KEYNOTE INTERVIEW

Mastering the next phase

CFOs are entering a period that demands planning and fresh thinking on strategies, valuations, tax and compliance, says Citrin Cooperman partner Alexander Reyes

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Q How has the pandemic affected CFOs in private equity?

Understandably, private equity CFOs are seeking insight and practical help to manage through a period of great uncertainty. A crisis brings out the best and the worst in humanity. The same holds true for business – it puts to the test a portfolio company's business model, strength and ability to adapt and transform.

It becomes necessary to go back to basics, understand and evaluate your business operations and priorities, understand cashflow, liquidity and budget forecasts, and make key – and sometimes difficult – decisions.

We have a covid-19 response unit, which brings together our collective knowledge on tax developments, the preparation needed for any potential recession, and industry-specific alerts and webcasts. Working from home is an interesting challenge for CFOs and the middle office. Many companies have discovered that staff being at home is now going to be far more common than when compared with working life before covid-19.

However, as companies move away from viewing the physical office as the only – or even the best – collaborative workspace, implementing the right remote work technology to enable seamless communication and productivity over the long haul is important. This raises questions about cybersecurity and privacy that were there before the pandemic hit but which have now become very critical.

The good news is that we bring a suite of advisory services to help them come to terms with these new work patterns. Our Technology, Risk Advisory, and Cybersecurity (TRAC) Practice, for example, is currently working overtime with clients, as you would imagine. For me, the most interesting thing has been to see how quickly clients have pivoted to accommodate the new world we are in.

Q Are CFOs thinking beyond the here-and-now and looking further ahead?

I think companies have a better sense of how the pandemic has impacted them and they are now beginning to enter a different phase and rethink both the strategies and the industries that they want to invest in.

History has proven that the key to a successful recovery is preparation. CFOs understand that the time to prepare is now, to put yourself in the best position to come back faster and stronger.

Deal-making fell off sharply when the global financial crisis hit in 2008, and this pandemic has also triggered a contraction. However, PE funds have over $1 trillion in uncalled capital. This will force GPs to stay on the lookout for deals, especially as valuations retreat.

Funds are also adjusting strategies to reflect the new world we live in. An example? A fund that was focused on healthcare may now look at virtual care, remote care and telemedicine.

How do you think through that? How do you price it? And, of course, there is a host of tax implications to consider in this environment.

So, I hope it is clear that we're not just helping CFOs in the short term because that certainly isn't how they're thinking.

Q What are the tax, accounting and regulatory issues in the US?

For tax, there are always new developments. Recent tax developments include those related to carried interest. Specifically, the Internal Revenue Service's proposed rules that would restrict a workaround in the 2017 tax overhaul that has allowed some fund managers to avoid a three-year holding period to qualify for preferential capital gains rates on carried interest.

This would disallow the use of S Corporations and PFICs to avoid the requirement that the carried interest must be held for at least three years, instead of one year as under previous law, for taxation under preferable long-term capital gains tax rates, rather than ordinary income rates.

There is also the issue of the limitation on business interest expense under Section 163(j). Prior to an amendment of Section 163(j), the deductibility of investment interest expense by partners in private investment funds was subject to limitation at the partner level.

Under these rules, partners could deduct their share of the investment interest expense of a private fund up to the amount of their investment income. This limitation applied to partners regardless of whether the fund was a "trader" or an "investor" in securities for federal income tax purposes.

The 2020 Proposed Regulations changed its application. Investors who do not actively participate in the trading activity of the private investment fund would not be subject to the limitation on business interest expense. However, investors who do actively participate would be subject to it.

Another tax issue relates to state reporting and filing where investors are or where the work is done. With much of the workforce working from home in 2020, if employees live in a different state than the entity, should the entity file in that state?

From a regulatory perspective, the Office of Compliance Inspections and Examinations in June looked at conflicts of interest, fees and expenses, and material non-public information.

The OCIE's alert underscores the need for CFOs to look closely at their firms' controls and policies and procedures. The pandemic does not ease that pressure and may compound it with staff working remotely.

Lastly, for certain offshore funds that did not previously need to register with the Cayman Islands Monetary Authority (CIMA), registration requirements have changed.

The Cayman Government enacted the Private Funds Law in January, which gave closed-ended fund vehicles, previously exempt, until August 7, 2020 to register with CIMA and comply with Cayman's investment funds regime.

Under these rules, private funds have to be audited annually by a CIMA-approved auditor.

Q What is happening with valuations?

Historically, there have been some very standard models around valuation such as a discounted cashflow model. This pandemic, however, has forced companies to rethink some of the inputs and key assumptions. For example, what is the expected revenue in 2020 resulting from the impact of social distancing and stay-at-home orders, the expected shape ("V," "U," "L" or "W") of the recovery, and the duration of suppressed performance?

Answers to these affect your assumptions on revenue, earnings and cash-flow, expense structure and net working capital needs.

Our valuations team can help on that. They will tell you: the methodology may not change but the assumptions could, depending on how covid has impacted the portfolio company today and in the future.

Q You are more than an accounting firm, right?

Yes, well beyond the assurance and audit that you would expect. We are truly a full-service accounting and consulting firm.

Our tax group has broad capabilities beyond traditional federal state and local tax compliance services. We also have mergers and acquisitions tax consulting, transfer pricing, tax research and planning, international tax as well as Private Client Services such as trust and estate and succession planning.

We also have a suite of advisory solutions including strategy and business transformation, business management and family office, healthcare advisory, forensic and litigations team, and the TRAC group.

Our teams are assisting clients in cutting-edge areas like AI, robotics process automation and blockchain.

And to round things out, we have a Transaction Advisory Services Practice offering buy-side and sell-side services and a Valuation Advisory Services Practice team. It means a CFO can open the door to us and pretty much all his or her challenges can be met with our help. ■

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