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The CARES Act: Considerations for Private Equity Funds with Corporate Portfolio Companies

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Private equity funds and their corporate portfolio companies may benefit significantly from the net operating loss ("NOL") and other tax provisions included in the Coronavirus Aid, Relief, and Economic Security Act, or "CARES Act."[1] This article highlights certain of the income tax provisions, and resulting opportunities, relevant to the operation and the acquisition/disposition of private equity portfolio companies that are classified as corporations for U.S. federal tax purposes.

What Changed?

The CARES Act includes sweeping changes to a number of provisions of the tax code as part of a broader package of economic stimulus measures. Most significant for private equity funds investing in corporate portfolio companies are the following tax provisions:

1. NOLs

The CARES Act makes a number of changes to the rules regarding the use of NOLs, including most notably:

— *Allowance of carrybacks*. The CARES Act provides taxpayers a five-year carryback period for NOLs arising in tax years beginning after December 31, 2017, and before January 1, 2021

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[1] Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136 (Mar. 27, 2020).

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(i.e., for calendar year taxpayers, 2018, 2019, and 2020). Prior to enactment of the CARES Act and pursuant to tax reform legislation enacted in 2017 (the so-called "Tax Cuts and Jobs Act," or "TCJA"), NOLs arising in those years could be carried forward indefinitely, but could not be carried back to prior tax years. Taxpayers may elect to relinquish the entire five-year carryback period with respect to a particular year's NOL, with the election being irrevocable.[2]

— *Temporary removal of 80 percent of taxable income limitation on use of NOLs*. The CARES Act permits corporate taxpayers to use NOLs to fully offset taxable income for tax years beginning before January 1, 2021. Under the TCJA, NOLs arising in tax years beginning after December 31, 2017, could be used only to offset 80 percent of taxable income in any year to which they were carried. By suspending the TCJA's taxable income limitation on the use of NOLs for tax years beginning before January 1, 2021, the CARES Act permits corporate taxpayers to use NOLs to fully offset taxable income in those years regardless of the year in which the NOL arose.[3]

As a result of these changes, there are now effectively three "buckets" of federal NOLs, as shown in the following table.

NOL Generated in Tax Years	Eligible for Carryback	Eligible for Carryforward	Eligible to Offset % of Taxable Income
Beginning on or before December 31, 2017	2 tax years	20 tax years	100% of taxable income
Beginning after December 31, 2017 & beginning before January 1, 2021	5 tax years	Indefinite	100% of taxable income (tax years beginning before January 1, 2021) 80% of taxable income (tax years beginning after December 31, 2020)
Beginning on or after January 1, 2021	Generally, no carryback	Indefinite	80% of taxable income

[2] The CARES Act also makes a technical correction to the TCJA under which taxpayers with tax years beginning on or before and ending after December 31, 2017, may carry back NOLs for up to two years under the pre-TCJA NOL rules. A drafting error in the TCJA had resulted in those NOLs only being eligible to be carried forward. Corporate portfolio companies with NOLs in tax years straddling December 31, 2017, are given120 days from the date of enactment of the CARES Act to file an application for a carryback refund under section 6411(a) or alternatively to elect to forgo this carryback period.

[3] In addition, the CARES Act makes certain technical corrections to the operation of the 80 percent of taxable income limitation for tax years beginning after 2020. Specifically, it requires that the limitation be calculated (1) based on 80 percent of taxable income after (rather than before) giving effect to the use of pre-2018 NOLs, a rule that is generally unfavorable for affected taxpayers; and (2) without giving effect to deductions for qualified business income, global intangible low-taxed income, and foreign derived intangible income, which may be favorable or unfavorable depending on a taxpayer's circumstances.

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2. Deductibility of Interest Expense

- The section 163(j)[4] limitation on the deductibility of interest expense will be based on 50 percent rather than 30 percent of "adjusted taxable income" ("ATI") for tax years beginning in 2019 and 2020. ATI is generally computed in manner similar to EBITDA, but based on tax rather than book amounts, for tax years beginning before 2022.[5]

- A taxpayer may base its limitation for a tax year beginning in 2020 on its ATI for its last tax year beginning in 2019 (effectively allowing taxpayers to choose the higher of their 2019 or 2020 ATI).

3. Accelerated refundability of minimum tax credits ("MTCs")

The CARES Act accelerates the ability of corporations to utilize any remaining minimum tax credits ("MTC") under the alternative minimum tax ("AMT") regime, which applied to corporate taxpayers until its repeal by the TCJA. Under the CARES Act, any remaining MTCs become 100 percent refundable in tax years beginning in 2019. Alternatively, corporations may elect to obtain refunds for their entire remaining MTC amount in 2018 by filing an application for a tentative refund by December 31, 2020. Prior to the CARES Act, taxpayers were permitted to claim a refundable credit equal to 50 percent of the excess of their MTCs over the amount otherwise allowable against regular tax liability for tax years beginning in 2018, 2019, and 2020, with the remainder becoming fully refundable in 2021.

4. Other Changes

In addition to the foregoing changes, the CARES Act includes various other income and non-income tax provisions that may be beneficial for corporate portfolio companies based on their individual circumstances. These include a technical correction permitting full expensing of expenditures for "qualified improvement property" (i.e., improvements made to the interior of a non-residential building after the building is initially placed in service); rules delaying payment of certain employer payroll taxes; a refundable employee retention payroll tax credit for qualifying employers that have fully or partially suspended operations or experienced a significant decline in gross receipts related to the coronavirus pandemic; modifications relating to advance refunding of payroll tax credits for required paid sick leave; and a temporary relaxation of the limitations on deductions for certain charitable contributions by corporations. In addition, prior to enactment of the CARES Act, the coronavirus pandemic was declared a national emergency under the Stafford Act, thereby permitting certain 2020 losses attributable to the national emergency to be claimed in 2019.

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[4] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code"), or the applicable regulations promulgated pursuant to the Code (the "regulations").

[5] More specifically, ATI equals a taxpayer's taxable income computed without regard to (1) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; (2) business interest expense or business interest income; (3) the amount of any NOL deduction; (4) the 20 percent deduction for certain passthrough income; and (5) in the case of tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. A taxpayer's section 163(j) limitation is also increased by the taxpayer's business interest income and floor plan financing interest for the relevant tax year. The CARES Act includes special section 163(j) rules for interest expense incurred by partnerships. These rules are not addressed in this article.

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Opportunities for Cash Generation/Enhanced After-Tax Cash Flow for Portfolio Companies

At their most basic level, these corporate related changes provide opportunities for certain corporate portfolio companies to generate cash and enhance after-tax cash flow.

1. NOL Carrybacks

Private equity portfolio companies with NOLs generated in 2018, 2019, and 2020 may carry those NOLs back for up to five tax years to generate cash tax refunds, including refunds of taxes paid at the pre-TCJA maximum rate of 35 percent.

— *Example.* X Inc., a wholly owned portfolio company of PE Fund, incurs a $150 loss in the 2020 tax year. X Inc. operates a historically profitable business and has reported $100 of taxable income in each of the five tax years prior to 2020, and is a calendar year taxpayer.[6] The CARES Act allows X Inc. to carry back the $150 loss first to the 2015 tax year, generating a $35 cash tax refund for that year ($100 x 35%), with the remainder carried to the 2016 tax year, generating a $17.50 refund for that year ($50 x 35%).

— *NOL Planning Opportunities.* Depending on the circumstances, various opportunities may exist to enhance and maximize the benefit of these carryback provisions, including:[7]

- o Filing accounting method changes for 2019 or 2020 to accelerate deductions or defer revenue and increase NOLs in those years.
- o Filing accounting method changes to defer deductions or accelerate revenue for 2019 (so-called "reverse accounting methods planning") to generate greater losses in 2020, which may allow for a greater NOL carryback amount.
- o Pursuing opportunities to crystalize tax losses in 2020 that can then be carried back to prior years for a cash refund through worthless stock loss planning or other measures. Note that certain losses attributable to the coronavirus pandemic that are sustained in 2020 may be reported on either the 2019 or 2020 return and contribute to a NOL for either year.
- o Changing tax years, for example to a November 30 year-end, to potentially bring an additional tax year into the purview of the carryback rules (in the case of portfolio companies with carryback capacity that anticipate generating losses into the calendar 2021 time frame).

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[6] For purposes of this example and others in this article, it is assumed for simplicity that the corporation that is the subject of the example did not pay AMT in any relevant pre-2018 carryback year.

[7] *See generally* KPMG's Washington National Tax Income Tax and Accounting group, Greg Bocchino, & Steve Borman, *Cash Flow Planning for COVID-19: Leveraging Tax Accounting Methods and Credits to Generate Cash Flow*, What's News in Tax (Mar. 30 2020).

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  - Revisiting prior decisions to elect out of 100 percent expensing with respect to particular classes of depreciable assets acquired in 2019 or 2020.[8] These decisions may have been driven by concern that full expensing would produce an NOL, which could only be carried forward and used subject to the 80 percent taxable income limitation in future years. However, the potential to carry back an NOL resulting from full expensing to obtain a prior year refund without a taxable income limitation may well change this calculus.

- *Collateral Consequences/Limitations.* In determining whether to take advantage of these new NOL carryback rules, it is important to consider:
  - The impact of NOL carrybacks on tax calculations in the carryback year, including foreign tax credit, AMT, and global intangible low-taxed income calculations.
  - Special rules in the CARES Act that apply to carrybacks to years (generally either 2017 or 2018 for affected corporations) in which a corporation had an income inclusion from one or more foreign subsidiaries under the deemed repatriation rules (also known as the "transition tax").
    - The newly permitted NOL carrybacks effectively will not be applied to offset any deemed repatriation income. Any refund that would otherwise arise from the application of the NOL to other income for the relevant tax year may, however, be held up and applied as effectively a "prepayment" of transition tax installments.
    - Although a taxpayer generally cannot waive a portion of the new carryback period (i.e., the waiver is "all or nothing"), a taxpayer is allowed to waive the application of the five year carryback to a year in which the taxpayer reported the transition tax on its tax return. Making this election should enable taxpayers to avoid using NOLs in a year in which the NOLs would produce only a reduction in future transition tax installments when they otherwise might be carried to a subsequent year to generate a cash refund.
  - Rules applicable to consolidated groups, including for example situations in which the loss-generating consolidated group member was acquired within the carryback period.
  - The effect of restrictions contained in acquisition and credit agreements.
    - Relevant transaction documents governing the acquisition of a portfolio company or an add-on acquisition may prohibit the amendment of pre-closing tax returns and/or contractually assign the economic benefit of any refunds for these periods to the sellers.[9]
    - Credit agreements may require the use of tax refunds to pay down debt.

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[8] Absent further guidance from Treasury in the wake of the CARES Act, it is currently not possible to reverse any such elections made on returns for the 2018 tax year.

[9] Conversely, sponsors of private equity funds may consider examining the transaction documents relating to recently divested portfolio companies and, depending on the specifics of those documents, proactively approach the buyers regarding potential refund opportunities as to which the funds may have a contractual entitlement.

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2. Increased Interest Limitation

The ability to determine the interest deduction limitation based on 50 percent of ATI, along with the ability to use the (in many cases higher) 2019 ATI number to calculate the 2020 interest deduction limitation, should allow portfolio companies to deduct a higher portion of their interest expense. Moreover, in some cases, the CARES Act's increased interest expense deduction limitation may result in an NOL that can then be carried back to generate a cash refund under the rules discussed above.

> *Example*. X Inc. was purchased by PE Fund on January 1, 2020, in a leveraged buyout. As a result, X Inc. will incur interest deductions of $50 in 2020. X Inc. is a calendar year taxpayer that operates a historically profitable business, has reported $100 of taxable income in each of the five tax years prior to 2020, and will accrue $50 of taxable income in 2020 without regard to the interest expense arising from the acquisition. Assume that ATI is equal to taxable income for each relevant year prior to 2020, and that X Inc. does not have and has not had any business interest income or floor plan financing interest.
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> Under the TCJA's section 163(j) interest limitation rules, X Inc. would be able to deduct up to $15 (30% of $50) of interest expense in 2020.
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> The CARES Act, however, allows X Inc. to use 2019 ATI ($100) to calculate its section 163(j) limitation and increases the ATI limitation from 30 percent ($30) to 50 percent ($50). By using 2019 ATI, X Inc. has an ATI limitation of $50 and is able to deduct all its interest expense for 2020, thus reducing its taxable income to $0.

See below for an example in which the increased limitation on interest expense deductions under the CARES Act results in a tax refund.

3. Accelerated AMT Refundability

If a private equity portfolio company historically paid AMT, the ability to more quickly monetize pre-existing MTCs can provide a meaningful cash generation opportunity.[10]

Impact on Transactional Planning

The corporate tax related changes will also affect planning for private equity acquisitions and dispositions. The specific impacts are likely to be highly fact dependent, and modeling is essential to assess the interaction of the various rules and the extent of any possible benefits. However, some examples may include:

1. Ability to Generate Cash Value from Transaction Tax Deductions

Prior to implementation of the CARES Act, due to the inability to carry back NOLs, losses resulting from transaction-related tax deductions ("TTDs") generally could be used only to obtain refunds of estimated

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[10] In certain cases in which a corporation's MTCs are subject to a limitation under section 383 as a result of a section 382 ownership change, it is possible that a technical application of the rules may not result in a full refund of the entire MTC amount. *See* Mark R. Hoffenberg & Stephen M. Marencik, *Are AMT Credit Refunds Subject to Limitation?*, 158 Tax Notes 1177 (Feb. 26, 2018).

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taxes paid for the tax year in which the acquisition occurs and to reduce taxes owed for that year. Excess deductions would simply contribute to an NOL that could be carried forward and used in future years subject to the 80 percent limitation and possibly a section 382 limitation. Following the CARES Act, if TTDs produce an NOL for the year of the transaction (and that year is within the purview of the CARES Act NOL carryback rules), the NOL can be carried back to yield an immediate cash refund of taxes paid in prior years. Private equity funds should carefully consider these potential tax benefits in negotiating acquisition and disposition agreements.

> *Example.* On June 30, 2020, P Inc., a newly formed holding corporation owned by PE Fund purchases one hundred percent (100%) of the stock of X Inc. for $1,000. X Inc. is a calendar year taxpayer whose tax year ends on the closing date as a result of its joining the new P, Inc. consolidated group. The sale gives rise to $330 of TTDs: $30 of deductible investment banking and advisory fees payable by X Inc. (i.e., the portion of the fees that is not required to be capitalized under the relevant Treasury regulations) and $300 of deductible bonus payments to X Inc.'s executives, all of which are treated as allocable to the pre-closing period.[11] X Inc. has reported $100 of taxable income in each of the five tax years prior to 2020 and would have accrued $20 of taxable income for its short year ending June 30, 2020, in the absence of the TTDs. X Inc. has not made any estimated tax payments for 2020.
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> The $330 of TTDs first offset the $20 of taxable income X Inc. otherwise accrued in the 2020 short year, and then give rise to a $310 NOL for that short year. Under the CARES Act, $300 of this $310 NOL is carried back to 2015, 2016, and 2017 to generate tax refunds of $35 in each of those tax years (i.e., $100 x 35% x 3 = $105) and the remaining $10 is carried back to 2018 to generate a refund of $2.10 (i.e., $10 x 21% = $2.10), for a total carryback refund of $107.10. This refund would be payable to X Inc., and accordingly in the first instance be for the benefit of the buyer, although depending on the deal negotiated by the parties, some or all of the refund amount may be contractually allocated to the selling X Inc. shareholders.

2. *Potential Additional Benefits for Add-On Acquisitions Structured as Asset Deals*

Portfolio companies may in certain cases be able to generate cash tax refunds to help finance the costs of add-on acquisitions structured as asset acquisitions (or deemed asset acquisitions, such as acquisitions of disregarded entities or acquisitions involving section 338(h)(10) elections, as well as certain acquisitions of partnership interests). In particular, when the target assets include significant assets that are eligible for 100 percent expensing, the deductions attributable to the acquisition of those assets may yield an NOL that can be carried back to a prior year to obtain a refund.

> *Example.* On December 31, 2020, X Inc. acquires all the equity interests in T LLC, a disregarded entity, for $1,000. X Inc. is a calendar year taxpayer that has reported $100 of taxable income in each of the five tax years prior to 2020 and will accrue $100 of taxable

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[11] In general, the tax year of a target corporation ends (creating two "short years") on the day that the corporation joins a new consolidated group (or leaves its historic consolidated group). This example assumes that the TTDs are allocated by the parties for U.S. federal income tax purposes to the pre-closing short year and are not, for example, allocated to the post-closing short year under the "next day rule" of section 1.1502-76(b)(2).

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income in 2020 without regard to the effects of the T acquisition. $500 of X Inc.'s $1,000 purchase price is allocable to "qualified property" eligible for immediate 100 percent expensing.

X Inc. reports a $500 deduction on its 2020 tax return as a result of its purchase of T LLC. This $500 deduction will offset X Inc.'s $100 of taxable income through December 31, 2020 (thereby permitting a refund of estimated taxes paid for 2020), and creates a $400 NOL. Under the CARES Act, the first $300 of this $400 NOL is carried back to 2015, 2016, and 2017 to generate tax refunds of $35 in each of those tax years (i.e., $100 x 35% x 3 = $105) and the remaining $100 is carried back to 2018 to generate a refund of $21 (i.e., $100 x 21%), for a total of $126 in carryback cash tax refunds to X Inc.

3. Potential Benefits from Additional Deductibility of Acquisition Debt

The increased deductibility of acquisition debt may result in increased after-tax cash flow for acquired corporate portfolio companies for the relevant tax years. The fact that the 50 percent ATI limitation is based on taxable income as a starting point limits the ability of interest deductions to create or increase an NOL that may be carried back to obtain a refund.[12] Nevertheless, there may be situations in which such a result is possible due to divergences in the calculation of taxable income and ATI, or when acquiring corporate portfolio companies that are engaged in businesses that are exempt from the interest expense limitation (such as certain regulated utilities and electing real property and farming businesses).[13]

Example. On June 30, 2020, PE Fund acquires all the stock of X Inc. for $1,000 in a leveraged buyout. X Inc. will accrue an interest deduction of $50 in 2020 as a result of debt incurred to finance the acquisition. X Inc. is a calendar year taxpayer that operates a historically profitable business and has reported $100 of taxable income in each of the five tax years prior to 2020. Moreover, X Inc. is engaged in a CapEx intensive business, such that its historical $100 of taxable income is actually composed of revenues of $150 and depreciation/amortization expense of $50 in each such prior year. For 2020, without regard to the interest deductions, X Inc. would have only $50 of revenue and depreciation/amortization expense of $50. Assume that X Inc. has no business interest income or floor plan financing interest in either 2019 or 2020.

As an initial matter, the CARES Act allows X Inc. to use its 2019 ATI to calculate its 2020 interest expense limitation. Because ATI is calculated by adding back depreciation and amortization deductions, X Inc. would have $150 of ATI in 2019 and an ATI limitation for 2020 of $75 (i.e., 50% of the $150 ATI). Therefore, all of the $50 interest deduction in 2020 is deductible. Because X Inc. otherwise has no taxable income for 2020, the $50 interest expense

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[12] Interest in excess of the section 163(j) limitation would be treated as a "section 163(j) interest carryover" and thus would not become an NOL, and therefore could not be carried back to a prior tax year.

[13] The CARES Act did not reinstate the corporate equity reduction transaction, or "CERT," rules that were repealed by the TCJA. These rules provided additional limitations on the ability to carry back NOLs attributable to increased interest expense following certain "major stock acquisitions" or "excess distributions."

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gives rise to a $50 NOL. Under the CARES Act, that NOL may be carried back to 2015 to generate a tax refund of $17.50 (i.e., $50 x 35%).

The foregoing fact patterns and examples are intended to be illustrative rather than exhaustive. They are also highly simplified for purposes of demonstrating potential benefits that may be available. In practice, the ability of private equity funds and their portfolio companies to derive benefits from the CARES Act provisions will depend on the specific facts, as well as careful analysis and modeling of the impact of the rules and their interactions with pre-existing law. It is clear, however, that the benefits may be significant in particular cases, and private equity sponsors and managers should consider the implications of the rules as part of their transactional planning.

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