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Tax Receivable Agreements and Tax Reform Proposals

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The House Republicans' tax reform plan includes, among other things, a reduction of the maximum federal corporate tax rate from 35% to 20%. It also contemplates changes to the deductibility of various expenses, including restricting the deductibility of certain interest payments and expanding the deductibility of capital expenditures. The Senate is drafting its own tax reform legislation that also contemplates a similar reduction in the corporate tax rate but with a delayed implementation. Among numerous other potential impacts, these potential changes currently being discussed in Congress could have significant consequences for current and prospective parties to so-called "tax receivable agreements" ("TRAs")—agreements that companies are entering into with increasing frequency in connection with initial public offerings ("IPOs") to monetize tax attributes of the post-IPO company for the benefit of pre-IPO owners.

Background

Briefly, TRAs seek to provide to pre-IPO owners of a public company much of the actual tax savings benefit resulting from the public company's use of specified tax attributes. This benefit is typically measured on a "with and without" basis, essentially assuming that the public company first uses tax attributes that are not covered by the TRA (e.g., interest payments and capital expenditures) to shield its income from tax. The two most common forms of TRAs are "NOL TRAs" and "Step-Up TRAs."

- *NOL TRAs*. Many companies complete IPOs when they have a substantial amount of net operating loss carry forwards ("NOLs"). Subject to certain limitations, these NOLs may reduce the post-IPO net taxable income and resulting tax obligations of the public company, thereby increasing its after-tax cash balance. An NOL TRA typically will provide, among other things, that the pre-IPO owners are entitled to 85% of the actual cash tax savings the public company realizes as a result of the pre-IPO NOLs.

- *Step-Up TRAs in Up-C Structures*. In a basic Up-C structure, a business that was historically conducted through an entity classified as a partnership for U.S. tax purposes would go public through the formation of a new public company that would serve as its general partner or managing member and acquire equity interests in the partnership. The pre-IPO owners obtain liquidity from time to time by transferring their partnership interests to the public company in exchange for public company stock and rights to payments under a TRA.

> These transfers typically result in the public company receiving a basis “step-up” with respect to the assets of the partnership, which is frequently amortizable over a fixed number of years (typically 15 years to the extent such step-up is attributed to the business’s goodwill). Similar to the impact that pre-IPO NOLs have on reducing the public company’s post-IPO tax burden, these amortization deductions may reduce the net taxable income and resulting tax obligations of the public company and increase the public company’s after-tax available cash balance. A Step-Up TRA typically will provide, among other things, that the pre-IPO owners are entitled to 85% of the actual cash tax savings the public company realizes as a result of these amortization deductions.

TRAs also typically include broad assignment provisions, which enable pre-IPO owners to sell their future entitlements to TRA payments to outside investors.

An increasingly common term of a TRA is a prepayment provision, which provides that a post-IPO change-of-control transaction (a “CoC”) will require the public company to make a termination payment based on the present value of the tax attributes subject to the TRA. This calculation often utilizes various assumptions favorable to the pre-IPO owners, including that the public company always has sufficient income to utilize the relevant tax attributes, and that the public company is always subject to the maximum tax rates in effect on the date of the CoC.

Given that TRA payments (other than generally in the context of a CoC) are determined by reference to actual cash tax savings of the public company, a reduction in tax rates will reduce projected TRA payments. As a simplified example, $1,000,000 of deductions that shield $1,000,000 of income that would otherwise be subject to a 35% tax will yield $350,000 in tax savings and a TRA payment of approximately $297,500. A reduction in the federal corporate tax rate to 20% would reduce the tax savings to $200,000 and the TRA payment to $170,000.

Impact of Tax Reform Proposals

Parties that are (or may soon be) direct or indirect beneficiaries (or obligors) under a TRA should carefully consider the potential impact of a reduction in federal corporate tax rates and changes to tax treatment of various expenditures. For example, a reduction in federal corporate tax rates reduces a company’s tax liability and thus the corresponding amount of potential tax savings through its tax attributes. As a result, TRA-related liabilities disclosed in a company’s financial statements will need to be reassessed. A company’s TRA calculations (and ultimately its cash balances) will also be impacted by how tax reform alters the deductibility of various expenses. Based on the “with and without” calculations used under most TRAs, a company’s TRA payments are likely to be reduced or delayed if tax reform results in the company having available more deductions from its operating business (because, for example, some capital expenditures are allowed to be deducted currently), and the reverse is likely to be true if tax reform results in the company having available fewer deductions from its operations (because, for example, interest expense deductions are limited).

In addition, to the extent a company’s TRA contains a provision accelerating payments upon the occurrence of a post-IPO change of control, some public companies may see buyers seek to discount or delay such payments while tax reform is pending in order to avoid the chance that the prepayment obligation (which is typically calculated using the rates in effect on the date of the CoC) exceeds the value of the tax attributes actually realized (which would be based on future, possibly lower, tax rates). It’s often the case that buyers accept the risk that tax rates will not change in the future, but while tax reform is pending, companies and TRA beneficiaries should anticipate that buyers may be more aggressive in protecting against that risk.

Similarly, while tax reform is pending, companies pursuing an IPO that involves a TRA may hear warnings from underwriters as to the potential impact of including provisions accelerating payments upon the occurrence of a post-IPO CoC.

There are a number of variables that will impact whether and to what extent tax reform will occur and how it will impact TRAs. For further information, please contact one of the following:

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