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Tax

Understanding Tax Receivable Agreements

Financial sponsors and other sellers are increasingly using tax receivable agreements to monetize tax attributes of corporations being brought to market in initial public offerings (IPOs).

Under a tax receivable agreement (TRA), a newly public company pays the pre-IPO equity holders (the historic equity owners) for the value of the corporation's tax attributes as those tax attributes are used after the IPO. This creates a market dynamic that permits value to be extracted from the corporation after the IPO, apparently without decreasing the value of the corporation in the offering.

This article examines the structural context, principal terms and operation of the most common types of TRAs, as well as the tax treatment of TRAs to the payor-corporations and the payee-historic equity owners.

TRAs AND IPO VALUATION

In the IPO market, TRAs do not appear to impact the valuation of a corporation in its IPO, despite shifting value from the corporation to its historic equity owners. There are several possible explanations for why the value is not adjusted downwards by a corresponding amount (on a present value basis).

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It has become conventional wisdom that public stockholders tend not to assign full value to the tax attributes of a corporation. Similarly, public stockholders apparently do not discount the value of a corporation to account fully for future payments to be made under a TRA. A possible explanation for this is that the tax attributes, and especially the terms of TRAs, are not fully understood by public stockholders, even though these agreements are publicly disclosed.

In addition, public company valuations generally are based on EBITDA (earnings before interest, taxes, depreciation and amortization) which disregards tax attributes because EBITDA does not take account of taxes. Another reason may be that tax attributes are difficult to value accurately, because any valuation would rely on income projections and other assumptions about the corporation's ability to use the tax attributes in the future.

In TRAs where the specified tax attribute is basis in the corporation's assets, the payments are sometimes viewed as compensation to historic equity owners who incur an upfront tax on the sale of their equity in connection with the IPO and who agree to structure the transaction so that it delivers an asset basis step-up for the corporation. Often, however, this tax would be incurred regardless of whether the transaction resulted in a basis step-up to the corporation.

Therefore, it may be that TRAs relate simply to value. Through the TRA, the IPO corporation pays for a valuable tax attribute (for example, a basis step-up), just as a buyer of assets would normally pay more than a buyer of stock because of the basis step-up that a buyer obtains in an asset sale. In a stock sale, the corporation's basis in its assets generally remains unchanged.

>> For more information on the tax treatment of stock and asset sales, search Stock Acquisitions: Tax Overview and Asset Acquisitions: Tax Overview on our website.

COMMON TYPES OF TRAs

Typically, a corporation enters into a TRA with the owners immediately prior to the IPO of the equity of the business being sold. Investors who purchase stock in the offering do not enter into the TRA.

Under a TRA, the corporation agrees to make payments to the historic equity owners in an amount equal to a percentage of the benefit the corporation derives from certain specified tax attributes, if, as and when realized. The specified tax attribute is most often basis in the corporation's assets (a Basis TRA). A corporation's basis in its assets generates amortization and depreciation deductions over time. In other deals, the specified tax attribute is a net operating loss (NOL) existing at the time of the IPO (an NOL TRA). NOLs can be used over time to reduce a corporation's taxable income. In at least one deal, the specified tax attribute was a deduction arising from the exercise of compensatory stock options (a Stock Option TRA).

BASIS TRAs

In a Basis TRA, the specified tax attribute results from a pre-IPO restructuring specifically designed to deliver a fair market value basis in the public company's assets. This type of IPO is sometimes referred to as a "supercharged" IPO and generally takes one of two forms:

- Internal Revenue Code (IRC) Section 338(h)(10) transaction.
- Up-C structure.

In both the Section 338(h)(10) transaction and the Up-C structure, the valuable tax attribute is an asset basis step-up for the public company. The value of a basis step-up lies in the resulting incremental increase in depreciation or amortization tax deductions.

Basis attributable to goodwill and certain other intangibles is especially valuable, both because these assets can be amortized over 15 years and because these assets tend to represent a

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significant portion of the value of many businesses. In certain cases, the amortization of intangibles can be subject to limitations under so-called anti-churning rules in IRC Section 197, which should be carefully analyzed. Certain tangible assets (for example, real property (other than land, which is not depreciable)) have depreciation periods longer than 15 years.

Section 338(h)(10) Transaction

In an IRC Section 338(h)(10) transaction, the stock of the historic operating corporation is contributed to a newly-formed corporation, which will serve as the public company. The contribution (together with the subsequent sale of stock to public investors) intentionally fails IRC Section 351 and any other tax rules that would otherwise treat the contribution as a tax-free transaction (often referred to as a busted Section 351 transaction). Instead, the contributors and the transferee make a joint election under Section 338(h)(10) to treat the contribution as a taxable deemed sale of assets for US federal income tax purposes, and not as a sale of stock.

This structure results in a fair market value basis in the public company's assets. To bust the tax-free Section 351 transaction, the historic equity owners often must sell a portion of their stock in the public company as part of the IPO. In addition, the public company may also issue stock to the public in a primary offering. An example of a Basis TRA using a Section 338(h)(10) transaction is the TRA entered into in connection with the IPO by Cooper Industries, Inc. of its subsidiary, Belden Inc. General Electric also used this structure in connection with the IPO of its Genworth subsidiary.

Up-C Structure

Recently, partnership or "Up-C" structures have also achieved a fair market value asset basis in connection with IPOs of businesses historically operated as partnerships. Under this structure, a newly-formed corporation is organized to serve as the public company. The public company uses cash it raises to buy interests in the partnership or limited liability company (LLC) (the operating partnership) from the pre-IPO owners of the operating partnership. The pre-IPO owners generally retain operating partnership interests as well.

Economically, the operating partnership interests retained by the pre-IPO owners are recapitalized to create parity in value between the operating partnership interests and the public company stock. Those operating partnership interests are also made exchangeable into the public company stock. This gives the pre-IPO owners liquidity in their retained operating partnership interests.

A critical element of an Up-C structure is an election by the operating partnership under IRC Section 754. This tax election provides a purchaser of partnership interests with a fair market value basis in the assets of the partnership to the extent of the proportionate share of the purchased interest. As a result, when the pre-IPO owners sell operating partnership interests to the public company in connection with the IPO, or exchange operating partnership interests for public company stock in the future by exercising the exchange right, the public company (as purchaser) obtains a fair market value basis in a proportionate share of the assets of the operating partnership.

The Up-C structure has been especially popular in connection with the IPOs of asset management companies (for example, The Blackstone Group LP and Fortress Investment Group LLC) because these types of businesses tend to be operated as partnerships prior to an IPO. Other examples include the IPOs of Duff & Phelps Corporation and Graham Packaging Company Inc. (which also entered into an NOL TRA, as mentioned below).

In addition to providing a path to a step-up in asset basis, the Up-C structure also allows pre-IPO owners to preserve their retained ownership in the business through a pass-though entity for US federal income tax purposes, which generally avoids an entity level corporate tax.

>> For more information on the taxation of pass-through entities, search Taxation of Pass-through Entities on our website.

NOL TRAs

Under an NOL TRA, a corporation with significant NOLs agrees to make payments to the historic equity owners over time, generally equal to a portion of the tax benefit of NOLs as they are used by the corporation to offset taxable income.

While the IRC limits the use of NOLs following a "change of control," including a change of control resulting from a primary or secondary stock offering, a tax benefit often is still available from NOLs following an IPO. First, the IPO might not result in a change of control that would trigger the IRC Section 382 loss limitation rules. Second, the IRC Section 382 loss limitation rules impose an annual ceiling on the use of NOLs, rather than a complete disallowance of those losses.

>> For more information on NOLs and the IRC Section 382 loss limitation rules, search Stock Acquisitions: Tax Overview and Tax Traps in an Acquisition of a Financially Distressed Target on our website.

As discussed above, conventional wisdom is that the value of a corporation's NOLs is not fully reflected in the price assigned by public investors to the corporation. As a result, entering into a TRA based on pre-IPO NOLs, despite being fully disclosed in offering documents, is believed not to decrease the valuation of the corporation in the IPO by an amount equal to the value of payments made under the TRA. Examples of IPOs that included NOL TRAs are Spirit Airlines, Inc., Vantiv, Inc., Graham Packaging Company Inc., and most recently, Berry Plastics Corporation.

STOCK OPTION TRAs

In at least one publicly filed TRA, the specified tax attribute was a deduction arising from the exercise of compensatory stock options. In connection with becoming a public company (achieved through a merger with a smaller, publicly traded industry participant), Endo Pharmaceuticals Holdings Inc. entered into a TRA with an LLC to which certain equity owners contributed their shares of Endo stock.

Certain employee stock options were amended in connection with the transaction to provide that they would be exercisable for the shares held by the LLC (as distinguished from new shares issued by Endo). Nonetheless, Endo would obtain a deduction upon the exercise of the stock options, because it was the employer of the individuals exercising the stock options. The payments under the TRA were calculated by reference to the deduction obtained by Endo upon the exercise of the employee stock options.

PRINCIPAL TERMS OF A TRA

While TRAs may relate to different specified tax attributes, the agreements typically operate in similar ways. The principal terms are explained below.

COMPUTATION OF TAX BENEFIT

TRAs typically calculate payments using a "with and without" approach. In other words, the actual tax liability of the corporation is compared to a hypothetical tax liability computed as if the relevant tax benefit (amortization or depreciation deductions in the case of a Basis TRA and NOL deductions in the case of an NOL TRA) did not exist. The excess of the hypothetical tax liability over the actual tax liability for each tax year is the tax benefit on which the amount of the annual payment is based.

For example, Corporation A, currently owned by Financial Sponsor X, has $500 of NOLs and is contemplating an IPO. In connection with the IPO, Corporation A enters into a TRA with Financial Sponsor X relating to the $500 of NOLs. Under IRC Section 382, Corporation A is limited to using only $50 of NOLs each year after the IPO. In the first post-IPO tax year, Corporation A has $100 of income (without regard to the NOL). Assuming a tax rate of 40%, Corporation A's actual tax liability is $20 ($100 of income minus $50 of NOL deductions times a 40% tax rate). Corporation A's hypothetical tax liability without the benefit of the NOLs would be $40 ($100 of income times a 40% tax rate). Therefore, the tax benefit for that year would be $20 ($40 minus $20). As further discussed below, 85% of tax benefits are typically paid under the TRA. Therefore, the payment under the TRA for that year would be $17 ($20 times 85%).

One effect of the "with and without" method is that all the corporation's other items of deduction and credit are used first before taking into account the specified tax attribute (which is taken into account last). For instance, in the example set forth above, if Corporation A also had $75 of interest deductions, its actual tax liability would be equal to $0 ($100 of income minus $75 of interest deductions minus $25 of NOL deductions times a 40% tax rate). Corporation A's hypothetical tax liability without the benefit of the NOLs but with the interest deduction would be equal to $10 ($100 of income minus $75 of interest deductions times a 40% tax rate). The tax benefit of the NOL is only $10. Therefore, the payment under the TRA for that year would be $8.50 ($10 times 85%).

If payments under a TRA are treated for US federal income tax purposes as additional consideration for the sale of partnership interests or assets (as may be the case in a Basis TRA), the calculation of the tax benefit can include an iterative element. Because the consideration paid for the partnership interests or assets increases as a result of the TRA payment, the asset basis giving rise to the tax benefit increases by a corresponding amount (except with respect to any portion of the payment treated as imputed interest). This in turn increases the amount of the tax benefit and the payments under the TRA. A similar phenomenon occurs with respect to any imputed interest, because imputed interest gives rise to additional deductions and therefore additional TRA payments.

AMOUNT OF PAYMENT

TRAs customarily provide for a payment of 85% of each year's tax benefit to the relevant historic equity owners. This percentage is itself arbitrary and certain agreements provide for other percentages (for example, the Sprint Airlines TRA provided for 90%).

Paying less than 100% of the tax benefit aligns the interests of the payor-corporation and the payee-historic equity owners. Both the payor and the payees have an economic incentive to maximize the value of the relevant tax attributes. For example, a corporation that is entitled to a portion of the economic benefit of its NOLs is more likely to protect the availability of that NOL by monitoring any activity that could result in a limitation on its use.

TERMINATION AND CHANGE OF CONTROL

TRAs frequently accelerate payments in certain circumstances, including a mutual early termination of the agreement by the parties and certain material breaches of the agreement by the payor-corporation. Some TRAs also accelerate payments upon a change of control of the payor-corporation.

Alternatively, other TRAs provide that following a change of control of the payor-corporation, payments, while not accelerated, are calculated by making certain assumptions (for example, that the corporation will have sufficient income in each subsequent year to fully utilize the relevant tax attribute in that year).

If the payments under a TRA are accelerated, the termination payment generally equals the present value (based on an agreed discount rate) of the tax benefit payments that would otherwise be paid after the termination. The calculation of the tax benefit payments is based on certain assumptions (for example, that the corporation will have sufficient income in each year to fully utilize the relevant tax attribute and that the applicable tax rates will not change).

IMPUTED INTEREST

Payments under a TRA that are treated for US federal income tax purposes as additional consideration for partnership interests or assets may be subject to rules applicable to deferred payments (for example, IRC Sections 453 and 483). Whether any resulting gain is recognized by the recipient upfront or over time as payments are received depends on whether the installment method of reporting under IRC Section 453 applies (see below *Tax Treatment*).

In addition, a portion of each deferred payment generally is recharacterized as interest to account for the time value of money. Any imputed interest payments would generally be deductible to the payor-corporation and includible in income to the payee-historic equity owners.

Basis TRAs generally provide that the deduction arising from any imputed interest is taken into account in the calculation of the tax benefit and therefore gives rise to additional payments under the agreement. In the current low interest rate environment, any imputed interest payments would generally be small.

TAX TREATMENT

The US federal income tax consequences of a TRA depend on the type of TRA and the form of the transaction.

TAX TREATMENT OF BASIS TRAs

Payments under a Basis TRA are generally treated as additional consideration for:

- The sale or exchange of operating partnership interests (either at the time of the IPO or upon an exchange of operating partnership interests for public company stock) in the case of an Up-C structure.
- The deemed sale of assets in a Section 338(h)(10) transaction.

The recipient should be able to report the payments using the installment method of reporting (*IRC § 453*). Because the amount of the payments is not determinable at the time of the transaction, the contingent payment installment sale rules apply to determine how much basis is allocated to each payment. As discussed above, a portion of each payment would generally be recharacterized as interest to account for the time value of money.

If the installment method is inapplicable and the "closed" transaction method applies, the fair market value of the right to receive payments under the Basis TRA is generally treated as consideration realized upfront (as of the date of the sale or exchange) and the sellers should recognize any resulting gain at that time. Going forward, payments made under the TRA (other than any portion recharacterized as interest) give rise to additional income or gain at the time of receipt, to the extent those payments exceed the amount taken into income upfront. Potentially, such excess payments would be characterized as ordinary income or capital gain by reference to the sale or exchange. However, this tax treatment is uncertain because sale or exchange treatment may be at odds with the closed transaction method.

The "open" transaction method may serve as an alternative way for a seller to report gain. The open transaction method permits gain recognition only when payments are received or fixed (depending on the applicable method of accounting and with basis being recovered first). However, the open transaction method can generally only be used in those rare and extraordinary cases where the fair market value of the payment obligation cannot be "reasonably ascertained."

Regardless of whether the installment method applies, the gain resulting from a Basis TRA (other than any imputed interest) should generally be characterized as capital gain rather than ordinary income (with certain exceptions, such as asset level gain relating to depreciation recapture or inventory). The capital gain should qualify as long term capital gain if the operating partnership interests or assets were held for more than one year.

In addition, regardless of the method chosen by the seller for reporting the transaction, the public company generally obtains additional basis in the underlying assets as payments under the Basis TRA are made. As discussed above, both the corporation's incremental basis and its deduction of imputed interest generally give rise to additional payments under the agreement.

TAX TREATMENT OF NOL TRAs

The tax treatment of an NOL TRA is less clear. The act of entering into the TRA may itself be viewed as a distribution from the corporation to the historic equity owners in respect of their stock. In this case, the fair market value of a historic equity owner's rights under the TRA (which is based on a discounted present value of future payments under the TRA) would be taxed as follows:

- Dividend income up to the amount of the corporation's earnings and profits.
- Non-taxable recovery of basis to the extent of the historic equity owner's basis in the stock.
- Any remaining amounts as capital gain.

Going forward, payments made under the TRA that exceed the amount already taken into account should apparently be treated as ordinary income, but the method for recovering basis in the contract right (for example, first, last or pro rata) is unclear.

Alternatively, if the stock held by a historic equity holder is recapitalized into a new class of stock to which the rights under the TRA attach, the transaction may qualify as a tax-free reorganization under IRC Section 368. In this case, no gain is recognized by the equity holders at the time of the recapitalization. When payments are made under the TRA, they should be treated as taxable distributions from the corporation.

To bolster this tax treatment, the TRA and the stock must generally be "stapled." This means that if a historic equity owner transfers the stock, the historic equity owner must also transfer its rights under the TRA, and vice versa. However, upon a sale of the stock to the public, as a practical matter, the stock and the TRA must detach from one another.

The treatment of the detachment for US federal income tax purposes is not completely clear. One possibility is that the historic equity owner is treated as receiving a distribution in respect of its stock in the form of the right to receive the remaining payments under the TRA. Alternatively, the detachment of the stock and the TRA could be treated as a recapitalization with taxable boot to the historic equity owners consisting of the TRA.

Another approach to distributing the NOL TRA to historic equity owners may be to style the TRA as a class of stock of the corporation and distribute that stock to the historic equity owners. That is, the TRA would contain the same terms that it would otherwise have but it would be incorporated in the corporation's charter, rather than be in the form of a contract.

In this case, IRC Section 305 may treat the stock distribution as tax-free. If so, a historic equity owner's basis in its stock in the corporation would be allocated between the historic stock and the new NOL TRA stock. Going forward, payments under the TRA may be viewed as distributions by the corporation to the historic equity owners in respect of the new NOL TRA stock, which may be taxed in whole or in part as dividend income (ordinary income to the recipient).

TAX TREATMENT OF STOCK OPTION TRAs

In the Endo TRA, the parties agreed to treat any payments under the agreement as redemptions of stock under IRC Section 302. This treatment provided the equity owners with capital gain treatment (unless the distribution was found to be essentially equivalent to a dividend). However, this tax treatment seems to be specific to the structure used in that agreement as the shares against which the options were exercisable were those held by the payee under the TRA.

TRAs IN PRIVATE TRANSACTIONS

Although TRAs have generally been entered into in connection with IPOs, TRAs or similar arrangements can also be used in connection with other types of transactions, including private company sales. It is not uncommon for the seller of a business to seek an increase in purchase price in exchange for valuable tax attributes of the sold business (for example, a basis step-up or NOL) or to compensate the seller for incremental tax liability resulting from a transaction that delivers a basis step-up in the business' assets to the buyer (for example, a stock sale with a Section 338(h)(10) election).

However, agreeing on the value of these tax attributes upfront may be difficult because the value depends on assumptions about the ability of the buyer to utilize the tax attributes in the future. Instead, a TRA can provide for additional payments by the buyer to the seller if, as and when the relevant tax attributes yield a tax benefit for the buyer.

As the use of TRAs becomes more common in the IPO context, we can expect to see these arrangements used in an increasing number of other types of transactions, as a means for sellers to monetize the value of their business' tax attributes.