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FINDING THE PEARL IN THE OYSTER: SUPERCHARGING IPOS THROUGH TAX RECEIVABLE AGREEMENTS

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ABSTRACT—A new, "supercharged" form of IPO has slowly developed over the last twenty years. This new form of IPO takes advantage of several seemingly unrelated provisions of the tax code to multiply pre-IPO owners' proceeds from a public offering without reducing the amount public investors are willing to pay for the stock. Supercharged IPOs use a tax receivable agreement to transfer tax assets created by the IPO back to the pre-IPO ownership, "monetizing" the tax assets. As these structures have become more efficient, commentators have expressed concerns that these agreements deceive shareholders who either ignore or do not understand the agreements' implications. This Note argues that tax receivable agreements are actually similar to other popular forms of monetizing tax assets. Further, this Note shows that tax receivable agreements permit parties to compensate each other for the value of tax assets, increase efficiency in the market, and encourage risk-taking.

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INTRODUCTION

A new form of initial public offering (IPO) has quietly proliferated over the last twenty years that can multiply pre-IPO owners' proceeds from the public offering by up to 20%.[1] These transactions enable owners to extract additional value from the IPO, without reducing the offering price,[2] through the use of creative tax structuring. The pre-IPO owners "supercharge" the IPO by contracting with the newly public entity to pass back to the pre-IPO owners a portion of the tax benefits created by structuring the IPO in specific ways—monetizing the tax assets created in the IPO.[3] These transactions are controversial in part because IPOs traditionally do not have tax implications,[4] and the tax benefits are created, and transferred, in a convoluted manner. This Note will argue that many of these concerns are exaggerated and the elements of the "supercharging" transaction, which enable the monetization of the new tax benefits, are actually not much different than other forms of uncontroversial monetization.

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[1] Amy S. Elliott, *IPO Agreements That Shift Basis Step-Up to Sellers Proliferate*, 132 TAX NOTES 334, 334 (2011).

[2] *See* Deborah L. Paul & Michael Sabbah, *Understanding Tax Receivable Agreements*, PRAC. L.J.: TRANSACTIONS & BUS., June 2013, at 74; *see also infra* text accompanying note 246 (explaining that public company valuations generally ignore tax attributes).

[3] *See* Lynnley Browning, *Squeezing out Cash Long After the I.P.O.*, N.Y. TIMES (Mar. 13, 2013, 6:26 PM), http://dealbook.nytimes.com/2013/03/13/private-equity-squeezes-out-cash-long-after-its-exit/?_r=0 [https://perma.cc/2BD3-C8HM]. See *infra* text accompanying notes 29–31 for an explanation of how the tax benefits are monetized.

[4] HOWARD E. ABRAMS ET AL., FEDERAL CORPORATE TAXATION 54 (7th ed. 2013); *see infra* text accompanying notes 13–14.

The first supercharged IPO occurred twenty-three years ago:[5] Cooper Industries, Inc. (Cooper) spun off its wire and cable manufacturing subsidiary, Belden, Inc. (Belden), as a separate publicly traded company.[6] Unlike traditional IPOs where the pre-IPO owners, Cooper in this case, take their sale proceeds and move into line with other shareholders, Belden and Cooper entered into a tax receivable agreement (TRA).[7] Under the basic terms of this agreement, Belden was obligated to pay Cooper 90% of the tax benefits it received as a result of the IPO.[8] These tax benefits were tied to the amortization and depreciation[9] of Belden's assets, with a possible payment schedule upwards of fifteen years.[10] In short, Belden became contractually bound to pay Cooper large sums of money annually for a period of time that could significantly outlast Cooper's ownership stake in publicly traded Belden.

To better appreciate how TRAs affect the tax advantages of going-public transactions, it is useful to first understand the mechanics and the tax implications of traditional IPOs. Assume that a corporation wishes to raise capital by selling shares of stock to the public. The corporation will hire an investment bank or an underwriter to market its stock.[11] In return for the stock, the corporation will receive cash from investors.[12] Despite the

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5 Thomas W. Avent, Jr. & John F. Simon, *Making a Section 338(h)(10) Election on a Public Offering*, PRAC. TAX STRATEGIES, Aug. 2005, at 74, 84–85; Elliott, *supra* note 1, at 334. The term "supercharged IPO" originated with Robert Willens, a corporate tax expert. Browning, *supra* note 3.

6 Avent & Simon, *supra* note 5, at 84–85.

7 *Id*. at 85. A TRA is an agreement between the new public company and the pre-IPO owners in which the company is obligated to pay to the pre-IPO owners a predetermined percentage of the tax savings or benefits created through the IPO. Browning, *supra* note 3.

8 Avent & Simon, *supra* note 5, at 85.

9 Depreciation and amortization are deductions that permit the recovery of the cost of property over the property's economic life. The idea is that the cost of using the asset during a particular year will offset the income produced by that asset in that year, matching expenses with the corresponding income. *See* MARVIN A. CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 182–83 (13th ed. 2015); RICHARD SCHMALBECK ET AL., FEDERAL INCOME TAXATION 593–94 (4th ed. 2015). Tangible assets are "depreciated" over a specified period, whereas intangible assets, such as goodwill, customer lists, and patents, are "amortized." *See* I.R.C. §§ 167–168 (2012) (describing the depreciation calculations); § 197 (describing the amortization calculations).

10 *See* Avent & Simon, *supra* note 5, at 86. The Belden IPO occurred following the enactment of § 197 of the Internal Revenue Code, which permits asset acquirers to utilize a fifteen-year amortization period on acquired assets, meaning tax benefit payments stemming from amortization could last up to fifteen years.

11 *See* PATRICK J. SCHULTHEIS ET AL., THE INITIAL PUBLIC OFFERING: A GUIDEBOOK FOR EXECUTIVES AND BOARDS OF DIRECTORS 1–2 (3d ed. 2008); Victor Fleischer & Nancy Staudt, *The Supercharged IPO*, 67 VAND. L. REV. 307, 319 n.50 (2014).

12 *See* Fleischer & Staudt, *supra* note 11, at 317.

exchange of large sums of money,[13] a traditional IPO is effectively disregarded for tax purposes.[14] After all, an IPO is simply an exchange of stock for cash: assets do not increase in value, services are not performed by the corporation or the investor, and no productive activity occurs.[15] While the corporation would not experience any tax effects, any pre-IPO owners of the corporation who sold their stock in connection with the IPO would likely experience capital gains and corresponding taxation of those gains.[16] After the IPO, there may be little in the way of ongoing relationships between the pre-IPO owners and the newly public corporation beyond the customary relationship enjoyed between shareholders and their corporations.[17]

In contrast, the pre-IPO owners of a supercharged IPO maintain a relationship with the company for up to fifteen years outside of the customary shareholder–corporation relationship.[18] This difference is the

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[13] According to SEC data, gross proceeds of IPOs in the United States totaled $74.4 billion in 2014. David A. Westenberg, *Practising Law Institute, Initial Public Offerings: A Practical Guide to Going Public* (Bloomberg) § 1.5 fig.1-4 (2d ed. 2015), https://www.bloomberglaw.com/document/5296709160 [https://perma.cc/Q98X-WZXG].

[14] *See* § 1032(a) ("No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock . . . of such corporation."). If the newly formed entity (Newco) is acquiring the assets or stock of another entity as part of the IPO, the transaction is structured as tax free under § 351. The transferors of the stock or assets defer gain recognition while Newco's basis in the assets will be carried over from the previous owners. *Id.* § 351; MARTIN D. GINSBURG ET AL., MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 405 (Mar. 2016 ed.).

[15] ABRAMS ET AL., *supra* note 4, at 54 (7th ed. 2013).

[16] *See* §§ 1(h), 61(a)(3), 1001(a). This Note analyzes tax issues surrounding the actual IPO itself and the transfer of tax benefits from the newly public company to the pre-IPO owners. The taxation of income resulting from the sale of stock or other property by the pre-IPO investors in the public market is outside the scope of this Note.

[17] This is somewhat of a simplification because there can be various ways for historical owners to remain involved in the corporate entity. For example, pre-IPO owners, such as founders, may remain on the board of directors or as employees of Newco. This raises the interesting question of whether these individuals have conflicts of interest with respect to Newco if they remain involved as directors or officers of Newco and are also parties to the TRA. This may raise fiduciary duty and business judgment rule implications. For example, a director, who is also party to a TRA, may prefer raising capital through equity rather than debt, since interest payments on debt are tax deductible, unlike equity dividends, and could reduce payments under the TRA. As an example of this type of relationship where the parties to the TRA were also key members of the management team, see Evercore Partners Inc. (Evercore), an early Up-C transaction. See *infra* Section I.C for a discussion of Up-C transactions. Evercore entered into a TRA with its senior managing directors, including Rodger Altman, who also served as Evercore's chairman and co-chief executive officer. Evercore Partners Inc., Amendment No. 4 to Form S-1 Registration Statement (Form S-1/A), at 6–7 (Aug. 9, 2006). However, in the simplest of IPOs, nothing requires historical owners to remain involved in the corporation.

[18] *See* Browning, *supra* note 3. Note that the original founders of the company may or may not still be involved in the company. For the purpose of simplicity, this discussion assumes the founders are no longer involved following the IPO, and the only relationships between the pre-IPO owners and the

result of a TRA between the pre-IPO owners and the company, which splits the value of the tax assets among the parties to the TRA.[19] Often, these tax assets are created through unique aspects of the IPO process itself.[20] In a standard supercharged IPO, the pre-IPO owners transfer their interests in an operating company (Opco) to a newly formed entity (Newco).[21] Opco becomes a subsidiary of Newco.[22] If properly structured, these transfers boost the value of certain assets for tax purposes by increasing or creating basis.[23] Basis is generally equivalent to cost[24] and is a concept used to track value in order to prevent double taxation on the same amount.[25] Basis is adjusted downward as depreciation tax deductions are taken.[26] Since a higher basis means greater depreciation deductions, Newco pays less tax if the basis in certain assets is increased.[27] For example, in some instances goodwill may be amortized over a period of fifteen years leading to fifteen years of deductions (amortization of an intangible asset, like goodwill, is functionally similar to depreciation of a tangible asset).[28]

Then, Newco agrees in a TRA to pay a percentage of the current and future tax savings to the pre-IPO owners to supercharge the transaction.[29] The newly public Newco keeps the remaining tax savings, giving Newco the benefit of a portion of the deductions that were attributable to the taxable transfers before the IPO.[30] As a result, the pre-IPO owners receive a stream of payments as amortization and depreciation deductions are taken over time.[31] These payments are often taxed at a capital gains tax rate,

company are from the TRA and the customary shareholder–corporation context. For an explanation of the standard fifteen-year term of the TRA, see *infra* text accompanying notes 60–61.

[19] Fleischer & Staudt, *supra* note 11, at 319. Tax assets are "tax deductions, credits, and exemptions that generate tax savings for the company in the future." *Id.* at 315.

[20] *Id.* at 319–20; *see also* GINSBURG ET AL., *supra* note 14, ¶ 405 (describing a "busted" § 351 exchange as compared to a tax-free transaction).

[21] Browning, *supra* note 3.

[22] *See id.*

[23] *See infra* Part I; Fleischer & Staudt, *supra* note 11, at 319 n.50. These assets include "tax credits, operating losses, good will, amortization and property depreciation." Browning, *supra* note 3. The transfer increases the value of these items, but it is important to remember that tax value is different than market value and these tax benefits may not be sold independently of the underlying assets.

[24] I.R.C. § 1012(a) (2012).

[25] SCHMALBECK ET AL., *supra* note 9, at 5–6.

[26] *See infra* Section I.A; Fleischer & Staudt, *supra* note 11, at 319 n.50.

[27] Fleischer & Staudt, *supra* note 11, at 319 n.50; Browning, *supra* note 3.

[28] § 197(a); Robert Willens, *The Private Equity Version of the 'Supercharged' IPO is Nothing New*, 116 TAX NOTES 601, 601 (2007).

[29] Browning, *supra* note 3.

[30] *Id.*

[31] *Id.*

which is lower than the rate for ordinary income.[32] Essentially, as between Newco and the pre-IPO owners, this is a means of saving money through advantageous categorization of income.[33] In other words, by structuring the transaction to increase future amortization and depreciation deductions, the IPO generates future tax savings for Newco. The TRA provides a mechanism to pass a percentage of these savings to the pre-IPO owners.

Commentators and market participants describe these transactions as finding the "pearl in the oyster" because the transactions generate or unlock hidden tax assets (the amortization and depreciation tax deductions) and convert them into cash.[34] And while only approximately one in fifty IPOs backed by private equity use this strategy,[35] experts argue its use is increasing.[36] The transfer of these tax benefits presents interesting questions surrounding the alienability of tax benefits. While the government significantly restricts the transfer of tax assets in some situations, in others, the government openly encourages such transfers, and, in cases where the government encourages such transfers, the purchase and sale of tax assets sometimes constitutes a significant component of corporate operating and acquisition strategies.[37]

This presents the question of whether and how the government should regulate supercharged IPOs that use TRAs to shift the savings associated with certain tax benefits. Traditionally, companies felt "there was something a little bit underhanded about [supercharged IPOs]."[38] One

[32] *Id.*; Elliott, *supra* note 1, at 334. *But see* Willens, *supra* note 28, at 603 n.9 (describing circumstances where pre-IPO owners may not enjoy capital gain rates). The distinction between capital gains and ordinary income rates is not important to the policy proposed by this Note. However, the tax advantages presented by a supercharged IPO would be reduced to the extent pre-IPO owners are taxed at a higher ordinary income rate.

[33] Willens, *supra* note 28, at 603 n.9; *supra* note 32. The income is categorized as capital gains income to the pre-IPO owners rather than ordinary income to Newco, which would be taxed at a higher rate. *See supra* note 32. However, it is not clear that the owners will actually see the benefits contemplated. *See supra* note 32..

[34] Browning, *supra* note 3; *see also* Fleischer & Staudt, *supra* note 11, at 324 n.66.

[35] Browning, *supra* note 3. For perspective, Ernst & Young estimates 120 private equity-backed IPOs occurred in the first three quarters of 2015, collectively raising $38.5 billion. This number is down from 163 private equity-backed IPOs raising $95.8 billion in 2014. *Private Equity, Public Exits Q3 2015*, ERNST & YOUNG (Mar. 21, 2016), http://www.ey.com/GL/en/Industries/Private-Equity/EY-private-equity-public-exits-q3-2015 [https://perma.cc/B7QN-XQZ7].

[36] Browning, *supra* note 3.

[37] Compare leasing depreciable property, discussed in Section II.B.1, which is generally prohibited, with tradeable tax credits, discussed in Section II.B.3, particularly the text accompanying note 231. Some companies invest heavily in tradeable tax credits to minimize their tax liability or, in the case of net operating losses, acquire other companies to access their tax assets. Net operating losses are discussed in Section II.B.2.

[38] Elliott, *supra* note 1, at 334 (quoting Robert Willens).

commentator admits they "drain[] money out of . . . compan[ies] that could be used for purposes that benefit all the shareholders."[39] Indeed, even today, these structures have been sharply characterized as examples of "opaque secretive financial engineering,"[40] "gimmick[s],"[41] and "obscure dirty little secret[s]."[42] Nonetheless, many in the mergers and acquisitions industry view the agreements as exploiting inefficiencies that occur because public stockholders do not fully understand, or value, tax attributes.[43] Tax expert Robert Willens argues that "a supercharged IPO is not a tax gimmick but instead is a reflection of how an IPO is priced."[44] Regardless of one's perspective as to the desirability of TRAs, it is clear that they are becoming more common and that they will be increasingly used "as a means for sellers to monetize the value of their business' [sic] tax attributes."[45]

TRAs are not entirely unique. Other methods of monetizing tax benefits exist or have been attempted. For example, in the 1980s, Congress authorized the effective purchase and sale of tax deductions tied to the depreciation of machinery and equipment through a statutory leasing program.[46] By taking advantage of a statutory safe harbor, a taxpayer (Taxpayer One) could lease depreciable property to another taxpayer (Taxpayer Two) for Taxpayer Two's use, while Taxpayer One retained the tax advantages stemming from depreciation deductions related to the property.[47] This program largely failed and was repealed shortly after enactment.[48] In contrast, the Internal Revenue Code (I.R.C.) permits the

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[39] Browning, *supra* note 3 (quoting Robert Willens).

[40] Matt Levine, *Supercharged IPOs: Like Regular IPOs, but Slower*, DEALBREAKER (Mar. 14, 2014, 4:53 PM), http://dealbreaker.com/2013/03/supercharged-ipos-like-regular-ipos-but-slower/ [https://perma.cc/G8XY-9DCP].

[41] Yves Smith, *Another Private Equity Scam – Tax Receivable Agreements*, NAKED CAPITALISM (Aug. 3, 2015), http://www.nakedcapitalism.com/2015/08/another-private-equity-scam-tax-receivable-agreements.html [https://perma.cc/ZR8P-W2RT].

[42] *A Dirty Little Private Equity Secret: Tax Receivable Agreements*, SEEKING ALPHA: COURAGE & CONVICTION INVESTING (Oct. 15, 2015, 8:58 AM), http://seekingalpha.com/article/3574146-a-dirty-little-private-equity-secret-tax-receivable-agreements [https://perma.cc/8GRG-YDKL].

[43] Paul & Sabbah, *supra* note 2, at 74–75.

[44] Willens, *supra* note 28, at 603.

[45] Paul & Sabbah, *supra* note 2, at 79.

[46] *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172; Alvin C. Warren, Jr. & Alan J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752, 1753 (1982); *see also infra* text accompanying notes 152–54 (explaining how the law operated in more detail).

[47] *See* DANIEL N. SHAVIRO, TAXES, SPENDING, AND THE U.S. GOVERNMENT'S MARCH TOWARD BANKRUPTCY 17–18 (2007); *see also infra* text accompanying notes 164–66.

[48] SHAVIRO, *supra* note 47, at 18.

partial monetization of net operating losses (NOLs).[49] NOLs can be used by taxpayers to offset future income against historical losses.[50] This benefit may be bought and sold in certain situations.[51] Moreover, the I.R.C. goes so far as to fully condone the direct buying and selling of certain tax credits, such as the low-income housing tax credit (LIHTC).[52] Indeed, the LIHTC program would not work if the tax credits could not be monetized.[53]

This Note will demonstrate that popular concerns that TRAs deceive public shareholders are overblown and, additionally, that TRAs reduce inefficiencies produced by the tax system by allowing those who create valuable tax assets to benefit from them. Part I will review the history of supercharged IPOs, starting with the enactment of § 197(a) of the I.R.C. and the Belden IPO. Part I will also demonstrate the increasing efficiency with which these agreements transfer tax benefits and explain the mechanics of a supercharged IPO from a tax standpoint. Part II will take a step back from TRAs to examine general policies toward the monetization of tax benefits, by (a) exploring different policies toward monetization and identifying the normative justifications for such policies and (b) examining the implementation of these policies through the current law applicable to (1) "leasing" depreciable property; (2) selling net operating losses; and (3) investing in certain types of tax credits. Part III will apply these policies to TRAs in the context of supercharged IPOs. It will argue that TRAs share the qualities of NOLs and investable tax credits that make both of these tax benefits good candidates for monetization and that TRAs, as mechanisms to monetize tax benefits, have little in common with failed monetization efforts. In short, this Note establishes that supercharged IPOs and TRAs are similar to other forms of tax benefit monetization and increase efficiency in the market.

I. HISTORY AND EVOLUTION OF SUPERCHARGED IPOS

This Part will trace the evolution of supercharged IPOs and describe the tax mechanisms that provide the supercharged value. There are three varieties of IPO transactions that may be supercharged: (1) § 338(h)(10) transactions; (2) publicly traded partnerships; and (3) Up-Cs.[54] To be truly

49 I.R.C. § 172(a)–(c) (2012); *see infra* text accompanying note 198.

50 § 172(a)–(b); *see infra* text accompanying note 199.

51 ABRAMS ET AL., *supra* note 4, at 347–48; *see infra* text accompanying notes 205–07.

52 Clinton G. Wallace, *The Case for Tradable Tax Credits*, 8 N.Y.U. J.L. & BUS. 227, 238–39 (2011).

53 *Id*. at 239; *see infra* text accompanying notes 232–33.

54 *See* John C. Hart, *The Umbrellas of Subchapter K*, SIMPSON THACHER & BARTLETT LLP (Jan. 2016), http://www.stblaw.com/docs/default-source/related-link-pdfs/umbrellas-of-subchapter-k.pdf?

supercharged, each of these transactions uses a TRA to monetize tax benefits, which are made available as a result of transactions that create new tax assets.[55]

A. Section 338(h)(10) Transactions

Section 338(h)(10) IPO transactions were the first supercharged IPOs.[56] If parties elect to conduct their transaction under § 338(h)(10), a buyer records a stepped-up,[57] or higher, basis in the corporation's assets, increasing the amount that can be depreciated and thus creating a tax benefit.[58] Although they would not become popular for over a decade, supercharged IPOs were effectively enabled in 1993 by the enactment of I.R.C. § 197(a).[59] Section 197(a) permits a tax deduction for the straight-line amortization[60] of most acquired intangible assets over a fifteen-year period, commencing when the assets are acquired.[61] Requiring a minimum amortization period for acquired intangibles encourages accountants to more accurately value acquired intangibles so that cost recovery on the intangibles through amortization is maximized.[62]

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sfvrsn=6 [https://perma.cc/5C5H-K2JQ] (describing the evolution of transactions such as publicly traded partnerships and Up-Cs and the use of TRAs in the IPO context). *See generally* Elliott, *supra* note 1 (describing the evolution of supercharged transactions from § 338(h)(10) transactions, to the publicly traded partnership form, to Up-Cs).

55 Fleischer & Staudt, *supra* note 11, at 319.

56 Gladriel Shobe, *Supercharged IPOs, the Up-C, and Private Tax Benefits in Public Offerings*, U. COLO. L. REV. (forthcoming) (manuscript at 16), http://ssrn.com/abstract=2754376 [https://perma.cc/4DAR-CNJD]; *see also* Elliott, *supra* note 1, at 334 (tracking the development of TRAs from § 338(h)(10) transactions to other types).

57 The stepped-up basis is an increase in the "basis" of an asset for tax purposes. Recall that an asset's basis is generally the cost of the asset. I.R.C. § 1012(a) (2012). Abrams et al. describe a § 338 transaction in which the basis of a corporation's assets steps up, or increases, to the assets' fair market value as a result of an acquisition of those assets. *See* ABRAMS ET AL., *supra* note 4, at 234–35. Since taxable gain is calculated as value less basis, a stepped-up basis will reduce the taxable gain, in turn reducing the amount of tax payable.

58 Shobe, *supra* note 56, at 16–17.

59 Willens, *supra* note 28, at 601 (describing the consequences of enacting § 197); *see* § 197(a).

60 In other words, the deduction will be taken in equal amounts over a fixed period of time. In this case, fifteen years. *See* CHIRELSTEIN & ZELENAK, *supra* note 9, at 187–88 (describing the application of the straight-line method).

61 Willens, *supra* note 28, at 601.

62 CHIRELSTEIN & ZELENAK, *supra* note 9, at 203–04 (discussing the implications of § 197 on the treatment of purchased intangibles). It is worth noting that because § 197(a) affects only intangible assets acquired in a *taxable* purchase of assets, the section does not authorize amortization where assets are acquired in a *nontaxable* acquisition in which acquired assets receive carryover basis. *See* GINSBURG ET AL., *supra* note 14, ¶ 403.4.1.2; Willens, *supra* note 28, at 601. Ginsburg et al. point out that § 197 applies to "(1) any [stepped-up basis] acquisition and (2) any [carryover basis] acquisition with a separately purchased non-compete covenant." GINSBURG ET AL., *supra* note 14, ¶ 403.4.1.2. Category two is outside the scope of this Note. Therefore, for our purposes, § 197 affects "[i]ntangible

The first supercharged IPO strategy to take advantage of § 197(a) used a qualified stock purchase (QSP) to exploit the basis step-up available under § 338(h)(10).[63] Electing to conduct a stock purchase or sale under this provision permits the purchase or sale to be deemed a purchase or sale of assets for income tax purposes.[64] Section 338(d)(3) defines a QSP as "any transaction or series of transactions in which stock . . . of [one] corporation is acquired by another corporation by purchase during [a] 12-month acquisition period."[65] The purchaser must acquire "at least 80 percent of the total voting power of the stock" of the target and "at least 80 percent of the total value of the stock" of the target[66] and must be a corporation.[67] Further, § 338(h)(3) defines "purchase" as any acquisition of stock, subject to certain complex criteria.[68]

Corporate parents primarily use § 338(h)(10) to buy and sell target subsidiaries.[69] However, if a parent corporation wishes to sell a subsidiary in the public market through an IPO, for example, a QSP can be used to set up a § 338(h)(10) election, which results in a stepped-up basis[70] in the

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assets acquired in (1) a taxable purchase of assets . . . or (2) a taxable purchase of stock . . . with a Code § 338, § 338(h)(10), or § 336(e) election." *Id.* The ability to amortize intangibles that do not fall within the definition of a "section 197 intangible," § 197(d)(1), is unclear. Robert Willens, *General Electric 'Supercharges' the Genworth Financial IPO*, 104 TAX NOTES 661, 663 n.4 (2004). Willens explains that prior to the enactment of § 197, intangibles could be amortized only if they satisfied two criteria: "[t]he asset had to be 'separate and distinct' from goodwill *and* useful to the business for only a limited period the duration of which could be ascertained with 'reasonable accuracy.'" *Id.*

63 Avent & Simon, *supra* note 5, at 84; Paul & Sabbah, *supra* note 2, at 76.

64 I.R.C. § 338(h)(10) (2012); Paul & Sabbah, *supra* note 2, at 76; *see also* Avent & Simon, *supra* note 5, at 84 (describing the consequences of electing to conduct a stock purchase under § 338(h)(10)).

65 § 338(d)(3).

66 *Id.* § 1504(a)(2); *see* Avent & Simon, *supra* note 5, at 75.

67 § 338(d)(3). A partnership or individual can meet this requirement by forming a corporation to purchase the target's stock, but the corporation cannot "merg[e] downstream into target, liquidat[e], or otherwise dispos[e] of the target stock following the purported" QSP. Treas. Reg. § 1.338-3(b)(1) (2001); *see* Avent & Simon, *supra* note 5, at 75.

68 § 338(h)(3); Willens, *supra* note 62, at 661. Section 338(h)(10) transactions are designed to meet these three complex criteria. Because the transactions meet the criteria, they are referred to as "busted 351" transactions. Section 351 permits tax-free asset transfers from one corporation to another, provided the first corporation is "in control" of the second. § 351(a). Control is defined in § 368(c) as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares." § 368(c). If a transaction satisfies § 351, the transaction would not meet the criteria in § 338(h)(3) and no § 338(h)(10) election for stepped-up basis would be available. However, by "busting 351," a parent transferor and a transferee can make a § 338(h)(10) election and treat the transfer as a taxable sale of assets and not a sale of stock. To bust § 351, the parent usually sells a portion of their equity in the transferee to the public through an IPO. Thus, the transferee becomes a public company. Paul & Sabbah, *supra* note 2, at 76.

69 Avent & Simon, *supra* note 5, at 74.

70 *See supra* note 57.

subsidiary's assets[71] when combined with the public offering.[72] The Belden IPO described in the Introduction is one of the earliest examples of using a § 338(h)(10) election to pave the way for a TRA to supercharge its IPO.[73]

Thus, to restructure a QSP into a supercharged IPO, the pre-IPO owner (the Parent, in the above scenario) must organize a new corporation (Newco) and transfer to Newco the stock of the subsidiary (Target) that will be sold in the public market.[74] In exchange for contributing stock of Target to Newco, Parent receives stock of Newco, plus additional consideration, such as a note for future cash payments.[75] Simultaneously, Parent hires an underwriter and agrees to sell at least 80% of its Newco stock to the underwriter.[76] The underwriter, in turn, sells the stock to the public.[77] By transferring 80% of the Newco stock to an underwriter for public sale, Parent ensures it will lack the 80% ownership requirement for control under § 351, which otherwise could result in a tax-free exchange.[78] By following the procedure above, Newco makes a QSP of Target under § 338. Finally, because Target is now part of Parent's consolidated group for tax purposes, Parent and Newco may make a § 338(h)(10) election, giving Newco a stepped-up basis in the assets owned by Target.[79] Since § 338(h)(10) applies, Newco's purchase of Target is deemed an asset purchase, and § 197(a) permits the amortization of intangibles.[80] A TRA is then used to share Newco's new tax benefits with Parent.[81]

One historic example of a § 338(h)(10) transaction is General Electric's (GE) 2004 spin-off IPO of Genworth Financial, Inc.[82] Genworth obtained a new, stepped-up basis in the GE subsidiaries it acquired, benefitting both GE and Genworth.[83] First, Genworth was able to utilize

[71] *See* Avent & Simon, *supra* note 5, at 74–75.

[72] This "busts" § 351. *See supra* note 68.

[73] *See* Elliott, *supra* note 1, at 334.

[74] Avent & Simon, *supra* note 5, at 74–75.

[75] *Id.* The note ensures that the transaction fails to meet the requirements of § 368(a)(1)(B) for a tax-free reorganization. *See* I.R.C. § 368(a)(1)(B) (2012); Avent & Simon, *supra* note 5, at 89.

[76] Avent & Simon, *supra* note 5, at 75.

[77] *Id.*

[78] *Id.* If the exchange is tax-free, then there will be no stepped-up basis and the IPO will not be supercharged. *See* §§ 351(a), 368; *see also supra* note 14.

[79] *See* § 338(h)(10); Avent & Simon, *supra* note 5, at 75; Willens, *supra* note 62, at 662.

[80] § 197(a); Avent & Simon, *supra* note 5, at 75; Paul & Sabbah, *supra* note 2, at 76; *see* text accompanying notes 63–64.

[81] Avent & Simon, *supra* note 5, at 84.

[82] *See* Raymond Hennessey, *Genworth Goes Public in Year's Largest IPO*, WALL ST. J. (May 26, 2004, 12:01 AM), http://www.wsj.com/articles/SB108549812788820708 [https://perma.cc/47ZZ-2YLH]; Willens, *supra* note 62, at 661.

[83] Willens, *supra* note 62, at 662.

§ 197, which allowed it to amortize the cost of acquired goodwill over fifteen years.[84] Second, a stepped-up basis in non-amortizable assets reduced the taxable gain that Genworth reported when Genworth sold those assets.[85] Finally, Genworth experienced significant tax savings over time as a result of the tax deductions associated with the amortization and stepped-up basis.[86] Of course, the TRA between Genworth and GE required that Genworth pass back 80% of the tax savings resulting from its IPO.[87]

B. Publicly Traded Partnerships

In the mid-2000s, investment partnerships, such as private equity firms, began utilizing I.R.C. sections other than § 338(h)(10) to create tax assets that could be combined with TRAs to supercharge the IPOs of their publicly traded partnerships (PTPs).[88] PTPs are taxed as corporations, unless the partnership is eligible for a qualifying income exemption and is not a regulated investment company.[89] Under the qualifying income exemption, a PTP is not subject to taxation as a corporation if 90% of its gross income comes from sources such as interest, dividends, and gains from the sale of certain assets.[90]

In the PTP structure, a publicly traded entity causes a subsidiary to purchase interests in a private equity firm's businesses through an investment fund.[91] The purchases entitle the subsidiary to a stepped-up basis in the acquired assets.[92] Thus, the purchasing subsidiaries also benefit

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[84] *Id.*

[85] *Id.*

[86] *Id.* (discussing amortization in the context of "antichurning," which is beyond the scope of this Note).

[87] *Id.*; *see* Genworth Fin. Inc., Annual Report (Form 10-K), at 64 (Mar. 2, 2015) (describing the present value of the TRA payments as $216 million as of December 31, 2014, with cumulative payments capped at $640 million).

[88] An early example, and likely the first instance of a supercharged publicly traded partnership, is the IPO of investment bank, Lazard Ltd., in May 2005. Elliott, *supra* note 1, at 334.

[89] I.R.C. § 7704(a), (c)–(d) (2012). Examples of publicly traded partnerships include Blackstone Group, Carlyle Group LP, and KKR & Co.

[90] *See id.* § 7704(c)(2), (d)(1). A regulated investment company is an investment fund that fits certain criteria and does not need to pay federal income tax on shareholder distributions. The required criteria are rather strict. *See* § 851; Joseph A. Riley, *The Regulated Investment Company Modernization Act of 2010*, INV. L., May 2011, at 3.

[91] Willens, *supra* note 28, at 603; *see* The Blackstone Grp. L.P., Amendment No. 9 to Form S-1 Registration Statement (Form S-1/A), at 69 (June 21, 2007) [hereinafter Blackstone S-1 Amendment]. Blackstone's S-1/A filing intricately describes the Blackstone structure, which is beyond the scope of this Note.

[92] In these cases, there is no need for a § 338 election because the assets themselves are being acquired, not the stock of the corporation that owns the assets. Willens, *supra* note 28, at 603. See *supra* note 57 for a discussion of the implications of the increased basis. In short, a higher basis leads to a lower capital gain if the assets are sold.

from § 197(a)'s amortization deductions for acquired intangibles.[93] As in the § 338(h)(10) transactions, TRAs compel the purchasing subsidiaries to pay the transferors (entities owned by private equity firms) a percentage of the subsequent tax savings.[94] Furthermore, since the structure is set up as a partnership, when the pre-IPO owners sell their securities, they will pay tax at the capital gains rate.[95] The PTP, on the other hand, receives the benefit of amortization deductions on income that would otherwise be taxed at the higher corporate tax rate.[96]

The highest profile, and most controversial, supercharged PTP IPO was The Blackstone Group, L.P.'s (Blackstone) IPO in 2007. As part of the IPO, Blackstone's subsidiaries entered into a TRA with the pre-IPO owners whereby the subsidiaries agreed to pay 85% of the cash savings resulting from the depreciation and amortization associated with the stepped-up basis.[97] Total payments under the TRA were expected to be $863.7 million, or between $35.5 million and $77.3 million per year for fifteen years.[98] In fact, the PTP structure was so efficient from a tax perspective that experts estimated the pre-IPO owners would receive $198 million (in present value) more in TRA payments from the IPO than they would pay in taxes.[99]

The U.S. Senate responded to the PTP structure by introducing legislation that would force companies such as Blackstone and Fortress Investment Group LLC, the first adopter of the PTP strategy, "to organize as corporations instead of partnerships for federal tax purposes."[100] In addition, the House of Representatives proposed legislation that targeted TRAs specifically.[101] The legislation proposed that "if a sale or exchange of a partnership interest contained a TRA, . . . any gain recognized by the transferor—stemming not just from the TRA payments but from all income generated by the partnership interest—would be treated as ordinary income."[102] Eliminating the different tax treatment for capital gains and

[93] Willens, *supra* note 28, at 603.

[94] *Id.*

[95] Elliott, *supra* note 1, at 334.

[96] *Id.*

[97] Blackstone S-1 Amendment, *supra* note 91, at 25.

[98] *Id.*

[99] David Cay Johnston, *Tax Loopholes Sweeten a Deal for Blackstone*, N.Y. TIMES (July 13, 2007), http://www.nytimes.com/2007/07/13/business/13tax.html?_r=0&pagewanted=print [https://perma.cc/VMS4-ATG2].

[100] Ryan J. Donmoyer & Elizabeth Hester, *Blackstone, Fortress Tax Structure Targeted by Senate (Update5)*, BLOOMBERG (June 15, 2007, 5:27 PM), https://www.bloomberglaw.com/document/JJP4XU0D9L35 [https://perma.cc/TJ82-XDFT].

[101] H.R. REP. NO. 110-431, at 24 (2007); Elliott, *supra* note 1, at 334–35.

[102] Elliott, *supra* note 1, at 335; *see* H.R. REP. NO. 110-431, at 24.

ordinary income in this context would have removed all incentive to pursue the PTP structure. While none of the proposed legislation became law, tax treatment of passthrough entities remains a controversial subject.[103] Most of the controversy stems from the notion that PTPs cross a line "between reasonably lowering their tax burdens and pretending to be something they're not to avoid most, if not all, corporate taxes."[104]

C. Up-Cs

The third iteration of supercharged IPOs utilizes an Up-C structure in combination with a TRA. The Up-C structure allows partnerships to execute a supercharged IPO even when they cannot satisfy the qualifying income exception[105] necessary for the PTP structure.[106] In these transactions, although the pre-IPO owners do not pay corporate income tax on their income, the public entity still pays corporate tax on its income, unlike in PTP structures.[107]

In an Up-C IPO, a new corporation is formed, which acts as the public entity.[108] The public company (Pubco) uses the money raised in the IPO to purchase partnership or limited liability company interests in the operating partnership from the pre-IPO owners.[109] The pre-IPO owners may retain operating partnership interests as well, but are not required to do so.[110] If the pre-IPO owners retain interests, the interests are recapitalized so that they are equal in value to the shares of Pubco and exchangeable for Pubco's stock.[111] As part of the transaction, Pubco will make a § 754 election, which gives a purchaser of partnership interests a stepped-up basis in the partnership assets.[112] Consequently, when the pre-IPO owners sell their interests to Pubco, Pubco will obtain a stepped-up basis in its share of

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103 Elliott, *supra* note 1, at 335.

104 Donmoyer & Hester, *supra* note 100 (quoting Senator Charles Grassley of the Senate Finance Committee).

105 *See* I.R.C. § 7704 (c)–(d) (2012); *supra* text accompanying note 89.

106 Elliott, *supra* note 1, at 335.

107 *Id.* Compare to PTP structures where the public partnership, subject to satisfying § 7704, pays corporate-level tax only on its share of the fee/services income. *Id.* at 334.

108 Paul & Sabbah, *supra* note 2, at 76. The Up-C is a derivation of an "UPREIT," or umbrella partnership real estate trust, a structure popular for public companies that invest in real estate. Elliott, *supra* note 1, at 336. The structure allows property owners to be compensated in partnership units of the real estate investment trust when they sell their property to the real estate investment trust. Hart, *supra* note 54, at 6. This minimizes taxes through the use of a nontaxable, like-kind exchange mechanism. *Id.* at 8.

109 Paul & Sabbah, *supra* note 2, at 76.

110 *Id.*

111 *Id.*; Elliott, *supra* note 1, at 336.

112 I.R.C. §§ 754, 743 (2012); Paul & Sabbah, *supra* note 2, at 76.

the operating partnership's assets.[113] The TRA between Pubco and the pre-IPO owners will then transfer a percentage of the tax benefits associated with the stepped-up basis back to the pre-IPO owners.

In April 2015, GoDaddy, Inc. launched its IPO using an Up-C structure.[114] GoDaddy was a party to five TRAs with its pre-IPO private equity owners.[115] The TRAs called for those entities to receive 85% of the tax savings resulting from the IPO.[116] Prior to the IPO, GoDaddy estimated that total payments due under the TRAs could total up to $1.4 billion,[117] one of the largest estimated TRA payments to date.[118] The Up-C structure remains popular with additional high-profile IPOs.[119] Given the evolution of supercharged IPOs since the original enactment of § 197(a), it is apparent that the concept is here to stay. In light of the increasing popularity of transferring tax benefits, Part II will evaluate the policy behind permitting or restricting the monetization of tax benefits.

II. THE MONETIZATION OF TAX BENEFITS

The federal government has adopted different stances regarding the monetization of tax benefits.[120] The academic debate has been equally divided. Some scholars claim that monetizing tax benefits incentivizes beneficial behavior[121] and increases competitive equality.[122] Other scholars argue that tax benefits are inalienable from the taxpayers who earned or

113 Elliott, *supra* note 1, at 334. The pre-IPO owners will either sell their interests to Pubco for purposes of the IPO or, after the IPO, exercise a right to exchange operating partnership interests for Pubco stock. Paul & Sabbah, *supra* note 2, at 76. The Up-C structure mimics Example 4 in § 1.701-2(d) of the income tax regulations, which describes a similar structure for REITs. Treas. Reg. § 1.701-2(d) (1994).

114 GoDaddy Inc., Amendment No. 7 to Form S-1 Registration Statement (Form S-1/A), at 7 (Mar. 19, 2015) [hereinafter GoDaddy S-1 Amendment]; *see also* Angela Chen, *GoDaddy Posts Upbeat Guidance as Sales Grow 18%*, WALL ST. J. (May 12, 2015, 5:00 PM), http://www.wsj.com/articles/godaddy-posts-upbeat-guidance-as-sales-grow-18-1431463377 [https://perma.cc/S83S-AQKW] (discussing the GoDaddy IPO).

115 GoDaddy S-1 Amendment, *supra* note 114, at 13.

116 *Id.*

117 *Id.* at 48.

118 This conclusion is based on the author's review of publicly available registration statements and TRAs.

119 *See, e.g.*, Shake Shack Inc., Registration Statement (Form S-1), at 14 (July 20, 2015).

120 *Compare* Wallace, *supra* note 52, at 227, 244–46 (describing the adoption of safe harbor leasing in 1981, the political backlash that followed, and the subsequent repeal in 1982), *with id.* at 38–41 (describing the temporary enactment and permanent adoption of the popular tradeable low-income housing tax credit). See *infra* Section II.B.1 for a discussion of the failed safe harbor leasing program and *infra* Section II.B.3 for a discussion of tradeable low-income housing tax credits.

121 *See* Wallace, *supra* note 52, at 238.

122 Warren & Auerbach, *supra* note 46, at 1772.

created the benefit,[123] and that most systems of monetization would be too administratively complex.[124] This Part will place these debates in context, outlining examples to clarify the views on both sides. Then, Part III will utilize this framework to evaluate supercharged IPOs and TRAs and argue that permitting monetization of tax benefits through the use of TRAs in the IPO context is beneficial, and reflects many of the positive attributes of monetization while avoiding many of the negative aspects.

Accordingly, this Part will begin by examining past and present policies toward the monetization of tax benefits and the theories supporting various views. Then, it will apply these various theories to different types of proposed transactions, each of which has received different treatment under the I.R.C. Finally, by way of example and application, it will discuss the I.R.C.'s treatment of leasing depreciable property, selling NOLs, and investing in specific entities that receive tax incentives from the government. This will lay the foundation for this Note's ultimate argument that TRAs in the supercharged IPO context should be viewed favorably in light of the positive qualities they share with the tax advantages of NOLs and investable tax credits, while simultaneously avoiding the complications that doomed the safe harbor leasing program.

A. Theories and Justifications of the Monetization of Tax Benefits

This Section discusses justifications for and against the monetization of tax benefits, initially within the context of the Economic Recovery Tax Act of 1981 (ERTA), the first federal program explicitly permitting the monetization of federal tax benefits.[125] Initially, the ERTA justified monetization on the grounds that different companies with different abilities to use tax benefits should be treated equally from a tax perspective.[126] Today, advocates of monetization argue that monetization increases risk-taking and investment in the economy.[127] Similarly, some contend monetization permits more efficient allocations of resources.[128] Conversely, opponents of monetization argue that monetization leads to tax avoidance, is poorly understood by the public, costs the federal government significant amounts of money, and is a poor substitute for other policy

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[123] Tsilly Dagan & Talia Fisher, *Rights for Sale*, 96 MINN. L. REV. 90, 93 (2011).

[124] Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 73 (2006).

[125] *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172; B. Anthony Billings & Buagu Musazi, *Monetize Tax Assets to Improve Bonus Depreciation Incentive*, 119 TAX NOTES 299, 299 (2008).

[126] Warren & Auerbach, *supra* note 45, at 1759–60.

[127] *See, e.g.*, Billings & Musazi, *supra* note 125, at 299–300.

[128] *See, e.g.*, Dagan & Fisher, *supra* note 123, at 132.

tools.[129] Moreover, scholars point out that tax benefits are inherently inalienable: they are attached to the taxpayer that earned the benefit.[130]

When the ERTA[131] was enacted, monetization proponents reasoned that all companies, regardless of profitability, should be treated equally from a tax perspective; the government, if it was going to cut taxes, should not favor more profitable enterprises.[132] However, equality (or competitive neutrality) can be evaluated by various measures and is at best an unclear term. For example, one goal of monetization could be to enable companies to achieve equal, if not similar, after-tax costs of capital for investments in the same assets, all else equal.[133] Another goal could be to provide all companies, regardless of profitability, with the same dollar benefits with respect to the economic depreciation of the associated property.[134] Professors Alvin Warren, Jr. and Alan Auerbach demonstrate that the amount of tax benefits that should be transferable under either of these goals is not necessarily the same.[135] Thus, the idea of competitive neutrality, while attractive in theory, is difficult to implement through tax benefit monetization.

While competitive neutrality may be difficult to achieve through tax policy, there are other advantages to monetization. Monetized tax benefits more effectively allocate public resources and distribute tax benefits to those who need them.[136] Individuals who wish to take advantage of tax benefits beyond individual limitations could purchase excess tax benefits from those unable to capitalize on such benefits.[137] In other words, taxpayers could match their tax benefits to their individual needs.[138] More efficient allocation of resources would increase economic risk-taking by giving value to unused credits and deductions.[139]

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[129] *See, e.g.*, STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 53 (Comm. Print 1983).

[130] Dagan & Fisher, *supra* note 123, at 93; *see* text accompanying note 139.

[131] The ERTA and its safe harbor leasing program are discussed more fully in Section II.B.1.

[132] Warren & Auerbach, *supra* note 46, at 1768.

[133] *Id.* The Joint Committee on Taxation suggests that one reason for making depreciation deductions transferable was to provide loss companies with the same cost of capital as other firms. STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., DESCRIPTION OF SAFE HARBOR LEASING PROVISIONS UNDER THE ACCELERATED COST RECOVERY SYSTEM 2 (Comm. Print 1981).

[134] Warren & Auerbach, *supra* note 46, at 1769–70.

[135] *Id.* at 1770.

[136] Dagan & Fisher, *supra* note 123, at 132.

[137] *Id.*

[138] *Id.*

[139] These were among the arguments advanced by the Treasury Department when monetization was again considered by Congress in 2007. Billings & Musazi, *supra* note 125, at 299.

However, because tax benefit monetization is complex and relatively novel, there are significant problems associated with the implementation of any such program. Depending on how a monetization scheme is structured, there may be significant tax avoidance opportunities, a hostile public reaction to the notion of selling tax benefits, and a large revenue cost to the federal government.[140] These were among the problems associated with the ERTA, which led to its repeal.[141] Furthermore, since tax benefits are allocated on a taxpayer basis (i.e., tax benefits are given directly to those taxpayers that qualify, as opposed to a third party), such benefits are widely considered "inherently personal and inalienable."[142] From the perspective of an individual taxpayer, this makes sense: deductions and credits are typically awarded to taxpayers who either earned the tax benefit (e.g., by donating money or goods to a charity) or have a defined feature that entitles them to the benefit (e.g., by having a certain number of children).[143] However, even though most tax benefits are thought of as inalienable, scholars acknowledge tax planners frequently find ways to effectively transfer these benefits.[144] Furthermore, there could be significant benefits to monetizing such tax benefits by making them alienable. After all, alienability allows tax benefits to flow to those who value them the most.[145]

Regardless, there is widespread belief that the tax system is not an instrument of social policy.[146] Scholars argue the tax system is a tool for revenue collection, not a market for government benefits.[147] Similarly, the complexity associated with monitoring a system in which tax benefits are monetized may be too administratively complex.[148] Nevertheless, these

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[140] STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., *supra* note 129, at 53.

[141] *Id.*

[142] Dagan & Fisher, *supra* note 123, at 93. Professor Daniel Shaviro states that "the folk definition of 'taxes' that governs our fiscal language apparently holds that favorable tax attributes, such as credits and deductions, cannot properly be traded." SHAVIRO, *supra* note 47, at 17.

[143] Dagan & Fisher, *supra* note 123, at 125 n.143.

[144] *Id.* Professor Shaviro goes so far as to colorfully describe a tax planner's job as "finding pinpricks in the law and driving trucks through them." SHAVIRO, *supra* note 47, at 54.

[145] Dagan & Fisher, *supra* note 123, at 132–33.

[146] Tracy A. Kaye, *Sheltering Social Policy in the Tax Code: The Low-Income Housing Credit*, 38 VILL. L. REV. 871, 872–73 (1993).

[147] Wallace, *supra* note 52, at 265. *But see* Batchelder et al., *supra* note 124, at 26–29 (confronting arguments that tax incentives narrow the tax base and complicate the system). Batchelder et al. argue that refundable tax benefits are the ideal method of creating behavioral incentives in the I.R.C. *Id.* at 28–29. Refundable tax credits, whereby the government will refund the taxpayer if the value of the credit exceeds the taxpayer's tax liability, are another form of monetizing tax benefits. Instead of creating a market for tax benefits, refundable tax credits give taxpayers money directly so they realize the full value of the credit.

[148] Batchelder et al., *supra* note 124, at 73. Even if other areas of the government were used to deliver the same benefits as monetized tax benefits (e.g., providing some form of government subsidy

concerns may be overcome through careful structuring of the monetization program. Additionally, shifting a government program out of the tax system into another area of government may only shift the total amount of bureaucracy and administrative tasks, without actually minimizing burdens. The following Section will apply these advantages and disadvantages to specific tax programs, which will then be compared to TRA-enabled supercharged IPOs.

B. Application to Current Tax Benefits

The preceding Section discussed the dominant reasoning and theories supporting and opposing the monetization of tax benefits. This Section will apply the principles discussed above to several common tax transactions where the government has taken differing positions regarding the monetization of the associated tax benefits. Identifying the benefits and concerns of three different tax transactions will lay the foundation to demonstrate that supercharged IPOs share the benefits of these transactions without the downsides. The qualities of tax transactions described in this Section justify permitting the use of TRAs to supercharge IPOs.

1. "Leasing" Depreciable Property.—"Leasing" depreciable property for the purpose of monetizing the tax benefits associated with the depreciation and any other investment tax credits is generally prohibited.[149] However, in 1981, Congress enacted the ERTA in an effort to stimulate the economy.[150] The ERTA contained a statutory safe harbor for leasing transactions and was the first federal program explicitly permitting the monetization of federal tax benefits.[151] The ERTA instituted an investment tax credit for purchases of certain types of property, generally machinery and equipment, and increased the rate of depreciation for other forms of property.[152] By implementing a system of statutory depreciation deductions plus tax credits, the ERTA enabled businesses to recover capital costs (through a reduction in taxes) for machinery and equipment faster than a

for loss corporations instead of permitting the future deductibility of net operating losses), there is an argument that administrative hurdles otherwise faced by the IRS will be replaced by the same administrative headaches at other agencies. Wallace, *supra* note 52, at 265–66.

149 STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 96 (Comm. Print 1987) ("Essentially, the law is that the economic substance of a transaction, not its form, determines who is the owner of the property for tax purposes. . . . [L]ease transactions cannot be used solely for the purpose of transferring tax benefits; they have to have nontax economic substance.").

150 Billings & Musazi, *supra* note 125, at 299.

151 *Id.*

152 Warren & Auerbach, *supra* note 46, at 1753. S*ee generally* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

system tied to economic depreciation.[153] However, the substantial tax benefits available under the ERTA were only available to companies with available income that the benefits could offset.[154] This meant that companies without income, usually startups and more mature companies operating at a loss (loss companies[155]), were effectively deprived of the ERTA tax benefits.[156]

Startups, which traditionally invest substantially in depreciable property, generally have no income for the credits and deductions to offset.[157] Loss companies also do not have any income, making them effectively tax-exempt.[158] In comparison, profitable companies, which invest in the same assets as startups and loss companies, are more likely to have excess income, enabling them to take advantage of the deductions and credits.[159] Lawmakers wanted startups and loss companies to be able to realize the same benefits from the program as profitable companies for two reasons. First, Congress thought the government should avoid favoring different investors in comparable projects.[160] Reduced taxes for some companies but not others could be economically inefficient if the companies that can take advantage of the tax benefits are not those "best able" to use the qualified property.[161] Second, a lack of government neutrality could lead to tax-induced mergers as profitable companies sought to acquire the unused tax benefits of startups and loss companies.[162]

To remedy this problem, Congress monetized the ERTA benefits through safe harbor leasing, which made the benefits transferable from companies that had no use for them to those that could use them to offset income.[163] In a safe harbor leasing transaction, tax benefits are not directly bought and sold. Instead, Company A, which seeks to invest in depreciable

[153] Warren & Auerbach, *supra* note 46, at 1753. The new depreciation system was known as the Accelerated Cost Recovery System (ACRS). ACRS was replaced by the Modified Accelerated Cost Recovery System (MACRS), still in use today, as part of the Tax Reform Act of 1986. Pub. L. No. 99-514, § 201, 100 Stat. 2085.

[154] Warren & Auerbach, *supra* note 46, at 1758.

[155] These companies, as defined by Warren and Auerbach, have little to no taxable income, which means they pay little to no tax. *Id.* at 1760.

[156] *Id.* at 1758–61.

[157] *See id.* at 1758–59.

[158] *Id.* at 1760.

[159] *See id.* at 1759.

[160] *Id.* at 1760; *see* STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., *supra* note 133, at 2 (discussing alternative proposals Congress considered to monetize the ERTA benefits so that they would not be lost by companies unable to use them).

[161] Warren & Auerbach, *supra* note 45, at 1761.

[162] *Id.* at 1760; *see* STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., *supra* note 133, at 2.

[163] SHAVIRO, *supra* note 47, at 17–18.

property such as a machine, but which cannot take advantage of the associated tax credits and deductions, will ostensibly sell the machine to Company B.[164] Company B will simultaneously lease the machine back to Company A. Company B would claim the depreciation deductions and investment tax credits as the machine's owner, while Company A would enjoy the use of the machine.[165] While similar sale–leaseback transactions were already common, the ERTA condoned transactions that "involve[d] nothing beyond mere paper shuffling, as opposed to being required to meet some minimum standard of genuine economic effect."[166]

Congress repealed the safe harbor leasing rules in 1982.[167] Significant problems arose with the program, including non-payment of taxes, public outcry at the idea of companies selling tax benefits, lost government revenue, and the ability to accomplish the same goals through alternative means.[168] Perhaps also important was that the sale–leaseback mechanism represented a "significant deviation" from the traditional rule in tax policy that the substance of a transaction, not the form of the transaction, determines tax liability.[169] As this Note will demonstrate, these concerns are largely absent in the TRA-enabled supercharged IPO context.

Congress considered addressing the monetization of tax assets again in 2004 and 2007, but monetization was not adopted in any final legislation.[170] In a 2007 Treasury Department report, the Treasury reasoned that the current tax system discourages risk-taking by "taxing profits but not refunding the tax effect of losses and unused tax credits."[171] Permitting firms to monetize tax assets would allow the startup and loss companies described above to benefit equally with other companies that pay a higher marginal tax rate.[172] This would potentially induce additional capital investment.[173]

Since the repeal of the safe harbor laws, the Internal Revenue Service (IRS) has instituted guidelines that determine when a contract is a lease

[164] *Id.* at 18.

[165] *See id.* (describing this transaction in more detail).

[166] *Id.*

[167] *Id.*

[168] STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., *supra* note 129, at 53.

[169] Warren & Auerbach, *supra* note 46, at 1762; *see, e.g.*, Gregory v. Helvering, 293 U.S. 465, 469–70 (1935) (holding that in a corporate reorganization, a taxpayer will be bound by the economic substance of a transaction, not necessarily the legal form of the transaction).

[170] Billings & Musazi, *supra* note 125, at 299.

[171] *Id.*

[172] *Id.* at 300.

[173] *Id.*

versus a "conditional sales contract."[174] Fundamentally, these rules look at the "economic substance of a transaction, not its form."[175] Under this standard, "lease transactions cannot be used solely for the purpose of transferring tax benefits; they have to have nontax economic substance."[176] In other words, the tax benefits associated with leasing can no longer be bought and sold absent some other economic justification for the transaction.

Safe harbor leases were only consistent with the theory that tax law should be neutral among loss companies and profitable companies in the most general sense. There were several issues with the safe harbor leasing program that did not allow it to achieve equality, leading to its abuse and repeal.

One theory of transferability under a program of competitive neutrality is to equalize the after-tax costs of capital when investing in the same assets.[177] However, the safe harbor leasing program required that any safe harbor lease be done on terms prescribed by the Treasury Department, consistent with a fictional loan used to acquire the property, which did not necessarily correspond with actual capital costs.[178] As a result, the market terms requirement did not ensure that profitable and loss companies were treated neutrally through equal after-tax costs of capital.[179]

A second theory of competitive neutrality is that transferability should enable different taxpayers to receive equal dollar benefits under the monetization program.[180] However, the down payments in the safe harbor lease transactions were calculated using a formula that incorporated the taxes on the lease income the lessor would receive over the length of the

[174] Rev. Rul. 55-540, 1955-2 C.B. 39, 41. The Tax Reform Act of 1986 repealed the finance lease rules which succeeded the safe harbor rules and never became fully effective. Tax Reform Act of 1986, Pub. L. No. 99-514, § 201, 100 Stat. 2085. Consequently, the earlier pre-ERTA leasing rules govern whether a transaction qualifies as a lease for tax purposes. The guidelines used by the IRS to evaluate leases are summarized in IRS Revenue Ruling 55-540, which states that "[w]hether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement . . . . Each case must be decided in the light of its particular facts." Rev. Rul. 55-540, 1955-2 C.B. 39, 41. A conditional sales contract, sometimes known as a retail installment contract, is an agreement whereby the buyer takes possession of the sold property while title remains with the seller, subject to installment payments made by the buyer. After the buyer fully pays for the property, the buyer receives title. *Retail Installment Contract*, BLACK'S LAW DICTIONARY (9th ed. 2011).

[175] STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., *supra* note 149, at 96.

[176] *Id.*

[177] Warren & Auerbach, *supra* note 46, at 1768.

[178] *Id.* at 1769.

[179] *Id.*

[180] *Id.* at 1769–70.

lease, instead of tax reductions the lessor would experience from economic depreciation that occurred over a shorter period of time.[181] This resulted in larger down payments upon the sale of the property than necessary to compensate for the sold tax benefits, resulting in an unequal stream of benefits received by the parties.[182]

A third theory of competitive neutrality takes for granted the difference in tax benefits between a lessor and lessee before the enactment of the monetizing rule.[183] Instead, the theory argues companies should only be able to monetize the incremental benefit of future subsidies.[184] However, even from this perspective, the safe harbor leasing rules failed to eliminate inequality.[185] There was still a considerable mismatch between the down payments in the leasing transactions and the incremental benefit of the tax subsidies.[186]

An additional problem with the safe harbor program, and another reason why leasing depreciable property without an economic reason is prohibited, is that under the fiction of leasing, the creditworthiness of the lessee is an important consideration.[187] If a party to one of these transactions entered bankruptcy, it was unclear how the amounts payable and receivable under the leasing contract would be treated. For example, if the lessee entered bankruptcy, would the bankruptcy court unwind the entire transaction or only discharge the payments made by the lessee?[188]

A similar problem related to monetized tax benefits generally, and safe harbor leases specifically, is that the buyer of the tax benefit needs to ensure that the seller legitimately earned the benefit in the first place.[189] In the case of safe harbor leases, buyers essentially became Treasury Department stand-ins for audit purposes.[190] This necessarily required

[181] *Id.* at 1770. Warren and Auerbach's calculations on this matter are fairly complex and involve several assumptions but reach the conclusion that the sellers of the tax benefits receive a larger down payment upon the lease of the equipment than they otherwise would in a scenario where both parties benefitted equally from the safe harbor lease rules over time. *Id.* at 1770–71.

[182] *Id.*

[183] *Id.* at 1771.

[184] *Id.*

[185] *Id.* at 1770.

[186] *Id.* at 1770 & tbl.V.

[187] *Id.* at 1776.

[188] *Id.* at 1776–77. This also raises the question of whether the tax benefits are severed from the property. Would the lessor continue to receive the full tax benefits of the transaction or would there be some sort of recapture? *See id.* at 1776 (questioning whether the transferee of an asset subject to a safe harbor lease would also receive the remaining tax benefits and how recapture rules would work).

[189] *Id.* at 1777.

[190] *Id.*

additional transaction protections such as indemnities, adding further complexities to the transactions.[191]

The system quickly grew out of control: in 1981 alone, the Treasury Department estimated that $19.1 billion of equipment had been leased under the program, with billions of dollars of potential revenue loss for the government.[192] The public turned against the system as the government realized the full cost of the program and perceived abuses were publicized.[193] Notably, General Electric was able to offset its entire 1981 tax liability through the program even though it had pretax earnings of $2.66 billion.[194] Moreover, it also purchased tax benefits to offset prior years' tax payments totaling $90 million.[195] In another instance, Occidental Petroleum Corp. was able to sell tax benefits attributable to almost $95 million of equipment.[196] In the face of mounting public criticism and ballooning federal deficits, the program was phased out.[197]

2. Selling NOL.—Another analogous tax transaction is the purchase and sale of NOLs, which may be partially monetized. Since these involve the transfer of tax benefits from one enterprise to another, subject to a well-defined set of rules, they are comparable to supercharged IPOs. NOLs occur when a taxpayer has deductions in excess of gross income for a given tax year, resulting in a net loss for the year.[198] Taxpayers are permitted to carry the loss back to apply to the two preceding years, or carry it forward up to twenty years.[199] In either case, the NOL is allowed as a deduction from the taxable income for that year.[200] Monetization occurs through § 381, which permits an acquiring corporation to carry over certain tax attributes, including NOLs, of the acquired corporation.[201]

The possibility of monetizing NOLs through acquisitions raises the specter of "trafficking" in NOLs: corporations engaging in acquisitions for the sole purpose of acquiring the target's NOLs. Congress has struggled with how to respond to the possibility of trafficking, or monetizing,

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191 *Id.* at 1777–78.

192 Richard J. Bronstein & Alan S. Waldenberg, *The Short Life and Lingering Death of Safe Harbor Leasing*, 69 A.B.A. J. 1844, 1846 (1983).

193 *Id.*

194 *Id.*

195 *Id.*

196 *Id.*

197 *Id.*

198 I.R.C. § 172(c) (2012). Gross income is "all income from whatever source derived." *Id.* § 61(a).

199 *Id.* § 172(b)(1)(A).

200 *Id.* § 172(a).

201 *Id.* § 381(a), (c); *see* ABRAMS ET AL., *supra* note 4, at 346–47 (describing the main provisions of § 381).

NOLs.[202] The carryover provisions were initially enacted to rectify the limitations of an annual accounting system by performing an "averaging function" across accounting periods.[203] Permitting NOLs to offset unrelated income of an acquirer does not appear to serve any averaging function.[204] Thus, Congress enacted § 382 to remove the incentive for an acquirer to purchase a target solely for its NOLs.[205] Section 382 is triggered if "the percentage of the stock of a loss corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage owned by each such shareholder during" a period lasting up to three years.[206] Once § 382 is triggered by such an ownership change, it prohibits the use of target company NOLs as a tax deduction unless the new corporation either continues the business of the old target corporation for a two-year period or "uses a significant portion of the old loss corporation's assets in [the combined] business."[207]

Congress, the courts, and the Treasury Department have advanced four main rationales to support the notion that NOLs should not be monetized through ownership changes.[208] First, taxpayers should not be permitted to engage in transactions solely to reduce tax liability.[209] These transactions violate the principle of neutrality, discussed earlier,[210] which holds that tax law should treat all taxpayers similarly: it should neither stimulate nor inhibit business decisions.[211] Absent a legislative goal to encourage or discourage behavior, tax laws should not interfere with normal business decisions.[212]

Second, monetization opponents argue that, consistent with the principles of inalienability, the tax benefits associated with losses should be enjoyed by the taxpayer that actually incurred the losses.[213] Since the shareholders of a corporation are ultimately the beneficiaries of the tax

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202 ABRAMS ET AL., *supra* note 4, at 347. *See generally* Mark Hoenig, *Trafficking in Net Operating Losses: What's So Bad?*, 145 TAX NOTES 919 (2014) (discussing the history of and policy behind NOL provisions in the I.R.C., from 1918 through the Tax Reform Act of 1986).

203 ABRAMS ET AL., *supra* note 4, at 347.

204 *Id.*

205 *Id.* at 348.

206 *Id.* at 349 (footnote omitted). This relatively simple formula becomes much more complex when combined with corporate tax reorganizations and other highly-structured transactions. *See id.* at 349–51.

207 ABRAMS ET AL., *supra* note 4, at 351; *see* I.R.C. § 382(c) (2012).

208 Hoenig, *supra* note 202, at 931.

209 *Id.*

210 *See* discussion of tax neutrality, *supra* text accompanying notes 177–86.

211 Hoenig, *supra* note 199, at 931–32.

212 *Id.* at 932.

213 *Id.* at 933.

benefits earned by the corporation, restrictions on ownership changes ensure that those shareholders who experienced the corporate losses also share in the gain associated with the tax benefits.[214] Third, some maintain that shareholders would receive inadequate compensation when selling the NOLs.[215] Finally, some contend that tax benefits should only be available to offset income generated by the same activity from which the losses arose.[216] While NOLs are not entirely monetizeable, they provide an important comparison to the TRA payments in a supercharged IPO. As Part III will explore, many of the arguments in favor of restricting the transferability of NOLs justify TRA payments in the supercharged IPO context.

3. Investing in LIHTCs.— In contrast to leasing depreciable property to take advantage of tax benefits (which is prohibited), or trafficking in NOLs (which is subject to ownership restrictions and other requirements discussed above),[217] there are several existing tax credit programs designed to allow tax credits to be sold to third parties. This Section will explore the justifications for trading in one of these credits, the LIHTC, but there are other programs that function in similar fashion.[218]

The LIHTC incentivizes the development of low-income housing by providing a credit of 70% of the applicable basis of new buildings and 30% of the applicable basis for other qualified buildings.[219] The applicable basis is the amount invested by the developer in certain depreciable construction

[214] *Id.*

[215] *Id.* at 934. This argument seems particularly weak since the tax benefits are inherently valuable and every transaction is different. By restricting the transfer of the NOLs, the I.R.C. makes them even less valuable, not more valuable. *See id.* at 935. On the other hand, this could be viewed as a protective measure for sellers on the assumption that sellers may be smaller and have fewer resources dedicated to accounting and tax functions. Thus, they may not be in a position to value their tax assets as effectively as a larger, more sophisticated acquirer.

[216] *Id.* This argument derives from *Libson Shops, Inc. v. Koehler*, in which the Court disallowed the use of carryover NOLs in a situation where "the income against which the offset [was] claimed was not produced by substantially the same businesses which incurred the losses." 353 U.S. 382, 390 (1957) (footnote omitted), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

[217] *See supra* Section II.B.2.

[218] These tradeable tax credits include new markets tax credits (designed to encourage investment in low-income areas through financing small businesses, working to improve community facilities, etc.), historic preservation tax credits (designed to rehabilitate designated historic, income-producing buildings), and several programs related to the production of renewable energy. *See New Markets Tax Credit*, INTERNAL REVENUE SERV., U.S. DEP'T OF TREASURY 1 (2010), https://www.cdfifund.gov/Documents/atgnmtc.pdf [https://perma.cc/27VH-PXYS]; *Tax Incentives for Preserving Historic Properties*, NAT'L PARK SERV., DEP'T OF THE INTERIOR, http://www.nps.gov/tps/tax-incentives.htm [https://perma.cc/32EL-WGL4]; *see also* Wallace, *supra* note 52, at 237–47 (discussing examples of tradeable tax credits, including safe harbor leases).

[219] I.R.C. § 42 (2012); Wallace, *supra* note 52, at 238.

costs.[220] The credit is generally provided when the building is completed.[221] To qualify for the credit, the developer must agree to lease the units to groups of people that fall into one of two groups designated "low-income,"[222] and the building must be designated as low-income housing for at least fifteen years.[223] Any development eligible for the credit must usually apply to a state or local agency, with each state receiving a limited amount of credit from the federal government to disburse every year.[224]

The I.R.C. specifically monetizes LIHTCs by making them tradeable.[225] The government provides the tax credits to the owner of a qualified building, and since they survive transfers of ownership, the tax credit owners can sell their tax credits by selling interests in the property.[226] The I.R.C. also provides that the credits may be allocated to partners based on their "distributive share" or by agreement of the parties.[227] Finally, certain activity rules that limit the ability of partnerships to take advantage of tax benefits arising from passive activities are waived in the case of LIHTCs.[228] Read together, these provisions allow for a property ownership structure whereby the developer is a general partner in the limited partnership that owns the property, with responsibility for the project, and tax credit investors are limited partners who utilize the tax credits.[229] Investors then receive the benefits and are free to sell their share of the limited partnership, along with the tax benefit, as they please.[230]

There are at least two strong reasons for permitting freely transferable tax credits in this type of transaction that that cannot serve as rationales for safe harbor leasing or acquisitions of NOLs. First, monetizing the tax credits allows developers to obtain financing upfront by selling the tax credits to investors, effectively converting what would otherwise be a tax credit with value spread out over ten years into a single cash payment.[231]

220 Wallace, *supra* note 52, at 238.

221 § 42(f)(1).

222 Either 20% or more of the residential units must be "rent-restricted and occupied by individuals whose income is [50%] or less [than the] area median gross income," or 40% or more of the units must be "rent-restricted and occupied by individuals whose income is [60%] or less [than the] area median gross income." *Id.* § 42(g)(1).

223 *Id.* § 42(h)(6)(D).

224 Kaye, *supra* note 146, at 881–82.

225 *See* Wallace, *supra* note 52, at 239 (explaining the relevant I.R.C. provisions in greater detail).

226 § 42(d)(7).

227 *Id.* § 704(a)–(b); Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 2016).

228 § 469(i)(6).

229 Wallace, *supra* note 52, at 239.

230 *Id.*

231 *Id.*

Nonprofits, the traditional builders of low-income housing, cannot capitalize on the tax credits due to their tax-exempt status.[232] By permitting nonprofit developers to sell the tax credits to for-profit entities with taxable income, the government enables tax-exempt, nonprofit organizations to use credits that would otherwise be worthless to them.[233] In effect, monetizing the tax credits enables the government to incentivize actors that would otherwise be indifferent to tax incentives. Second, the LIHTC program has a well-defined public policy goal of providing affordable housing.[234] Unlike the safe harbor regime, which instituted a roundabout mechanism to provide tax benefits to startups and loss companies, the LIHTC is a federal subsidy.[235] Moreover, the beneficiaries of LIHTCs are well defined and "clearly defensible," namely, low-income individuals in need of affordable housing.[236]

The principal criticism of a system of tradeable tax benefits is that tradeable tax benefits are inherently complex and the IRS, a revenue collector, is not the best agency to implement what amounts to a social policy.[237] Furthermore, there are significant costs associated with the formation and management of the complex partnership structure that operates within the LIHTC program, and this complexity leads to enforcement concerns.[238] Those critical of LIHTCs argue that policy initiatives are better administered through programs that can be supervised by people with relevant expertise.[239] For example, the IRS likely has little development expertise.

Despite these administrative criticisms, policy programs that rely on tax expertise may actually be better enforced by the IRS.[240] For example, the LIHTC program requires anyone exercising oversight to have the tax knowledge to determine which expenses are depreciable and qualify toward

[232] *Id.* at 240.

[233] *Id.* The I.R.C. requires that at least 10% of a state's annual allocation of tax credits be given to nonprofit developers. § 42(h)(5)(A)–(B).

[234] Thomas W. Giegerich, *The Monetization of Business Tax Credits*, 12 FLA. TAX REV. 709, 750 (2012).

[235] *Id.*

[236] *Id.* In contrast, Alan Greenspan reportedly referred to safe harbor leasing as the "equivalent of food stamps for undernourished corporations . . . [which] basically subsidize capital investment in areas which the market wouldn't support." Bronstein & Waldenberg, *supra* note 192, at 1846. In the case of safe harbor leases, it was not easy to defend relaxing tax rules for corporations that already had minimized their federal tax liability.

[237] *See* Wallace, *supra* note 52, at 263 (arguing that tradeable tax benefits are "too complex to compete with the technical efficiency of other mechanisms of government intervention").

[238] *Id.* at 264.

[239] *Id.* at 265.

[240] *Id.* at 266.

the tax credit.[241] The IRS has the expertise and organization necessary to measure compliance with tax statutes.[242] Moreover, the LIHTC monetization scheme enlists the help of the third-party purchaser (in this case, the LIHTC investor) to verify that the transaction complies with the I.R.C.[243] This allows the IRS to "outsource" part of the "expertise and labor necessary for enforcement."[244] The LIHTC and similar programs are the most apparent, and perhaps common, example of easily monetized tax benefits. The success of the LIHTC program demonstrates that monetizing tax benefits can be an efficient and effective tool to achieve policy goals and encourage investment.

III. AN ARGUMENT IN SUPPORT OF SUPERCHARGED IPOS AND TRAS

TRAs share many qualities with NOLs and investable tax credits that make those benefits good candidates for monetization. Likewise, TRAs lack many of the complications that doomed the safe harbor leasing program. This Part will evaluate these qualities and complications to establish that TRAs should be embraced as novel tools that increase efficiency in markets and encourage economic activity.

TRAs serve a beneficial purpose by permitting private parties to compensate each other for the relative value of tax benefits.[245] In other words, in much the same way that the LIHTC permits private investors to acquire otherwise worthless tax credits from low-income housing developers, TRAs permit tax benefits to go to the party that values them more. However, in the case of a supercharged IPO, the tax benefits are distributed via contractual agreement instead of a partnership structure

241 *Id.*

242 However, this simply raises the question of whether certain behavior should be incentivized through the I.R.C. at all. The IRS may be most adept at enforcing a tax credit, but perhaps a tax credit is not preferable to some other incentive program in the first place.

243 Wallace, *supra* note 52, at 267. This verification system is similar to the ERTA, wherein transaction counterparties effectively audited the other side, but the LIHTC system is more developed, and unlike with safe harbor leases, standards have developed that allow LIHTC parties to easily determine compliance. *See Insights Report, New Markets Tax Credits: Unlocking Investment Potential*, CMTY. AFFAIRS DEP'T, OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF TREASURY 18, 25 (2013), https://www.occ.gov/topics/community-affairs/publications/insights/insights-new-markets-tax-credits.pdf [https://perma.cc/73HJ-U58N] (discussing property-level performance standards that have developed over time to monitor individual properties in the LIHTC program and the development of "industry standardization and experience" despite the complexity of the program).

244 Wallace*, supra* note 52, at 266 ("In a tradable tax credit system, the third parties that buy a tradable credit are incentivized both to undertake ex ante due diligence and ex post oversight.").

245 *See* Paul & Sabbah, *supra* note 2, at 75 (describing how public company valuations are generally based on earnings before interest, taxes, depreciation, and amortization (EBITDA), which disregards the value of tax benefits).

mandated by government rules.[246] Public company valuations are generally based on metrics that disregard tax attributes.[247] Moreover, corporate tax attributes are difficult to accurately value, because "any valuation . . . rel[ies] on income projections and other assumptions about the corporation's ability to use the tax attributes in the future."[248] This suggests that the tax assets held by public companies are not properly valued by public company investors, either because they are not well understood by investors, or because investors care more about recurring income over time rather than nonuniform items similar to tax benefits, which are difficult to value and may not be realized evenly across time.[249] If public company investors do not value these assets, then it makes sense the assets should be able to be transferred to other interested parties that can take advantage of them.[250] The TRA arrangements are similar to the safe harbor leasing regime in this regard: the party that values the tax benefit more is permitted to acquire the tax asset.[251] However, TRA arrangements are free of the compliance costs associated with the safe harbor leasing program. First, TRA payments are made after taxes are calculated,[252] minimizing audit costs on the part of the IRS. Second, unlike the safe harbor leasing program where the parties to a transaction may have no prior relationship, the parties to a TRA often have an extensive relationship dating back to the early stages of the company.[253] While similar deal protections may be required,[254]

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[246] *See* Wallace, *supra* note 52, at 239 (discussing the LIHTC partnership rules); *see also supra* text accompanying note 229 (describing the ownership structure used in LIHTC projects).

[247] Paul & Sabbah, *supra* note 2, at 75; Elliott, *supra* note 1, at 337.

[248] Paul & Sabbah, *supra* note 2, at 75.

[249] *Id.* (discussing the difficulties involved in valuing tax attributes).

[250] Interestingly, the legislative history with respect to the transferability of NOL deductions suggests that Congress agrees companies should *not* be valued based upon their tax attributes. By restricting the transferability of NOLs, Congress reduced their value to the NOL owners, implying that other parts of the company are more valuable. Hoenig, *supra* note 202, at 928 ("The enunciated goal of the new rules was to limit use of loss carryovers following an ownership change to the amount of losses that would have been used by the loss corporation had no ownership change occurred."); *see* S. REP. NO. 99-313, at 232 (1986) (discussing how Congress's "limitation on earnings" approach limits the use of NOLs by a taxpayer that did not create the NOL).

[251] Warren & Auerbach, *supra* note 46, at 1768; *see also supra* text accompanying note 163 (discussing how safe harbor leasing essentially permitted tax benefit transfers from companies that could not use them—startups and loss companies—to companies that valued them greatly, presumably those with taxable income).

[252] *See* Paul & Sabbah, *supra* note 2, at 77 (discussing the typical method TRAs use to calculate payments).

[253] *See* discussion *supra* notes 17–18.

[254] Warren & Auerbach, *supra* note 46, at 1776–78; *see also supra* text accompanying notes 190–91 (discussing requiring additional indemnities in safe harbor leases).

the parties are at least familiar with each other and have a history of working together.

Permitting monetization of tax benefits through TRAs is also likely to encourage beneficial risk-taking in the economy.[255] For example, Congress sometimes grants tax incentives to spur growth in times of economic weakness.[256] However, absent some form of monetization, loss companies (those struggling to make a profit) are also those companies that have the least need for tax incentives.[257] Therefore, permitting monetization makes these incentive programs more efficient by allowing companies most in need of the incentives the ability to utilize them.[258] Enabling pre-IPO owners to earn a greater return encourages more investors to invest in private, growing enterprises. Furthermore, before TRAs, private investors taking a company public had to determine the value of the company at one moment in time: the moment of the IPO. With TRAs, pre-IPO owners are no longer forced to estimate the present value of future tax benefits because they receive the tax benefits as they are recognized.[259] If private investors are better able to value companies when they exit their investments, it is reasonable to conclude they will be more willing to take additional upfront risk. Furthermore, if public investors do not value the tax attributes created in the supercharged IPO, permitting pre-IPO owners to extract that value over time maximizes values for all parties involved. In fact, if pre-IPO owners are willing to accept payments over time as the public entity realizes tax savings, instead of a single upfront payment, it may indicate to the market a high degree of confidence in the success of the public company.[260]

One of the key reasons NOLs are only partially transferable is that many believe tax benefits should be used by those whose capital produced the losses resulting in the benefit.[261] In much the same way, TRAs transfer

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[255] Billings & Musazi, *supra* note 125, at 299; *see supra* text accompanying note 171.

[256] *See* Billings & Musazi, *supra* note 125, at 299–300.

[257] *Id.* at 300 ("[T]here is an expected differential response to the bonus depreciation provisions between low marginal tax rate firms and high marginal tax rate firms.").

[258] Billings & Musazi, *supra* note 125, at 299 (reasoning that while "accumulated tax losses can be carried forward and deducted," nearly "25 percent to 30 percent of the carryovers expire before they can be used").

[259] Browning, *supra* note 3 (describing the cash payments received over time).

[260] *See generally* Alexander Edwards et al., *Supercharged IPOs: Rent Extraction or Signal of Future Firm Performance?* (Kelley Sch. of Bus., Research Paper No. 16-14; Rotman Sch. of Mgmt., Working Paper No. 2725531, 2016), http://ssrn.com/abstract=2725531 [https://perma.cc/6E9T-QKVP] (discussing the signaling that may be implicit in pre-IPO owners choosing to receive a contingent stream of payments over time instead of a single upfront payment).

[261] Hoenig, *supra* note 202, at 932; *see supra* text accompanying notes 213–14. Recall also that many tax benefits are inalienable and the large amount of tax benefits alienated from companies that

value to those who suffered the taxable gain that produced the tax benefit in the first place. In particular, the pre-IPO owners contributed the capital that enabled the new public company to grow before the IPO.[262] TRAs are simply a mechanism for enabling the taxpayer who should receive the corresponding tax benefit to monetize that benefit.[263] TRAs are unlike safe harbor leasing in this respect. Under the safe harbor leasing regime, tax benefits could be transferred between unrelated parties.[264] The company that ultimately obtained the benefit of the depreciation deductions was not required to have actually used the depreciable property and incurred actual economic depreciation of the property's value. While it is true there is no requirement that the parties to a TRA be somehow related, the complexity inherent in such a document makes it reasonable to assume that only the pre-IPO owners would have the knowledge, wherewithal, and opportunity necessary to enter into such a transaction with an entity about to go public. Furthermore, it seems likely that the pre-IPO owners would have an interest in ensuring that outside parties are not permitted to enter the picture given the potentially large recurring payments involved.

The entire supercharged IPO structure operates within the provisions of the I.R.C. A corporate taxpayer does not need to have any particular qualities to take advantage of a TRA other than basis that can be stepped up. In this way, TRAs are different from safe harbor leases. Safe harbor leases took advantage of a statutory fiction to complete a transaction solely for tax purposes.[265] TRAs, on the other hand, are done in the context of an IPO, an economic transaction, and permit additional economic value to be extracted from that IPO.[266] TRAs involve the transfer of after-tax dollars. In comparison, safe harbor leases involved the complicated transfer of pretax dollars, which could lead to compliance costs.[267] With a TRA, the IRS does not need to worry about significant enforcement costs. While it is true that the value of a TRA-enabled supercharged IPO stems from the I.R.C.,

earned the benefits was one of the reasons for the public backlash to the safe harbor leasing program. *See* Bronstein & Waldenberg, *supra* note 192, at 1846; Dagan & Fisher, *supra* note 123, at 93; *see, e.g.*, *supra* text accompanying notes 194–96.

262 Elliott, *supra* note 1, at 339. Phillip Gall, a former co-managing principal of Deloitte Tax's passthroughs group, stated that "'If the sellers can get paid for the stepped-up basis, why wouldn't they get paid for any tax attribute that they're delivering?'" *Id.*

263 *Id.* at 337.

264 *See* SHAVIRO, *supra* note 47, at 18 (noting that the deductions were easily transferable for an "arm's-length fee").

265 *Id.* at 18; *see supra* text accompanying note 166.

266 Elliott, *supra* note 1, at 339.

267 *See supra* text accompanying notes 252–54 (explaining why TRAs do not entail the same compliance costs as safe harbor leasing transactions).

tradeable tax credits such as the LIHTC are also only monetizeable because of a market created by a statutory scheme.

Finally, and perhaps most importantly, any attempt to prohibit TRAs without fixing larger inconsistencies in the I.R.C. would only lead to additional tax engineering in the future.[268] As the evolution of the supercharged IPO after the enactment of § 197(a) demonstrates, taxpayers, particularly those with sophisticated accountants and lawyers, will always seek new and creative ways to minimize tax payments. Any attempt to prohibit TRAs today without resolving more fundamental inconsistencies within the tax system will only be a temporary fix.[269] The TRA-enabled supercharged IPOs of today will only be replaced by new, more complicated devices tomorrow that can accomplish the same goals.

CONCLUSION

This Note does not pretend to propose a conclusive framework for the classification of tax assets with respect to their transferability. However, it does raise awareness of the inconsistent treatment of various transactions that in some cases are very similar. Ultimately, TRAs minimize inefficiencies in the I.R.C. and reward those who unlock value from tax benefits. While the complexity of TRA-enabled supercharged IPOs may appear ominous at first glance, their tax attributes are more similar to those of tradeable investment tax credits and partially transferable NOLs than they are to those of the failed safe harbor leasing program. Moreover, given the benefits TRAs provide to pre-IPO owners, the public market's apparent disregard for the transfer of capital associated with TRA payments, and the low compliance costs associated with the transactions, their use is likely to increase in the future. TRAs should be valued as creative devices that effectively unlock IPO value.

[268] *See* Fleischer & Staudt, *supra* note 11, at 368–69 (arguing that the primary factor keeping supercharged IPOs from becoming more popular is the entity type of the pre-IPO entity); Paul & Sabbah, *supra* note 2, at 79 (maintaining that as supercharged IPOs become more common, TRA arrangements will become increasing popular in other contexts as well).

[269] Two obvious examples are the different tax treatment of labor and capital and the different tax regimes applied to partnerships and limited liability companies (optional passthrough taxation) and corporations (entity-level taxation).