

COVID-19: TAX CONSIDERATIONS IN THE TIME OF THE CORONAVIRUS PANDEMIC - PART 1

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U.S. Tax Alert

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We are living in an unprecedented time in which COVID-19, unheard of six months ago, now has grown into a pandemic that significantly impacts all aspects of our daily lives. The personal toll of the pandemic is reflected in increased rates of illness and death, the widespread cancelling of events, and the increasing ubiquity of working from home. Not surprisingly, and within a very short period of time, COVID-19 has also significantly impacted the transactional and investment landscape. Market values of private equity portfolio companies and potential targets are more difficult to ascertain with certainty, and are likely to have declined significantly, causing many potential deals to be placed on hold. Businesses of all sizes face reduced cash flows which will undoubtedly impact their debt servicing capacity.

Transactional and private-investment-related tax considerations in a bear market are undoubtedly different than those associated with a bull market, but careful tax planning can continue to add meaningful economic value. As a consequence, tax considerations have suddenly shifted towards concepts such as "loss harvesting", "cancellation of indebtedness", etc. This article, the first installment of a multi-part series that will address transactional and other tax considerations in an economic downturn, provides a general overview of some of the tax tools that have suddenly become useful in this new environment, as well as some of the tax traps for the unwary that taxpayers are more likely to encounter. Subsequent articles will address some of these issues in more detail.

General Deal Structuring Considerations

- Due to uncertainty regarding the valuation of businesses, acquisitions may be structured with increased rollover percentages and earnouts. Depending on the classification of the target and the acquirer, increased rollover percentages will require careful planning in order to utilize structures that allow for a partial tax-basis step-up.
- Declining stock values and the increased use of earnouts may potentially impact the qualification of transactions that previously were eligible for "tax-free reorganization" status.
- Due to declining stock values, employee stock options may be underwater, in some cases necessitating transaction bonus plans or retention pools in order to incentivize key employees who are critical to facilitating a transaction.
- As more companies incur tax losses, additional steps may be taken both to preserve those losses and to monetize them in a deal. Lenders may be able to craft strategies to take control of loss companies while maintaining net operating losses. In addition, possibilities to monetize any refundable credits ultimately authorized by Congress should be evaluated.

- Sellers may be more receptive to structuring transactions as asset sales if loss carryforwards are available to shield significant amounts of corporate-level tax, including in respect of recapture of bonus depreciation claimed during the last few years.
- Certain limitations on the deductibility of interest are more likely to impact businesses. Increasing numbers of insolvent businesses will be required to determine whether they may continue to deduct original issue discount ("OID") and conversely debt holders may have the opportunity to stop accruing OID.
- Worthless assets (including securities) should be evaluated to determine whether and when tax deductions should be claimed

Restructurings

- Debt restructurings (including debt amendments and debt-for-equity swaps) can be taxable events for the borrower and lender. Borrowers faced with defaults should consider cancellation of indebtedness mitigation strategies prior to engaging in any restructurings.
- Depressed asset values present an opportunity for internal group restructurings (including to accomplish jurisdictional changes) to occur with minimal reduced gain, and to structure transactions to allow for the harvesting of tax losses.
- Guarantors may be called upon to make payments on the debt of insolvent issuers.

Fund Structuring

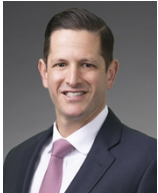
- Distressed debt investments, which give rise to unique tax issues related to effectively connected income ("ECI") and the market discount rules, are likely to become more common. Secondary debt purchasers that traditionally did not have ECI concerns will need to address ECI that may result from significant modifications.
- The value of previously-issued profits interests may be impacted. Conversely, changes in valuation may make the issuance of additional profits (or capital) interests more attractive.
- More foreign companies may become subject to the passive foreign investment company ("PFIC") rules due to changes in asset value or drawdowns of credit.
- Investment funds may be required to involuntarily reduce the tax basis in their assets.

Policy Considerations

- Pending federal legislation will impact the liquidity of companies, their ability to monetize losses, and mitigate the cost of capital. Examples of such pending legislation include proposals providing loans and loan guarantees to distressed businesses, to reinstate net operating loss carrybacks and allow refundability of business credits, and to increase the limitation on deductible interest expense. This could be significant for certain acquisitive and other transactions. For example, an increase in the limitations on deductible interest expense can make debt financing for an acquisition more attractive. Alternatively, a relaxation on the limitations on the use of NOLs in connection with an ownership change may enable sellers to extract value for their NOLs. While the final outcome of these proposals is yet to be decided, the White House and Congress are moving quickly to finalize a relief package. We are in the early stages

of the policy implications, and it's not too late to engage in legislative discussions with the appropriate stakeholders.

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