Schulte Roth & Zabel

Alert

CARES Act Provides Financial Assistance for Mid-Sized Companies

March 30, 2020

Overview

On March 25, 2020, the Senate unanimously passed the Coronavirus Aid, Relief and Economic Security Act ("CARES Act"). On March 27, 2020, the CARES Act passed the House of Representatives and President Trump signed the bill into law.

The CARES Act is an emergency stimulus package that provides $2 trillion in aid to provide financial support to individuals and businesses that have been affected by the coronavirus pandemic. In particular, Title IV of the CARES Act, referred to as the "Coronavirus Economic Stabilization Act of 2020" ("CESA"), provides that from now until Dec. 31, 2020, the Secretary of the Treasury ("Secretary") is authorized to make loans, guarantees and "other investments" to support certain eligible businesses, as well as state and local governments, of up to $500 billion in the aggregate. Of the $500 billion allocated for the relief program under CESA, (i) up to $25 billion is available for loans and guarantees for passenger air carriers; (ii) up to $4 billion is available for loans and guarantees for air cargo carriers; (iii) up to $17 billion is available for loans and guarantees for businesses critical to maintaining national security; and (iv) up to $454 billion (plus any amounts not actually given out under (i) through (iii)) is available for loans, guarantees, or other investments to support programs established by the Board of Governors of the Federal Reserve System ("Federal Reserve") "for the purpose of providing liquidity to the financial system that supports lending to eligible businesses, States, or municipalities."[1]

The CARES Act and other recent legislation also effectuates certain tax law changes and payroll and social security tax relief that are also addressed in this Alert.

Loan and Guaranty Program for Mid-Sized Businesses

Using the $454 billion available for eligible businesses, States, or municipalities, the Secretary shall "endeavor" to provide special assistance specifically to mid-sized businesses and non-profit organizations that meet certain eligibility requirements by creating a program or facility that provides financing to banks and other lenders[2] to make direct loans to eligible businesses on the terms described below (each, a "CESA Private Loan"). CESA Private Loans must be made directly from the bank or the other lender to the business, and cannot be part of a syndicated loan or other form of capital market transaction.

[1] On March 23, 2020, the Federal Reserve announced that it expects to establish a Main Street Business Lending Program. CESA clarifies that the loan and guaranty program for mid-size businesses would be in addition to the Main Street Business Lending Program established by the Federal Reserve.

[2] CESA does not indicate how a nonbank lender may participate, what eligibility criteria will apply, or what requirements will be imposed. Accordingly, until further guidance is provided, it is not certain to what extent nonbank lenders will be able to participate.

Terms of CESA Private Loans

CESA provides that CESA Private Loans will have an annualized interest rate not greater than 2% per annum. For the first six months after such CESA Private Loan is made, or for a longer period as the Secretary may determine at his discretion, no principal or interest will be due and payable. In contrast to those loans to small businesses (i.e., those with 500 or fewer employees) contemplated by the "Paycheck Protection Program" under Title I of the CARES Act,[3] any CESA Private Loan cannot be forgiven.

Eligibility for CESA Private Loans

In order to be eligible for a CESA Private Loan, a company or non-profit organization must (i) be a U.S. business, (ii) not have otherwise received adequate economic relief under the CARES Act in the form of loans or loan guarantees, and (iii) employ between 500 and 10,000 employees, with a majority of its employees based in the United States.

Borrower Requirements

An eligible business applying to receive a CESA Private Loan must make a "good-faith certification" that:

1. The uncertainty of the current economic environment makes the loan "necessary" to maintain its operations;[4]
2. It will use the funds received to retain at least 90% of its workforce at full compensation and benefits until Sept. 30, 2020;
3. It intends to restore at least 90% of its workforce as in existence on Feb. 1, 2020 and restore all compensation and benefits for those employees, no later than four months after the Secretary of Health and Human Services declares an end to the COVID-19 public health emergency;
4. It is an entity or business that is domiciled in the United States with significant operations and employees located in the United States;
5. It is not a debtor in a bankruptcy proceeding;
6. It is organized in the United States or under U.S. law and has significant operations and a majority of its employees in the United States;
7. It will not pay dividends or make any stock buyback while the loan is outstanding, except pursuant to any contractual obligation in effect as of March 27, 2020;
8. it will not outsource or offshore jobs for the term of the loan and for two years after repaying the loan;

[3] Titled the "Keeping American Workers Paid and Employed Act."

[4] CESA provides no guidance as to what set of circumstances would render a CESA Private Loan "necessary." Nonetheless, it should be noted that while the other facilities under CESA require that recipients be "an eligible business for which credit is not reasonably available at the time of the transaction" no such requirement is included with in relation to CESA Private Loans. Thus, it could be inferred that a CESA Private Loan could still be "necessary" for purposes of the aforementioned certification, even if the borrower has access to alternative sources of credit. However, until further guidance is promulgated, such a conclusion is not certain. Without further guidance, it is also uncertain how the existence of a control party with potentially available funds to contribute would affect the analysis.

9. It will not abrogate an existing collective bargaining agreement for the term of the loan and for two years after completing repayment of the loan; and
10. It will remain neutral in any union organizing campaigns for the term of the loan.

Moreover, while not included in the required certifications, another provision of CESA seems to require that a borrower must agree to:

1. Refrain from repurchasing any of its securities (or those of a parent company) listed on a national exchange *until 12 months after* the loan is repaid, except to the extent required under a contractual obligation that is in effect as of March 27, 2020;
2. Refrain from paying any dividend or other capital distributions *until 12 months after* the loan is repaid; and
3. As more fully described under "Executive Compensation Limitations" below, abide by certain employee compensation restrictions until one year after the loan is repaid.

However, because none of these covenants are included in the certifications explicitly required for a CESA Private Loan (and the first two have a scope that is inconsistent with the certifications), some ambiguity exists as to whether they will actually be required of a CESA Private Loan borrower.

Next Steps

At present, it is uncertain when the CESA Private Loan program will launch. Given the urgency of the policies underlying CESA, it is expected that the United States Department of the Treasury ("Treasury"), the Federal Reserve, and participating lenders will move quickly to implement the program. However, much work remains to be done before any eligible business will be able to apply for a CESA Private Loan. The Treasury and Federal Reserve must first establish the funding facility, including all of the terms and processes for participating lenders (as well as determining which nonbank lenders will be eligible), none of which is detailed in CESA. In addition to establishing the facility and getting approved lenders in place, loan documentation and policies and procedures regarding the loan process must be developed and implemented. Future Alerts will be published as the Treasury and the Federal Reserve provide further guidance. In the meantime, please contact one of the authors or your SRZ attorney with any questions.

Tax Law Changes

2018, 2019 and 2020 NOLs Can Offset 100% of Taxable Income

Net operating losses ("NOLs") generated in 2018, 2019 or 2020 will be permitted to offset up to 100% of income in 2018, 2019 or 2020. This relaxes the restrictions introduced under the 2017 Tax Cuts and Jobs Act ("TCJA"), which precluded an NOL generated after 2017 taxable years from being able to offset greater than 80% of the income in any subsequent taxable year and prohibited the carryback of such NOLs.

Five-Year NOL Carryback

Any NOLs generated in 2018, 2019 or 2020 may now be carried back to the five preceding tax years and allow a tax refund for taxes paid in any such prior year. This would serve to temporarily lift the TCJA's elimination of the carryback of NOLs generated after 2017 taxable years.

Note, for corporate taxpayers, NOLs carried back to a pre-2018 taxable year when corporate rates were 35% are more valuable than losses used to offset income taxable at the current 21% rate.

A REIT is precluded from carrying back losses under the CARES Act.

The legislation also restricts loss carrybacks from being used to offset any deemed repatriation income (under Section 965 of the Internal Revenue Code) that was includable to the corporation as a result of the TCJA. But in calculating the five-year carryback period, taxpayers are permitted to exclude any taxable years in which foreign earnings were included in gross income under the deemed repatriation rules of the TCJA, which potentially allows some taxpayers to carryback NOLs further than five years.

Loss Limitations on Noncorporate Taxpayers Do Not Apply Until 2021

The TCJA limited the ability of noncorporate taxpayers to use business losses to offset their other non-business income to $250,000 ($500,000 for a married couple filing jointly). Under the CARES Act, this restriction does not apply until 2021.

Section 163(j) Limitation Increased to 50% of Adjusted Taxable Income

Business interest will be permitted to offset up to 50% of adjusted taxable income in 2019 and 2020 ("163(j) Limitation"), as opposed to the 30% limitation imposed by the TCJA. Currently, adjusted taxable income ("ATI") is calculated in a manner similar to EBITDA, subject to certain modifications.

In addition, the CARES Act allows a taxpayer to elect to use its 2019 ATI for purposes of determining its 163(j) Limitation for 2020, which will potentially benefit taxpayers that will have a lower than projected ATI for 2020 due to the impact of COVID-19.

This favorable 50% limitation is only available to partnerships in 2020. For 2019, however, any excess business interest of a partnership is allocated to the partners and is then bifurcated: 50% of such excess business interest becomes fully deductible in the 2020 taxable year and 50% remains subject to the limitations of present law — i.e., such remaining interest will not be deductible until the partnership allocates additional excess taxable income or excess interest income to the partner.

Private equity funds will need to analyze the potential benefits of the CARES Act as relates to the 163(j) Limitation and ensure that they are maximizing the potential benefit for their funds and their various portfolio companies. In addition, consideration should be given as to whether to put in place short term financing that can benefit from the temporary increased deduction limitations afforded by the CARES Act.

Tax Rules for Loans Made under the CARES Act

The CARES Act also provides for special rules governing the treatment of loans made pursuant to the Act.[5]

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[5] In addition, the CARES Act directs the Treasury to issue regulations implementing the provisions of the Act, including guidance providing that the acquisition of warrants, stock options, or equity under the Act will not result in an ownership change under Section 382 of the Internal Revenue Code.

A loan issued or guaranteed by the Treasury will be treated as debt under the Internal Revenue, with an issue price equal to their stated principal amount, and the interest will be treated as qualified stated interest, with the result that such loans will not bear OID. It is unclear how this rule will apply in practice, including whether it would apply to CESA Private Loans. Taxpayers will need to await further guidance on this issue.

Executive Compensation Limitations

Although the CARES Act includes specific compensation restrictions for companies receiving a loan directly from the Treasury, it is unclear whether the compensation restrictions also apply to CESA Private Loans for mid-size business. The Treasury may issue guidance to clarify this point. If the compensation restrictions are construed to apply to CESA Private Loans, then the following will apply:

An employer must agree that until the one-year anniversary of the date the loan is no longer outstanding:

- Any employee whose 2019 total compensation exceeded $425,000 will not be permitted to receive:
    - In any 12 consecutive month period, total compensation in excess of the employee's 2019 total compensation; and
    - Severance pay or other termination benefits in excess of two times the employee's 2019 total compensation.
- Any employee whose 2019 total compensation exceeded $3,000,000 will not be permitted to receive:
    - In any 12 consecutive month period, total compensation in excess of $3 million plus one-half of the amount of the employee's 2019 total compensation that exceeded $3 million.
    - For example, an employee whose 2019 total compensation was $5 million would be limited to $4 million in total compensation for any 12-month period ending on the one-year anniversary of the employer's loan repayment.

The definition of "total compensation" under the CARES Act includes:

- Salary;
- Bonuses;
- Awards of stock; and
- Other financial benefits provided by the employer.

The CARES Act does not indicate what types of equity and equity-based incentive awards are covered by the "awards of stock" provision. It also does not indicate how and when awards will be valued for the purposes of the compensation limits.

Because there is no exception under the CARES Act for any payment obligations under any employment or similar agreement existing prior to the date of a loan, employers may be required to amend agreements that would cause employees to receive payments exceeding the CARES Act's limits (e.g., a promised retention bonus to an employee whose 2019 total compensation exceeded $425,000).

Employers considering applying for a loan under the CARES Act should evaluate their executive compensation plans and programs to determine how they would be affected by receiving relief. This would include identifying impacted employees; determining whether compensation plans or employment agreements need to be amended to limit compensation; and, if compensation plans or employment agreements require amendments, determining what steps must be taken to effectuate such amendments.

Payroll and Social Security Tax Relief

An eligible employer (including a tax exempt entity) may choose to receive a refundable payroll tax credit of 50% of wages paid against the employment taxes for each quarter (not to exceed $10,000 for all quarters in qualified wages with respect to any single employee). To be eligible, the employer must have:

- Fully or partially suspended operations as a result of a government authority limiting commerce, travel, or group meetings due to COVID-19; or
- Experienced a greater than 50% reduction in quarterly gross receipts measured on a year-over-year basis.

Employers taking a small business interruption loan are not eligible for the tax credit.

Employers may claim the credit only for wages to furloughed employees, or employees who had reduced hours, for services not rendered. Wages for this purpose include amounts paid or incurred by the eligible employer to provide and maintain a group health plan. The credit is for wages paid after March 12, 2020 and before Jan. 1, 2021.

In addition to the payroll tax credit, an employer may choose to defer the payment of the employer share of social security taxes for the remainder of calendar year 2020. The deferred taxes must be paid 50% on or before Dec. 31, 2021, and the remaining 50% on or before Dec. 31, 2022. Employers that have had indebtedness forgiven for certain types of loans are not eligible for deferral.

Expansion of Permitted Employee Leave

Employers with more than 500 employees are not covered by the federal Families First Coronavirus Response Act ("FFCRA") which required paid childcare leave and paid sick leave. For employers that may have furloughed employees by placing them on a paid or unpaid leave of absence, and thereby dropped below 500 active employees, the U.S. Department of Labor ("DOL") has provided initial guidance on whether they become covered by the FFCRA's requirements. The DOL's initial set of questions and answers (https://www.dol.gov/agencies/whd/pandemic/ffcra-questions) notes that, in counting employees at the time of the request for leave, employees on leave must be included. It does not specify whether the leave must be paid. Formal regulations are expected to be issued next month.

Even though the federal paid leave laws may not apply, employers must consider state or local paid leave laws and benefits that are being enacted to address the pandemic. For example, New York implemented new requirements for employers to provide sick leave and other benefits for employees subject to a mandatory or precautionary quarantine or isolation order by a government agency due to COVID-19, as well as to provide paid sick leave generally. See *SRZ Alert* COVID-19 Legislation — Impact on Individuals.

Expanded Unemployment Benefits for Terminated Employees

The CARES Act sets up a framework for states to agree to expand their unemployment insurance benefits for individuals with total or partial unemployment, including because they are unable or unavailable to work due to COVID-19. The expansion is retroactive to Jan. 27, 2020 and generally covers weeks of unemployment through July 31, 2020. Qualifying COVID-19 reasons for these expanded benefits include:

- Being unable to reach the place of employment due to quarantine orders or the place of employment was shut down due to COVID-19;
- Having been diagnosed with COVID-19 or experiencing symptoms and seeking a medical diagnosis;
- Being a member of a household where someone was diagnosed with COVID-19;
- Being the primary caretaker of a minor who cannot attend school or another facility as a result of COVID-19; and
- Becoming the head of household as a result of the death of the previous head of household due to COVID-19.

The CARES Act expands the eligibility for unemployment insurance benefits to individuals who would not qualify ordinarily for unemployment, such as those who are self-employed or those who have exhausted all rights to unemployment under state law, provided they can certify that they have been impacted by COVID-19. Individuals who have the ability to telework with pay or who are receiving paid sick leave or other paid leave benefits are not entitled to receive the expanded benefits.

The CARES Act provides for lengthening the usual period for receipt of unemployment insurance benefits to a period not exceeding 39 weeks and the waiver of a one week waiting period to receive unemployment insurance. These provisions are applicable through Dec. 31, 2020.

The CARES Act adds "Federal Pandemic Unemployment Compensation" of $600 per week to the amount of unemployment compensation an individual would qualify for under state law or certain amounts for those who would not otherwise qualify under state law (such as independent contractors) and also sets a minimum weekly amount equal to 50% of the average weekly payment of regular compensation in the applicable state for unemployment insurance before the $600 is added. The Federal Pandemic Unemployment Compensation will be disregarded when determining income for the purposes of certain programs such as Medicaid and the Child Health Insurance Program.

The CARES Act encourages states to utilize or adopt programs through which employers can reduce employee hours while still allowing employees to receive unemployment insurance. Such programs permit employees to receive pro rata amounts of unemployment insurance if employers reduce hours, from 10% to up to 60%, in lieu of layoffs. For example, New York State has the Shared Work Program (https://labor.ny.gov/ui/employerinfo/shared-work-program.shtm). The federal government funds the expanded unemployment benefits to which states have agreed to provide, including by providing funds to reimburse non-profit organizations with special arrangements for paying for unemployment insurance claims.

Expanded Educational Reimbursement

The CARES Act temporarily expands an employer's ability to provide tax-free educational assistance to employees by allowing for the employer, through a Section 127 educational assistance program, to reimburse or pay an employee's student loan payments for the period beginning on March 27, 2020 and ending on Dec. 31, 2020, up to a limit of $5,250 per employee. Employees who benefit are not able to deduct interest with respect to amounts paid or reimbursed by an employer on their 2020 taxes.

Changes to Tax-Qualified Plans under the CARES Act

Among the many provisions of the CARES Act are those that cover tax-qualified plans, including 401(k) plans and defined benefit pension plans, as well as group health plans. Specifically, the stimulus legislation provides greater flexibility to participants in defined contribution plans who are impacted by the pandemic to access more of their account balances. It also allows plan sponsors of all tax-qualified retirement plans, including single, multiple and multiemployer defined benefit pension plans, to amend their plans to permit participants who experience certain financial hardships as a result of the COVID-19 pandemic to receive early distributions without an early distribution penalty. The CARES Act also amends the Families First Coronavirus Response Act ("FFCRA") to even further expand coverage for certain COVID-19-related testing and treatment and lifts certain restrictions on reimbursements from tax-favored vehicles.

Special Rules for Qualified Individuals

Qualified Individuals

Under the CARES Act, "Qualified Individuals" are eligible to take special distributions, and increased loans from defined contribution plans. In general, a person is a "Qualified Individual" if:

1. The individual or the individual's spouse or dependent is diagnosed with COVID-19 by a CDC-approved test; or
2. The individual experiences adverse financial consequences due to COVID-19 as a result of:
    - Being quarantined, furloughed or laid off;
    - A reduction of work hours or the closing of the business owned or operated by the individual;
    - Inability to work due to lack of child care; or
    - Other factors determined by the Treasury.

A plan administrator may rely on an employee's certification that the conditions for the employee to receive a special distribution have been met.

Distribution Amounts and Tax Treatment

Until Dec. 31, 2020, plan sponsors of tax-qualified retirement plans, including IRAs, defined benefit and defined contribution plans, may amend their plans to permit Qualified Individuals to take distributions of up to $100,000. For federal tax purposes, the amount of a Qualified Individual's distribution may be spread (to the extent taxable) equally over three years, and if made to anyone under the age of 59 and 1/2, a distribution will not be subject to a 10% early distribution tax. Importantly, participants should be aware that the tax treatment of these distributions may differ under state tax laws. While a distribution to a Qualified Individual is not a loan, it may be repaid, at any time during the three-year period following the withdrawal, to any eligible plan that the individual becomes a participant, or to an IRA.

Increased Loan Limits

Plan sponsors of defined contribution plans can amend their plans to enable participants who are Qualified Individuals to take enhanced loans of up to the lesser of 100% of the participant's vested account balance or $100,000 (ordinarily, 50% of the participant's vested account balance or $50,000). These enhanced loans are available only for the next 180 days. Plans may also be amended to allow participants who have existing outstanding loans for the rest of the calendar year to delay repayment of such loans for one year.

Plan Amendments

The availability of distributions to Qualified individuals and increased loan limits can be implemented immediately. Timely plan amendments that reflect any implemented measures can be adopted later.

Temporary Waiver of Minimum Required Distributions

The CARES Act provides relief to individuals who would otherwise be required to withdraw required minimum distributions (often referred to as "RMDs") in 2020 from defined contributions plans, including 401(k) plans, 403(b) plans and certain 457(b) plan (as well as IRAs). RMDs that would otherwise have been required to be made from those plans to an individual whose required beginning date occurs in 2020 may be delayed until 2021. The delay does not apply to any RMD that should have been made before Jan. 1, 2020 and RMDs under defined benefit pension plans.

Single Employer Defined Benefit Pension Plans

Minimum Required Contributions by Employers

The CARES Act allows employers to delay until Jan. 1, 2021, minimum contributions to a single employer defined benefit pension plans (including multiple employer plans) that an employer would otherwise be required to make (including quarterly contributions) during the 2020 calendar year (regardless of the applicable plan year). Each delayed contribution will be subject to interest from the original due date through the date the amounts are contributed to the pension plan.

Benefit Restrictions

The CARES Act provides relief from certain benefit restrictions that would otherwise have been triggered by a pension plan's lower funding status (its "adjusted funding target attainment percentage" or "AFTAP"). If a pension plan does meet statutorily-established funding thresholds, certain restrictions may be imposed on the plan, such as restricting lump sum distributions. To avoid such restrictions from being imposed on pension plans whose funding levels decline due to the COVID-19 pandemic, the CARES Act permits a plan sponsor to elect to treat the plan's adjusted funding target attainment percentage for the last plan year ending before Jan. 1, 2020, as the adjusted funding target attainment percentage for plan years which include the 2020 calendar year.

Changes Concerning Health Plans

As discussed in our *SRZ Alert*, the FFCRA mandated group health plans, including self-insured plans, to cover certain expenses, without cost-sharing, related to COVID-19 testing and treatment. The CARES Act expands the types of COVID-19 tests and treatments that group health plans and health insurance issuers must cover without cost-sharing, prior authorization, or other medical management requirements. Now, these plans must cover at 100% tests for which the developer has requested "emergency use authorization" under the Federal Food, Drug and Cosmetic Act. In addition, the CARES Act also directs the Secretaries of Health and Human Services, Labor and Treasury to require plans and issuers to cover any COVID-19-related preventive services without cost-sharing (including vaccines) and permits sponsors of high deductible health plans to waive deductibles for all telehealth or remote care services in plan years beginning on or before Dec. 31, 2021 (even if not related to COVID-19).

The CARES Act also eliminates the requirement that individuals obtain a prescription to receive tax-favored reimbursement for over-the-counter drugs from health savings accounts, health reimbursement accounts and health flexible spending arrangements, effective Jan. 1, 2020.

For more information on the CARES Act and emerging legal issues on the COVID-19 crises, visit our COVID-19 Resource Center: https://www.srz.com/resources/emerging-issues/covid-19-resource-center-1.html

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