Demystifying The Monetization of TRAs

A Success Kit For Building Liquidity

Saish Setty, General Counsel

Andy Lee, Chief Investment Officer

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INTRODUCTION[1]

This paper aims to facilitate the growth of the tax receivable agreement ("TRA") market by demystifying the secondary market and introducing potential items for standardization.[2] While TRAs have existed for thirty years,[3] TRAs are often misunderstood and rarely drafted with a secondary purchaser in mind. This paper will cover a few issues that Parallaxes Capital has found particularly pertinent from our perspective as secondary purchasers. We also anticipate publishing annual updates with new learnings and developments in the market.

Parallaxes Capital is the market leader in monetizing TRAs, and as such, it is incumbent upon us to steward this fast-growing sector by promoting standardization of terms and increasing transparency in the ecosystem. We are an alternative asset manager and, since 2017, have raised four funds dedicated to the space. We have closed on seven times the number of TRA acquisitions as the next most active market participant.[4]

While there has been academic debate on the benefits of TRAs, the adoption of TRAs has only increased in the past few years. Over 75 TRAs were created in 2021 compared to fewer than 15 TRAs in 2015. This market growth is stunning and bears a striking resemblance to the growth of representation and

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[1] Parallaxes Capital is excited to be at the forefront of this rapidly growing asset class, and we are thankful to have engaged with many extremely constructive industry participants who have afforded us their time and resources to enable us to write this paper.

[2] This paper is not intended to introduce TRAs and their basic mechanics. There have been many pieces put out by academics and practitioners that provide a detailed overview of TRAs—the following pieces offer excellent summaries of TRAs:

1) Victor Fleischer & Nancy Staudt, *The Supercharged IPO*
2) Gladriel Shobe, *Supercharged IPOs, the Up-C, and Private Tax Benefits in Public Offerings*
3) Gladriel Shobe, *Private Benefits in Public Offerings: Tax Receivable Agreements in IPOs*
4) Alexander Edwards, Michelle Hutchens & Sonja Olhoft Rego, *The Pricing and Performance of Supercharged IPOs*
5) Christopher B. Grady, *Finding the Pearl in the Oyster: Supercharging IPOs Through Tax Receivable Agreements*
6) Ropes & Gray, *Investing in Tax Receivable Agreements*

[3] The first TRA was the Belden Inc. IPO (spin-off from Cooper Industries, Inc.) in the early 1990s. *See*, e.g., Deborah Paul & Michael Sabbah, Understanding Tax Receivable Agreements; Ian Fontana Brown, The Up-C IPO and Tax Receivable Agreements: Legal Loophole?; Alexander Edwards et al., *supra* note 1.

[4] Based on Parallaxes' internal market analyses concerning activity over the last five years.

warranty ("R&W") insurance in the early 2010s. We anticipate that this trend will continue and likely accelerate in the coming years.[5]

Numerous commentators have suggested that TRAs exist as the presence of a TRA does not appear to have a negative impact on the market capitalization of a company.[6] This observation is initially counterintuitive, as TRAs are disclosed in excruciating detail in a company's public filings and typically involve post-IPO cash payments from a company to its pre-IPO owners. This general disregard for tax assets may stem from the inherent difficulty in valuing tax attributes,[7] as the valuation of tax assets would require, among other things, estimates of a company's future taxable income along with predictions as to when pre-IPO holders will exchange their LLC units for common stock in an Up-C structure.[8] Additionally, this undervaluation may simply stem from public investors' focus on metrics such as revenue and EBITDA, which disregard the impact of taxes.[9]

While TRAs likely allow pre-IPO owners to capture value stemming from tax assets otherwise ignored by the public markets, TRAs are also potentially beneficial to a newly public company and its shareholders. TRAs align pre-IPO owners' interests with those of the firm since TRA holders benefit from strong future earnings. From this perspective, TRAs may be viewed as an alternate commitment

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[5] Notably, this growth has occurred even with the reduction of the corporate tax rate to 21% in the Tax Cut and Jobs Act of 2017. *See*, e.g., Gladriel Shobe, *The Substance Over Form Doctrine and the Up-C*; Dean Shulman, Sara Zablotney, and Margaret Dewar, *Upended: The Impact of Tax Reform on Up-C Structures*.

[6] *See*, e.g., Fleischer & Staudt *supra* note 1; Jeffrey Bilsky and Avi Goodman *An Alternate Route to an IPO: The Up-C Partnership Structure (Part 1)*. *But see* Amy Foshee Holmes, *Tax Receivable Agreements in Initial Public Offerings: An Analysis of the Innovation Incorporated in IPO Agreements* ("The negative association of the TRAs to price is not significant but does indicate a potential drag on price for all periods analyzed").

[7] *See*, e.g., Debevoise & Plimpton, *Monetizing the Shield: Tax Receivable Agreements in Private Equity Deals.*

[8] The step-up, which typically generates the benefits covered by a TRA in an Up-C structure, only occurs when pre-IPO owners actually exchange their LLC units for common stock of the publicly-traded company. Additionally, the step-up will be allocated to the company's assets, and this allocation will dictate the relevant amortization or depreciation periods for the step-up basis—as discussed below, uncertainty about this future allocation increases the difficulties inherent in valuing the TRA.

[9] *See*, e.g., Gregg D. Polsky & Adam H. Rosenzweig, *The Up-C Revolution*; Amy S. Elliott, *IPO Agreements That Shift Basis Step-Up Benefit to Sellers Proliferate*.

mechanism (like a lockup, for example) that ensures that pre-IPO owners' incentives align with those of public shareholders.[10]

We view TRAs as a valuable tool to reduce the moral hazard problems and informational asymmetry inherent in a public offering.[11] TRAs ensure that pre-IPO owners are economically aligned with new public shareholders and also offer a tool to provide value to such pre-IPO owners (on account of assets that are not only thought to have limited value in the public market but also only exist due to the pre-IPO owners' willingness to structure the IPO in an Up-C). We discuss some methods to value TRA interests on page 8 but generally, as discussed in the FAQs, it is extremely difficult to create an *ex ante* estimate of the value of certain tax assets.[12] TRAs deliver value from the relevant tax benefits to their holders on an as-realized basis and completely remove the complications associated with an *ex ante* valuation.[13]

At Parallaxes, we anticipate that the 2020s will bring enhanced awareness and understanding of TRAs, driving increased adoption and innovation among stakeholders. To further this effort, this paper will focus on the following:

- League Tables: We celebrate many of our close friends who rank among the law firms active in public transactions involving TRAs in 2020 and 2021.
- Valuation: We share our knowledge to foster a broader understanding of how TRAs are valued on the secondary market.

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[10] This finding was quantitatively supported by Edwards et al., *supra* note 1, which argued that TRAs are correlated to higher IPO offer prices and increased future performance (including higher earnings and greater future cash flow).
[11] Another potential benefit is that the step-up basis results in the public company's financial statements reflecting its assets' fair market value, reducing information asymmetry. *See* Holmes *supra* note 6.
[12] Note that this whitepaper focuses on TRAs relating to basis adjustments in an Up-C transaction. As discussed below, these basis adjustments only crystallize upon the pre-IPO owners' exchange of LLC units at some uncertain future time—this concern may also illustrate why public market investors seemingly do not place significant value on these tax assets.
[13] *See*, e.g., Polsky *supra* note 8; Christopher B. Grady, *Finding the Pearl in the Oyster: Supercharging IPOs Through Tax Receivable Agreements*. The prospect of additional returns from the TRA that accrue to pre-IPO holders may also encourage greater investment in such companies. *See* Grady.

- Best-in-Class Terms: We hope to enable market growth by driving standardization across TRAs and sharing terms that are particularly important to us as secondary purchasers.
- Capital Allocation: We briefly discuss some considerations for a company considering a buyback of its TRA obligations.
- Interesting Items: We present some interesting TRA provisions we have noticed over the past few years.
- Frequently Asked Questions

TRA League Tables

Based on publicly disclosed information and verification from industry participants, below are our inaugural league tables for legal advisors involved with TRAs in 2020 and 2021. The increasing prevalence of TRAs has been largely driven by elite law firms[14], and such firms have been crucial in developing TRAs. The tables below summarize the number of distinct TRAs that a given firm has been involved in, either as the primary counsel for the TRA obligor or the relevant underwriter in the IPO.

UNDERWRITER REPRESENTATIONS [15]

Rank	*Firm*	*TRAs*
1	Davis Polk	14
2	Latham & Watkins LLP	13
3	Ropes & Gray	4
3	Simpson Thacher	4
5	Vinson & Elkins	3
5	Fried Frank	3
5	Paul Weiss	3
5	Skadden	3
9	EGS Ellenoff Grossman & Schole LLP	2
9	Freshfields Bruckhaus Deringer	2
9	Goodwin	2
9	Sidley	2
9	White & Case	2

[14] *See* Fleischer *supra* note 1.
[15] Note that this includes representations of SPAC acquirers.

ISSUER REPRESENTATIONS		
Rank	***Firm***	***TRAs***
1	KIRKLAND & ELLIS LLP	16
2	LATHAM & WATKINS LLP	15
3	Paul | Weiss	5
4	Simpson Thacher	4
4	GIBSON DUNN	4
4	GOODWIN	4
7	Davis Polk	3
7	Vinson&Elkins	3
7	Cooley	3
7	Skadden	3
7	Weil	3
12	GT GreenbergTraurig	2
12	ROPES & GRAY	2
12	WHITE & CASE	2

VALUATION

The valuation of a TRA is not substantially different from that of many other investments—it is a present value delivered today (upfront) in return for expected future cash flows. There are three primary considerations underlying the valuation of a TRA:

A) Verification of the "Collateral"

B) Forecast of Taxable Income

C) Construction of a Discount Rate

For background, IPOs involving a TRA are often structured so that when a pre-IPO owner exchanges units in a subsidiary (the "Partnership") of the relevant TRA obligor (the "Corporation") for stock of the Corporation, the Corporation receives a stepped-up basis in a portion of its subsidiaries' assets. Based on the assets that the step-up is allocated to (the "Collateral"), this exchange creates additional deductions that shield the Corporation from future tax liabilities.[16] TRA payments are then made to TRA holders (i.e., the pre-IPO owners), as the Corporation uses (or is deemed to use) these deductions to reduce its tax liabilities.

A) VERIFICATION OF THE "COLLATERAL"

The undiscounted value (or Undiscounted Principal Balance, or "UPB") of a TRA is the product of *(i)* the applicable tax rate (%), *(ii)* the Collateral or amount of tax assets available ($), and *(iii)* the sharing percentage (%).[17] One may think of the applicable tax rate as Price ("P") and the Collateral as Volume ("V") with a royalty attached to it in the form of the sharing percentage ("S").

$$P \times V \times S = UPB$$

[16] For example, if the step-up is allocated to goodwill, the Corporation would be able to amortize this step-up over 15 years.
[17] Generally, most TRAs include a sharing percentage of 85%—in this construct, TRA holders are entitled to 85% of the tax benefits arising from the relevant collateral while the Corporation retains the remaining 15%.

Let's attach numbers to our example involving $100 million of Collateral, a 25% tax rate and an 85% sharing percentage:

25% (P) x $100 million (V) x 85% (S) = $21.25 million

While $25.0 million of tax savings is generated by the Collateral, only $21.25 million (S, or 85%) will be distributed to the TRA holders as and when the Corporation is able to fully utilize the tax asset (that is, when it has generated sufficient taxable income to utilize the tax shield provided by the Collateral).

The knowable variable in the above equation is S (the sharing percentage), which is documented in the relevant TRA. However, P and V must be verified via diligence.

Price is inherently variable given the constantly evolving nature of the Corporation as it is related to the jurisdictions of its operations and the applicable federal, state, and local tax rates. Suppose the Corporation only has operations in New Jersey, which has an 11.5% marginal tax rate. In that case, there is likely a significant risk that Price has only one direction to go (i.e., decrease). Conversely, should the Corporation only have operations in North Carolina, which has a 2.5% marginal tax rate, there is likely a significant opportunity for Price to improve. Diligence would be sought to understand the nexus of the Corporation's operations.[18]

As mentioned above, Volume is established by understanding the Corporation's inside basis (similar to its adjusted cost basis) and the price at which units of the Corporation's partnership subsidiary are exchanged—these factors establish the amount of the step-up.[19] This should be fixed and determinable

[18] Some TRAs utilize a fixed rate to approximate the impact of state and local taxes, simplifying the administration of the TRA.

[19] Note that TRAs may also be constructed to relate to the benefit derived from other tax assets, including, for example, NOLs and stock-based compensation deductions.

only upon completion of the exchange transaction. Diligence would be sought to verify inside basis and the price at which the entity's units were exchanged.

Taken together, Volume is not available immediately at the time of IPO. Volume is determined at the time of subsequent exchanges and allocated among assets by fair market value ("FMV") to working capital, buildings, and intangibles. Any excess of FMV is allocated to tax-deductible goodwill. Each underlying asset has a different recovery period for tax deductibility, which further complicates the determination of value, as such timing considerations impact the present value calculations. While Volume is based on the undiscounted value of the TRA and is the total amount of the tax shield derived, the annual maximum benefit is dependent on, among other things, the recovery periods of each of the underlying assets that benefit from the step-up.

B) FORECAST OF TAXABLE INCOME

As mentioned above, the ability to utilize the tax asset is driven by the availability of taxable income. This can be estimated by reconciling book income to taxable income, but this exercise has many inherent challenges.

Several items have an obvious impact on taxable income, such as capital expenditures (which could be immediately expensed) and interest expense from debt. Additionally, aside from the inherent difficulties in forecasting future income, other factors may have surprisingly outsized impacts on estimates of taxable income.

TRA payments are typically calculated on a "with and without" basis, and the tax benefit related to the Collateral is calculated by assuming that the Corporation first uses all tax attributes that are not TRA Collateral. In our experience, we have seen *(i)* income from foreign subsidiaries that are subject to Foreign Tax Credits ("FTC"), *(ii)* deductions related to Foreign Derived Intangible Income ("FDII"), *(iii)* tax credits (from renewable projects), *(iv)* deductions for stock-based compensation in the context of a rapidly appreciating stock price, *(v)* temporal (such as the ability to expense capital expenditures) and permanent (such as the inability to deduct certain compensation for "Covered Employees" for tax purposes) differences between book and tax accounting and *(vi)* the interplay between the pass-through entity and the publicly traded Corporation[20] having a large impact on taxable income and the calculation of the tax benefit.

C) CONSTRUCTION OF A DISCOUNT RATE

Once you have overlaid (b) over (a), there will be a stream of assumed cash flows for TRA payments requiring a discount rate to arrive at a present value. Constructing a discount rate is as much art as science, inherently manifesting multiple forms of risk, including:

- <u>Credit Risk</u>: Given that the TRA claim will likely be junior in the event of bankruptcy, a spread is necessary to compensate for default risk. High-yield instruments generally do not recover fully in bankruptcy, and since TRA claims are typically both payment and structurally subordinated, the assumed loss given default ("LGD") that Parallaxes underwrites is effectively 100%. Additionally, the Corporation could increase total leverage, putting pressure on earnings and cash flows and increasing its risk of default.
- <u>Duration / Extension Risk</u>: Payments and benefits under the TRA are inherently reliant on a Corporation's taxable income. This creates duration risk, as management could seek to maximize long-term earnings power by embarking on an expansion plan that results in large near-term capital spending. Such capital expenditures would reduce taxable income in the near term and delay any cash flows to TRA holders.

[20] For example, in the context of a Corporation with a rapidly appreciating stock price, exchanges would result in a relatively large step-up basis. If the company's growth in taxable income has lagged its stock price appreciation, its taxable income would disproportionately benefit from a large deduction attributable to the step-up.

- Illiquidity Risk: The lack of a liquid market for TRAs results in a likely hold-to-maturity base case for Parallaxes.
- Tax Reform Risk: Given the importance of tax rates (P) and tax policy on the value of a TRA, these instruments carry substantial risk related to legislation and other tax changes. Any changes in tax laws could adversely impact the tax assets subject to a TRA.

Considering these factors, we generally find a discount rate in the mid to high teens appropriate as a starting point for a discussion.

BEST-IN-CLASS TERMS

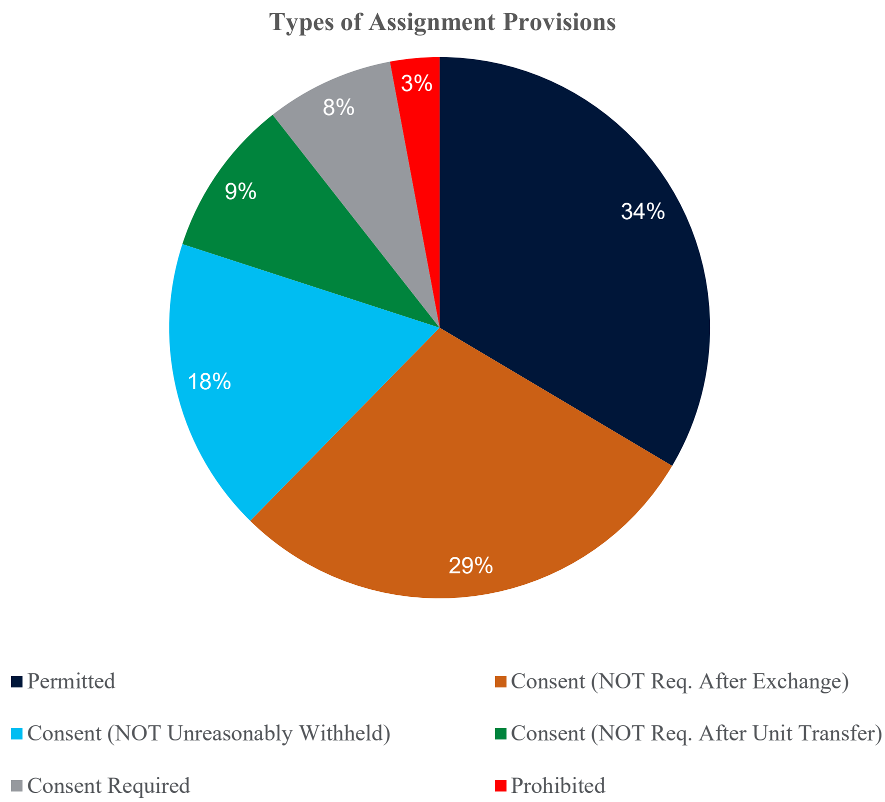
Many terms may make TRAs difficult to transact. While it is by no means exhaustive, the discussion below illustrates some of the most common TRA provisions that have complicated Parallaxes' ability to invest in a TRA.

TRANSFERABILITY CONCERNS—ASSIGNMENTS

Assignment provisions may create substantial hindrances to secondary market liquidity if they are overly difficult to comply with. We have found that assignment provisions in TRAs generally fall into one of six categories:

1. Transfers are generally permitted
2. No consent is required after an exchange[21]
3. No consent is required in connection with a transfer of Partnership units
4. Transfers are permitted with company consent (not to be unreasonably withheld)
5. Transfers are permitted with company consent
6. Transfers are prohibited

[21] Note that this includes constructs requiring no consent after an exchange or transfer of Partnership units.



The chart above summarizes the prevalence of these constructs across a sample of 170 TRAs. Thankfully, a complete prohibition on transfers is rare (3%) and typically only found in TRAs with a single holder. However, to improve secondary market liquidity, assignment provisions should be constructed to permit assignments without company consent.

Additionally, a transferee is typically required to execute a joinder to the TRA in connection with an assignment. To improve the ease of transferability, the TRA should include a form joinder (rather than simply requiring the joinder to be reasonably satisfactory to the company). In our sample of TRAs, we have found that only about 40% of TRAs include a form joinder. We have included a sample form joinder here in Appendix I for ease of reference. As with the assignment provisions themselves, the joinder itself should be structured such that company input is not required—the joinder should only serve to provide notice of the transfer to the company.

Taken together, we would recommend that TRAs include *(i)* assignment provisions that liberally permit transfers and *(ii)* a form joinder.[22]

> **Suggested Language:** A Holder is permitted to transfer any of its rights upon execution and delivery by the transferee of a joinder (Exhibit A) to this Agreement, in which the transferee agrees to become a "Holder" for all purposes of this Agreement.

SEPARATENESS

Unlike a third-party debt provider, TRA holders may be otherwise involved in a company's structure or operations, most likely as equity owners. This sometimes results in a tendency to include provisions in the TRA that do not solely relate to the TRA. Unfortunately, such inclusions may render a TRA un-investible from the perspective of a potential TRA buyer.

For example, there have been TRAs with employment provisions—in the instance of the Moelis & Company TRA, if a TRA holder ceases to be employed with the company prior to an exchange and such holder engages in certain detrimental activities (including violations of non-competition obligations), the holder relinquishes their rights to certain TRA payments.

While it may be attractive to the company to include such provisions in the TRA, a potential buyer cannot underwrite such risk. We view TRAs that stand alone (and are more debt-like in that regard) to be highly preferred.

RIGHT-OF-FIRST-REFUSAL (ROFR)

While rare, some TRAs (approx. 2% of those sampled) include provisions obligating a transferor to provide the company and / or other TRA holders a right of first refusal over any transfers. Again, such

[22] While the Bumble Inc. TRA (link) offers a good example of this construct, the form joinder requires that the company execute the joinder.

provisions restrict secondary market liquidity, as a potential buyer will be reluctant to invest the required diligence if the ROFR can undermine their investment efforts.

ABILITY TO DEFAULT

While all TRAs would impose duties of good faith and fair dealing on the parties involved, we would recommend the inclusion of non-interference or non-circumvention provisions that explicitly limit the company's ability to circumvent its obligations under the TRA.[23] Provisions that limit a company's ability to incur debt that materially restricts the company's ability to make TRA payments may also be desirable—an example of this provision in the Foundation Building Materials TRA is discussed below.

> **Suggested Language:** The Company shall use commercially reasonable efforts not to enter into any agreement if such agreement restricts in any material respect the amounts payable hereunder. The Company shall not take any action that circumvents the achievement or attainment of any payment under this agreement.

ACCELERATION UPON DEFAULT

Generally, upon a material breach under the TRA, all obligations under the TRA should be accelerated (as though the company had opted to exercise its right of early termination).[24] However, under some TRAs, if there is a breach of the agreement, the obligations thereunder are only accelerated if a majority of TRA holders so elect. Given that a secondary purchaser may not be able to obtain a majority position, this creates undue risk for a minority holder if there is a breach and a majority fails to accelerate the TRA obligations. This risk is heightened as TRA holders typically include pre-IPO owners and management, parties that may have other interests in the company that incentivize them against accelerating the TRA

[23] *See* European Wax Center's TRA (link)
[24] *See* below in footnote 29 for additional background on early termination rights.

obligations. We would suggest that TRAs include a formulation where the obligations are automatically accelerated upon a material breach of the agreement.

> **Suggested Language:** In the event that the Company breaches any of its material obligations under this Agreement, then all obligations hereunder shall be accelerated, and such obligations shall be calculated as if an Early Termination Notice had been delivered on the date of such breach.

Bankruptcy Risks

Our internal analyses have found that TRA holders generally do not receive a meaningful recovery on their claims.[25] Given this backdrop, bankruptcy avoidance is a key concern, and over-leverage in the structure is particularly dangerous. Incorporating a leverage covenant into the TRA itself is one possible solution to this. While this may limit the company's operational flexibility, such a provision would give TRA holders some protection against a company incurring an undue amount of debt and increasing its likelihood of bankruptcy.

> **Suggested Language:** Without the prior written consent of the TRA Representative (not to be unreasonably withheld, conditioned or delayed), the Company shall not incur any indebtedness for borrowed money if, immediately after giving effect to such incurrence and the application of proceeds therefrom, the Company's Consolidated Total Leverage Ratio pro forma for such indebtedness exceeds [•].

Adverse Amendments

Unlike a typical debt instrument, TRAs often do not offer substantial protection to minority holders from amendments that adversely impact their entitlements under the TRA. For example, in connection with its acquisition by Goldman Sachs, GreenSky, Inc. modified its TRA so that no payments would be made in

[25] Despite some cases where the TRAs had a minimal recovery, we did not find those cases instructive due to other factors.

connection with the acquisition. Meanwhile, in the 2014 bankruptcy of DynaVox, a majority of TRA holders simply waived all rights to payment under the TRA in advance of bankruptcy.

Without a blocking position in the TRA, such adverse amendments are difficult to protect against. Some TRAs include provisions that place additional requirements on amendments that disproportionately impact certain parties—however, a full termination or waiver of payments under the TRA would impact all holders, and such disproportionate impact protections likely do not offer much protection. Rather, the amendment provisions should also include language that prohibits amendments that have a substantial economically adverse effect on a holder without their consent.

> **Suggested Language:** Notwithstanding anything in the foregoing to the contrary, no amendment may adversely affect a TRA Holder unless such amendment is consented to in writing by such Holder.

Additionally, similar to the separateness concept above—constructs where a "TRA Representative" (or other such similar position) is given broad flexibility to consent to amendments on behalf of a TRA holder are undesirable. A TRA holder should generally be able to consent to amendments on behalf of itself (and have a consent right over amendments that disproportionately impact them or have an economically adverse effect on their holding).

DILUTION

A company may also enter into future TRAs, and such TRAs could dilute the claims under an existing TRA. While these future TRAs would generally relate to the benefits from tax assets that the original TRA does not cover, the additional payment obligations are likely to stress the cash requirements of the TRA obligor. Generally, some TRAs (such as the Bakkt TRA) explicitly require that any future TRA be subordinated in right of payment to the existing TRA. The Foundation Building Materials' TRA went further and noted that if a future TRA is entered into, the tax benefits under such agreement are disregarded for the original TRA.[26] Given that the company shares the savings of such future tax benefits with the holders of such future TRAs, such a construct is desirable.

> **Suggested Language:** Any Tax Benefit Payment or Early Termination Payment required to be made by the Company under this Agreement shall rank senior in right of payment to any principal, interest or other amounts due and payable in respect of any similar agreement.
>
> If the Company or any of its Affiliates enters into any other agreement that obligates the Company or any of its Affiliates to make payments to another party in exchange for tax benefits conferred upon the Company or any of its Affiliates, such tax benefits and such payments shall be ignored for all purposes of this Agreement, including for purposes of calculating the "with and without" tax liabilities.

ADMINISTRATIVE CONCERNS

TRAs impose high administrative costs on companies, especially in connection with tracking exchanges (and the associated basis step-ups) and required TRA payments. Companies may be able to ease the administrative burden by ensuring that the requirements for schedules and deliverables under the TRA are clearly laid out in the agreement. Additionally, underlying TRA calculations may be simplified if the company utilizes a fixed rate for state and local tax liabilities.[27] The frequency of exchanges of units for Corporation stock will also impact the administrative burden for companies. To the extent that unitholders are afforded broader freedom to make exchanges, the Corporation will likely be required to keep track of more exchanges and the basis adjustments (and payments) related to them.[28] As such, limits on exchangeability will ease administrative burdens under the TRA.

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[26] The Clearwater Analytics Holdings Inc. TRA and Finance of America Equity Capital TRA offer similar language.
[27] Forterra's TRA used an assumed tax rate for state and local tax liabilities.
[28] Notably, exchange rights will be limited to prevent the Up-C structure from running afoul of certain tax rules relating to the taxation of a publicly traded partnership. While companies are already likely balancing the desires of unitholders (who will prefer greater flexibility to make exchanges) against tax considerations, they should also take administrative considerations into account as well.

CAPITAL ALLOCATION

There have been many transactions whereby companies have executed TRA buybacks. We find that curious because of the inherent message being sent to equity shareholders given the long-dated, contingent, and uncertain nature of the TRA. A TRA buyback can be analyzed within the traditional frameworks of a capital allocation model that includes:

1) Re-Investment: An investment in organic growth projects or *via* acquisitions
2) Capital Structure: De-leveraging traditional debt
3) Return: One-time or ongoing distributions (dividends or share buybacks)

Obligations under a TRA are only payable when there is sufficient taxable income to utilize available tax assets (almost like a deeply out-of-money convertible note that also provides the company optionality around taxable income), and buyback of a TRA would likely fall under the second point above given its debt-like characteristics.

Repurchasing outstanding TRA obligations may suggest to public company shareholders that the company lacks appropriate investment opportunities where its return on investment exceeds its cost of capital (that is, the company has exhausted its investment runway). This is especially true for a company exercising its right of early termination[29] under a TRA. Given the relatively low discount rates utilized in calculating the early termination payment, a company's decision to exercise its right of early termination may indicate an even more negative view of its growth opportunities.[30]

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[29] TRAs typically allow companies to terminate the TRA by making an early termination payment. The early termination payment is generally defined as the present value (the discount rate varies, but L+ 100 bps is a common formulation) of tax benefits calculated under certain valuation assumptions. These valuation assumptions may include (i) the Corporation will have sufficient taxable income to fully utilize the relevant deductions in any given year and (ii) all unexchanged Partnership interests are exchanged for Corporation stock. These assumptions substantially eliminate all duration and extension risks related to the Corporation's taxable income. Additionally, these calculations generally utilize a relatively low discount rate (compared to the discount rate discussed above).

[30] However, some commentators have suggested that a Corporation may be incentivized to exercise its right of early termination to take advantage of historically low tax rates. *See* Shulman et al. *supra* note 5.

Interesting Items

There have been several TRAs with interesting terms, which we summarize below for your consideration.

Foundation Building Materials, Inc.

- Cross-Default: While a variation of this provision is common in most credit agreements and indentures, it is typically not prevalent in TRAs. Here, upon an event of default under certain of the company's debt, the TRA obligations may also be accelerated.
- Early Payment Right: After the 15th anniversary of the TRA, holders are permitted to terminate the TRA though the remaining obligations had been accelerated.
- Financing Agreements: Leverage covenants would benefit a TRA holder. Here, the agreement also prohibits amendments to the company's existing debt (or incurrences of new debt) if they would materially restrict its ability to make tax benefit payments.

Ryan Specialty Group Holdings: Unitholders that fully exchanged (or sold) their units in connection with the IPO were entitled to receive a lump sum payment on account of certain tax attributes arising from the sale of such interests (and additional consideration relating to the exchange of units even though such exchanges may not have generated tax attributes).

Vince Holding Corp.: The TRA here included a termination date such that the TRA was terminated ten years after the relevant IPO.

Vine Energy: TRA payments were only required for tax benefits realized after 2025 (Vine Energy was a 2021 IPO).

Graphic Packaging Holding Company: Rather than receiving tax benefit payments as the company realizes the relevant tax benefits, after an exchange, holders instead receive a lump sum payment tied to the present value of the related tax benefits.

FREQUENTLY ASKED QUESTIONS (FAQ)

How common have TRAs become in recent years?

The TRA included in Cooper Industries Ltd.'s 1993 spin-off of Belden Inc. is one of the earliest (if not the first) TRAs, while the 1999 IPO of barnesandnoble.com is generally regarded as the first IPO relying on an Up-C structure (though it did not include a TRA). Since then, the market has grown substantially, and we estimate that over 75 TRAs were created in 2021 alone.

Are purchases of TRA rights related to unexchanged units possible?

TRAs help address the uncertainty related to the value of the resulting step-up tax assets in an Up-C transaction. The value of the related tax assets is dependent on, among other things, *(i)* timing of the exchanges, *(ii)* the value of the exchanged interests at the time of the exchange, and *(iii)* the assets to which the step-up is allocated. These valuation difficulties may motivate the existence of TRAs—it is inherently difficult to value these future tax assets, so the TRA delivers such value to holders on an as-realized basis. Given these considerations, before an exchange of Partnership units, it is virtually impossible to estimate the value of the resulting tax assets, and any purchase would require almost option-like pricing. Because of this, while Parallaxes has purchased these in the past, the firm generally does NOT purchase uncrystallized TRA rights given the option-like pricing.

Why would a company enter into an Up-C transaction?

There are many benefits to an Up-C transaction, but in particular, it *(i)* allows pre-IPO holders to hold their economic ownership through a partnership entity (and maintain the benefits stemming from pass-through tax treatment), *(ii)* allows pre-IPO owners to access liquidity because they can exchange Partnership units for publicly traded stock and *(iii)* provides the company with a step-up basis that would not otherwise be available in a traditional IPO.

What other tax assets may a TRA cover?

This paper focused on TRAs in an Up-C transaction where the main tax attribute covered was the step-up basis. However, TRAs may also be structured to cover other tax attributes—including *(i)* net operating losses, *(ii)* tax credits, and *(iii)* deductions related to stock-based compensation, debt issuance costs, and various transaction expenses.

This discussion focused on TRAs for publicly traded companies. Are there TRAs in private transactions?

Tax receivable agreements are becoming increasingly common in private transactions. In a private acquisition, a seller will typically demand a higher purchase price for the tax assets of the target company (and a private buyer is generally better equipped to negotiate and value the associated tax assets). However, as noted in our discussion of valuation, there is a great deal of uncertainty about how such assets would be valued, and a buyer may be unwilling to accept the seller's valuation. As in the case of companies in an IPO, in such instances, a TRA would help address this uncertainty by providing the seller additional consideration while the buyer is at limited risk of "over-paying" for the tax assets. The TRA would help address the difficulties inherent in an *ex ante* valuation of tax assets by simply providing the seller the benefits of the tax assets as they are realized. We expect TRAs in private transactions to continue increasing in prevalence over the coming years.

Are secondary purchases of TRAs publicly disclosed?

Entry into a TRA and ongoing obligations under the TRA are disclosed in a company's filings. However, we believe the disclosure of secondary sales provides limited informational benefit. While some companies have included such purchases in their public filings, we generally do not believe this necessary (or helpful). Just as secondary purchases of a company's bank or bond debt are typically not disclosed in a company's filings, TRA purchases need not be disclosed.

Conclusion

TRAs have experienced substantial growth in the past few years, and we (Parallaxes) anticipate that this trend will only continue such that TRAs will become increasingly commonplace in public (and private) companies. While TRAs today generally encompass tax assets related to basis step-ups and NOLs, we predict that as TRAs evolve and become increasingly sophisticated, they will also grow to cover a broader set of tax assets.

As the trend of growth for TRAs continues, we expect that there will be increased activity in the secondary market (and capital formation around the opportunity). In fact, over the next decade, we would expect to see publicly traded vehicles that are focused on purchasing TRA rights (much like the IPOs of Healthcare Royalty and Royalty Pharma in the pharmaceutical royalty space).

In 2023, we hope to share more information on TRAs and contribute to the growth of this dynamic sector. In particular,

- For Legal Counsels: We plan to publish standard TRA forms with best-in-class technology included and additional materials on TRA-specific issues
- For Internal Tax Directors / External Tax Accountants: We plan to publish reporting guidelines to enable standardization of deliverables under the TRA

Building in public is daunting, and we do not believe anyone should have a monopoly on good ideas. We welcome dissenting views as we endeavor to enable the ecosystem's growth. If you have questions about our strategy or the space, Parallaxes would love to engage with you.

APPENDIX I

FORM OF JOINDER AGREEMENT

This JOINDER AGREEMENT (this "Joinder"), dated as of [●] (the "Effective Date"), is delivered pursuant to that certain [Tax Receivable Agreement] dated as of [●] (as amended, restated, amended and restated, supplemented or otherwise modified from time to time, the "Tax Receivable Agreement"), by and among [●] (the "Company"), [●] (each a "Seller" and collectively the "Sellers") and the other parties thereto. Capitalized terms used but not otherwise defined herein have the respective meanings set forth in the Tax Receivable Agreement.

WHEREAS, on the Effective Date, the Sellers assigned to [●] ("Purchaser"), and the Purchaser assumed from the Sellers, effective as of the Effective Date, all of the Sellers' right, title and interest in, to and under the Tax Receivable Agreement in their respective capacity as a [TRA Holder], including the right of the Sellers to receive all payments that are or may become payable to the Sellers pursuant to the TRA on or after the Effective Date; and

WHEREAS, in connection with such assignment and assumption, the Purchaser is required to execute and deliver this Joinder pursuant to the Tax Receivable Agreement.

NOW, THEREFORE, in consideration of the foregoing and the agreements contained herein, the Purchaser hereby agrees as follows:

Section 1.1 Joinder. By executing this Joinder, effective as of the Effective Date, the Purchaser hereby acknowledges and agrees to become a party to the Tax Receivable Agreement (in the capacity of a [TRA Holder]) and to be bound by all of the terms and provisions of the Tax Receivable Agreement for all purposes as if the Purchaser were an original signatory thereto for all purposes.

Section 1.2 Incorporation by Reference. All terms and conditions of the Tax Receivable Agreement are hereby incorporated by reference in this Joinder as if set forth herein in full.

Section 1.3 Notice. All notices hereunder or under the Tax Receivable Agreement to the Purchaser shall be delivered as set forth below, or pursuant to such other instructions as may be designated in writing by the Purchaser: [●]

The Company is hereby notified and directed to ensure that, from and after the Effective Date, all future Tax Benefit Payments and all other payments that would otherwise be transmitted to the Sellers (in their previous capacity as a TRA Holder) pursuant to the Tax Receivable Agreement shall be made to the bank account of the Purchaser provided to the Company in writing by the Purchaser.

Section 1.4 Governing Law. THIS JOINDER SHALL BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF [●], WITHOUT GIVING EFFECT TO CONFLICT OF LAWS PRINCIPLES THEREOF.

[*Signature pages follow*]

IN WITNESS WHEREOF, this Joinder has been duly executed and delivered as of the date first above written.

PURCHASER:

[●]

By: ________________________________
Name:
Title:

Acknowledged and agreed as of the date first set forth above:

SELLER:

[●]

By: ____
Name:
Title: