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Investing in Tax Receivable Agreements

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Introduction

The enactment of tax reform last December provided investors increased certainty regarding corporate tax rates for the near future. One consequence of this has been an increased interest by certain investors in purchasing payment rights under existing so-called "tax receivable agreements" ("TRAs"). Briefly, TRAs are agreements entered into by a company (a "Pubco") in connection with an initial public offering ("IPO") to monetize tax attributes of the post-IPO Pubco for the benefit of pre-IPO owners and investors who purchase rights to payment under TRAs from such pre-IPO owners. Our prior article on TRAs focused on some of the ways in which tax reform might impact the value of TRA payment rights. Since the enactment of tax reform, we have witnessed a substantial increase in investor interest in acquiring TRA payment rights, particularly by hedge funds, family offices, and special purpose private investment funds. This article describes some of the features of a TRA that an investor should analyze prior to acquiring rights under a TRA.

Background

Briefly, TRAs seek to provide to pre-IPO owners of a Pubco much of the actual tax savings benefit resulting from the Pubco's use of specified tax attributes. This benefit is typically measured on a "with and without" basis, essentially assuming that the Pubco 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 carryforwards ("NOLs"). Subject to certain limitations, these NOLs may reduce the post-IPO net taxable income and resulting tax obligations of the Pubco, 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 Pubco realizes as a result of the pre-IPO NOLs.

- *Step-Up TRAs in Up-C Structures*. A business that was historically conducted through an entity classified as a partnership for U.S. tax purposes may go public through the formation of a new Pubco that would serve as its general partner or managing member and acquire equity interests in the partnership. (These structures are often referred to as "Up-C structures" because the upper-tier entity that goes public is a corporation that is subject to tax under subchapter C of the U.S. income tax laws.) The pre-IPO owners obtain liquidity from time to time by transferring their partnership interests to the Pubco in exchange for Pubco stock and rights to payments under a TRA. These transfers typically result in the Pubco receiving a basis "step-up" with respect to the fraction of the assets of the partnership attributable to the transferred partnership interests, 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 Pubco's post-IPO tax burden, these amortization deductions may reduce the net taxable income and resulting tax obligations of the Pubco and increase the Pubco'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 Pubco realizes as a result of these amortization deductions.

Key Diligence Questions

Each particular TRA investment should be considered in light of the specific provisions of the TRA and the facts that apply to the relevant Pubco. Those specific facts may give rise to specific diligence questions. However, there are a number of issues to consider that apply to most purchases of TRA payment rights, including the following:

- *Assignability*. Most TRAs provide the parties thereto with broad rights to assign their entitlements to payments pursuant to the TRA, but there is some variation. The Pubco may have certain consent rights.
- *Historical TRA payments by Pubco, projected net taxable earnings and impact of Pubco acquisitions and divestitures*. As noted, most TRAs result in payments to parties thereto when the Pubco has net income before taking into account the attributes being monetized. Therefore, it is important to understand Pubco's projected income stream to understand the projected timing and extent to which it will be able to utilize its tax assets. It is also valuable to assess if the Pubco is expecting to make significant capital expenditures or acquisitions or divestitures that will generate current deductions, particularly in light of recent changes in law regarding the ability to immediately deduct the cost of acquired tangible assets. TRAs will also typically provide additional provisions on the impact of losses realized from non-ordinary-course acquisitions and divestitures of businesses for purposes of determining TRA payment obligations.
- *Ability for Pubco to defer payment obligations*. A Pubco that is party to a TRA may have the ability to defer its obligations to make payments under certain circumstances (e.g., if the disinterested members of its board determine that the payments would adversely impact the Pubco). TRAs also vary in terms of the interest charges that apply to the Pubco for deferral of TRA payments.
- *Capital structure of Pubco*. As TRA holders typically are unsecured creditors of the Pubco, it is important to determine the extent to which third parties have senior claims over the assets of the Pubco as well as the creditworthiness of Pubco.
- *Formulas for determining TRA payments*. The technical formulas for determining a party's entitlement to payments under a TRA are complex and should be carefully scrutinized.
- *Impact of change-of-control transactions*. TRAs vary as to whether a change-of-control of the Pubco will accelerate TRA obligations. These accelerated payments often make assumptions to calculate the amount payable pursuant to the TRA that are very favorable to TRA holders, and an investor should carefully analyze these so-called "valuation assumptions." In this context, it is also valuable to assess if a Pubco is in a sector that is likely to undergo consolidation.
- *Impact of breaches by Pubco*. Similarly, TRAs vary as to whether a breach by the Pubco accelerates payment obligations or if another remedy applies.
- *Amendment provisions*. TRAs widely vary as to the ability for amendments of their terms. Some TRAs only permit amendments upon a vote of persons holding entitlements to a majority or two-thirds of projected TRA payments, and others provide broad amendment rights to the principal beneficiary of a TRA.
- *Indemnification/clawback obligations*. Most TRAs do not include any obligations of a recipient of TRA payments to ever return TRA payments, but this should be confirmed prior to investing.
- *Impact of future changes in law*. Subject to the "valuation assumptions" that may apply in the context of a change-of-control transaction or a breach of the TRA, the calculation provisions under most TRAs simply rely on the prevailing applicable rates. However, there are exceptions, including TRAs entered into or amended shortly before the enactment of tax reform last year that adopted bespoke approaches to address pending tax law changes.

- *U.S. tax treatment of TRA payments*. The U.S. tax treatment of TRA payments to purchasers of TRA rights is not free from doubt. For instance, an investor's ability to treat any TRA payments as a tax-free recovery of cost basis, and the timing of any such recovery, is unclear. Also, certain non-U.S. investors may be subject to U.S. withholding taxes in respect of TRA payments.

For further information regarding investments in TRAs, please contact one of the following members of the Ropes & Gray team:

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