Managing Enterprise Risk Through Liquidity Planning

The Importance of Tax in the Response to COVID-19 | April 3, 2020

Speakers

Jennifer Molnar
Partner, Washington, DC
Tel: +1 202 452 7033
Email: jennifer.molnar
@bakermckenzie.com

Matthew Nochowitz
Partner, Chicago
Tel: +1 312 861 8855
Email: matthew.nochowitz
@bakermckenzie.com

Joshua Odintz
Partner, Washington, DC
Tel: +1 202 835 6164
Email: joshua.odintz
@bakermckenzie.com

Daniel Stern
Partner, Washington, DC
Tel: +1 202 835 6012
Email: daniel.stern
@bakermckenzie.com

Daniel Cullen
Partner, Chicago
Tel: +1 312 861 8162
Email: daniel.cullen
@bakermckenzie.com

Agenda

1. Current Economic Environment and Challenges Placed on Finance Departments

2. Prioritizing Objectives For Changing Control Environment and Business Needs

3. Enterprise Risk & Liquidity Planning: Covenant Calculations, Impairment Considerations, Valuation Allowances, Trapped Cash, Supply Chain Finance, Sale Leaseback Transactions, and Liquidity in the CARES Act

4.
   - Deeper Dives
     - Liquidity in the CARES Act
     - Cash Repatriation
     - Sale Leaseback Transactions

Current Economic Environment and Challenges Placed on Finance Departments

- The coronavirus continues to impact both our local and global community, and the current situation is tragic for humanitarian reasons and the economy.
- Our primary concern is for the well-being of all those affected by this crisis.
- Finance departments will be tasked to rapidly respond to this changing economic environment. Root cause of requests can vary by company, industry and changing business needs.

Tax departments will be required to respond rapidly to a changing environment. By working within the broader finance organization groups can help mitigate Enterprise Risk.

Prioritizing Objectives & Mitigating Enterprise
Risk w/ Liquidity Planning

Current Economic Environment and Challenges Placed on Finance Departments

- Alternative Transactions within the company's risk profile to help improve: financial metrics, increase forecast accuracy, mitigate losses or otherwise protect the company.

- Liquidity Planning – Cash is the most important thing if you don't have any

- Controversy – Navigate draws on liquidity, consider potential Amnesty Programs or Monetization of Plaintiff Litigation in some countries

- Accelerated Compliance Process due to NOL carryback provisions

- Enhanced Controls and Communication Given Remote Work Environment

There is no group in finance better situated in the current environment
to help companies meet their financial objectives and mitigate risk.

Liquidity Basics

- In order for tax departments to increase their effectiveness in the current environment they need to understand the basics of liquidity and how traditional transactions and transfer pricing policies can impact it.
- Bonds, term loans, committed credit facilities, commercial paper programs are some of the most popular ways to raise capital and their availability and pricing are contingent a company's credit rating.
- The committed credit facility is largely considered a liquidity backstop for companies as a host of banks are legally obligated to provide funding within a contractual amount.
- Other types of more exotic financing exists as well, but these are the most basic.

Liquidity Basics and Covenant Calculations

- Debt Covenants are heavily negotiated and can vary dramatically depending on a company's credit rating, cash balances, and earnings volatility.
- The most common debt covenant is Debt / EBITDA $< x\%$ (though others are often negotiated)
- This calculation can be extremely volatile – especially in the current environment when Debt is increasing to fund existing corporate infrastructure and EBITDA is falling due to reduced top line revenue
- Debt covenant language can be renegotiated, but note that it is difficult and expensive to do so if the company is approaching its contractual limit.

The Debt Covenant Calculation can by influenced by transactions tax departments are familiar with for totally unrelated reasons.

Impairment Considerations, Valuation Allowances and Covenant Calculations

- In the 4th quarter of each year most companies are required to test for impairment of goodwill and intangibles. The process is highly judgmental and considers a number of variables that depend upon the type of asset being tested.
- Qualitative and Quantitative testing are both possible and an impairment will occur when the asset's market value and carrying value invert. Testing is particularly challenging in the current environment due to market capitalization limitations.
- Worse, once the carrying value is reset to the lower market value, future impairment is possible – as by definition the two numbers are break even at that time so any further degradation can result in further impairment.
- An impairment has significant implications on the street in most cases calling into question whether the company over paid on an acquisition and in some cases whether the company is a going concern.

An impairment will effect GAAP earnings and can compromise a company's debt covenant calculation even though it does not directly impact cash.

Impairment considerations, Valuation Allowances and Covenant Calculations.

- A valuation allowance (VA) is required against a deferred tax asset when you do not believe the asset will be used before it expires.
- When a company is in a cumulative loss position (an aggregate loss over the prior two and current year) that is considered strong negative evidence that a valuation allowance is required and you in theory cannot rely on forecasting to rebut the presumption that a VA is necessary.
- A valuation allowance will likely not directly impact a company's covenant calculation but it can severely impact GAAP (and often times) ongoing Earnings. Thus it can create a severe unexpected drag on a company's earnings per share.
- Liquidity concerns can exacerbate these problems as many transactions used to rebut a valuation allowance require cash movements.

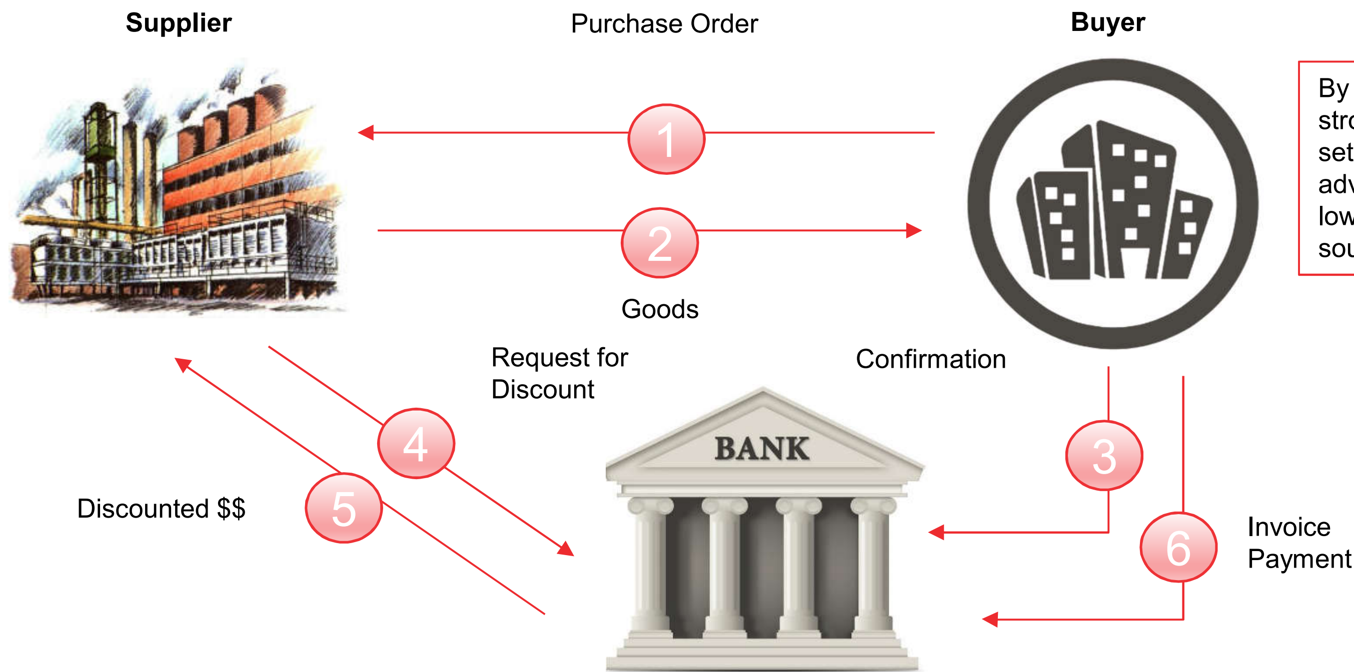
Impairment and Valuation Allowance planning is another place where tax departments can partner with finance to provide enterprise wide value to the company.

Mitigating Enterprise Risk With Trapped Cash

- The definition of trapped cash has evolved and is no longer typically constrained by US tax rules. For some companies, trapped cash can merely be cash that is cost prohibitive to access. For others there could be various local country restrictions.
- Cash is trapped for a reason and it typically can only be accessed by working together with multiple disciplines within legal and finance across multiple borders – no one being more important than the others.
- Where should you expect trapped cash in the future: China, Brazil, India? The real answer is that it's impossible to know in the current environment and the solution to accessing this cash must be highly tailored to a company's facts.
- What can be done: Transactions and Transfer Pricing

It is important to increase transparency throughout the organization when accessing trapped cash: prominently highlighting cost and risk associated with any transaction.

Mitigating Enterprise Risk with Supply Chain Finance

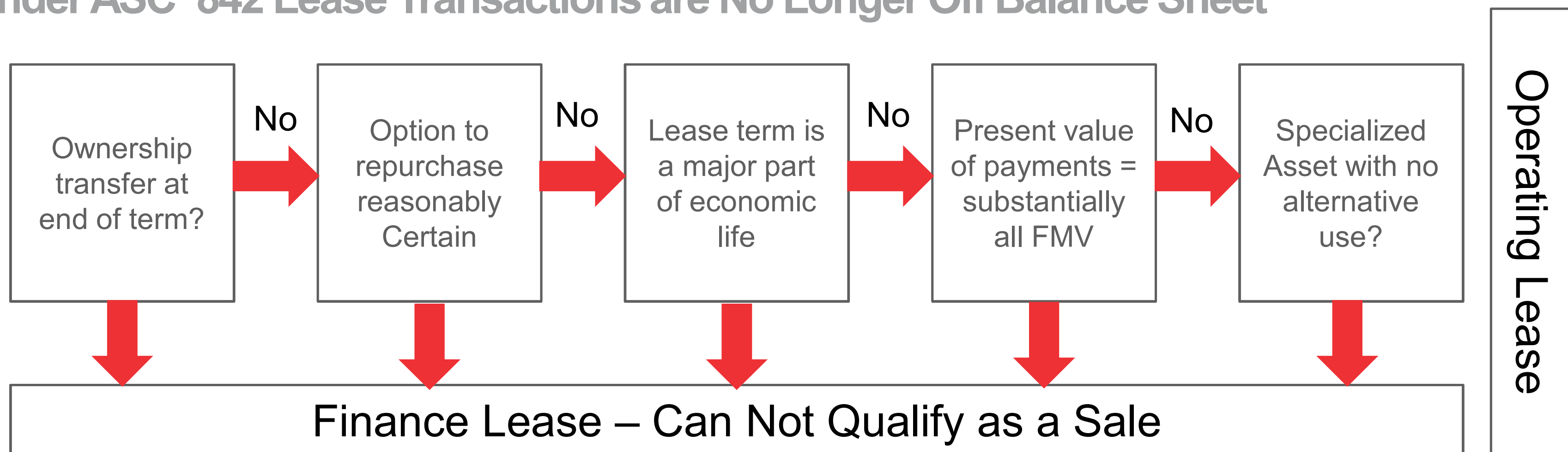


By leveraging the Buyer's stronger credit rating, the Bank settles Supplier invoices in advance of invoice date and at a lower cost than Suppliers' own source of funds.

Supply Chain Finance can be used to lessen Enterprise Risk by helping to optimize working capital but also by supporting the weaker links in the chain

Mitigating Enterprise Risk through Sale Leaseback Transactions

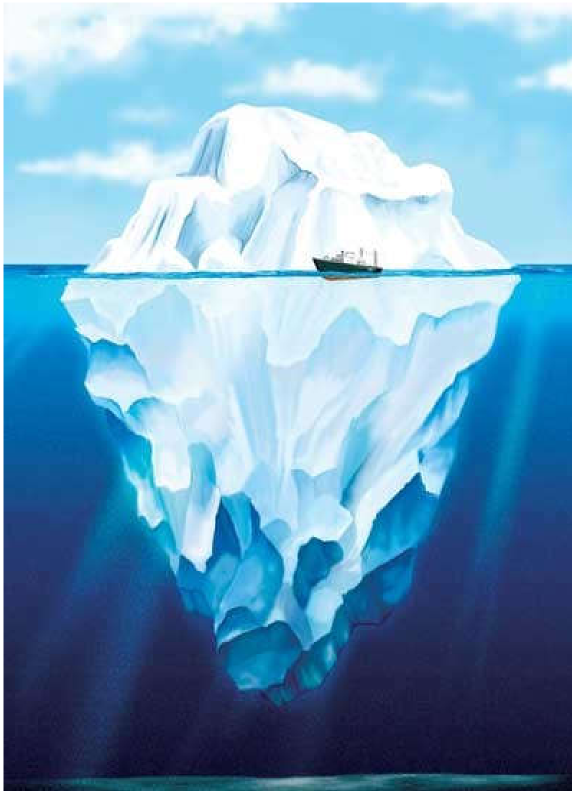
Under ASC 842 Lease Transactions are No Longer Off Balance Sheet



- A SLB is considered a sale when control of the asset is transferred
- If structured as an operating lease it can still qualify as a sale (despite leaseback) but only if both: the exercise price of the option is its FMV and there are alternative assets that are substantially similar (not land or buildings)
- If qualifies as a sale: full gain or loss is recognized from the transaction, but only PV of lease payments recorded as liability.

A SLB can provide alternative access to liquidity and have a positive impact on a company's covenant calculation compared to other options

Mitigating Enterprise Risk with Liquidity Planning: Deep Dives



- Liquidity in the CARES Act
- Repatriation
- Sale Leaseback Transactions

Deep Dive: Liquidity in CARES Act

Mitigating Enterprise Risk with Liquidity Solutions in the CARES Act

	Paycheck Protection Program	Assistance for American Workers and Businesses	Economic Stabilization and Assistance to Severely Distressed Sectors
Major Impacts to Corporate Liquidity	1. Provides $350B of loans to small businesses - not more than 500 people per location and meeting certain gross receipts limits Maximum loan is $10M. Debt is nonrecourse and no personal guarantee required. No fees for loan allowed. Allowable uses of the loan include payroll, insurance, mortgage interest (not principal) rent, utilities Max rate is 4% w/ no prepayment fee. Max term is 10 yrs	1. Refundable payroll tax credits up to 50% wages paid for retained employees Credit is available if operations were suspended or gross receipts declined > 50% Dollar limits of $10,000 per employee Application of provisions differs depending on size of employer 2. Delay of Payment of employer payroll taxes 3. Five Year NOL Carryback 4. Alternative minimum tax reform for earlier refunds 5. Modification of limits on deductibility of interest expense 6. Clarified deductibility of qualified improvement property (especially in the hospitality industry)	1. Provides $500B to Treasury Exchange stabilization fund to provide loans, guarantees and other investments Specific amounts set aside to particular industries - including subsets of the airline industry and national security Lion's share ($450B) available to help mitigate extraordinary pressure in the financial markets more generally Provisions exist to make sure that interest is arm's length and the term of the loan is capped at 5 years Secretary can waive statutory terms for some of the loan programs

Mitigating Enterprise Risk with Liquidity Solutions in the CARES Act

	Paycheck Protection Program	Assistance for American Workers and Businesses	Economic Stabilization and Assistance to Severely Distressed Sectors
What's remarkable	Loan forgiveness possible for amounts used for specific purposes within 1st 8 weeks of the loan COULD BE VERY HELPFUL TO MITIGATE SUPPLY CHAIN RISK		Note that dividends and stock repurchase is prevented, but M&A is possible NOTE THAT M&A IS NOT PROHIBITED
Important Limitations to Highlight	Loan forgiveness reduced proportionately if employees eliminated or compensation reduced beyond certain levels Exceptions exist if employees rehired within certain time limits)		Borrowers cannot buy back stock or pay dividends until the loan is repaid or 1 year after repaid Borrowers must maintain 3/24 employment levels through end of September to extent practical but no less than 90% of employees as of that date There are limits on employee compensation and severance that vary by income level starting at $425K Midsize businesses (500 - 10,000 employees) have strict rules against collective bargaining

Deep Dive: Cash Repatriation

Repatriation Options

Common Strategies

- Distributions
- Loans
- Repayment of Existing Loans
- Prepayments

Repatriation Options

Distributions

- Foreign subsidiaries make distributions to the US
- General tax treatment of distributions
  - PTEP
  - Untaxed E&P / Dividend
  - Return of basis
  - Capital gain

Repatriation Options

Distributions, cont'd

- PTEP
  - PTEP is distributed before untaxed E&P, and section 965 PTEP has priority
  - PTEP can be distributed tax-free
  - Special Considerations
    - Withholding taxes on distribution of section 965 PTEP subject to haircut
    - Potential gain recognition if insufficient basis when section 961 basis reduction - mid-year distribution vs. end-of-year basis increase
    - Section 986 foreign exchange gain or loss on distribution of PTEP

Repatriation Options

Distributions, cont'd

- Untaxed E&P / Dividend
  - With section 245A, can directly distribute untaxed E&P tax-free assuming requirements are satisfied
  - Special Considerations
    - No tax credits for any withholding taxes imposed on distribution
    - Consider any hybrid instruments which would deny 245A deduction to the extent of hybrid deduction account - even on other class of stock
    - Consider impact of section 245A temporary regulations for any "gap year" GILTI planning earnings

Repatriation Options

Loans

- Foreign subsidiaries loan funds to the US
- US Tax Considerations
  - Historically avoided loans from foreign subs due to section 956, but now can avoid section 956 inclusion to the extent amount qualifies for section 245A
  - Also no section 956 inclusion to the extent of PTEP
  - As with section 245A, consider any hybrid instruments in structure which would trigger section 956, but without benefit of any tax credits

Repatriation Options

Repayment of Existing Loans

- Foreign subsidiaries repay any existing loans from the US
- US Tax Considerations
  - Interest income is taxable, but repayment of principal is tax-free
  - Loan likely denominated in local currency so consider Section 988 foreign exchange gain or loss

Repatriation Options

Prepayments

- Foreign subsidiaries prepay the US for inventory, services, royalties, etc.
- US Tax Considerations
  - Transfer pricing principles would generally require discount, e.g., prepayment of two years' worth of inventory should reflect discount consistent with unrelated party transactions
  - Practical limit on how many times can be repeated

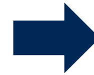
Corporate Considerations

Potential Issues and Solutions

Traps/ Issues

Impairment

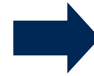
- If the payment of a dividend by a subsidiary requires its parent to impair or "write down" its investment in that subsidiary, this may impact the ability of parent (and companies farther up the chain) to make distributions up the chain.



Remedies:
- Loan
- Repayment of existing Payable to Shareholder

Insufficient Retained Earnings

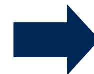
- In many countries an entity's ability to distribute funds is limited by its profits or retained earnings



Remedies:
- Capital Reduction
- Share Repurchase or Redemption
- Possible Distribution from other Reserves

Timing

- Many times cash needs to be repatriated to the U.S. by a certain date without having sufficient time to process all dividends up the chain of companies



Remedies:
- Loan(s) to TopCo followed by
- In-kind Distributions of the Receivable(s)

Corporate Considerations

Difficult Jurisdictions

Country (companies with limited liability)	Observations
CHINA	Interim dividends are in practice not feasible in China (not supported by banks and tax authorities). For annual dividends the audit report has to be ready for the dividend declaration. The tax authorities and local remittance banks should be involved early on, especially if no prior dividends have been declared by the Chinese entity. For dividends of USD 50Mio or more the timing increases as the Central Bank will need to get involved. For the calculation of distributable profits, losses of prior years have to be covered first and the mandatory statutory reserves filled.
GERMANY	For an interim dividend in Germany management accounts according to German GAAP need to be presented. German capital maintenance rules and insolvency/liquidity test apply. A distribution out of reserves is possible. Capital reduction is not an option to increase distributable profits due to 1 year waiting period. In some cases, works council consultation may be required. Depending on dividend amount and recipient of dividend, German Central Bank has to be notified.
HONG KONG	Last audited and recent management accounts need to be prepared for an interim dividend. It is easier to distribute an amount of profit shown in a previous fiscal year instead of accrued realized profits as auditors will request a claw-back and shareholders will have to return the funds if the distributed amount was too high.
JAPAN	For an interim dividend approved financials (audited if required) of the most recent fiscal year are required and are basis for calculating the amount left for interim dividend. Only retained earnings can be distributed, which should be calculated together with the company' accountants/auditors. Legal reserves need to be filled prior to the dividend declaration. For payments to a foreign entity a report to the Bank of Japan might have to be submitted based on the amount.
KOREA	For an interim dividend, approved financials of the most recent fiscal year are required and are basis for calculating the amount left for interim dividend. Similar to Japan, the accountants/auditors should be consulted to calculate the dividend amount that can be distributed, which is the so-called 'dividendable income'. Filings with the Bank of Korea might be necessary. Dividends can only be distributed out of dividendable income shown in the last annual accounts.
SWITZERLAND	For an interim dividend in Switzerland a confirmation by the statutory auditor will be required in addition to audited annual financials and, if those are older than 6 mo., interim financials. Only the distributable equity can be distributed, which is usually the total equity minus the nominal share capital, the legal capital reserves and available earnings earmarked for distribution. Reserves can be increased by share buyback or a capital reduction. However, restrictions/ waiting period apply.

Deep Dive: Sale Leaseback Transactions

SLB Tax Treatment: Lease vs. Loan

- For tax purposes, a lease is characterized as either a “true lease” or as a financing
  - Book mostly follows tax; operating lease = true lease; direct finance lease = loan
  - Under a tax lease the lessor is considered the owner of the asset for income tax purposes
  - Legal title sometimes resides with the lessee while the lessor has tax ownership or vice versa
- As asset owner, on its tax return the lessor includes:
  - Tax depreciation and potentially other benefits (usually MACRS, bonus depreciation if applicable)
  - Rental income (subject to tax reporting guidance for level rents)
  - Interest expense deductions (if the transaction is leveraged with debt)
  - Residual income on disposition of the asset (sales value less tax basis)
  - If a lease fails the guidance for tax lease characterization, the IRS can re-characterize the lease as a loan, thus changing the economics of the transaction

SLB Tax Treatment: Lease vs. Loan

Tax characterization of a lease transaction is dependent on multiple factors:

- Form of documentation: loan agreement or lease agreement?
- Limited use asset?
- Is legal title held by the lessor?
- Does legal title automatically transfer to the lessee at any time?
- Does the lessee have any rights to the residual value of the asset?
- Does the lessor assume substantially all of the risks and rewards of ownership of the asset?
- Can the lessee implicitly claim a right in the asset because they contributed towards its initial purchase?
- Is the lessee guaranteeing any of the future value of the residual value?
- Can the lessee buy the asset from the lessor for a value which is substantially less than the fair market value of the asset at that time?
- Is the lease of such a long term that the asset has only a trivial future economic useful life or residual value?

True Lease Guidelines: Revenue Procedure 2001-28

Rev. Proc. 2001-28 provides: to be respected as a true lease, at inception a lease must adhere to the following guidelines:

- The asset cannot be “limited as to its use” only by the lessee
- The lessee cannot furnish any part of the cost of the asset (unless removed without causing material damage); the lessee may not lend any of the funds necessary to acquire the property
- The lessor must maintain a minimum unconditional “at risk” investment (the residual value) in the property at all times throughout the entire lease term
- The lease term, including all the renewal and extension periods expected to be exercised (bargain renewals), must not be greater than 80% of the asset’s economic useful life
- The lessee must not have a contractual right to buy the asset at a price which is less than its fair market value at the time of exercise
- The lessor must expect to receive a profit apart from the value of or benefits derived from tax deductions

True Lease: Key Factors – IRS Position & Case Law Authority

Key Factor	Lease	Loan
1. Lessor has minimum investment of at least 20% in leased property . Courts have recognized the lessor as owner even where the minimum equity investment is lower than 20%.	X	
2. Lessor's minimum investment in leased property is at risk. Courts have permitted lease characterization where the lessee has assumed the risks of casualties, obsolescence or burdensome governmental regulations.	X	
3. Lessee (or affiliate) guarantees Lessor's indebtedness created in connection with the acquisition of the asset. Courts have not placed significance on lease debt guarantees as long as the lessor is the true borrower.		X
4. Residual value of leased property is at least 20% at the end of lease term. Courts have held that residual values less than 10% of original cost were sufficient.	X	
5. Remaining useful life of leased property is at least 20% at end of lease term. IRS authority that a remaining useful life of 16.7% was sufficient.	X	
6. Lessee's purchase option approximates FMV at time of exercise. Courts have respected lease characterization as long as the lessee's purchase option is not "nominal" or a bargain.	X	
7. Lessor has expectation of profit. Courts have focused more on the economic viability of the transaction.	X	
8. Portion of the rental payments are applied to equity		X
9. Lessee acquires title after payment of stated rentals		X
10. Rental payments exceed current fair rental value		X
11. Portion of the rental payments are specifically designated as interest		X
Note: case law authority often provides greater flexibility than stated IRS position.		

Prepaid Master Lease or Synthetic Lease Structures

For taxpayers desiring to avoid recognizing gain on assets with significant built-in gain, the following alternative structures should be considered:

Prepaid Master Lease Structures:

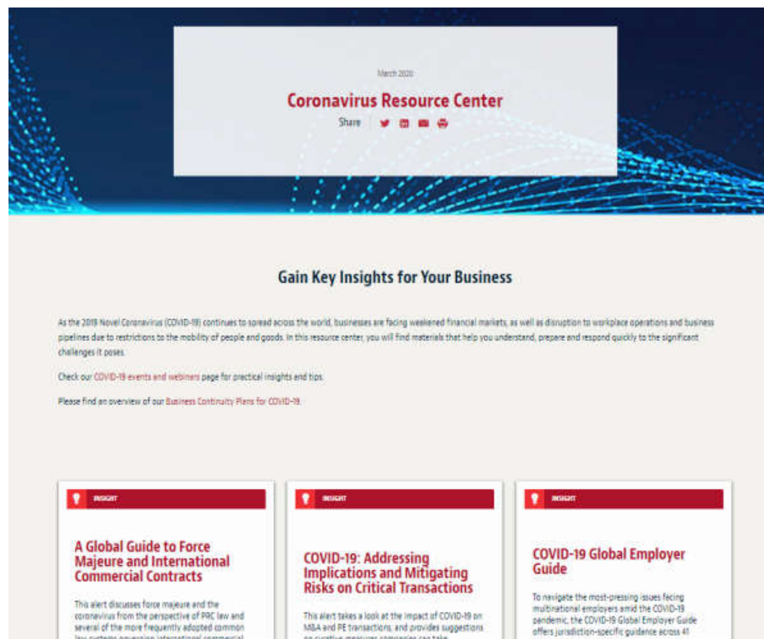
- For tax purposes, the prepayment of rent alone should not cause a lease to be recharacterized as a sale in a head-lease / lease-back transaction. The courts and the IRS have respected leases providing for prepaid rent. Generally speaking, the tax owner (lessor under head-lease) should maintain approximately 10% of the asset's fair market value. A fixed price purchase option at end of lease term can be used in certain cases as long as formal opinion relating to reasonable approximation of future fair market value is obtained.

Synthetic Lease:

- At a basic level, a synthetic lease is an operating lease. The asset is owned by the lessor for accounting purposes but is owned by the lessee for tax purposes. The lessor retains formal ownership of the asset and rents it out to the lessee for the duration of the lease. If structured properly, one of the primary attractions is that the asset should not appear on the lessee's balance sheet and can be written off as an expense – as long as sufficient risk of loss resides with the lessor for accounting purposes. For tax purposes, if structured properly, the transaction is treated as a loan, rather than a sale.

Baker McKenzie COVID-19 Resources

Baker McKenzie COVID-19 Resources



The Baker Coronavirus Resource Center site includes materials to help you understand, prepare and respond quickly to the significant challenges COVID-19 poses.

Resources include a variety of client alerts, publications and webinars that cover pressing issues, including employer obligations, force majeure claims, contractual obligations, product safety and liability, corporate government and tax, data privacy concerns and liabilities for supply chain disruptions, among other concerns.

Please visit the Baker Coronavirus Resource Center site here.

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