanded number of fund activities
- For SBICs that have surrendered their licenses as part of their wind down, the amendment states that they will be ***excluded*** from the definition of Covered Fund
- Effective ***October 1, 2020***

Definition of “Accredited Investor”

The SEC added in the following categories as “accredited investors”:

- Individuals holding certain professional certifications, such as FINRA Series 7, 65 or 82 licenses;
- “Knowledgeable employees” of a private fund or an investment adviser to the fund, or such person’s spouse, for **that fund’s** securities;
- LLCs with assets in excess of $5M
- RIAs
- Exempt reporting advisers
- RBICs
- Family offices with at least $5M in AUM and their “family clients,” as defined in the Advisers Act
- Couples in a “spousal equivalent” relationship
- Any entity, including any Indian tribe or governmental body, that has investments valued at more than $5M and not formed for the specific purpose of investing in the securities offered

Definition of “Qualified Institutional Buyer”

The SEC amended the following regulations related to “qualified institutional buyers”:

- Adding the following entities to the definition of “qualified institutional buyer”
  - LLCs RBICs
- Creating new Rule 144A(a)(I)(i)(J) to allow any institutions that are accredited investors under Rule 501(a) to qualify as a qualified institutional buyer when they satisfy the $100 million in securities owned and invested threshold.

Carried Interests

Carried Interests

- Brief History
  - Profits Interests granted to fund managers in exchange for services to be rendered ("Carried Interests") have had congressional and national attention since 2007 ("rich fund managers paying tax at a lower marginal rate than janitors that cleaned their buildings").
  - The Tax Cuts and Jobs Act added §1061, providing for a 3-year holding period for determining long-term capital gain for certain Carried Interests.
  - On July 31, the IRS issued proposed regulations on numerous applications of §1061 including:
    - The types of partnership interests and businesses subject to §1061.
    - The computation of the amount re-characterized as short-term capital gain subject to tax at ordinary income rates.
    - Rules relating to transfers of partnership interest to related and unrelated persons
    - Reporting requirements.

Partnership Interests Subject to §1061

- In general – a partnership interest is subject to §1061 if transferred in connection with the performance of substantial services for a business subject to §1061.
  - Known as an Applicable Partnership Interest (“API”)
  - Presumption that any services performed are substantial services.
  - Once characterized as an API, it generally retains that character until an exception applies, even if service providing ceases.
- A partnership interest may also be subject to §1061 when held indirectly through tired passthrough entitles (e.g. partnerships, S corporations).

API Exceptions

- Certain types of partnership interests are exempt from §1061:
  - Partnership interests held by corporations (not including S corporations).
  - Capital interests in a partnership.
  - Partnership interests held by employees of certain other entities.
  - Partnership interests acquired by purchase for FMV by non-service providers.

Businesses Subject to §1061

- An API is not subject to §1061 unless transferred in connection with performance of services for a business subject to §1061.
- A business subject to §1061 is an activity conducted on a regular, continuous, and substantial basis that consists of (i) raising or returning capital, and (ii) either investing in or developing specified types of assets (referred to an Applicable Trade or Business (ATB)).
  - A business is conducted on a regular, continuous, and substantial basis if the level of activity would qualify as a trade or business under §162.
  - The specified types of assets include securities, commodities, real estate, cash or cash equivalents, partnership interests, and options or derivative contracts with respect to such assets.
  - The two types of activities (raising or returning and investing or developing) don't have to both be performed during the year, as long as the activity not performed during the year was performed in a previous year, or is anticipated to be performed in a subsequent year.

Computation of Recharacterized Gain

- General Rules
  - The holding period of the asset owner applies; thus, when a partnership disposes of an asset, the partnership's holding period for the asset applies, regardless of the partner's holding period.
  - For tiered pass-through structures, LTCG and LTCL retain their character as they flow through each tier and the taxpayer then nets them for purposes of its computation.
  - Installment sale gains are taken into account regardless of timing.
  - Amounts not taken into account include (i) LTCG under §1231, (ii) LTCG under §1256, (iii) qualified dividends, and (iv) other LTCG not determined on the basis of a §1222 holding period.
  - Special rules apply for purposes of the capital gain dividends of RICs and REITs

Transfer of Partnership Interest to Related Party

- If a taxpayer transfers a §1061 partnership interest to a related party, certain capital gain must be included in income as short-term capital gain (STCG), regardless of whether the transfer is otherwise a taxable event.
  - Covered transfers include contributions, distributions, sales and exchanges, and gifts; however, a transfer does not include a contribution of the interest to a partnership under §721(a).
  - Related parties are family members, colleagues who also perform services in the trade or business, and passthrough entities they own.
- If transfer is not otherwise taxable, the amount of STCG equals excess of net built-in LTCG in partnership's assets with holding period of 3 years or less over any amount otherwise recharacterized as STCG under §1061.
- If transfer is otherwise taxable, all or a portion of the capital gain otherwise recognized on the transfer is recharacterized as STCG.
  - If capital gain otherwise recognized is less than the amount required to be included under these transfer rules, the difference must be included as STCG.

Reporting Requirements

- The taxpayer must report any information the IRS may require in forms, instructions, or other guidance, sufficient for the IRS to determine whether the taxpayer has complied with §1061 and the regulations.
- A partnership (and other passthrough entities in tiered structures) must also report any information the IRS may require in forms, instructions, or other guidance, sufficient for the IRS to determine the partnership and its partners have complied with the rules.
  - A partnership that issued a §1061 partnership interest must furnish the taxpayer the information necessary to compute the amount of LTCG recharacterized as STCG under §1061.
  - If a passthrough entity requires information from a lower-tier entity to meet its reporting and filing requirements, it must request that information by the later of the 30th day after the close of the calendar year or 14 days after the date of a request for information from an upper-tier entity, and the lower-tier entity from which information is requested must respond by the due date of the Schedule K-1 for the tax year.

Payroll Holidays

COVID-19: Payroll Holidays

- Reminder of Payroll Holiday Part 1
  - CARES Act - For wages paid from March 27, 2020 through December 31, 2021, employers can delay paying the employer's share of social security tax (6.2%) on all employees. Delayed payments are due 50% on December 31, 2021 and 50% on December 31, 2022.

- New Payroll Holiday Part 2
  - Executive Order/Memorandum - On August 8, 2020, President Trump signed an executive order/memorandum to defer the payment of the employee's share of the social security tax for wages paid from September 1, 2020, until December 31, 2020.
    - Applies to only the employee's share of the Social Security portion of the payroll tax (6.2%).
    - Limited to employees with biweekly, pretax income of less than $4,000, or a similar amount where a different pay period applies (equates to an annual salary of $104,000).
    - This order does not affect the payroll tax deferral provisions of the CARES Act (payroll Holiday Part 1)

COVID-19: Payroll Holidays

- Employer Options
  - Option 1:
    - Not withhold the employee portion of the payroll tax subject to deferral.
  - Option 2:
    - Withhold the employee portion of the payroll tax subject to deferral, retain until guidance provides more certainty.
  - Option 3
    - Withhold the employee portion of the payroll tax subject to deferral, remit the tax to Treasury with normal withholds.
- Secretary Mnuchin Public Comments – “optional”
- Future Guidance

Main Street Lending

Main Street Lending Program

- As of August 19 - $500M of loans made and accepted
- Key updates:
  - Borrowers and Lenders are discourage from originating MSLP loans for the purpose of funding debt payments that may become due by operation of a debt covenant or other provision that creates a prepayment obligation based on the origination of the loan
  - Safe Harbor: The SBA's "ineligible business" definition excluded borrowers owned by the MSLP lender (or its affiliates). There is now a 5% safe harbor.

Thank You!

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Join us for our upcoming webinars:

Managing Credit in a Downturn
September 15 | 12:00 pm – 1:00 pm ET

Impact of COVID-19 on Portfolio Company Valuations
September 22 | 12:00 pm – 1:00 pm ET

Corporate Performance Management:
A Key Element to Mid-Market Transformation
September 29 | 12:00 pm – 1:00 pm ET