‘Phase Three’ CARES Act and Notice 2020-18: The impact on the Asset and Wealth Management industry

April 2, 2020

In brief

The “Phase Three” COVID-19 economic stabilization package, H.R. 748, the ‘Coronavirus Aid, Relief, and Economic Security Act’ (the CARES Act) that President Donald Trump signed into law on March 27 features significant tax provisions relevant to the Asset and Wealth Management (AWM) industry. Separate from the CARES Act, the IRS on March 20 issued Notice 2020-18 extending to July 15, 2020, without penalties and interest, the April 15, 2020 due date for filing certain federal income tax returns and making federal income tax payments, and on March 24 the IRS posted to its website frequently asked questions (FAQs) related to Notice 2020-18.

This Insight examines the impact of relevant CARES Act tax provisions and Notice 2020-18 on the AWM industry. Certain provisions discussed in detail below provide temporary relief from limitations imposed by the 2017 federal tax reform act, namely, the Section 461(l) limitation on excess business losses, the Section 163(j) interest deduction limitations, and the Section 172 limitation on net operating loss (NOL) carrybacks and carryforwards. Other relevant CARES Act provisions discussed below include the technical correction for expensing and depreciation of qualified improvement property, the deferral of employer payroll tax, the employer retention credit, and the paycheck protection program.

In addition to the federal filing and payment due-date relief provisions, numerous state and local jurisdictions have provided filing and payment relief. It should be noted that state income tax conformity to the CARES Act provisions will vary significantly, and there likely will be a rolling series of decoupling announcements in states that would otherwise automatically conform to the provisions, much like with the passage of the federal tax reform act in 2017.

In detail

Relevant CARES Act tax components

Excess business loss limitation relief (Section 461(l))

The 2017 tax reform act added Section 461(l) to limit the deduction of business losses incurred by noncorporate taxpayers. Section 461(l) disallows a deduction for the amount of business losses in excess
of $250k ($500k for joint filers), indexed for inflation, attributable to a trade or business in which the taxpayer actively participates. While not clear based on the statute, the disallowed excess business loss was generally understood to be treated as an NOL carryforward in the subsequent year.

The CARES Act turns off the excess business loss limitation rules for tax years beginning before 2021, including with retroactive effect for all years to which Section 461(l) applied (previously, Section 461(l) applied to tax years beginning after 2017). The CARES Act also makes several technical corrections to Section 461(l). First, net capital loss deductions are not taken into account in computing the Section 461(l) limitation, and the amount of capital gain taken into account in calculating the Section 461(l) limitation cannot exceed the lesser of capital gain net income from a trade or business or capital gain net income. Other technical corrections to Section 461(l) clarify that excess business losses (1) are treated as a net operating loss for the taxable year for purposes of determining NOL carryovers for subsequent years (which was not entirely clear based on the prior text), and (2) are determined without regard to net operating loss deductions (Section 172) or the 20% deduction for qualified business income (Section 199A) or any deductions, gross income, or gains attributable to any trade or business of performing services as an employee.

Observations:

The retroactive application may allow individuals who were limited in 2018 to obtain refunds of taxes paid in 2018 by amending their returns, and treat any excess as an NOL that may be carried back 5 years to obtain additional refunds. Similarly, taxpayers may be able to fully deduct flow-through losses in 2019 and 2020, and carry back any resulting NOL.

The Section 461(l) relief may be beneficial for partners in either ‘trader’ or ‘investor’ funds. Partners invested in a ‘trader’ fund can, prior to 2021, utilize losses from the fund (other than capital losses) to offset income from other sources including wages, interest, or other investments. This provision could be especially beneficial for partners in trader funds with Section 475(f) mark-to-market elections, which generate ordinary income/loss instead of capital gain/loss. As such, partners may carry back ordinary losses against ordinary income recognized in prior years.

Partners invested in ‘investor’ funds can, prior to 2021, offset gains and income from those funds with trade or business losses from other activities. This includes principals who earn the majority of their income via carried interest allocations as general partners in the funds, and concurrently generate business losses in their management company.

The technical corrections regarding the treatment of capital gains and losses provide clarity and a more beneficial treatment than many in the industry had originally interpreted. Prior to this correction, many interpreted business losses to include capital losses. The CARES Act clarifies that net capital losses are excluded, while net capital gains from a trade or business (subject to limitation) can be offset by business losses for purposes of calculating the excess business loss limitation.

This CARES Act provision raises many questions regarding its application. The Act summary states the provision modifies the excess business loss rules in order to allow taxpayers to “access critical cash flow to maintain operations and payroll for their employees”. For 2019 and 2020 taxpayers can file a Form 1045, Application for Tentative Refund, and obtain a quick refund. The recovery of excess business losses that were suspended in 2018, however, could turn into a very lengthy process. It appears taxpayers will first have to file a Form 1040x, Amended U.S. Individual Income Tax Return, to amend 2018 returns and recover taxes from that year and then carry back any losses not utilized in 2018 to prior years. Depending on the size of the associated refund this could require Joint Committee on Taxation (JCT) review, which at least in the case of a Form 1040x, is typically a lengthy process and would significantly delay any cash recovery.

Interest expense deduction limitation relief (Section 163(j))

As enacted under the 2017 tax reform act, Section 163(j) limits an entity’s deduction for net business interest expense (i.e., the excess of business interest expense over business interest income) to 30% of the business’s adjusted taxable income (ATI), and generally allows unused or limited interest expense deductions to be carried forward indefinitely. In the case of businesses in partnerships, the net business interest expense limitation is calculated at the partnership level, and partners can use their share of the partnership’s excess taxable income and excess business interest income to deduct business interest expense incurred at their level. If the partnership has disallowed business interest expense for a taxable year (excess business interest expense), that excess business interest expense is allocated to its partners to be carried forward at the partner level indefinitely. The excess business interest expense carryforward is treated as paid or accrued.
in a later taxable year only to the extent a partner is allocated excess taxable income or excess business interest income in a later year from the same partnership that generated the excess business interest expense in a prior year. Once the prior year excess business interest expense is treated as paid or accrued such amount as well as the excess taxable income and excess business interest income are included in the partner’s Section 163(j) calculation to determine whether the partner can deduct such prior year excess business interest expense.

The CARES Act raises the interest deduction limit from 30% of ATI to 50% for tax years beginning in 2019 or 2020. However, this 50% limitation does not apply to partnerships for tax years beginning in 2019. Instead, partners would get the following alternative benefit (unless the partner elects for this not to apply): 50% of the 2019 excess business interest expense from a partnership will be treated as paid or accrued by the partner in 2020 and not subject to limitation, and the remaining 50% of the 2019 excess business interest expense will be subject to the current rules (i.e., only treated as paid or accrued in 2020 if there is excess taxable income or excess business interest income from the same partnership).

For example, if a partner had $100 of excess business interest expense allocated from a partnership in 2019 and $30 of excess taxable income allocated from this same partnership in 2020, absent this benefit the partner would only be able to treat $30 of the 2019 excess business interest expense as paid or accrued in 2020 (resulting in a potential deduction to the extent there is enough ATI at the partner level) and the remaining $70 would be carried forward to 2021. When utilizing this benefit, in 2020 the partner would be able to deduct $50 of the 2019 excess business interest expense and treat $30 of the remaining $50 as paid or accrued (resulting in a potential deduction to the extent there is enough ATI at the partner level). The remaining $20 of 2019 excess business interest expense would be carried forward to 2021.

A taxpayer can elect not to apply the 50% limitation for any tax year, and instead be subject to the 30% limitation. Partnerships can only make such an election for 2020 (since the 50% limitation does not apply to partnerships for 2019).

In addition, taxpayers (including partnerships) with a tax year beginning in 2020 could elect to use their 2019 ATI in determining their 2020 Section 163(j) limitation. This substitution is prorated for short tax years.

**Observations:**

The election to use 2019 ATI for 2020 should provide a benefit for taxpayers with lower ATI in 2020, which may be the case for many due to the expected economic downturn. For example, if a partnership’s 2020 ATI is $30, but it reported ATI of $100 in 2019, the election would permit the partnership to deduct $50 of business interest expense (50% of $100) against its 2020 taxable income even though its 2020 ATI is only $30. Conversely, if a partnership’s 2020 ATI is $80, but it only reported ATI of $30 in 2019, the partnership would generally not apply the election and be able to deduct $40 of business interest expense (50% of $80) against its 2020 taxable income by utilizing its 2020 ATI.

The revised Section 163(j) limitation does not apply to partnerships for 2019, so there is no need to amend 2019 Schedules K-1 that have already been issued. While this does not provide partners immediate cash savings with respect to the 2019 tax year, it does address the administrative concerns associated with partnerships that had already prepared or issued Schedules K-1 for the 2019 tax year.

There are several elections whereby a taxpayer is afforded the ability to opt out of the Section 163(j) relief provisions: (1) a taxpayer may elect to not apply the increased 50% of ATI limitation and continue to use 30% of ATI, (2) a partner may elect to not apply the benefit of deducting 50% of 2019 excess business interest expense allocated from a partnership in 2020, and (3) a taxpayer may choose not to elect to substitute 2019 ATI for 2020 ATI. While in general the Section 163(j) relief provisions provide a benefit, the ability to continue to apply the current regime may be beneficial for taxpayers looking to minimize their base erosion and anti-avoidance tax (BEAT) liability. For funds where BEAT comes into play, modeling should be considered to determine which elections provide for the maximum tax benefit.

**NOL carryback and/or carryforward limitation relief (Section 172)**

The 2017 federal tax reform act revised Section 172 to limit a taxpayer’s ability to utilize NOLs arising in tax years beginning after 2017 such that they may only offset up to 80% of taxable income in any given year (determined without regard to the NOL deduction), and to eliminate the carryback of all NOLs arising in a tax year ending after 2017 (instead permitting all such NOLs to be carried forward indefinitely).

The CARES Act provides some relief from these limitations for tax years beginning before 2021. First, business losses arising in tax years beginning in 2018, 2019, and 2020 generally can now be carried back to the five taxable years
preceding the year of the loss (REITs, which had limited carrybacks prior to the 2017 tax reform act, are a notable exception and are not allowed to carry back an NOL). Second, for tax years beginning before 2021, NOLs can be used to offset 100% of income. For tax years beginning after 2020, NOLs being carried forward from tax years prior to 2018 can be used to offset up to 100% of modified taxable income, but NOLs being carried forward from tax years beginning after 2017 can only be used to offset up to 80% of modified taxable income.

New rules clarify how the NOL carryback interacts with the Section 965 toll charge. While NOLs cannot be used against amounts included in gross income for the Section 965 toll charge, if the five-year carryback period includes one or more tax years in which an amount is includible in gross income by reason of Section 965(a) (a ‘toll charge year’), then the taxpayer may elect to exclude the toll charge years from the five-year carryback period.

Observations:

The 2017 tax reform act reduced the corporate income tax rate from 35% to 21% for tax years beginning after December 31, 2017; this provision allows losses to be carried back to a period during which there was a 35% tax rate. However, it should be noted that carrying back NOLs may also impact foreign tax credit limitations in affected years, as additional NOL deductions may reduce the FTC limitation in the periods in which they are carried back.

As the 2017 tax reform act also reduced individual income tax rates, individuals may have an opportunity to carry losses back to years where the individual federal income tax rate was 39.6% (i.e., higher than the current 37%). There may also be more opportunities for individuals by allowing them to claim additional tax deductions in pre-2018 tax years. Prior to 2018, taxpayers could deduct miscellaneous itemized deductions provided they exceeded 2% of adjusted gross income (AGI). Carrying back an NOL reduces AGI, thereby reducing the 2% floor. A reduction in AGI also reduces the Pease limitation (which for pre-2018 tax years reduced most itemized deductions by 3% of the excess AGI above an AGI threshold), thereby increasing overall itemized deductions.

This provision may have a significant impact for private equity funds as certain portfolio companies may have the opportunity to carry back losses to years with the 35% corporate income tax rate, bringing cash tax refunds, and also financial statement benefits.

While the carryback of NOLs is optional (the taxpayer can elect to waive the carryback), it should be noted that the 5-year carryback provision requires NOLs to be carried back to the earliest year first. As such, to the extent that a portfolio company has not been owned for the full 5 years, a detailed review of the purchase agreement will be required to determine how beneficial this provision may ultimately be to the current owners of the company. It is possible that a portion of the NOL carryback benefit could be carried back to a year, which under the purchase agreement, would benefit the previous owner. Further, even states that generally conform to federal law often have different carryback rules which need to be considered.

Deal economics and company valuations may be impacted as NOLs become more valuable, increasing tax asset value.

Taxpayers should consider the implications associated with the application of certain international tax provisions as the interaction of the NOL carryback with such provisions may impact the potential cash tax savings provided by the NOL carryback. For example, corporate taxpayers that hold controlled foreign corporations (CFC) which gave rise to global intangible low-taxed income (GILTI) inclusion or generated foreign-derived intangible income (FDII) in prior years should carefully consider how their Section 250 deduction may be affected as a result of the NOL carryback. The 37.5% and 50% deductions applicable to FDII and GILTI provided under Section 250 is limited to the taxpayer’s taxable income after the NOL deduction. Accordingly, carrying back NOLs may reduce the amount of deduction available under Section 250 such that a portion of the taxpayer’s FDII and GILTI inclusions is effectively subject to US corporate income tax at an effective rate of 21%. Any limitation to the 50% deduction created by the NOL carryback may also reduce the tax benefit from the associated GILTI FTCs as no carryover is permitted with respect to excess GILTI FTC.

Furthermore, taxpayers subject to the BEAT regime in prior years should also assess how the NOL carryback may impact their modified taxable income amounts in these periods as one of the key adjustments for calculating modified taxable income is the add back of the base erosion percentage of any NOL deduction utilized by that taxpayer for that period. Notably, the base erosion percentage of an NOL deduction is determined based on the year that the NOL arose and not the year it was utilized. Additionally, as the base erosion minimum tax imposed by the BEAT regime is calculated as the
excess of 10% of modified taxable income over the taxpayer's regular tax liability, a reduction in the regular tax liability may also adversely impact the BEAT amount.

As also highlighted above, Section 163(j) relief provisions may also have an impact on BEAT.

Qualified improvement property technical correction
The CARES Act corrects an error in the text of the 2017 tax reform act regarding the expensing and depreciation of 'qualified improvement property' which would include many interior improvements to a non-residential building. Under the prior text, qualified improvement property had to be depreciated over 39 years or 40 years, depending on the depreciation method, and was not eligible for immediate expensing. After the technical correction, qualified improvement property may be depreciated over 15 or 20 years, depending on the depreciation method, and may be immediately expensed. The CARES Act also clarifies that qualified improvement property only includes improvements made by the taxpayer claiming the deduction. These changes are effective as if they were originally included in the 2017 tax reform act.

Observations:
While taxpayers had been optimistic that this error would ultimately be corrected, this technical correction brings welcome relief to taxpayers that have, to date, been unable to take advantage of immediate expensing of certain interior improvements. It is still unclear how taxpayers should avail themselves of these corrected provisions for periods in which they have already filed tax returns.

Taxpayers that make the real property trade or business election to be exempt from the interest deductibility limits in Section 163(j) are required to depreciate the qualified improvement property over 20 years (i.e., the property is not available for immediate expensing).

From a state income tax perspective, it should be noted that this will likely continue to be an area requiring significant state tax modification scrutiny, given states’ general non-conformity to both the depreciation/amortization rule changes enacted by the 2017 tax reform act, as well as previous non-conformity to historic federal bonus depreciation rules.

Employer payroll tax deferral
The CARES Act allows employers and self-employed individuals to defer payment of the employer's share of Social Security taxes and half of SECA taxes attributable to Social Security, respectively, from March 27 (i.e., date of enactment) through December 31, 2020. The deferral is calculated after taking into account any employer retention credit (discussed below). The deferred amount would be required to be paid 50% by December 31, 2021 and the other 50% by December 31, 2022. This provision does not apply to a taxpayer whose loan is forgiven under the paycheck protection program (discussed below).

Observations:
This deferral may be a cash benefit to management companies and portfolio companies. However, there may be administrative complexities in implementing this deferral (as well as the employer retention credit discussed below) for companies that use professional employer organizations.

Employer retention credit
The CARES Act provides eligible employers a refundable employee retention credit for up to 50% of qualified wages paid to each employee during the calendar quarter (up to $10,000 in wages total per employee, for a maximum credit of $5,000 per employee). Eligible employers are those whose business operations are fully or partially suspended due to orders from an appropriate government authority, or for employers whose gross receipts have significantly declined (i.e., gross receipts for a quarter beginning January 1, 2020 are less than 50% of gross receipts for the same quarter in 2019). For employers with over 100 employees, the credit is available for employees being paid for services not being performed due to the COVID-19 crisis, and for employers with 100 or fewer employees is available for all employees.

The credit applies to qualified wages paid after March 12, 2020 through December 31, 2020. An employer can no longer claim the credit due to a significant decline in gross receipts in any quarter after the quarter in which gross receipts are greater than 80% of the gross receipts received in the same quarter in 2019.
An employer that receives a loan under the paycheck protection program (discussed below) is not eligible for the employer retention credit.

Observations:
Eligible employers should determine whether the employer retention program or the paycheck protection program is more beneficial to them based on their particular circumstances.

While this may be applicable to many portfolio companies who can no longer operate due to the governmental restrictions, it is less likely management companies will be able to claim this credit given it may be more difficult to take the position that their business is suspended if they are able to work remotely. Hopefully, there will be further guidance on what support a taxpayer would need to demonstrate the partial or full suspension of the business. Note, with respect to the gross receipts test, it is unlikely gross receipts would decline so significantly if the management company receives an asset based fee only (as opposed to a performance fee that may show more volatility).

Paycheck protection program
The CARES Act includes a non-tax economic stabilization provision that may be relevant to the AWM industry. The 'paycheck protection program' provides loans, through lending institutions approved to participate through the existing Small Business Administration (SBA) lending program, in an amount of 2.5 times monthly payroll costs (up to $10 million) for certain eligible businesses (including self-employed individuals). Borrowers generally must employ no more than 500 employees (including employees of affiliates), and, according to the Loan Application Form, must certify that "current economic uncertainty makes the loan request necessary to support the ongoing operations of the Applicant". Designated uses of the loans include payroll, mortgage interest, rent, utilities, and interest on other debt obligations.

The covered loan period begins February 15, 2020 through June 30, 2020. The loan may be forgiven (including interest) for amounts spent during the first eight weeks after the origination date on certain expenses, including payroll, mortgage interest, rent, and utilities, and depends on employee retention. If all employees are retained during the eight-week period, the entire loan will be forgiven. If employees are laid off, the amount forgiven is reduced based on the percentage of employees laid off. The amount forgiven during that eight-week period generally would not be considered cancellation of indebtedness income. Borrowers are responsible for any portion of the loan that is not forgiven, with interest capped at 4%.

Observations:
Portfolio companies should consider eligibility for the paycheck protection loans, and whether it would be more beneficial than the employer retention credit (if applicable).

There is currently uncertainty around the affiliation rules for purposes of counting the number of employees of the borrower so as not to exceed the maximum of 500 employees. If the SBA’s affiliation rules apply, a portfolio company arguably may need to include in its count of employees the employees of the private equity fund’s other portfolio companies. Clarification has been sought on how to apply the affiliation rule so that certain businesses are not excluded from this benefit simply because they have a common owner with other businesses, as that does not appear consistent with the intention.

Small business sick leave and family leave tax credit (Phase Two)
The Phase Two stimulus package included a tax credit for certain employers to cover qualified sick leave and family leave wages. Employers with fewer than 500 employees can take the credit in an amount limited to: (1) $511 per day for an employee who must self-isolate or obtain a diagnosis with respect to COVID-19, and (2) $200 per day for an employee caring for a family member or child whose school is closed. The credit is limited to 10 aggregate days per employee, and expires before 2021.

The credit is applied against an employer’s portion of Social Security taxes, and certain excess amounts may be refundable. To prevent double dipping, employers are required to include in taxable income the amount claimed as tax credits.

Observations:
Management companies and portfolio companies should evaluate whether they can utilize these credits, and review taxable income considerations if the credit is claimed.

Other Individual Relief Provisions
The CARES Act raises the adjusted gross income (AGI) limitation on charitable contributions from 60% to 100%. Individuals who itemize their deduction can deduct charitable contributions within certain limits. The limitations are based on a percentage of the individual’s AGI, the type of charity to whom the contribution is made and the type of property contributed. In general, cash contributions to public charities are deductible up to 60% of an individual’s AGI. The CARES Act expands the AGI limitation to 100% for cash contributions to public charities. For this purpose, donor advised funds are excluded from the definition of public charities. To qualify for this enhanced benefit the taxpayer must make an election on his or her income tax return for 2020. This benefit is also available to individuals who are shareholders or partners in S corporations and partnerships that make cash gifts to public charities.

The CARES Act also provides relief from certain tax provisions related to retirement accounts. The CARES Act eliminates required minimum distributions from qualified retirement accounts that are required to be made in 2020. For anyone who may have already received a distribution, the amount received may be re-contributed to the retirement account within 60-days. The CARES Act also eliminates the 10% early withdrawal penalty for COVID related distributions up to $100,000.

Notice 2020-18 reporting and payment due dates
On March 20, the IRS issued Notice 2020-18, which extends to July 15, 2020, without penalties and interest, the April 15, 2020 due date for filing certain federal income tax returns and making federal income tax payments. Notice 2020-18 applies broadly to all taxpayers, including individuals, trusts, estates, partnerships, and corporations, with a federal income tax return due April 15, 2020. These taxpayers are not required to file a return (or an extension) or pay tax (regardless of amount owed), including self-employment tax, due on April 15, but instead are required to pay and file by July 15. The extension also applies to estimated tax payments that would have been due on April 15, but does not apply to estimated tax payments due June 15. The due date for Section 965(h) toll charge installment payments due on April 15 is also extended to July 15.

A taxpayer may request an extension (e.g., by filing Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return) by July 15 for an income tax return that would otherwise have been due on April 15, and pursuant to such extension, that return will be due October 15 (that is, 6 months from the April 15 un-extended due date, not 6 months from the July 15 extended date). Taxpayers requesting an extension must pay estimated taxes due in connection with the extension by July 15 to avoid interest and penalties.

For fiscal year taxpayers, the due date for a taxpayer’s federal income tax return for a fiscal year ending during 2019 is postponed until July 15 if the return was otherwise due on April 15, regardless of whether that is the original due date or the due date on extension.

Finally, note that the IRS also released Notice 2020-20, which extends the due date for filing gift tax returns and paying gift tax to July 15th.

Observations:
Notice 2020-18 explicitly indicates that the extension does not apply to the filing of any “information return” (information returns are documents filed with the IRS to report certain transactions). While not entirely clear, we believe that the extension applies to information returns that are filed with covered income tax returns such as Form 5471, 8621, etc., and await clarification from the IRS.

It also appears that the extension does not apply to withholding tax payments. Therefore, for example, a partnership that is required to withhold under Section 1446 with respect to a foreign partner’s share of effectively connected income apparently cannot defer the withholding tax nor the filing of required forms (Forms 8804, Annual Return for Partnership Withholding Tax (Section 1446) and 8805, Foreign Partner’s Information Statement of Section 1446 Withholding Tax). Also, withholding on U.S. dividend income and other forms of income under Section 1441 reported on Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons and Form 1042-S, Foreign Person’s U.S. Source Income Subject to Withholding are not extended by this Notice. A taxpayer could consider asserting a reasonable cause position to abate a penalty on a late withholding tax payment or filing.
Notice 2020-18 provides relief for 2019 federal corporate income tax return payments due April 15, 2020 as well as 2020 corporate estimated tax payments due April 15, 2020. As a result, blocker corporations may consider deferring these payments previously due on April 15, 2020 (original balance/1st quarter) until July 15, 2020.

Notice 2020-18 does not provide relief for required installments of estimated tax for the 2019 taxable year that were due prior to April 15, 2020 (e.g., June 15, 2019, September 16, 2019 or January 15, 2020 payments). The IRS makes this clear in FAQ24 and adds that relief from penalty may be available under the normal rules (Form 2210, Underpayment of Estimated Tax by Individuals, Estates and Trusts and Form 2220, Underpayment of Estimated Tax By Corporations). However, the period of underpayment for such required installments does not run past April 15, 2020. Therefore, there should not be additional estimated tax penalties accruing on these required installments after April 15, 2020. However, there could be 2019 underpayment penalties arising after July 15, 2020 with respect to the 2019 tax year.

Funds should consider reporting obligations they may have pursuant to limited partnership agreements, side-letters, or other contractual arrangements. For example, agreements may provide additional flexibility to not make distributions of cash for tax payments to their partners, which needs to be balanced with expectations around cash planning expectations.

While almost all the states have provided some relief for April 15 income tax filing and payment deadlines, to date some states have not. Without all states aligning with the federal extension, many taxpayers will be required to move forward with the federal return so that the returns in non-aligning states can be filed. Please see PwC’s tracker Select state and local tax relief relating to Coronavirus, which summarizes certain state and local tax relief efforts.

Global tax and other mobility tax considerations
Select international tax issues impacting the AWM industry include:

Workforce mobility
Permanent Establishment - Taxpayers should consider workforce mobility and monitoring employee working locations to manage risk of permanent establishment for the jurisdictional employer and/or the fund or investing entity. Several countries are relaxing the rules and enforcement in light of the travel restrictions imposed by their governments in light of COVID-19.

Management and Control - While the U.S. does not have the concept of management and control as a determination of tax residency, many jurisdictions determine tax residence based on place of management. Therefore, clients should consider what is being done (whether governance or management team function) and where.

Global tax incentives
Countries around the world are providing relief and introducing other forms of liquidity measures. Please see PwC’s tracker Navigate tax measures in response to COVID-19, which summarizes numerous countries’ tax relief efforts.

Select state & local issues impacting the AWM industry include:

Management company considerations
Management companies will need to reevaluate their state and local nexus footprint in the wake of mandatory shelter in place orders, or voluntary work from home mandates. Payroll tax withholding, state income tax and entity level locality filing obligations may result from employees working remotely in a state or city other than their normal work location.

While guidance is still pending, companies should consider the potential impact of remote employees on state apportionment, both for the payroll factor and the sales factor in certain cost of performance jurisdictions (i.e., New York state and New York city) that may be impacted. If necessary, estimated income tax payments may need to be adjusted accordingly for both changes to apportionment factors, as well as changes to estimated taxable income and/or other tax bases.

Finally, companies should monitor state legislative developments impacting state conformity to the CARES Act provisions and other state specific legislation that either provide benefits/incentives to in-state companies, or create newly enacted economic nexus provisions that go after out-of-state companies.
Other operational and tax considerations

In addition to these new provisions, certain existing rules will be more relevant to the AWM industry in the current environment. For example, funds and portfolio companies should consider the rules for cancellation of debt (COD), debt modifications, and original issue discount (OID) when renegotiating debt terms, to be aware of the possibility such action may give rise to taxable income, and where possible, mitigate or eliminate such income. Portfolio companies, credit funds and their investors around the world are evaluating existing financing arrangements, with an increased focus on the potential to repurchase debt at a discount. In what may be a trap for the unwary, COD income can result when a fund purchases the debt of a portfolio company, or one deemed related by attribution. Additionally, in the case of non-U.S. debt, foreign jurisdictions often have rules similar to the U.S. COD rules, which should be considered when evaluating whether to repurchase debt.

Many portfolio companies are also facing an immediate cash need, resulting in short-term financing. Such financings may give rise to several important tax considerations, including withholding tax implications, debt versus equity classification, the potential to give rise to ‘dry income’, potential impact of hybrids and associated rules, and deductibility limitations or restrictions.

Funds should also consider laws relating to tax losses, and plan accordingly. This may include consideration of wash sale rules that may suspend realization of losses, lot identification on sales of investments to meet redemptions, and weighing Section 475 mark-to-market elections to convert capital losses to ordinary losses.

Furthermore, from a state and local tax perspective, given our experience with rolling decoupling announcements by state authorities, for those AWM clients that release K-1s earlier in the year, it is possible that subsequent law changes may require state K-1 amendments and/or communications with their partners and their partners’ tax preparers.

Finally, COVID-19 will likely accelerate the trend around fund managers driving greater optimization in their tax operating model through new efficiencies and innovation. Over the past several years, many fund managers have been reevaluating their in-house tax function and how it operates in an attempt to reduce costs, increase efficiency, redeploy personnel on more value-added work, and make better use of data to improve tax planning and strategy. Managers may find it financially attractive to outsource significant components of the tax function, including middle-office and front-office activities that have not been traditionally outsourced.

The takeaway

The CARES Act includes a wide range of provisions that will impact the AWM industry. Numerous short-term and near-term cash incentives exist presenting opportunities for managers to optimize cash. Significant tax opportunities will arise relating to COVID-19 and other operational tax planning for the 2020 tax year. Loss planning strategies and minimizing taxable income will take on added significance. Asset managers should review and assess the potential application to their investors, general partners and investments. The President’s signature on March 27, 2020 was merely the first step in the government’s implementation of the significant new legislation. There remains a myriad of questions in all areas of the law surrounding intent, interpretation, and applicability. Managers will need to continue to assess how tax reform impacts their business and monitor guidance released in IRS notices and Treasury Regulations.

Other materials

For a detailed discussion of the broader set of CARES Act provisions, access PwC’s Insight Senate passes ‘Phase Three’ COVID-19 economic stabilization legislation. For a discussion of the legislative and administrative activity, including the previously enacted ‘Phase One’ and ‘Phase Two’ packages, access PwC’s Insights Tax return filings delayed until July 15; Negotiations underway on COVID-19 ‘Phase Three’ economic stabilization legislation, Tax advantaged assistance to COVID-19 impacted employees, and President declares National Emergency; House passes COVID-19 relief bill; talks continue on additional tax measures. For more details regarding Notice 2020-18 and the associated FAQs, please access PwC’s prior Insight IRS issues FAQs on filing and payment relief. For a detailed summary of the state and local tax jurisdictions providing filing and payment extensions, access PwC’s Select state and local tax relief relating to Coronavirus.
Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

**Puneet Arora**  
US Private Equity Tax Leader  
+1 917-593-3803  
puneet.arora@pwc.com

**Gina Biondo**  
AWM Tax Solutions Leader  
+1 917-859-0955  
gina.biondo@pwc.com

**Caragh DeLuca**  
State and Local Tax AWM Leader  
+1 516-330-2825  
caragh.deluca@pwc.com

**Adam Feuerstein**  
National Real Estate Tax Technical Leader  
+1 240-476-2647  
adam.s.feuerstein@pwc.com

**Kara Friedenberg**  
AWM Tax Partner  
+1 917-648-5667  
kara.l.friedenberg@pwc.com

**Brian Rebhun**  
US Tax AWM Leader  
+1 732-267-6371  
brian.rebhun@pwc.com

**Caragh DeLuca**  
State and Local Tax AWM Leader  
+1 516-330-2825  
caragh.deluca@pwc.com

**Robert Roeder**  
AWM Tax Partner  
+1 917-817-6984  
robert.roeder@pwc.com

**Alan Biegeleisen**  
AWM Tax Managing Director  
+1 917-930-3887  
alan.j.biegeleisen@pwc.com

**Alexander Birkenfeld**  
AWM Tax Senior Manager  
+1 646-565-8838  
alexander.birkenfeld@pwc.com

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