UPENDED: THE IMPACT OF TAX REFORM ON UP-C STRUCTURES

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I. INTRODUCTION

Over the past 15 years, umbrella partnership structures (commonly referred to as “Up-Cs”), in which a newly-formed publicly traded C corporation (“PubCo”) acquires interests in an existing business operated in flow-through form (generally, a limited partnership or limited liability company treated as a partnership for U.S. federal income tax purposes) (the “Partnership”), have become the dominant structure through which Partnerships have raised equity capital through the public markets. It is easy to understand why: an Up-C structure allows the Partnership to raise money (and its historic owners (the “Partners”) to sell equity) through a public offering while allowing its Partners to retain flow-through economics (including a single level of tax and pass-through of tax losses) until the Partners are ready to sell. At the time of sale, the Partners have access to liquidity through the right (negotiated at the time of the IPO) to exchange their Partnership interests for PubCo stock (usually on a one-for-one basis), which stock can be sold on the open market. As a bonus, in connection with Partner liquidity, PubCo receives a step-up in its allocable portion of the basis of the Partnership’s assets as a result of such an exchange, which can be used to offset future income at PubCo. In nearly all Up-Cs, the Partners negotiate for the right to receive a portion of these benefits as and when used by PubCo (or upon certain exit events) through a Tax Receivables Agreement (“TRA”).4 Because of these benefits, practitioners generally believed that Up-Cs would become the dominant IPO structure for any pass-through business.

Tax reform perhaps changes the calculus, both with respect to existing Up-C structures and for Partnerships that are considering raising capital from the public markets. In December 2017, President Trump signed into law a tax reform bill commonly referred to as the Tax Cuts and Jobs Act (the “Act”).6 The Act included a number of significant changes to the U.S. federal income tax system, including meaningful changes to the calculation of an individual’s income tax liability and applicable income tax rates. For example, the Act reduced the corporate federal income tax rate from 35...
percent to 21 percent, without a commensurate reduction in the individual federal income tax rate (which was only reduced from a top rate of 39.6 percent to 37 percent). Additionally, the Act reduced or eliminated several tax deductions previously available to individuals who itemize deductions, including the deduction for state and local income taxes. In certain high tax states (e.g., New York and California), this has meant that individual taxpayers are subject to income tax at effective rates of over 50 percent on marginal ordinary income, while corporations are subject to effective income tax rates on average of 24 to 26 percent. As discussed further below, these and other changes meaningfully affect the value of both current and future Up-C structures. While the benefits of an Up-C structure are generally preserved under the Act, whether an Up-C structure, or certain market terms related thereto, is ideal going forward will depend on the taxpayers’ specific facts. We have summarized some of these considerations (including the Act’s effect on existing Up-C structures) below.8 Section II provides a brief background of Up-C structures. Section III discusses certain provisions of the Act relevant to Up-Cs in general. Section IV describes how these provisions of the Act create opportunities and challenges for businesses operating, or considering whether to operate, as Up-Cs, such as considerations for choosing an IPO structure and retaining a TRA.

II. BACKGROUND

There is a great deal of existing literature that provides a thorough description of the historical development of, and technical issues that arise in connection with, Up-C structures.9 To avoid duplicating this discussion and analysis, this section is limited to a general overview of Up-C structures, focused on the typical mechanics and terms. We encourage you to consult these other materials for detailed discussions of these and other structural issues.

In Part A, we discuss how the Up-C structure is formed. In Part B, we discuss the mechanics for, and consequences of, a Partner’s exchange of Partnership interests for PubCo stock. In Part C, we explain common terms of existing Up-C TRAs, including the payment of benefits related to the exchanges described in Part B.

A. Forming an Up-C

An Up-C structure is typically established through the following steps:

- The Partnership recapitalizes its interests so that it has two classes of units: Class A units, which have economic and voting rights, and Class B units, which have no voting rights but have the same economic rights as the Class A units.10 Class A units will ultimately be held by PubCo. Class B units will be held by existing Partners.

- PubCo is formed with two classes of stock: Class A shares of common stock, which have voting rights and entitle the holder to its pro rata share of the assets of PubCo and will be sold to the public, and Class B shares, which have voting rights but no economic rights (except perhaps with respect to the return of a nominal par value) and will be owned by the existing Partners. In some structures, the Class B shares are “high vote” shares, which ultimately will allow existing partners to retain voting control over the business conducted by the Partnership.11

- PubCo issues the Class A shares to the public in exchange for cash, and contributes that cash (together with the Class B shares) to the Partnership in exchange for Class A units of the Partnership. PubCo’s ownership of Class A units gives PubCo voting control of the Partnership.

- The Partnership may use a portion of the cash received from PubCo to redeem certain of the Partners’ interests. This redemption is treated as a direct purchase of partnership interests by PubCo from the Partners, which gives PubCo a step-up in the tax basis of its allocable share of the Partnership’s assets under Section 743 of the Code.12

- The Partners receive the Class B shares of PubCo on a pro rata basis in accordance with the ownership of Class B units.

- The Partnership, the Partners and PubCo enter into an exchange agreement that allows the Partners to exchange their Class B units and Class B shares for Class A common stock, typically on a one-to-one basis.13 Certain exchange agreements allow PubCo to settle the exchange request in cash rather than delivering actual shares.14
The resulting structure is as follows:

Following these steps, the Partners: (1) generally retain control of the Partnership through their voting stock of PubCo, which in turn has voting control of the Partnership; (2) maintain a single-level of tax and flow-through economics through their Partnership interests; and (3) create an opportunity for future liquidity through the exchange rights.

As is typical for most flow-through entities, the operating documents of the Partnership in an Up-C structure will usually require the Partnership to make cash distributions to the Partners and PubCo to ensure that they have sufficient cash to pay their income taxes. Predominant market practice is to calculate such tax distributions by reference to the highest combined marginal federal, state and local income tax rate applicable to a corporation or individual resident in a specific jurisdiction (generally, California or New York). Although some operating partnerships differ in how such payments are made, in Up-C structures, such payments are generally made pro rata, regardless of the actual tax liability of any particular partner. This is intended to preserve economic parity and to reduce administrative complexity.

B. Exchange Rights

Under a typical Up-C structure, the Partners may achieve liquidity by exchanging one Class B unit and one share of PubCo Class B stock for one share of Class A stock. This transaction is generally taxable to the Partner, and for this reason (among others) the Partner generally immediately sells the Class A stock on the open market (likely for no additional gain or loss). These exchange mechanics present a number of considerations for taxpayers that are beyond the scope of this article, including common limitations on exchange rights that are designed to satisfy certain exceptions under the “publicly traded partnership” rules. However, there are certain aspects of the exchange mechanics that are relevant to this article.
First, the one-to-one exchange ratio described above is premised on economic parity between a share of PubCo Class A stock and a Class B Partnership unit. Generally, there is economic parity if the Partnership unit and the PubCo common stock “represent the same right to the same proportional interest in the same underlying pool of assets.” Theoretically, economic parity is achieved if PubCo owns no assets, and conducts no activities, other than its ownership of the Partnership units. However, if PubCo were to own other assets, (e.g., cash from tax distributions exceeding the cash tax needs and TRA obligations of PubCo), or if there was not economic parity for other reasons, the exchange ratio might need to be adjusted.

Second, as described above, the exchange of Partnership interests for PubCo stock is treated as a taxable sale of the Partnership interests to PubCo by the exchanging Partners. The Partnership is generally required to have an election in place under Section 754 of the Code for any year in which an exchange occurs so that PubCo receives a step-up in the portion of the Partnership’s assets attributable to the exchanged interests. This step-up creates additional amortization and depreciation deductions that PubCo may be able to use to offset its tax liability, which in turn gives rise to TRA payments, as discussed below.

C. Tax Receivables Agreement

i. Calculation of TRA Payments

As discussed above, the initial acquisition of Partnership interests by PubCo from a Partner and a later exchange of a Partner’s Partnership interests for PubCo Class A stock results in a stepped-up basis in the portion of the Partnership’s assets attributable to the acquired or exchanged units under Section 743 of the Code (provided that the Partnership has an election under Section 754 of the Code in effect.) This step-up creates additional depreciation and amortization deductions that PubCo can use to offset its tax liability. The particular impact of this step-up depends on the nature of the Partnership’s assets, but is usually allocated to certain intangible assets under Section 197 of the Code (such as goodwill), which are amortizable over 15 years.

A TRA allows the Partners to benefit from the use by PubCo of any tax asset so created. As a result, the Partners receive a debt-like stream of future payments based on PubCo’s use of specified tax attributes. The general view is that payments to the Partners for these tax assets are acceptable because, in many cases, public markets do not fully value the tax attributes of publicly traded companies.

In general, for federal income tax purposes, the TRA payments are treated as additional payments by PubCo of contingent purchase price for the exchanged Partnership units. This creates an additional step-up in basis, such that payments under the TRA beget additional TRA payments.

Fortunately for PubCo, it usually need only make TRA payments as and when it is actually deemed to use the tax benefits created by the step-up to reduce its cash tax burden. Typically, a TRA’s terms calculate the amount of any payment for any applicable tax period by comparing PubCo’s actual tax liability for “Covered Taxes,” taking into account the relevant tax benefits for such period, with its hypothetical tax liability for such taxes, determined without taking into account such tax benefits but otherwise using the same methods and elections used to calculate PubCo’s actual tax liability (i.e., on a “with and without” basis) (the “Realized Tax Benefit”). “Covered Taxes” is generally limited to U.S. federal, state, local and foreign income taxes (including franchise taxes).

Also, PubCo need not pay over all of the benefit it receives. Most commonly, the TRA only requires payment of 85 percent of the value of the Realized Tax Benefit. To accommodate the uncertainty as to the amount and timing of these payments, TRAs often have a term of a set number of years (e.g., 30 years from the date of the IPO) or until all payments for tax benefits have been made.

ii. Early Termination Payments

Another common feature of TRAs is an acceleration provision that requires PubCo to make a lump-sum payment (the “Early Termination Payment”) to eligible Partners upon the occurrence of certain events. PubCo’s payment of the Early Termination Payment extinguishes PubCo’s ongoing payment obligations. Relevant events may include a change of control of PubCo, PubCo’s material breach of its obligations under the TRA, or PubCo’s bankruptcy. Most TRAs also allow PubCo to elect to make an Early Termination Payment. Alternatively, a TRA may provide that if there is a change of control, the payments are not accelerated, but PubCo is deemed to have sufficient taxable income to make the TRA payments on a go-forward basis.