INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

HOW PRIVATE EQUITY FUNDS MAY POSITIVELY IMPACT EBITDA WITH THE EMPLOYEE RETENTION CREDIT

Private equity (PE) funds typically do not consider tax planning an effective strategy for boosting portfolio company earnings before interest, taxes, depreciation, and amortization (EBITDA). This is because realized tax benefits and the accompanying tax planning expenses generally do not positively impact EBITDA, thus causing an unintended impact on this critical metric used to evaluate a company's operating performance.

However, the federal employee retention credit (ERC) may positively impact EBITDA, and in addition, the non-recurring fee paid to support the credit may qualify as an EBITDA add-back. Specifically, PE funds looking to maximize financial performance may generate cash by claiming the recently enhanced ERC for eligible portfolio companies. The ERC is a refundable payroll tax credit first introduced as part of the Coronavirus Aid, Relief, and Economic Security Act, commonly referred to as the CARES Act, that provides employers a credit up to $26,000 per employee for qualified wages paid to employees after March 12, 2020, and before September 30, 2021.[1] Although Congress does not permit taxpayers to claim the ERC for calendar year 2022, PE funds may still claim the credit for these prior years on behalf of their eligible portfolio companies.

Many portfolio companies have been able to avoid reporting a financial loss during the pandemic by claiming the ERC. For example, an eligible company with 40 employees could receive over $1 million in retention credit and would not need to report a federal income tax liability to qualify. While the ERC may provide PE funds substantial benefit, navigating the qualification and calculation considerations for PE portfolio companies can be complex. Summarized below are the ERC eligibility requirements PE portfolio companies must evaluate before determining whether and to what extent they qualify for the credit.

ELIGIBILITY REQUIREMENTS

To be eligible for the ERC, an employer must meet at least one of the following tests:

Governmental Order Test:

The employer's operations were fully or partially suspended due to a governmental order related to COVID-19; or

Gross Receipts Test:

- **2020:** The employer incurred a decline in gross receipts of more than 50% during a 2020 calendar quarter compared to the same calendar quarter in 2019. Eligibility ends at the conclusion of the quarter in which the company's decline in gross receipts is less than 20%.
- **2021:** The employer incurred a decline in gross receipts of more than 20% during a 2021 calendar quarter compared to the same calendar quarter in 2019. Special rules apply to employers that started a business in 2019 and employers that did not exist in 2019. There is also an optional one-quarter look-back to compare the gross receipts for the preceding quarter to the same quarter in 2019.

To determine employer eligibility, all entities that are treated as a single employer under the IRC Sec. 52(a) or (b) controlled group rules or are otherwise aggregated under IRC Sec. 414(m) and (o) are considered one employer for purposes of the ERC rules. Due to the ownership structures of PE portfolio companies, special considerations must be evaluated on a facts-and-circumstances basis to determine whether other portfolio companies directly or indirectly owned or controlled by the fund may need to be considered in determining eligibility for the ERC.

1 On November 15, 2021, the Infrastructure Investment and Jobs Act was signed into law, which retroactively eliminated most employers' ability to claim the ERC for eligible wages paid after the quarter ending September 30, 2021. Under exception, qualifying recovery startup businesses may be eligible to claim the ERC for the entire 2021 calendar year.

ERC BENEFIT

The ERC is calculated differently for 2020 and 2021. For each of these calendar years, the ERC equals a percentage of up to $10,000 of "qualified wage" and allocable health plan expenditures paid to employees during the eligibility periods, namely, March 13, 2020 to December 31, 2020 and January 1, 2021 to September 30, 2021 ("qualified ERC costs"). The amount of the ERC allowed for each employee is capped as shown below.

Year	% of Qualified ERC Costs	Cap Per Employee
2020	50%	$5,000
2021	70%	$7,000

The definition of "qualified wages" for ERC purposes depends on the employer's average number of full-time employees in 2019 and varies for the 2020 and 2021 ERC calculation.

For 2020:

- If an eligible employer had 100 or fewer full-time employees in 2019, then qualified wages include both wages and health plan costs paid to all employees during the period of eligibility. For eligible employers with more than 100 full-time employees in 2019, qualified wages include wages and health plan costs paid to employees who are not performing services due to COVID-19 during the period of eligibility.

For 2021:

- If an eligible employer had 500 or fewer full-time employees in 2019, then qualified wages include both wages and health plan costs paid to all employees during the period of eligibility. For eligible employers with more than 500 full-time employees in 2019, qualified wages include wages and health plan costs paid to employees who are not performing services due to COVID-19 during the period of eligibility.

To determine the number of full-time employees, PE portfolio companies should consult with a tax advisor to determine whether the aggregation considerations referred to above need to be evaluated. Depending on each portfolio company's relationship with its PE sponsor, a facts-and-circumstances evaluation will determine whether the portfolio company may or may not have to include employees of other portfolio companies under common control by the fund in its full-time employee count. This is important because there are minimum employee thresholds for certain quarters when the ERC was effective, so that a portfolio company otherwise not eligible as a result of the minimum employee threshold may be eligible following application of the aggregation rules.

MAXIMIZING EBITDA

While the ERC may provide significant opportunities for PE portfolio companies, a nuanced and complicated analysis is necessary to evaluate whether the governmental order test or the gross receipts test is met, when the aggregation rules apply, what wage and health-plan expenses qualify, and, ultimately, the amount of a proper ERC claim. This article does not address every potential situation and factor to be considered and, therefore, PE portfolio companies should seek professional guidance. Specialized tax advisors have developed significant expertise working with PE funds and their portfolio companies to identify and document ERCs in a manner that helps maximize EBITDA, net income, and free cash flow.

BDO's ERC Calculator makes it easy to find out if you qualify for the credit, and if so, by how much.

CALCULATE YOUR BENEFIT ▶

or visit www.bdo.com/erc-acg

The ERC is one of many tax credits and incentives offered by federal, state, local and non-U.S. governments. BDO helps organizations identify, negotiate and secure tax credits and incentives — including retroactive and future opportunities — to minimize total tax liability and increase cash flow.

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