TRAilblazing

A Parallaxes Capital Podcast

S01 E08 – The Path to TRAs Becoming Ubiquitous, Like Rep & Warranty Insurance (April 01, 2024)

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 Host - Andy Lee

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Welcome to TRAilblazing: capitalizing on Tax Receivable Agreements. A Parallaxes Capital podcast that is here to guide you through the world of tax receivable agreements. It's time for TRAilblazing.

Intro – 00:13

Thanks for everyone for joining us today. I'm here with my good friend, Phil DeSalvo. Phil is the founder of the KPMG Partnership Transactions Group, which focuses on tax and structuring engagements for complex transactions. Phillip’s also an adjunct professor at Northwestern University where he teaches an LLM class on the practical applications of tax modeling. Phil is a proud alum of the University of Illinois just like yours truly, ILL. Thanks for joining us today, Phil.

00:44

Andy, thank you for having me. Appreciate it.

00:46

So as you know from the questions that we've asked others in the past, tell us how you found yourself into the wonderful world of tax.

Phillip’s Background – 00:52

Yeah, wonderful world. It is, but like many Andy, I didn't grow up thinking that I was going to be a tax attorney or go to a big four firm and lead a vertical within M&A. When I was growing up, I thought I'm going to be a major league baseball player, let's say for the Chicago Cubs or some other silly non-attainable goal. And then over time I realized I wasn't going to be the third base for the Cubs and moved into law school. That's where I really had a passion for tax and did that after a brief failure in the real estate industry.

01:26

Would you mind sharing a little bit about that?

01:29

No problem. So my dad, as well as other family members within my family, they're real estate and building contractor professionals. So when I was at University of Illinois, I took some real estate classes, including a real estate law class. After college I got my Illinois real Estate broker's license, and I thought, I'm going to jump into the family business, expand, do real estate development, et cetera. And it turns out I wasn't great at that. I wasn't great at real estate development. I just didn't have the knack for it like my dad did, and my sister now does. So I ended up doing a bunch of odd jobs. I was a construction worker, I was an ice cream truck driver, I was a serial assembly line worker, so I packed, like, cereal boxes for a bit. I was even the owner-operator of a hotdog and Italian beef stand at a local bar in Palatine, which is a suburb of Chicago. And so after a year and a half of doing all of these different things, which weren't for me long term, I decided to move into a different career path. I went to law school at DePaul and at DePaul Law, that's really where I started to develop that passion for tax law.

02:41

How do you follow that from coming out of DePaul into tax?

02:44

Yeah. Yeah. So obviously law school has a bunch of different avenues and transparently. When I went into law school, I went in because of the real estate law class I took at University of Illinois. So still kind of thought, okay, maybe I'll stick a bit in the real estate realm and I'll just, instead of doing the developing and the contracting that my family was doing, I'll be a lawyer, right? I'll do real estate law. But I quickly found that wasn't quite right for me. So I took a US Federal income tax class, really, really enjoyed it, really liked the policy that underpinned a lot of the laws and the regulations for US tax, and I did quite well at it. So I thought, okay, maybe I should keep pulling that string. Then I had a sports law class and you could pick whatever you want in sports law for your final paper.

03:31

It didn't matter what it was, had to be a legal topic. And I of course chose the tax aspects of selling a sports franchise. And then finally, I think this is the final straw, Andy, I was at a bar with some of my law school buddies and I found myself writing out the structure charts for a tax reorganization coming up in anticipation of, might've been that paper I was writing. And I realized if I'm here sitting in a social setting with my friends, drafting up some simple structure charts on some bar coasters, maybe I should really look into pursuing that career in tax law.

04:07

Man, I'll have to ask you where that bar was or have you ever kept those beverage coasters?

04:12

So I don't remember the exact bar at that time. I was living in either Bucktown or Wicker Park for those that are familiar with Chicago. So it was likely a bot in that area and I definitely don't have those bar coasters anymore.

04:27

Got it. When and how do you first learn about the magical world of TRAs?

4:32

Yeah, so TRAs. After DePaul, I ended up going to Northwestern Law for my LLM in tax, and that shot me to the big four accounting firm and then into Mergers and Acquisitions. So there's a little period in between DePaul Law until I got my first taste of TRA and it came in the context of an up-C transaction in 2012. So I was pulled onto a team. It was a little more cursory, but I did get to help a little bit with some modeling high level structuring and that particular deal, it died, it didn't go forward, but I at least heard of what a TRA was generally heard of what the up-C structure was. And so it kind of put me on the map as somebody in the M&A practice that had at least one rep in that area. And often this is how it works sometimes in M&A, if you get a rep in one area, a partner or principal will know that you have that experience and then you get pulled on to the next one.

05:30

And that's what happened. So in 2013, I was lucky enough to get drafted to be the senior manager on a bigger up-C transaction for one of our Denver clients at KPMG. And from there it just really, it took off. So that particular deal in 2013, we took from pick, you're saying cradle to grave, soup to nuts. I'm sure there's other that are out there, but we took it from the very all the way through the final transaction. They're now public in an up-C IPO. Then we also maintained the structure going forward for the exchanges, the TRA computations, all that good stuff. So, it was a really good case study that kind of went from all different facets of the transaction, and that of course gives you or me a lot of confidence in being able to execute on that over and over. What was really, what I think is interesting about that 2013 transaction and what I think most folks that currently now work with me are happy about that transaction is it was the bedrock of basically the foundation of our partnership transactions group team within KPMG.

<u>Sub K Rules – 06:43</u>

So acronym, if you'll hear me say PTG, right? So that's inside our M&A practice. So it's a transactions group that focuses on partnership tax, right? So anytime you have a triangle, which is your LLC, your LPs and there is a relatively complex or a super complex partnership transaction, our team comes in and helps out. But yeah, I mean that's kind of where it started. It was really back in 2013 and it just stemmed from some deep work, deep diving into the sub K rules, me and now a partner of mine here at KPMG, remember late nights building out the economic entitlement waterfall for the partnership and figuring out how different tax elections for built in gain and built in lost property, how does that impact the partners like real people and how does that impact the cash taxes that they have to pay and the ultimate proceeds that they get after the IPO and in connection with the TRA proceeds. So all of that really drove the desire for us to build this team that would focus on those types of deals. And now today we have about 70 professionals across the country, a mix of tax attorneys and tax accountants within KPMG, and now we focus on those nuances of partnership transactions.

08:01

That's incredible. Look, many tax accountants struggle to become rainmakers. You've clearly done that many hope to inherit books of businesses from retiring partners. You've not only built a thriving business for yourself, you've also built one that supports an entire team and platform. How did you go about doing that?

08:22

Well, I wouldn't say I'm a rainmaker per se. It was a lot of collaboration, teamwork, and really I'd say the combination of two major things. So one is opportunity, Andy, this is probably going to sound similar to your story. And then the second is support, right? In my case, it was both leadership level and peer support. So opportunity wise, you kind of heard the story about the 2013 transaction, and really that was just a couple of us falling into the complexities of partnership tax and really enjoying it. At the same time as we were working with other accounting firms and other law firms, we noticed as well as the fact that some of us came from different firms, we noticed there was not an existing industry out there that focus specifically on partnership transactions within the given firms. So each firm would have a broader M&A practice.

09:20

They have super technical and smart folks within their Washington national tax groups, but we had not seen a transaction focused business model that would basically focus on the partnership transactions. So that's the opportunity. It was, we knew that there was a demand. As we move forward, we made sure, we kept our eye on how many partnerships we're filing, looking at IRS data versus corporate entities. And as you may know, that kind of graph goes up and up for partnerships where corporations kind of stayed around the same. And now at least since I think 2020 or so, there are two times as many partnerships filing in the US as there are corps. So we saw there was this demand, we knew there was not a huge supply, and so we kind of set forth and said, Hey, let's build up this practice focusing on partnership tax in transactions.

10:13

And then the second, it was fun. I mean it was also within a very large firm, but kind of small because we're trying to build something up from the ground up. But from that ground level area, we had a ton of support. So as we found the opportunity, we also had leaders. The partner that I worked with was incredibly supportive. The M&A tax leadership at the time, also very supportive. And so we were able to basically get that buy-in to invest our time and firm capital to go out and hire talented individuals, spend our time building up that practice and over time it just took off. Right,

10:54

Absolutely. How have you seen your client perceptions change on the topic of TRAs?

Change in TRA perceptions – 10:59

It has changed quite a bit. If we're going back to the 2012 transaction now, we are about 12 years out from that. Early on, the sentiment was a bit hesitant as to whether or not this would work from a tax and from a market perspective. So there was a lot of skepticism about the TRA technology and whether there might've been an impact on company valuations going forward. And a lot of folks had to be convinced that the tax technical rules that underpin that TRA, that contract between the public company and the partnership partners that are selling their units to the public company, whether that worked, and it is kind of foundational, like how it works out from a tax law perspective, there's not anything that is if you do a, I'll say a down the middle of the fairway or non-aggressive TRA or non-aggressive structure, there isn't anything that is super controversial from a tax law perspective.

12:01

So the tax was there, and it did take a bit of modeling and explanation to some of our clients to explain why it worked out that you could give this tax asset to the public company in that exchange, that monetization event. But once people were on that, I understood the rules and they understood that there wasn't anything very controversial or aggressive about that planning, then you had to move on to a couple other factors. Economics to the capital markets. Do they approve such a contract? As we know the public company has to file with the SEC, they file things that are now publicly out there and it will specifically state that TRA liability. So there was a little bit of consternation with regard to that number and how is it going to impact the markets. It's just like talking through this, Sandy, I remember there were times where I'd be in meetings, we'd be talking about what we're working on, and folks would speak up and say, well, the public markets, they're slowing down. Or it was after the 2017 tax reform when corporate rates dropped. A lot of talk about up-Cs are dead, no one's going to do a TRA, all that type of stuff. And it turns out they were not dead. They were just fine. And I think nowadays, if you do have a flow through entity and it wants to go public, typically I think you're looking at an up-C as your method for doing so regardless of whether or not you have a TRA in place or not.

13:33

Absolutely. I mean, what is preventing from TRAs from becoming more ubiquitous, just like rep and warranty insurance?

TRAs vs Rep and Warranty Insurance – 13:40

So I think TRAs, they're a little different than a rep and warranty insurance. So a bit more speculation on my part. I'm not in that area, not a valuation expert, et cetera, but from my perspective, there's general hesitancy from buyers and sellers to enter into an arrangement that might last 20 plus years. The TRA is often a contract to essentially get paid for the tax asset that you deliver to a buyer. And a lot of times that tax asset that attribute it amortizes off over 15 plus years. And so it's a long time to have that agreement with a buyer and a seller. So if you're looking at a traditional private equity transaction, so either buyer or seller– but let's say seller in this case– sells their company to another, a buyer and they want to get paid for that step up, right? Let's say it's in either a 3-38-H10, so it's a corporate setting, but you get a step up or maybe you are selling a partnership interest and you're delivering a step up either to the assets or to the partnership interest, which then gets allocated to the assets under certain tax provisions.

14:54

In those cases, what we typically would see is that the buyer and seller would model those benefits into the free cashflow model, their financial model, look at what the discount rate is, figure out how you might bake that into the equity value, the equity number, and you kind of go from there, right? That's your default. As far as contracts that span past the closing, we do see earnouts, right? So earnouts are relatively common in transactions where a buyer is willing to pay incremental proceeds on the basis of some economic performance down the road. In other words, let's say they used EBITDA as that measuring point. If you get to EBITDA times X, perhaps the buyer's going to pay the seller another 5%. If it gets EBITDA times Y in year two or three, they might pay purchase price plus 10%. But those are usually just a couple of years, a couple of years out is what I've seen.

TRAs being more ubiquitous – 15:57

And they're not typically dependent upon tax attributes. They're usually dependent upon, I'll say overall cash flow and financial statement, economic performance. And so when you move into the land of TRAs where you are talking about a tax attribute that is contingent upon the company making taxable income and then also the span it could just last decades, there's that hesitancy there. And what I would say though is if and when that secondary market for a TRA grows and there are more avenues for what would now be the seller, right? The seller of the entity that gets that TRA asset, if they have an avenue to monetize that, I could see TRAs being much more ubiquitous, possibly more in line with rep and warranty to the extent that the seller is delivering that tax asset. The reason I say that is because it gives a little bit of protection to the buyer. So someone that's paying that TRA payment, well, they don't have to pay it unless they get the benefit of the tax attribute, right? So there's a little protection there. Then if you have that secondary market for the seller, so the recipient of the receivable, now they have an avenue to monetize a bit faster than you might in the past where you had to hold onto it for 15, 20 years till the end of the actual rollout of the tax asset.

17:19

Absolutely. I mean, what is the hardest part of your job today running a business like this?

Managing Early Career Professionals – 17:24

That's a tough one. You had some easier questions on the front end, Andy, you're throwing the harder ones at me. The curve balls, hardest part probably time management and bouncing the requirement to deliver on client demands with the critical component of developing our earlier career professionals. So as you're aware in the professional services realm, our job requires a lot of effort to respond to client demands, particularly when you're talking about the transaction context, right? So when you're doing buying selling companies, you're trying to help one of your clients close on a particular deal, or even in the IPO context, even though they're longer term, you still have a lot of different milestones you have to push for. And so when you're balancing those timeline constraints and the client demands, you also have to focus a lot of your time and effort, at least at the partner principle and manager level at developing our people. Because long-term building a practice, it is only sustainable if your early career professionals are built up. They can then of course grow and have their own career progression and then essentially be the succession plan for when the existing partners and principles retire and then ride off into the sunset. And so it really is balancing the delivery to our clients and then base our training and our building of our early career professionals, which is to me the most challenging part of the job.

18:56

Absolutely. How do you train this next generation? I mean, business acumen is something that many which hide tax accountants as not really having. How do we change that element?

19:08

That's a very brief question, but there are a couple of different avenues to dive in there. More acutely just making sure that your folks are on with you for your client discussions. They're part of all of your communications, they see how you contract with your clients, and they also see how you discuss business and deal points with the other tax advisors, whether it's the counterparty to the deal or whether it's your tax attorneys and your commercial attorneys on the same side of the deal. So getting them those reps and then offering them the opportunity to chime in to eventually lead those calls and to see how those calls developed and they change depending on who the parties are. So that's more of maybe a precise response to that question about how I would go about and building that business acumen and getting folks to kind of buy in to the practice long-term.

Generational Gap between the workforce – 20:06

But there's I think an overarching issue that we also have to deal with right now, and it's a bit of a generational gap between the workforce, and this is just both personal experience as well as a couple of good TED Talk lectures on where our workforce sits today. But some of our earlier career professionals, they have a little bit of a different mindset and goal than I'll say the current upper management has at a different way of getting there. So the way we work is a little bit different. Newer folks have a much stronger focus on personal life and balancing your work and your personal life and your free time. And I think one of the biggest challenges, which goes to why I think that's one of the hardest parts of our job today, it's getting upper management, which I guess I'm part of that now as leaders to acknowledge that their priorities, the earlier career folks, it's a little different than ours.

21:05

And so we need to work with them to successfully get them excited about the career, excited about building up the practice as a whole, excited about partnership tax. So it's just a little bit different I think, than the historical way of doing it. And we have a couple of different strategies that we try and implement. One way is we do attempt to basically make the work environment a bit more rewarding and not have it again, all about work. It's not all about tax law, right? Some of us might think so, but there's a little bit more to it. You have to build that culture, that teaming and building trust within your teams type of a culture to make it, I'd say an enjoyable place to work. And that's a lot of what we focus on. It's making sure that the way that we are building and training our folks the way we're developing our people, it is an effective way of doing so.

22:00

And then the second thing, and this is a little bit on kind of my team a little bit as well, on a more national approach and a national effort to drive technology solutions. So helping get our work done more efficiently through technology is another way that we kind of bridge that gap where historically you might have an associate or senior associate in Excel hammering away on a calculation for 30, 40 hours. Now we might have some technology tools that can help carve that time down to five or 10. So there are a couple of different strategies we use. Those are two of them.

22:38

What advice do you have for the next generation?

Advice for the Next Generation – 22:41

Sure. So I'll give two general pieces of advice. The first, it really dovetails into what I just talked about, teaming and collaboration. And that is for those younger earlier career professionals, team with your colleagues and team with your peers and develop those relationships. I'll say particularly in the accounting firm setting, again, I haven't worked, I'll say as an adult, I did some law clerking in the law firms but haven't worked since my LLM in a law firm setting. But in the accounting firm setting, it is critical to develop those relationships with your peers because the tax profession, and really I think any professional services group, it can be a challenging career. It can be incredibly rewarding as well. But to overcome those challenges, you really– at least from my perspective – you need to have those relationships. You need to have those folks that you can work together with and collaborate with to basically overcome a bunch of those challenges.

23:47

They might be tax technical, it could be you're having problem with time management. Maybe you're going to go on vacation PTO, but you're on a big deal and you need someone to help cover you. None of those things are really, they're not going to be available to you unless you develop those relationships and you have that team of peers and hopefully friends later on, we might talk about some other tax individuals that I'm good friends with. It all came from work, right? So overall you want to make work, not feel like work and not feel like a job. You want to make it feel like part of your life, and hopefully that happens if you build those relationships. The second piece of advice, different direction, but can be related, it's be a rhinoceros. You might say, well, what does that mean? So I'll explain briefly at the suggestion of a very good friend of mine.

Rhino Success – 24:38

Many years ago I read a book called, I think the full name is, I call it Rhino Success, but the full name is Rhinoceros Success by Scott Alexander. And it always stuck with me. And from a very high level, the premise is if you want to go out and be successful at any identified opportunity, be a rhinoceros, which is have thick skin because we all know you're not going to succeed on the first try, maybe not the second, maybe not the 10th, but have that thick skin to keep going and don't take things too personally if possible as you progress in your career. And the second is be hard charging. So with that tough skin, you can keep pushing, right? You can keep moving forward. Even if you run into certain hurdles or certain blockages, you can break through those with that hard charging attitude.

25:32

Many view tax professionals,

25:35

Not mine though, so

25:36

Absolutely. But thank you for sharing it. Many view tax professionals to have boring personalities, I feel like you might have something to share that might help dispel that notion.

25:46

Okay, well, shots fired at the tax folks out there. Tax people are people too. That's not my quote either. I'm barring that from a friend and colleague of mine. But yeah, I mean, outside of work, I think the tax folks are just as fun and exciting as anyone else. I think we lead pretty or can lead of course, pretty interesting and fun lives. Most recently, for example, a couple of friends of mine, they are tax professionals. One I alluded to him earlier, works within the PTG team. We ended up going to kind of a long weekend trip ended up at the Phoenix Open or the Waste Management open in Phoenix. I'm not sure if you're familiar with that. It's the golf outing in Phoenix. It's quite a fun event. We ended up in the 16th hole,

26:32

So that was what was trending on Twitter.

26:35

Okay. I don't think it was any of us specifically trending on Twitter. We were there though, so we were with the fun people in the crowd. And then just so happens that the Kansas City Chiefs made the Super Bowl and some of the tax people there are big Chiefs fans. So we drove to Vegas that next morning just for the party. We did not end up going to the game, unfortunately, but the celebration was awesome in Vegas. And then other non-work related stuff, I know some of us have been known to fly across the country to New York to visit their favorite tattoo artist, maybe also head to Belgium to hit up one of their favorite heavy metal shows. Those types of things. They often happen in the tax world. Those, I'll say examples, not work-related, just tax people being tax people. But we also do like to sprinkle in fun events as we are traveling for work.

27:27

A couple of years ago I was doing an IPO bootcamp in New York City. I was out preparing, I'll say, out preparing, but you can do both of those things at the same time. I was watching the Chicago Cubs play Game six of the World Series against Cleveland. They won, and as you may or may not know, the Cubs had not won a World Series in 108 years at the time. And so I had to get to Cleveland if they won that game. So the IPO bootcamp, it stayed, right. I still did that bootcamp. And to your credit, Andy, what I talked about really was the Up-C and TRAs. It was a major topic of that particular conference. And then right after that conference, I flew to Cleveland and then caught that game. So doing the tax travel can sometimes get you closer to fun events and you just got to pull the trigger and get there.

28:19

So we have you to thank for the Cubs breaking that hundred-year curse.

28:22

I think it's a combination of me, the IPO bootcamp in New York and maybe even up-Cs and TRAs because it probably wasn't going to be there had I not worked on that original up C back in 2012 and 2013 and then this year. Just kind of one more thing just to, again, I'm going to try and convince folks out there that tax people can be fun. A couple of us are going to the Solar and Wind Conference in Phoenix in a few weeks. We'll talk about tax credits, the green energy credits and structuring and that type of stuff. But we're popping in a day early. We're headed out to Mesa to go check out a major league baseball spring training game as well.

29:01

How do I get an invite to that?

29:03

Are you headed to the conference? Are you going to be there?

29:05

Sadly, no.

29:07

Happy to have you. I mean, or you can just fly in if you'd like spring training. It is fun. Unfortunately, the cubbies are not close enough. They're a bit farther away, so we're not going to see the Cubs, but it'll still be a good time.

29:21

Absolutely. Thank you so much for taking the time today, sir.

29:24

Yeah, Andy, always a pleasure talking with you.

29:28

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Sub K Rules

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Rep and Warranty Insurance in M&A

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Rhinoceros Success by Scott Alexander