Understanding Tax Provisions in M&A Agreements

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Gladriel Shobe, *Private Benefits in Public Offerings: Tax Receivable Agreements in IPOs,* **Vand. L. Rev.** (forthcoming 2018), available at SSRN.

In *Private Benefits in Public Offerings*, Prof. Shobe describes the emergence and evolution of a fascinating term in initial public offerings: tax receivable agreements (TRAs). These agreements reserve for the pre-IPO owners of the business the economic value of certain tax attributes that are either created in the course of the IPO or which were created over a course of years before the IPO. TRAs are contracts between the post-IPO corporation and the pre-IPO owners, pursuant to which the corporation makes distributions to those pre-IPO owners as tax assets are used. In one variation, pre-IPO owners receive the economic benefit of basis step ups that arise in certain “turbocharged” IPOs, and in other variations the pre-IPO owners receive the economic benefit of net operating losses and historical basis in the corporation’s assets.

Shobe then goes on to evaluate the fairness of these agreements. One view that motivates her discussion is that tax assets are underpriced in IPOs, and that TRAs are one way of ensuring that the pre-IPO owners receive a “fair price” for these assets. The opposing view is that the tax assets are properly valued in IPOs already, so that the TRAs allow pre-IPO owners to extract a greater purchase price from new investors than they otherwise would, and perhaps should.

One important contribution of the paper is to describe how these agreements work, and to document how they have both proliferated and mutated into different forms. Shobe teaches the reader a great deal about this feature of IPOs and make some important observations about how they operate. Her work raises the question of why certain variants of the TRA were adopted in some IPOs and other variants were adopted in others, and why TRAs that convey the benefits of net operating losses and historical basis have become increasingly popular over time. Exploring the relationship between the form of the TRA and other characteristics of the IPO might help explain what function they serve.

The paper’s normative discussion focuses almost exclusively on the question of whether such agreements are fair, because the pre-IPO owners are being compensated for a valuable tax asset, or unfair because new investors are unaware of the liability that the corporation is assuming when they set the purchase price. One might also think more broadly about why such an agreement might exist, beyond simply extracting value from unwitting purchasers. Thinking carefully about how tax assets differ from other assets points in some interesting directions.

For example, the value of net operating losses (NOLs) depends on the IPO corporation’s taxable income. Pre-IPO owners that reserve for themselves payments contingent on the use of those NOLs are sending a signal to potential investors about their expectations about the profitability of the company. Those same pre-IPO owners might be thought to have better information about the corporation’s prospects, so that the signal allows them to extract a higher price in the IPO. The same rationale would not apply with the same force to TRAs in which the pre-IPO owners reserve for themselves the benefits of historical basis in non-depreciable assets, since the benefits of the basis are contingent on the future value of those assets (and whether they are ever sold) and do not depend only on the income of the corporation generally. This suggests that empirical testing of the signaling hypothesis might be of value. Shobe

notes that private deals often require purchasers to pay sellers for the value of tax assets but also require sellers to pay buyers for undisclosed tax liabilities. She suggests that the fact that TRAs in public deals only incorporate one half of this bargain might be unfair. Perhaps. But there might be are other differences between public and private deals they could justify the use of TRAs to resolve information asymmetries in expected future income, but not to address tax liabilities, which arose in the past and are subject to due diligence.

More generally, there is a fascinating puzzle about what work TRAs are doing. Shobe lays the descriptive groundwork and takes a first step in assessing the merits, and I hope that this paper also sparks additional work by contract law and corporate law scholars exploring the reasons for these provisions.

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