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Memorandum

Impacts of the Tax Reform Framework on UP-C Structures

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Summary

With the recent release of a tax reform framework by President Trump and Republican Congressional leaders (the "Tax Reform Framework"), it is a good time to review how tax reform could affect the desirability of umbrella partnership – C-corporation (UP-C) structures. Our conclusion is that, even if the Tax Reform Framework is enacted, UP-C structures are likely to continue to provide tax and other benefits to pre-IPO owners of a pass-through business in a manner similar to current law.

UP-C Overview

For businesses taxed as partnerships that are considering an initial public offering, the UP-C structure can offer owners the liquidity and other benefits of a public listing in a more tax efficient manner than the traditional alternative of converting into a corporation at the time of an offering.

The UP-C is a two tiered structure in which an entity organized as a limited partnership, limited liability company or other legal form taxable as a partnership (commonly referred to as the operating partnership or "OP") holds all of the assets and operations of a business. Public investors hold their interest in the tax partnership indirectly through an entity (the "Pubco") organized as a corporation or other legal form taxable as corporation. The pre-IPO owners continue to hold their interests directly in the OP and, accordingly, their share of the income of the business is not subject to an entity-level tax.

In order to provide the holders of OP Units with liquidity, OP Units held by persons other than the Pubco ("OP Unitholders") are typically exchangeable for Pubco Shares on a one-for-one basis (in some cases, subject to the right of the Pubco or the OP to elect to deliver instead the cash value of such shares).

When a holder of OP Units exchanges such units for Pubco Shares, this transaction may result in increases in the tax basis of the assets of the OP that increase (for tax purposes) depreciation and amortization deductions and therefore reduce the amount of tax that the Pubco is required to pay in the future. It is common in an UP-C structure for the Pubco to share a percentage (which by market practice is typically 85%) of any such tax benefits with the exchanging holder. This arrangement is typically set forth in a tax receivable agreement or "TRA."

Click here for additional information regarding the UP-C structure.

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The major benefit of the UP-C structure—i.e., allowing the pre-IPO owners to continue to hold their interest in pass-through form—would be preserved and could be as beneficial under the Tax Reform Framework as under current law, depending on the facts.

- **Current Law.** Under current law, partnership income is taxed to an individual partner at a top rate of 39.6% and to a corporate partner at a top rate of 35%. In a traditional corporate structure, income is taxed to the corporation at a 35% rate, and then the 65% after-tax portion is potentially taxed again as a dividend at a 20% rate for an individual shareholder (or at a 7% rate for a significant corporate shareholder). Thus, for an individual in an UP-C partnership, flow-through income (other than long-term capital gain) is taxed at a rate roughly 8 percentage points lower than the corporate alternative (assuming the corporation distributes the income as a dividend); (a) 39.6% versus (b) 35%, plus 20% of 65% or 13%, for a total of **48**%.
- **Operating Income.** Under the Tax Reform Framework, partnership business income would be taxed at a top rate of 25% for small or family-owned partnerships. It is unclear which partnerships would be covered but presumably any favorable pass-through regime will be extended to many if not most active businesses conducted in pass-through form (other than professional service firms). Under the Tax Reform Framework, income earned by a corporation would be taxed to the corporation at a 20% rate, and then the after-tax portion (80%) would be potentially taxed again to the shareholder as a dividend. The Tax Reform Framework does not specify how dividend income will be treated but earlier reform proposals would tax dividends at half the normal rate, which could mean a 17.5% rate for an individual shareholder (or at a 4% rate for a significant corporate shareholder). Thus, for an individual holding an interest in a partnership eligible for the favorable rate, the flow-through income could be taxed at a rate roughly 9 percentage points lower than the corporate alternative (again assuming distribution as a dividend); (a) **25**% versus (b) 20%, plus 17.5% of 80% or 14%, for a total of **34**%.
- **Interest Deductions.** It is possible under the Tax Reform Framework that interest deductions would be subject to stricter limits for corporations than for businesses in partnership form, which could further increase the benefit of remaining in partnership form.

- **Capital Gains on Exit or Other Asset Sales.** Under current law, the UP-C facilitates tax-efficient post-IPO sales of partnership interests or assets. In such cases, the buyer generally obtains a stepped up tax basis (reflecting its purchase price) for the assets directly or indirectly purchased and thus may pay a premium, while the sellers pay a single tax on the gain on the portion of their position still held in pass-through form, generally at favorable capital gains rates for an individual, subject to exceptions for recapture and certain other items. In a traditional corporate structure, the corporation would pay one tax on the sale of partnership interests or assets at the full rate (35%), and then the shareholders would have gain and potentially a second tax on receiving sale proceeds on distribution from the corporation. For that reason, in an exit scenario, the transaction may be structured as a sale of stock of the corporation. In that case, however, the buyer would not obtain a stepped up tax basis in the underlying assets and may discount the purchase price accordingly. Under current law, individuals pay a top tax rate on long-term capital gains of 20%, compared to the top rate for capital gains of corporations of 35% or a double tax (corporate and shareholder) aggregating 48% as described above. It is unclear how capital gains would be treated under the Tax Reform Framework, but prior GOP reform proposals have called for a capital gains rate of 50% of the ordinary rate. Assuming that approach is ultimately included in any enacted tax reform, a tax benefit for the UP-C structure on exits or other capital gains transactions would be preserved—for the pass-through portion, a single tax of perhaps 17.5% (one-half of 35%) versus a double tax in a corporate structure aggregating 34% as described above for the Tax Reform Framework. The buyer would obtain a stepped up tax basis for that portion of the business. Although the step up would be worth less to a corporate buyer, as deductions would produce only a 20% benefit compared to 35% under current law, the overall effect would be similar to that applicable under current law.

Impact of the Tax Reform Framework on TRA Payments. Under the Tax Reform Framework, the top corporate income tax rate would be reduced from 35% to 20%. As the top corporate income tax rate declines, the benefit of deductions to the Pubco, and accordingly the corresponding TRA payments to an exchanging OP Unitholder are reduced as well. As an example, $100 of deduction from income taxed at 35% is worth $35, while $100 of deduction from income taxed at 20% is worth only $20. Notwithstanding these reductions, we would expect the use of TRAs to continue.

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