The Umbrellas of Subchapter K

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The Umbrellas of Subchapter K[1]

This paper discusses "umbrella partnership" structures in which partners in a private partnership achieve enhanced liquidity through exchange rights into publicly traded equity. Umbrella partnerships have been used since the 1990s with publicly traded real estate investment trusts ("REITs") and C Corporations and more recently with publicly traded partnerships ("PTPs").

The discussion below recounts the history of umbrella partnership structures in each of the three areas; addresses key features and tax issues for the tax agreements that have become standard in each area; and discusses certain core premises on which the intended tax treatment of the structures depends.

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[1] In the 1964 film *The Umbrellas of Cherbourg*, a shopgirl in an umbrella store (played by Catherine Deneuve) meets a wealthy customer and eventually marries him. The obvious parallel is that, just as umbrellas gave the film's shopgirl access to an affluent life, umbrella partnerships allow private business owners tax-efficient access to enhanced liquidity.

I would like to thank my colleague Judy Yan for her assistance in updating this paper.

I. Umbrella Partnership History and Structures

A. UPREITs

1. The Quest for Tax-Free Acquisitions

Private real estate is often owned through an entity treated as a partnership for tax purposes (or, in the case of a single owner, through a disregarded entity). For a public real estate holding company, a REIT is usually the preferred vehicle to avoid an entity-level tax.[2] A publicly traded partnership might be considered,[3] but there may be disadvantages when compared to a REIT. For instance, partners in a PTP (or the PTP on their behalf) may be required to pay an income tax in states where the PTP operates and may be subject to burdensome state filing

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[2] See generally sections 856, 857. Unless otherwise specified, all section references are to the U.S. Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

[3] A PTP is treated as a corporation unless at least 90% of its income is "qualifying income" within the meaning of section 7704(d). See sections 7704(a), 7704(c)(2). Subject to certain exceptions, income from real estate will typically be qualifying income for PTP purposes, meaning that a business that would qualify for REIT treatment will often have the option of organizing as a PTP without being characterized as a corporation. The qualifying income rules are described in greater detail below.

requirements. In contrast, nonresident owners of REIT shares are not generally subject to tax or filing requirements in the states in which the REIT holds real estate. In addition, the "related party rent" rules are more stringent in the PTP context then the REIT context.[4]

A disadvantage of REITs, however, is that assets cannot be transferred to a REIT in exchange for REIT stock on a tax-free basis except in limited circumstances. Section 351(a), which provides for nonrecognition of gain on transfers to controlled corporations, is not available to shareholders who contribute property to an "investment company."[5] A contribution to an

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[4] Rental income will qualify neither as "good income" for purposes of the REIT's 95% gross income test nor as qualifying income for PTP purposes if received from a person 10% or more of whom is actually or constructively owned by the REIT or the PTP, as the case may be. See sections 856(d)(2)(B), 7704(d)(3). However, different constructive ownership rules are applied depending on whether the lessor company is a REIT or a PTP. A REIT will constructively own an interest in a tenant owned by a shareholder owning 10% or more of the stock of the REIT. See section 856(d)(5)(A). On the other hand, a PTP will constructively own an interest in a tenant owned by a partner holding only 5% or more of the interests (by value) in the PTP. See section 7704(d)(3)(B).

[5] Section 351(e)(1).

investment company includes a contribution to a REIT if the contributors' interests are diversified as a result of the transfer,[6] which would generally occur upon the transferors' contribution of nonidentical assets.[7] In this regard, cash raised from the public equity markets will be considered nonidentical property to the contributed real estate.[8]

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[6] Treas. Reg. section 1.351-1(c)(1). A contribution to an investment company also includes a contribution to a regulated investment company ("RIC"), and a contribution to a corporation more than 80% of the value of whose assets are held for investment and are money, stocks or securities, and certain other investment assets, in either case where the transfer results in a diversification of the transferors' interests. Section 351(e)(1).

[7] Treas. Reg. section 1.351-1(c)(5).

[8] Under an exception contained in the investment company regulations, a contribution by each transferor of a "diversified portfolio of stocks and securities" to the corporation is not deemed to result in a diversification of the transferors' interests. See Treas. Reg. section 1.351-1(c)(6). No similar rule protects transfers of diversified portfolios of real estate from the investment company rule, and, in fact, the preamble to the investment company regulations states that Treasury specifically considered and declined a commenter's invitation to adopt a rule allowing diversified portfolios of real estate to be transferred to a REIT. See TD 8663 (May 1, 1996). Nevertheless, without explanation, at least two private letter rulings allowed taxpayers to transfer nonidentical property to a REIT in exchange for REIT stock under section 351(a). See PLR 9744003 (shares of another REIT, partnership

Before 1992, many private owners of real estate kept their holdings private because the investment company rule prevented them from incorporating their holdings into a REIT and accessing the public markets on a tax-efficient basis. In addition, even those owners who were willing to take their real estate businesses public through an offering of stock of a regular C corporation (and suffer a tax at the entity level) often could not incorporate on a tax-free basis. Though the investment company rule would not typically apply to a real estate holding corporation not electing REIT status,[9] tax-free treatment under section 351(a) may be significantly limited where the transferors' liabilities that are assumed by the transferee corporation exceed the transferors' basis in the contributed property. Specifically, if the contributed properties are secured by liabilities in excess of their adjusted basis, which is

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interests and cash transferred to a REIT by different shareholders); PLR 200450018 (transferors contributed identical partnership interests to REIT, which also received cash proceeds from an IPO). See also PLR 199947001 (transferors contributed identical partnership interests to a newly formed REIT, but engaged in some amount of pre-contribution diversification at the partnership level).

[9] See supra note 6.

often the case where highly leveraged property has been depreciated over the precontribution period, the contributing partner would recognize gain in the amount of the difference under section 357(c).

In 1992, the "umbrella partnership REIT" (or "UPREIT") structure emerged as a more tax-efficient way for investors to acquire and hold diverse real property assets. In an UPREIT structure, the initial real estate owners contribute their real estate business (whether held directly or through a partnership) to a newly formed limited partnership – the "umbrella partnership," "operating partnership" or "OP" – in exchange for limited partner interests (or "units") in the OP.[10] A newly formed REIT, which is

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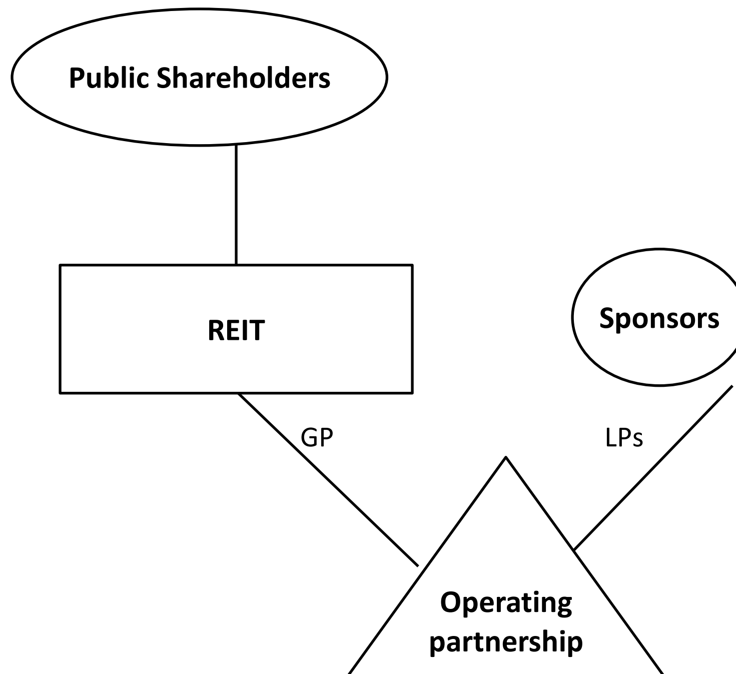
[10] If a real estate holding partnership contributes its assets directly to the OP and then liquidates, the OP will succeed to the real estate holding partnership's basis in the assets. See section 722. On the other hand, if the real estate holding partnership liquidates prior to the contribution, each owner of the real estate holding partnership will take a basis in his share of the liquidated assets equal to his basis in his partnership interest in the real estate holding partnership. See section 732(b). The OP will then succeed to this asset basis upon the owners' contribution of the real estate assets. Thus, by choosing the form of the contribution transaction the owners of the real estate holding partnership may be able to maximize the basis that the OP takes in the contributed assets.

the general partner of the OP, receives cash in a public offering of stock, which cash is then contributed to the OP in exchange for additional partnership interests. Where the IPO also includes a "secondary" component, a portion of the proceeds is used to purchase interests in the OP from the initial owners, also known as the "sponsors." To the extent the sponsors remain partners in the OP, they are granted, as part of their OP units, the right to exchange their OP units for shares of the public REIT. Thus, the sponsors would continue to own interests in the OP until such time as they want to sell their interests, at which point the sponsors would exchange a portion of their partnership interests for interests in the REIT and sell the REIT shares into the public market.



By allowing the sponsors to contribute their property interests to a partnership rather than a REIT, the UPREIT structure takes advantage of the ability to transfer property tax-free to a partnership under section 721(a) as well as the more flexible rules governing liability assumption in the partnership context.[11]

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[11] Unlike contributions to corporations, in which gain is recognized if liabilities assumed exceed the basis of the contributed property, such gain may be avoided in the partnership context if liabilities are properly allocated to the contributing partner. See Treas. Reg. sections 1.707-5(a), 1.752-1(a)(1), 1.752-3. It is also worth noting that a narrower version of the investment company rules does apply to contributions to partnerships. Specifically, the

Additionally, OP interests may be used as a tax-efficient acquisition currency for future acquisitions of real property. Unlike section 351(a), which requires the transferors to own at least 80% of the stock of the transferee company immediately after a transfer, section 721(a) has no such requirement.[12]

Because the REIT will be general partner of the OP, the sponsors' ownership of limited partner units will not afford them control of the business. To continue controlling the business after it converts into UPREIT form, sponsors will sometimes form an advisor entity to conduct the operations of the REIT pursuant to an advisory agreement. The REIT may have no employees of its own

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tax-free treatment of a contribution to a partnership under section 721(a) is denied if the partnership would be an investment company if it were a corporation. See section 721(b). A partnership is not presumed to have made a REIT election in determining whether it would be an investment company if it were a corporation. Treas. Reg. section 1.701-2(d), Ex. 4(i). Therefore, a transfer to a partnership will be considered to be a transfer to an investment company only if 80% of the of the value of the partnership's assets are held for investment and are money, stocks or securities, and certain other investment assets, and the transfer results in a diversification of the transferors' interests. Treas. Reg. section 1.351-1(c)(1).

[12] Subsequent contributors of property to the REIT will often receive consideration amounting to less than 80% of the REIT.

and therefore be completely reliant on the advisor entity, which will be owned and controlled by the sponsors.[13]

2. Maintaining the Deferral

After an UPREIT has been formed, the contributing partner's tax deferral will last only until the umbrella partnership disposes of that partner's contributed property in a taxable transaction. Upon such a disposition, the built-in gain on the disposed-of asset – that is, the difference between the fair market value of the asset at the time of contribution and its adjusted basis – will be allocated, under section 704(c) and its regulations, to the partner that contributed the asset. To ensure that the contributing partners' deferral on the built-in gain lasts for a certain minimum duration, contributing partners and the OP may enter into a "tax protection agreement" requiring the partnership to indemnify them for any gain recognized as the result of the sale of contributed

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[13] See, e.g., S-11 of Paladin Realty Income Properties, Inc. (filed with the SEC on July 22, 2011); S-11 of CB Richard Ellis Realty Trust (filed with the SEC on July 30, 2008). In one UPREIT IPO, the current real estate owners retained control through ownership of high-vote shares in the REIT. See Form S-11 for Empire State Realty Trust, Inc. (filed with the SEC on February 13, 2012) (high-vote shares have equal dividend rights but fifty times the vote of common shares).

property for a specified period of time (or as a result of the discharge or shifting of a liability allocated to the contributing partner). The agreement will be particularly important to contributing partners who do not participate in the management of the REIT (or its advisor) and therefore have no control over the timing of the disposition of the OP's assets. Tax protection agreements are discussed in further detail below in Part III.

3. The Laws of UPREIT Physics

A fundamental characteristic of the UPREIT structure is that each OP unit is similar economically to a share of REIT stock. This economic result is achieved through the combination of a few features. First, substantially all of the assets of the REIT are interests in the OP, and the REIT does not generally engage in any business activities aside from serving as general partner of the OP. Second, "structural parity" is present between the OP and the REIT in that a single OP unit is exchangeable for a single share of REIT stock.[14] Finally, each OP unit is entitled to receive

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[14] The one-to-one exchange ratio is typical, but umbrella partnership units may be designed to be convertible into (and therefore economically equivalent to) some other fixed number of REIT shares. The REIT may have the right to elect whether to redeem a unit with a share of

distributions equal to the dividends paid on a share of REIT stock. These features, taken together, allow sponsors to realize the tax benefits of owning interests in the OP while achieving similar economics and much of the liquidity they would have had if they owned shares directly in the REIT.[15]

To ensure that this economic parity is maintained, any issuance of additional REIT shares to the public must be followed by a contribution of the proceeds by the REIT to the OP (or to the sponsors in a secondary sale) in exchange for an additional number of equivalent OP units. Without this requirement, the REIT shareholders' interests in the OP would be diluted, but the interests of the holders of OP units would not. Similarly, any redemption of REIT shares must be funded by the OP's redemption of an equivalent number of its units from the REIT. Moreover, this mirroring requirement applies to all securities of the UPREIT – any equity or debt instrument in the REIT must be mirrored by an

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REIT stock or with cash in an amount equal to the value of a share of REIT stock.

[15] Certain limitations may be placed on the transferability and exchange of OP units. See the discussion below in IV.B.

equity or debt instrument with equivalent terms issued by the OP to the REIT.

4. Proliferation in the 1990s

In late 1992, Taubman Centers, Inc., became the first public REIT to operate through an UPREIT structure. Six other public UPREITs were formed in 1993: General Growth Properties, Carr Realty, Manufactured Home Communities, Mark Centers Trust, Tucker Properties Corp., and Spieker Properties Inc. During the two year period from the end of 1992 to the end of 1994, the market capitalization of REITs nearly tripled, rising from $16 billion to $44 billion, and then tripled again by the end of 1997, rising to $140 billion. At the end of 2013, the figure stood at $670 billion.[16]

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[16] See http://www.reit.com/DataAndResearch/US-REIT-Industry-MarketCap.aspx. For examples of UPREITs, see, e.g., Agreement of Limited Partnership of Excel Trust, L.P. dated April 15, 2010 (filed with the SEC as Exhibit 10.1 to Form S-11/A of Excel Trust, Inc., on April 16, 2010); Second Amended and Restated Agreement of Limited Partnership of Paladin Realty Income Properties, L.P. dated February 6, 2008 (filed with the SEC as Exhibit 10.2 to Form S-11/A of Paladin Realty Income Properties, Inc., on July 18, 2008); Amendment No. 1 to the Second Amended and Restated Agreement of Limited Partnership of Mack-Cali Realty, L.P. dated August 21, 1998 (filed with the SEC as Exhibit 3.1 to Form S-3/A of Mack-Cali

5. The Anti-Abuse Regulations

The viability of the UPREIT structure was briefly threatened following the proposal of the partnership anti-abuse regulations in 1994.[17] Under the regulations, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Internal Revenue Service ("IRS") has the authority to recast the transaction for U.S. federal income tax purposes as appropriate to achieve tax results that are consistent with such intent. [18] Under one potential recast

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Realty Corp. on August 24, 1998); Second Restated Agreement of Limited Partnership of Highwoods Realty Limited Partnership, dated as of January 1, 2000 (filed with the SEC as Exhibit 10.1 to Form 10-K of Highwoods Properties, Inc., on December 22, 2005).

[17] Prop. Treas. Reg. section 1.701-2, 59 FR 25584 (May 17, 1994).

[18] Treas. Reg. section 1.701-2(b). To be consistent with the intent of Subchapter K, (i) the partnership must be bona fide and each partnership transaction or series of related transaction must be entered into for a substantial business purpose, (ii) the form of each partnership transaction must be respected under substance over form principles, and (iii) generally, the tax consequences under Subchapter K to each partner of partnership operations and of transactions

specifically mentioned by the regulations, the partnership is disregarded as separate from one or more of its partners.[19] In light of the economic parity between ownership of umbrella partnership units and REIT shares in a typical UPREIT structure, practitioners questioned whether the broad language of the anti-abuse regulations would be used to challenge UPREITs.[20]

In response to a series of comment letters from tax advisers,[21] the IRS added an example to the final anti-abuse

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between the partner and the partners must accurately reflect the partners' economic agreement and clearly reflect the partner's income. See Treas. Reg. section 1.701-2(a).

19 Treas. Reg. section 1.701-2(b)(1).

20 See comment letter from the National Association of Real Estate Trusts, June 24, 1994, 94 TNT 139-71 (proposing that the final regulations incorporate an example demonstrating that an UPREIT transaction is not abusive). Arguments for respecting the UPREIT structure are discussed below in IV.B.

21 See, e.g., comment letter from the New York State Society of Certified Public Accountants, July 6, 1994, 94 TNT 139-62 (noting that while an IRS official "reportedly stated that the regulation was not meant to apply to the so-called UPREIT structure . . . [i]t is in no way apparent from the language of the regulation that it does not apply UPREITs."); comment letter from Douglas J. Antonio of Sugar, Friedberg & Felsenthal, June 10, 1994, 94 TNT 121-11 ("The Proposed Regulation as currently worded is

regulations, finalized in late 1994, essentially blessing the UPREIT structure. In Treas. Reg. section 1.701-2(d), Example 4 (the "Example"), two existing partnerships with substantial real estate holdings contribute all of their real property assets to a new operating partnership ("New Partnership") in exchange for limited partner interests in New Partnership, after which the contributing partnerships terminate. The general partner of New Partnership is a newly formed REIT, which offers its stock to the public and contributes substantially all of the proceeds from the public offering to New Partnership. The limited partners in New Partnership are given the right, beginning two years after the formation of New Partnership, to require the redemption of their limited partner interests in exchange for cash or stock of the REIT (at the REIT's option) equal to the fair market value of their respective partnership interests at the time of the redemption. The Example concludes that such a structure is consistent with the

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so vague and ambiguous that it creates a stifling effect on legitimate economic transactions. . . . The effect on UPREIT transactions caused by the uncertainty generated by the language of the Proposed Regulation will have an annual effect on the economy measuring well into the billions of dollars.").

intent of Subchapter K and will not constitute an abusive transaction under section 701.

Notably, certain features of the UPREIT structure described in the Example differ from the features generally present in UPREITs. First, the Example notes that the REIT "may make other real estate investments and other business decisions, including the decision to raise additional capital for those purposes." Typical UPREIT structures, on the other hand, do not contemplate the REIT's acquisition of assets outside of the partnership, as discussed above. In addition, in the Example, partnership units are exchangeable for REIT shares of equal value to the exchanged units, rather than at a fixed exchange ratio, as is the typical arrangement. This, however, is less of a difference than it might seem given that the structural parity should cause the value of the OP units to track the value of the REIT stock. Finally, in the Example, only "some" of the limited partners possess the right to exercise a conversion privilege, whereas in a typical

structure all partners (other than the REIT) have the right to convert units to REIT shares.[22]

Because of these differences, many real estate practitioners (as well as the National Association of Real Estate Investment Trusts, the national trade group representing REITs) expressed concern upon the initial promulgation of the Example that it did not actually bless typical UPREIT transactions. However, based on statements by senior U.S. Treasury officials, it is now well-accepted that the anti-abuse regulations were not intended to apply to common UPREIT transactions, and that the differences between the Example and a typical UPREIT transaction should not be a cause for concern.[23]

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[22] Consider whether a variant of the UPREIT known as the "DownREIT" may be more consistent with the structure sanctioned in the Example. In a DownREIT, the REIT may make investments outside the OP, including through other OPs. Partners in these OPs, however, often have the right to exchange their OP units for a fixed number of REIT shares.

[23] See Unofficial Transcript of IRS Hearings on Partnerships, Doc PS-27-94, 94 TNT 147-18 (July 25, 1994) (Michael Thomson, acting Deputy Tax Legislative Counsel, agreeing with a witness's observation that senior members of the Treasury Department announced that the partnership anti-abuse regulations were not intended to apply to UPREITs); "Samuels Says Partnership Anti-abuse,

B. UP-Cs

1. Retaining Flow-Through Treatment

The UPREIT structure described above was a precursor to what has come to be known as an "UP-C," or "Pubco" structure. The UP-C looks very similar to an UPREIT, but substitutes a regular C corporation for a REIT, and accordingly is an IPO structure that can be used for businesses whose assets and activities are not REIT-eligible (i.e., non-real estate). In the words

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Consolidated Return Rules No Concern," Daily Tax Rep. (BNA) No. 93, at G-3 (May 17, 1994) (reporting that Leslie Samuels, Assistant Treasury Secretary, said that the proposed partnership anti-abuse rules do not apply to common real estate funding vehicles, known as UPREITs); Blake D. Rubin, Andrea R. Macintosh and Jonathan I. Forrest, "Doing a Deal with a REIT From the Owner's Perspective," 27 J. of Real Estate Tax'n 15 (Fall 1999) ("While there are slight differences between the example and the typical UPREIT structure, given the number of UPREIT deals in the market, challenges based on these differences in structure are unlikely."). See also Blake D. Rubin, Andrea M. Whiteway, and Jon G. Finklestein, "Representing the Owner in UPREIT and DOWNREIT Transactions," J. of Real Estate Tax'n (Third Quarter 2007) ("[T]he UPREIT structure has become well established and it is unlikely that the typical UPREIT structure would be subject to challenge."). One commentator recently suggested that the conclusion in Example 4 be reexamined. See Monte A. Jackel, "The Partnership Antiabuse Rule and UPREIT Structures Revisited," 150 Tax Notes 113 (Jan. 4, 2016).

of one commentator, "the Pubco structure expands the UPREIT beyond its real estate roots into corporate America."[24] Many U.S. companies have used the UP-C structure in connection with their initial public offerings, including barnesandnoble.com inc.,[25] Charter Communications,[26] Accenture[27] and Evercore.[28] More recent examples of UP-C structures include Emdeon,[29] Duff & Phelps,[30] Graham Packaging,[31] DynaVox,[32] and PBF Energy.[33]

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[24] Eric Sloan and Matthew Lay, "Beyond the Master Limited Partnership: A Comprehensive Review of Publicly Traded Partnerships," Taxes: the Tax Magazine (March 1, 2010).

[25] Prospectus of barnesandnoble.com inc. (filed with the SEC on May 26, 1999, although dated as of May 25, 1999). In fact, since barnesandnoble.com is widely credited as being the first non-REIT to use this structure, the UP-C is sometimes referred to as the barnesandnoble.com structure.

[26] Prospectus of Charter Communications, Inc. (filed with the SEC on Nov. 8, 1999).

[27] Prospectus of Accenture Ltd. (filed with the SEC on July 18, 2001).

[28] Prospectus of Evercore Partners Inc. (filed with the SEC on Aug. 11, 2006).

[29] Prospectus of Emdeon, Inc. (filed with the SEC on August 12, 2009).

[30] Prospectus of Duff & Phelps (filed with the SEC on October 1, 2007).

The establishment of an UP-C structure is very similar to that of an UPREIT. Specifically, a new C corporation is created, which issues common stock to the public in an initial public offering. Cash proceeds from the IPO are invested directly into the umbrella partnership (which may be an LLC treated as a partnership for tax purposes) in exchange for a managing interest, and a portion of the proceeds may be used to purchase interests in the umbrella partnership from the pre-IPO owners. The pre-IPO owners' interests in the umbrella partnership are then converted into limited partner interests (or nonmanaging member interests).[34] Similar to the right granted to the former real property owners in an UPREIT, the pre-IPO owners in an UP-C structure will enter into an exchange agreement with the umbrella partnership,

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[31] Prospectus of Graham Packaging Company Inc. (filed with the SEC on February 11, 2010).

[32] Prospectus of DynaVox Inc. (filed with the SEC on April 23, 2010).

[33] Prospectus of PBF Energy Inc. (filed with the SEC on December 13, 2012).

[34] This transaction would generally be governed by section 721(a) and would be treated in the same fashion as a contribution to an umbrella partnership in an UPREIT structure, as discussed above.

pursuant to which their partnership interests are exchangeable for stock in the C corporation or, often, the cash equivalent thereof.[35] It is common for the pre-IPO owners to receive special non-economic voting shares in the C corporation. These shares typically give the pre-IPO owners voting rights tied to the number of umbrella partnership units held by the holder at any given time, and therefore may allow the pre-IPO owners to continue to control the business.[36]

Despite its structural similarities to the UPREIT, the UP-C is designed to achieve different tax objectives. As described above, UPREITs developed as a way for real estate owners to raise capital in a going-public transaction without triggering tax on the

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[35] The C corporation may exercise its right to deliver cash in lieu of shares so as to safeguard against triggering of loss limitations under section 382. For a general discussion, see Eric B. Sloan, "Partnerships in the Public Space," 921 PLI/Tax 218A-1 (2011).

[36] See, e.g., Form S-1 of Evercore Partners Inc. (as filed with the SEC on May 12, 2006) ("Each limited partner of Evercore LP will be issued one or more shares of our Class B common stock. The shares of Class B common stock have no economic rights but will entitle the holder, without regard to the number of shares of Class B common stock held, to a number of votes that is determined pursuant to a formula that relates to the number of Evercore LP partnership units held by such holder.").

contribution of their assets to the REIT. The tax on contribution is not as much of a concern in the C corporation context, because the investment company rule will not typically apply when operating business assets are contributed to a C corporation. However, even if the sponsors could incorporate their business without any current tax using a C corporation, a C corporation is far less tax efficient than a REIT (or a partnership) because it is subject to an entity-level tax. Accordingly, by using an UP-C structure, these owners can use a corporate IPO vehicle while continuing to hold their interests on a tax-efficient basis at the flow-through level, and their share of the business' income will not be subject to an entity-level tax.[37] Additionally, the flow-through structure allows the character of the income to flow through to the pre-IPO owners, preserving the potential benefit of a preferred tax rate on capital gains and the use of excess capital losses.

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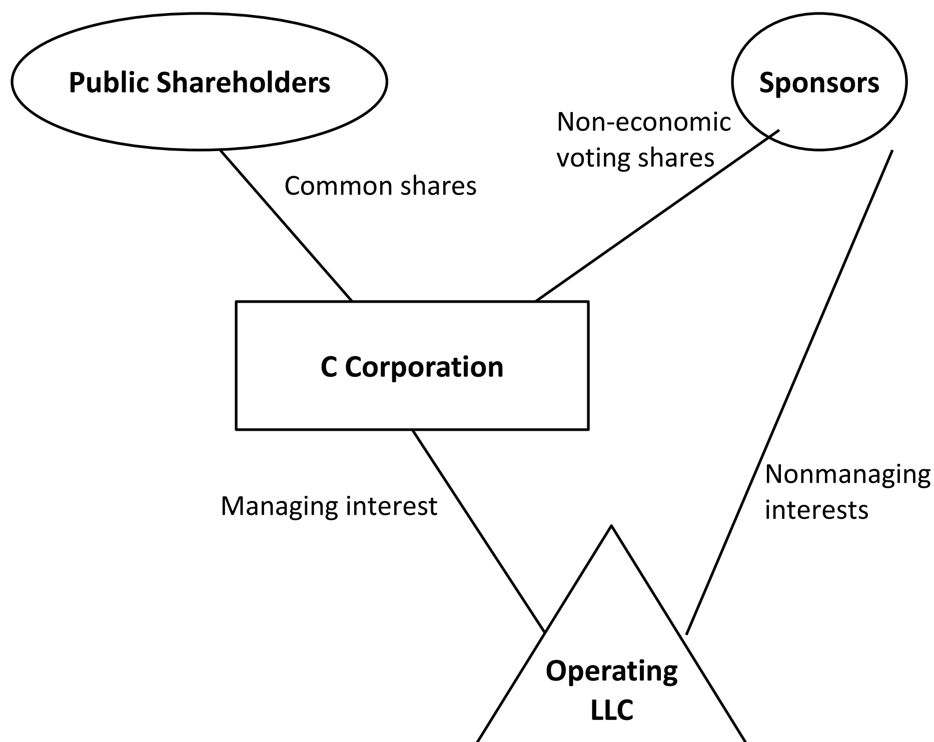
[37] As a corollary, allocations of income to the partners will increase their basis in their interests, reducing gain upon future sale and thus preserving the single level of tax on earnings.



2. A Step-Up for the C Corporation

Another major benefit of the UP-C relates to the exchange of interests in the OP for stock of the public company when the sponsors desire liquidity. When these exchanges take place, the corporation will obtain a step-up in the tax basis of its proportionate share of the assets of the partnership (which has in place an election under Section 754),[38] which will serve to increase

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[38] Sections 754 and 743.

depreciation and amortization deductions. In a typical non-UP-C public company, future sales of interests in the public corporation do not give rise to a step-up in the basis of the assets of the public company. In contrast to an UPREIT, which does not generally pay an entity-level tax, the C corporation in an UP-C may enjoy substantial cash tax savings as a result of this step-up.

The ability to pass along a step-up to the C corporation in connection with a taxable exchange of umbrella partnership units led to the adoption of what is generally known as a "tax receivable agreement" (or "TRA") in UP-C transactions.[39] TRAs provide the historic owners additional consideration upon exchange reflecting a substantial portion (often 85%) of the value of any tax savings attributable to the basis step-up resulting from an exchange. These TRA arrangements are addressed more fully in Part II, with

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[39] Evercore Partners Inc. appears to have been the first UP-C structure to use a TRA. (Although Lazard implemented a TRA in connection with its IPO in 2005, a year prior to Evercore's IPO, the Lazard transaction featured an UP-PTP structure, as described below.) As described more fully below, the TRA has evolved as a nearly ubiquitous component of umbrella partnership IPO structures, although there were IPOs well before the advent of the UP-C structure that featured agreements that shifted the tax benefits to historic equityholders.

specific reference to some of the more notable IPO transactions that have implemented such agreements.[40]

C. UP-PTPs

1. Background

In February, 2007, the Fortress Investment Group closed its initial public offering and became the first of a wave of investment fund sponsors using umbrella partnership structures with a publicly traded partnership, or UP-PTP. Since the Fortress transaction, other private investment fund sponsors have gone public or are considering going public using a similar structure,

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40 The tax efficiencies created by an UP-C structure exist irrespective of any TRA-like arrangements that provide for the allocation of certain of such benefits. In the IPO of barnesandnoble.com, for example, the pre-IPO owners of the business (Barnes and Noble and German media empire Bertelsmann AG) did not enter into a TRA with the public corporation.

Recently, UP-C structures have been used in effect to transfer U.S. corporations to foreign acquiring corporations without an actual transfer and thus without having to comply with section 367(a) for tax free treatment. See Amy S. Elliott, "Up-C Structures in Inversions May Raise Policy Concerns, 149 Tax Notes 610 (Nov. 2, 2015).

including Och-Ziff,[41] Blackstone,[42] KKR,[43] Carlyle,[44] and Oaktree.[45]

UP-PTP structures, which substitute a publicly traded partnership for a corporation as the public vehicle, follow the same general contours of the UP-C structure and generally afford fund

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[41] See Form S-1 of Och-Ziff Capital Management Group LLC (filed with the SEC on July 2, 2007).

[42] See Form S-1 of the Blackstone Group L.P. (filed with the SEC on March 22, 2007).

[43] See Form S-1 of KKR & Co. L.P. (filed with the SEC on July 3, 2007).

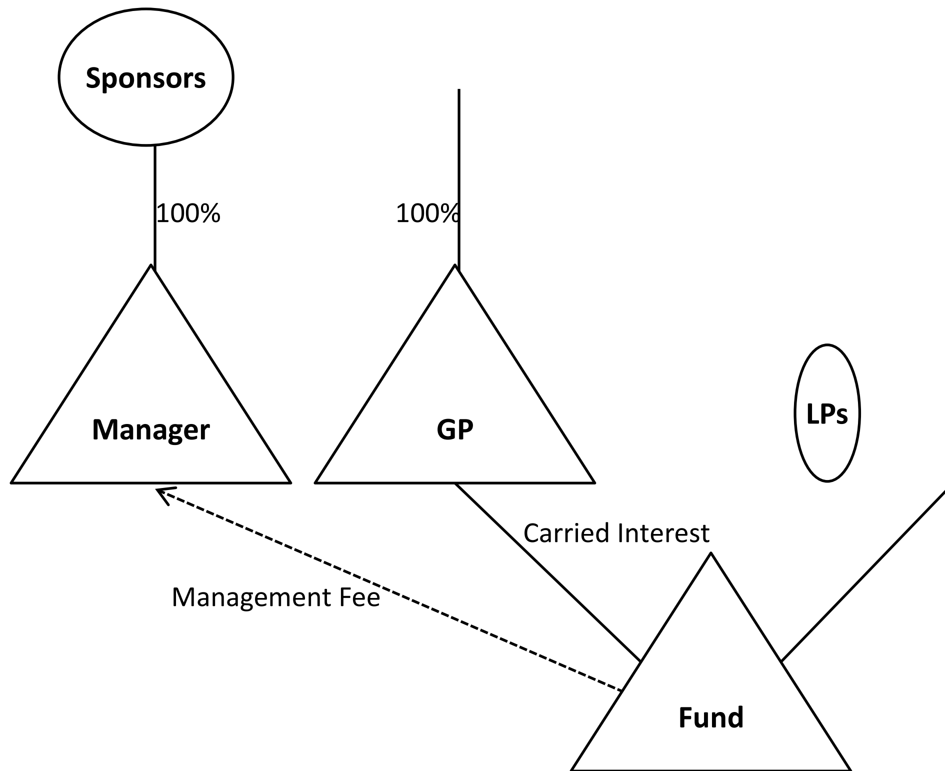
[44] See Form S-1 of the Carlyle Group L.P. (filed with the SEC on September 6, 2011).

[45] See Form S-1 of Oaktree Capital Group, LLC (filed with the SEC on July 17, 2011). The IPO of the investment bank Lazard Ltd. in 2005 is an interesting footnote in the history of UP-C and UP-PTP structuring. Lazard was actually an UP-PTP structure that preceded the IPOs of Blackstone and Fortress by a couple of years. However, Lazard's use of a PTP structure appears to have been structured in an effort to avoid the application of the section 7874 anti-inversion rule. The anti-inversion rules were later revised to treat foreign PTPs as U.S. corporations in certain circumstances. See 71 FR 32437, TD 9265 (June 6, 2006); TD 9453 (June 9, 2009). For a good general discussion of the Lazard IPO and section 7874, see Robert S. Bernstein, "Use of Foreign Publicly Traded Partnerships and the Lazard IPO," 32 Corp. Tax'n 45 (2005).

sponsors all of the benefits present in a typical UP-C structure. However, there are certain important structural differences and some significant incremental benefits of using an UP-PTP structure versus an UP-C structure. The most important such difference relates to the fact that, as discussed below, many investment funds generate significant amounts of "qualifying income" for purposes of the rules governing PTPs. To appreciate the reasons why an UP-PTP is used by private fund sponsors and the significant incremental benefits that flow from such structures, a digression into the structure and business of private equity and hedge funds, as well as the relevant PTP rules, may be useful.

2. The Nature of a Fund Sponsor's Income

In private investment funds, fund managers are generally entitled to a profits interest in excess of their capital interest (a "carry" or "carried interest") and a management fee, which is often calculated as a percentage of fund commitments or invested capital. The specific structures used vary greatly between fund sponsors, but below is a basic structure for a typical private equity fund.



As the diagram shows, the fund sponsor receives its two income streams – carry and management fees – through different vehicles. The carried interest is received by the sponsor in its capacity as the general partner of the fund and is generally structured as a "profits interest." Under current law, the receipt by a service provider of a profits interest, which entitles the service

provider only to share in future profits, is generally not a taxable event at the time of grant.[46] Rather, the service provider is taxable only on its allocable share of future partnership profits.

The management fee, on the other hand, is received by the adviser entity – typically a different entity than the general partner – pursuant to a management contract, and not as an interest in the partnership. In this regard, the management fee would generally be taxable as ordinary income for services and not as a distributive share of income from the fund. Generally, both the general partner and the entity organized to act as the adviser would be treated as partnerships for tax purposes.

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[46] See Rev. Proc. 93-27 (IRS generally will not attempt to treat transfer of a partnership profits interest to a partner for services as a taxable event); Rev. Proc. 2001-43 (supplementing Rev. Proc. 93-27). Prior to the issuance of Rev. Proc. 93-27, it was uncertain whether the IRS would successfully take the position that receipt of such a profits interest was nontaxable. Compare *Sol Diamond*, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974) (taxable) with *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991) (nontaxable). Under proposed regulations issued in 2005, the partnership and all of its partners would be required to elect treatment under which receipt of a partnership interest would be taxable in the amount of the interest's liquidation value. See Prop. Treas. Reg. section 1.721-1(b) and section 1.83-3(l), 70 FR 29675 (May 24, 2005).

3. The PTP Rules – 90% Qualifying Income Exception

Subject to certain exceptions, a PTP is treated as a corporation for U.S. tax purposes. For this reason, a typical operating business, such as those that have used the UP-C structure described above, could not maintain its status as a partnership upon becoming a publicly traded company. There is, however, an exception to the general rule treating PTPs as corporations for companies 90% or more of whose income constitutes "qualifying income" within the meaning of section 7704(d) and applicable Treasury regulations. Qualifying income generally includes interest, dividends, rents from real property and gains from the disposition of real property, or of a capital asset (or property described in section 1231(b)) that is held for the production of income that is qualifying income.[47]

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[47] Qualifying income under section 7704(d) also includes income or gains derived from a broad category of activities related to mineral or natural resources, income and gains derived from commodities (not described in section 1221(a)(1)) or futures, forwards, and options with respect to commodities, and income from categories relevant under the REIT and RIC qualification tests. The regulations expand the definition of qualifying income to include certain other types of investment income. See Treas. Reg. section 1.7704-3(a).

As discussed above, the carried interest in a fund is generally structured as a partnership interest in the entities through which the fund makes its investments. Accordingly, the income generated by the carried interest takes its character from the partnership's underlying income. For example, if a fund makes investments in entities treated as corporations for U.S. tax purposes, the income generated by the fund and any distributive share allocable to the carried interest would generally consist of dividends and capital gain, both of which constitute qualifying income. On the other hand, to the extent a fund's income constitutes fees or income from operating entities owned in pass-through form, such income would not generally constitute qualifying income. In this respect, management fees would not generally satisfy any of the categories of qualifying income.

4. The UP-PTP Structure

As mentioned above, an UP-PTP is structured much like an UPREIT or UP-C, but with a PTP employed as the vehicle in which the public invests through an offering of limited partner units in the PTP. The sponsors control the business through a general partner interest in the PTP, and may exchange their non-publicly traded equity for the publicly traded PTP units. The

operating business initially owned by the sponsors is typically an investment fund manager that earns (through separate entities) nonqualifying income in the form of management fees, and qualifying income in the form of capital gains, with the nonqualifying income often exceeding 10% of the total income of the operating business. The PTP will invest in the portion of the operating business that generates nonqualifying income through a corporate subsidiary. Though the underlying income earned by the corporation would not constitute qualifying income, from the perspective of the PTP, the only income that would be realized would be in the form of dividends and capital gains – both of which are forms of qualifying income. In this way, the PTP can satisfy the 90% test and preserve the benefit of avoiding an entity level tax with respect to any income not earned through the corporation. Therefore, unlike operating companies whose only option is an UP-C structure (or simply a corporation without an umbrella partnership), private investment firms can use a PTP vehicle as the public vehicle and thereby avoid a second layer of tax on qualifying income such as that attributable to carried interest.

5. Retaining Flow-Through Treatment; Step-Up for the PTP

As in a standard UP-C structure, the fund sponsors in an UP-PTP are able to continue to enjoy the benefits of full pass-through treatment prior to exchanging their interests and exiting. Ownership through the PTP entails bearing corporate income tax on the portion of the income passing through the subsidiary corporation, which the holders of interests in the umbrella partnership avoid. In addition, as in the typical UP-C IPO structure, sponsors generally benefit from a TRA allowing them to monetize a portion of the depreciation and amortization deductions recognized by the corporation in connection with the corporation's acquisition of interests from the sponsors.[48]

6. Additional Umbrellas

Because it may be necessary to use a corporate subsidiary for income that would not constitute qualifying income for

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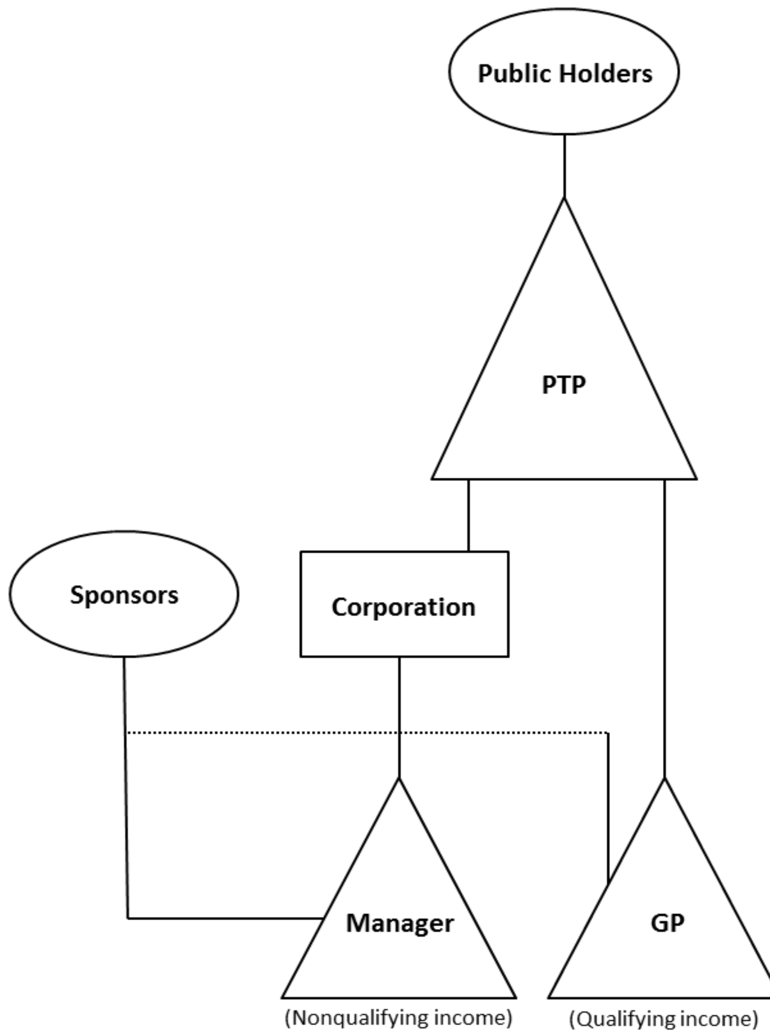
[48] The anti-churning rules of section 197(f)(9) deny an amortization benefit for intangible assets that have been held or used by the taxpayer or a related person at any time between July 25, 1991 and August 10, 1993. In the UP-PTP context, the anti-churning rules would not apply to a basis increase under section 743 so long as the corporation is not related to the exchanging holder. See Treas. Reg. section 1.197-2(h)(12)(v).

purposes of the PTP rules, UP-PTPs generally use at least two umbrella partnerships – one umbrella partnership whose income is "good" income for PTP purposes and which flows directly (or through one or more flow-through entities) up to the PTP, and one umbrella partnership whose income is "bad" income for PTP purposes and flows up to the corporate subsidiary owned by the PTP. Additional umbrella partnerships may be used if, for example, an additional foreign corporation is used for foreign income that would not necessarily constitute qualifying income.

The principles of structural parity present in the UPREIT and UP-C structures must also be present in the UP-PTP structure. Maintaining this parity requires the holder of interests in the umbrella partnerships to own the same number of units in each such partnership. The sum of the distributions received by the sponsors with respect to all of their umbrella partnership interests are then the same as what a holder of the equivalent PTP units would receive (less any taxes or costs in the public structure). The umbrella partnership units are exchangeable for interests in the PTP at a ratio of one unit in all umbrella partnerships for one PTP unit.



II. Tax Receivable Agreements

As mentioned above, TRAs have become an integral part of umbrella partnership IPO structures. In fact, umbrella partnership sponsors often insert provisions in shareholder

agreements, partnership agreements and even debt documents that contemplate the potential use of a TRA in connection with a public exit. However, while umbrella partnership IPO structures have made TRAs more commonplace, TRA arrangements predate the use of umbrella partnerships. This section describes some of the history of TRAs, both prior to, and including their use in umbrella partnership structures, and then describes common features of umbrella partnership TRAs and their tax treatment to the beneficiaries.

A. First Generation TRAs not Involving Umbrella Partnerships

1. O'Sullivan Industries, Inc. – 1994

One of the earliest reported TRAs was entered into in 1994 by O'Sullivan Industries Holdings, Inc., ("O'Sullivan") a designer and manufacturer of furniture products.[49] Prior to its 1994 IPO, O'Sullivan was owned by Tandy Corporation. In connection with its IPO, O'Sullivan entered into a "tax sharing and tax benefit

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[49] The TRA in O'Sullivan is described in the registration statement associated with the going-private transaction of the company in 1999. See Form S-4/A of O'Sullivan Industries Holdings, Inc. (filed with the SEC on October 29, 1999).

reimbursement agreement" with Tandy. This agreement was based on the fact that the IPO was structured as a "qualified stock purchase" (or "QSP") under section 338,[50] resulting in a step-up in the tax basis of O'Sullivan's assets. Under the tax sharing and tax benefit reimbursement agreement, O'Sullivan agreed to pay Tandy "nearly all" of any tax benefits it received as a result of the increased deductions.[51]

2. Endo Pharmaceuticals – 2000

In 1999, in connection with its IPO, Endo Pharmaceuticals Holdings Inc. ("Endo") acquired all of the stock of Algos Pharmaceutical Corporation ("Algos") in exchange for Endo stock and warrants to purchase additional Endo stock. As a result of the transaction, the historical Endo stockholders owned approximately 80% of the combined company, and former Algos stockholders

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[50] See the discussion below of the "supercharged" IPO of Genworth Financial. See also FSA 2111 (June 2, 1997) (addressing the IRS's analysis of a qualified stock purchase IPO structure).

[51] Five years after the IPO, O'Sullivan was acquired in a leveraged buyout. A controversy arose between the parties as to the effect of the newly incurred acquisition debt on the payments required to be made under the tax agreement. The disagreement resulted in litigation between the parties. See O'Sullivan S-4/A.

owned 20%.[52] At the time of the transaction, Endo employees held a number of outstanding and unexercised Endo stock options. To ensure that any post-transaction exercise of these options would dilute only the historical Endo shareholders, Endo agreed to use its reasonable best efforts to cause the historical Endo stockholders to contribute their shares of Endo common stock to a newly formed LLC subsidiary, Endo Pharma LLC ("Endo Pharma"). Endo Pharma agreed to provide the Endo stock due to an employee upon such employee's future exercise of an option.

Though it was Endo Pharma that assumed the obligation to provide Endo stock upon exercise of the options, as a matter of tax law, it was Endo that would receive the corresponding compensation deduction. Thus, the parties entered into a tax sharing agreement which provided that Endo would pay Endo Pharma (and indirectly, the transferring shareholders) any tax benefits realized as a result of these option exercises. The payments to Endo Pharma were required only upon the occurrence

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[52] See Form S-4/A of Endo Pharmaceutical Holdings Inc. (filed with the SEC on June 14, 2000).

of certain "liquidity events," and equaled 100% of the tax savings attributable to the compensation deductions at issue.[53]

Although the tax sharing agreement and the relevant facts in the Endo transaction were somewhat unique, it is important as an early example of equityholders' negotiating for the right to additional, contingent consideration on a disposition of property based on tax benefits expected to be enjoyed by the acquirors.

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[53] The tax savings were to be measured on a "with and without" basis. The Endo agreement actually included an example in order to illustrate the computation: "By way of example, and solely for the avoidance of doubt, if Endo has a loss for tax purposes in Year 1 of $100, consisting of $65 of deductions attributable to the exercise of Endo LLC Options and $35 of deductions attributable to interest expense, and in Year 2 Endo has $40 of taxable income prior to application of the NOL, $35 of the $40 NOL applied against Year 2 income will be deemed to be attributable to the interest expense and $5 of the NOL will be deemed attributable to the exercise of the Endo LLC Options. Therefore, the Tax Benefit Amount would be the Taxes that would have been payable by Endo if its NOL in Year 2 had been only $35. The NOL carryforward to Year 3 of $60 would then be treated as consisting entirely of deductions resulting from the exercise of the Endo LLC Options." Form of Tax Sharing Agreement (attached as Exhibit G to Appendix A of Endo Pharmaceutical Holdings' S-4/A).

3. "Supercharged" IPO – Genworth Financial – 2004

In 2004, General Electric ("GE") sold a substantial portion of its insurance business by offering shares of Genworth Financial ("Genworth") to the public in an IPO. In the transaction, a GE subsidiary transferred shares of several subsidiaries to Genworth in exchange for Genworth stock. As part of a plan, GE sold 30% of the Genworth stock to the public through a firm-commitment underwriting.[54] GE did not contractually obligate itself to dispose of any additional Genworth equity beyond the 30%, but it did state that it "expect[ed] to reduce its interest to below 50% within two years of the completion of this offering."[55]

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[54] See Prospectus of Genworth Financial, Inc. (filed with the SEC on May 25, 2004). The underwriters also had an overallotment option covering another 4% of the Genworth stock.

[55] Genworth Prospectus. Selling more than 50% of its interest was necessary to qualify the transfer as a QSP, as described in the text immediately below. In the private letter ruling issued to GE in connection with the transaction, GE actually represented to the IRS that "A sale to the public of less than 50% of [Genworth] (after the [[s]ubsidiaries] have been transferred by [GE] to [Genworth]) would not achieve the objectives of [GE] in connection with the planned disposition of the [[s]ubsidiaries]. In addition, [GE] would not effect the proposed transfer of the [[s]ubsidiaries] to [Genworth] and

By selling more than 30% of its Genworth stock in the IPO transaction to persons not treated as transferors for purposes of section 351, GE was able to "bust" the tax-free nature of the contribution to Genworth. In addition, by committing to reduce its ownership in Genworth to below 50%, the transfer of assets to Genworth could be treated as a QSP under section 338.[56] Since the

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the Initial Public Offering without being reasonably certain, based on advice received from their financial advisers, that they will be able to effect a disposition of sufficient additional shares of [Genworth] to reduce their ownership of [Genworth] below 50% through one or more additional public offerings." PLR 200427011.

[56] Section 338(d)(3) defines a QSP as a transaction, or series of transactions within a 12-month period, in which the purchasing corporation acquires, by means of a statutory purchase, stock possessing at least 80 percent of the voting power and value of the target's outstanding stock (excluding certain "plain vanilla" preferred stock). A "purchase" is defined in section 338(h)(3) and excludes certain tax-free acquisitions or transactions between related entities. Specifically, under section 338(h)(3)(A)(iii), an acquisition is not a "purchase" if the stock is acquired from "a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) thereof) be attributed the person acquiring such stock." For these purposes, the relevant attribution rule is section 318(a)(3)(C), which is triggered by an ownership percentage of 50%. Accordingly, by committing to sell more than 50% of the Genworth stock in connection with the transaction, GE was able to avoid this relatedness rule and thereby avoid this exception to the statutory "purchase" definition.

exchange was treated as a QSP, GE was able to elect under section 338(h)(10) to treat the transfer of shares as a taxable asset acquisition for U.S. federal income tax purposes. Accordingly, Genworth obtained a stepped up, fair market value tax basis in the acquired insurance assets.[57] In connection therewith, GE entered into a "Tax Matters Agreement" with Genworth which required Genworth to pay GE 80% of the tax savings resulting from this tax basis increase.[58]

B. Umbrella Partnership TRAs

1. Background

Although it did not feature a TRA, the barnesandnoble.com IPO was significant in that it introduced a structure that afforded companies a basis step-up in connection

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57 For a discussion regarding the applicability of the anti-churning rules of section 197 to the Genworth IPO, see Robert Willens, "General Electric 'Supercharges' the Genworth Financial IPO," 104 Tax Notes 661 (Aug. 9, 2004). See also Treas. Reg. section 1.197-2(h)(8) and Treas. Reg. section 1.197-2(k), Ex. 24.

58 The magnitude of the TRA payments (excluding certain contingent payments and interest) was capped at $640 million, but this cap could increase if the estimates done at the time of the IPO proved inaccurate. See Genworth Prospectus.

with initial public offerings and on-going secondary market sales by sponsors. Lazard, in 2005, appears to have been the first issuer to combine a TRA with an umbrella partnership structure to allow the sponsors to share in the benefit of this step-up. Since then, employing a TRA has become fairly standard in public UP-C or UP-PTP transactions. The following sections describe some of the common terms of the TRAs used in connection with umbrella partnership IPOs, as well as certain innovations or enhancements that have emerged in the market.

2. Overview of Basic TRA Terms

Certain terms have become fairly standard in TRA arrangements in umbrella partnership structures. TRAs typically provide that the umbrella partnership have in effect an election under section 754 for each taxable year in which an exchange occurs. This election will result in a basis adjustment to partnership assets in the case of taxable exchanges (via section 743(b)) and partnership distributions (via section 734(b)).[59] Below is a summary list of some of the more typical features of TRAs.

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[59] Basis adjustment under section 1012 or section 732 may also be relevant in the event that an exchange results in the

Supporting Documentation. The public corporation is required to deliver to the exchanging partner (or other TRA beneficiary) within a specified number of days following the filing of its U.S. federal income tax return,[60] a schedule showing the basis adjustments triggered by any exchanges, along with the computation of any "realized tax benefit" for the year. This schedule, as well as supporting work papers, is subject to standard dispute resolution and reconciliation procedures that are spelled out in the TRA.

Payment of Realized Tax Benefits. Within a specified number of days of the schedule's becoming final, the corporation is required to pay the partner a "tax benefit payment" equal to 85%[61] of the realized tax benefit for the year attributable to the

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OP being treated as a disregarded entity for U.S. federal income tax purposes.

60 This period is typically 45, 90 or 180 calendar days.

61 Nearly all umbrella partnership TRAs provide for an 85%/15% split of tax benefits. A few notable exceptions are Virgin Mobile USA Inc. (100%), Crumbs Bake Shop, Inc. (75%) and Spirit Airlines, Inc. (90%). The Spirit Airlines, Inc. TRA, however, does not relate to tax basis adjustments, but instead relates to the use of net operating losses that existed at the time of the IPO. This TRA innovation is discussed more fully below. One

exchange, plus interest at an agreed rate (computed from the due date of the applicable tax return).[62] The tax benefit for the year is computed by comparing the hypothetical[63] tax obligation that would have been due in the absence of the basis adjustments (and in the absence of any imputed interest attributable to TRA payments under the Code provisions dealing with interest on deferred sale transactions, such as section 483),[64] with the actual tax liability for the year (i.e., on a "with and without" basis).[65]

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commentator has noted that "[t]here's no magic to the 85/15. It was something that was developed in the early deals that has stuck." Amy S. Elliott, "IPO Agreements that Shift Basis Step-Up to Sellers Proliferate," 132 Tax Notes 334 (July 25, 2011) (quoting Philip Gall at a May 2011 PLI conference).

[62] The TRAs typically also provide for additional payments (or negative adjustments) if a schedule is amended as a result of (i) determinations by taxing authorities, (ii) material inaccuracies, (iii) changes as a result of carrybacks or carryforwards of tax items, and (iv) payments under the TRA itself (which have the effect of further increasing basis, as discussed below).

[63] This defined term for this hypothetical tax liability is generally the "Non-Stepped Up Tax Liability," or the "Hypothetical Tax Liability."

[64] In the typical TRA arrangement, the taxable exchange by pre-IPO owners of their interest in the umbrella partnership triggers the payment obligations under the TRA. Since those exchanges are taxable sales, any

Company's Right to Terminate. Typically, the public company can elect to terminate the TRA at any time with respect to some or all of the partnership interests held by the pre-IPO owners. In such event, the company is required to pay to the TRA

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additional payments made to the pre-IPO owners in respect of such exchange (whether pursuant to the TRA itself or otherwise) are analyzed as additional sale consideration giving rise to further basis adjustments. Since TRAs will always provide for payments beyond the year in which the initial exchange occurred, a portion of the amounts paid to such exchanging equity holders will be recharacterized as "unstated interest" under section 483. These recharacterized payments, in turn, will give rise to interest deductions benefitting the public company, and the benefits attributable to these interest deductions are typically covered under the TRA. The portion of the TRA payments that are not recharacterized as unstated interest are treated as additional purchase price, which serve to further increase the basis of the partnership's assets (sometimes referred to as "step-up on the step-up"). In the case of intangible assets amortizable under section 197 (which comprise much of the value of TRAs), the additional basis is amortized ratably over the remainder of the 15-year amortization period, beginning with the first day of the month in which the basis increase occurs. Treas. Reg. 1.197-2(f)(2)(i).

[65] Since the rules that mandate basis adjustments can also create a step-down in tax basis, TRAs will typically refer to a "realized tax detriment," which represents the excess of the company's actual taxes over the hypothetical tax obligation that would have been due in the absence of the basis adjustment. These tax detriments, where applicable, can serve to adjust downward any tax benefit payments that would otherwise be due.

beneficiaries an “early termination payment.” The early termination payment is generally defined as the present value (using an agreed-upon discount rate) of all tax benefit payments that would have been required to be made to the applicable partner under the TRA, using certain “valuation assumptions.” These assumptions include (1) for each taxable year ending on or after termination date, the company will have sufficient taxable income to use the deductions arising from the basis adjustments (as well as the imputed interest deductions) during such taxable year, (2) the tax rates in effect as of the early termination will remain in effect, (3) loss carryovers available as of the termination will be used on a pro rata basis for each year following the termination, and (4) all unexchanged partnership interests are actually exchanged as of the termination date.[66]

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[66] The valuation assumptions also include assumptions as to the timing of the disposition of nonamortizable assets. Specifically, nonamortizable assets are customarily treated as being disposed of on the 15th anniversary of the relevant basis adjustment (or other appropriate period depending upon an assumed holding period for the asset). Private investment fund TRAs (i.e., the UP-PTPs) typically also provide that “private equity fund related assets” are deemed to be disposed of pro-rata over the number of years remaining under the applicable fund agreement.

Change of Control. In the event of a "change of control," the TRA payments will be calculated based on certain assumptions intended to avoid significant distortions that may otherwise result from the company's inheriting of tax attributes from M&A counterparties.[67]

Subordination. Payments under the TRA are typically subordinated to any payments due in respect of indebtedness of the company and its subsidiaries.[68]

Late Payments. Late payments under the TRA will bear interest at an agreed rate.[69]

TRA Term. The TRAs typically have a term that lasts until all relevant tax benefits have been used or have expired (or until an early termination of the TRA).

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[67] These assumptions are described in greater detail in II.B.3.c) below. Also as discussed below, a TRA may alternatively provide that a change of control is an acceleration event.

[68] See the discussion regarding creditor issues in II.B.3.e) below.

[69] The most common rate used for late payments is LIBOR plus 100 basis points.

3. Additional TRA Provisions and Variations

Although the TRA terms described above are typical, the terms of a given TRA may vary significantly from the above terms. This section discusses certain issues and pressure points that arise in the negotiation of TRAs. As described below, some of these issues are not necessarily unique to umbrella partnership TRAs, but are discussed here because of their significance to TRAs in general.

a) New Basis versus "Historic" Basis

In general, TRAs compensate sponsors for a portion of the value of the step-up in basis to the corporation resulting from the IPO or future exchanges. These arrangements are premised on the assumption that the public does not value such tax benefits and therefore would pay the same amount for shares of a company that did not own these attributes. However, there have been at least two TRAs that provide for the payment of tax benefits attributable to the amortization of *all* tax basis in certain assets, and not simply the step-up in tax basis resulting from taxable exchanges by pre-IPO owners.

In 2007, Duff & Phelps Corporation, a financial advisory and investment banking firm, sold its shares in an initial public offering. In connection with the IPO, the company entered into a TRA with the existing unitholders of Duff & Phelps Acquisitions, LLC, through which the business had been run. The TRA, like the ones described above, provided for the payment by the corporation to the exchanging unitholders of 85% of the tax benefits attributable to basis increases triggered by such exchanges. However, the agreement also provided for the payment of 85% of *any* tax benefits attributable to "IPO Date Intangible Assets." This includes any historic tax basis in such assets.[70] The way this economic term was implemented was to provide in the agreement that in computing the "Hypothetical Tax Liability" of the corporation, the "Non-Stepped Up Tax Basis" of the "IPO Date Intangible Assets" is deemed to be zero. Although an exchange of

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[70] Form of Tax Receivable Agreement (filed with the SEC as Exhibit 10.6 to Form S-1/A of Duff & Phelps Corporation on September 21, 2007). The TRA defined "IPO Date Intangible Assets" as "each asset that is held by [Duff & Phelps Acquisitions LLC], or by any of its direct or indirect subsidiaries treated as a partnership or disregarded entity for purposes of the applicable Tax, immediately prior to the IPO Date and is described in Section 197(d) of the Code."

units was still necessary to trigger a payment under the TRA, the actual computation for the relevant year would reflect not only the amortization of the increased basis created by the exchange, but also by any other amortization of basis for such asset during the relevant year.[71]

Although this TRA feature is somewhat unique, its justification is not all that different from the "base case" TRA that calls for contingent consideration to be paid to sponsors by virtue of tax basis that will arise in the future. According to one tax practitioner, "[i]t's true that the corporation would have gotten that existing basis even in a full-on incorporation, but if investors value stocks based on EBITDA, the investors wouldn't have taken into account any tax basis from existing basis either."[72]

b) NOLs

A few recent IPO issuers have used TRAs that compensate pre-IPO owners for tax attributes (most significantly, net operating losses) that exist at the time of the IPO and that the now publicly

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71 In 2010, another issuer, DynaVox, Inc., a maker of communications solutions, also used the "historic basis" TRA arrangement.

72 Elliott, supra note 61 (quoting Gall).

traded business expects to be able to use to reduce its tax burden going forward.[73] These arrangements do not relate to future increases in tax basis, but instead compensate pre-IPO owners for future realization of tax attributes that the public company can use from day one. Although these arrangements have arisen primarily in UP-C transactions, a TRA that is based on NOLs has no specific connection to an umbrella partnership structure, but rather is based on the fact that a business may go public using a vehicle that has (or whose subsidiaries have) significant loss carryforwards.

An NOL-based TRA was used in connection with the 2010 IPO of Graham Packaging. Graham Packaging employed an UP-C IPO structure, using an existing corporation controlled by a sponsor group that had been used as the vehicle to acquire interests in the Graham operating partnership in 1998. The 1998 acquisition gave rise to a stepped-up basis (and resulting amortization deductions) that left the corporate "blocker" entity with a significant amount of NOL carryforwards. Graham Packaging entered into a TRA based on these NOL

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[73] Virgin Mobile actually implemented a TRA in 2007 based on the utilization of NOLs that existed at the time of its IPO.

carryforwards,[74] which provided for the payment to the corporation's shareholders of 85% of the cash tax savings attributable to these NOLs.[75]

c) Impact of Change of Control Transactions on TRAs

Nearly all umbrella partnership TRAs contain special provisions dealing with "change of control" transactions involving the public company. A change of control is usually defined, with some variations, as any of the following events: (i) a person or group of persons becoming the beneficial owner of 50%[76] of the company's stock; (ii) the directors of the company as of the IPO date ceasing to constitute a majority of the board; (iii) an adoption of a plan of liquidation of the company (other than a liquidation

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[74] The Graham Packaging transaction actually featured two separate TRAs, one of which was comparable to the more "typical" TRA that is based on future taxable exchanges by historic equityholders of their partnership interests. Additionally, the TRA relating to the NOLs covered other attributes as well, specifically, capital losses, charitable deductions and AMT credit carryforwards.

[75] See "Monetizing the Shield: Tax Receivable Agreements in Private Equity Deals," Debevoise & Plimpton Private Equity Report, Fall 2010, Volume 11, Number 1.

[76] In the Lazard TRA the threshold percentage was 20%.

into an entity under common control by the company's shareholders); and (iv) a merger or consolidation of the company or any of its subsidiaries unless (1) the company's board immediately prior to the transaction continues to constitute a majority of the board, and (2) the company's shareholders continue to own more than 50% of the voting power of the company.[77]

The consequence of a change of control transaction will typically be that the valuation assumptions described above (in connection with the company's right to electively terminate the TRA at any time) will be triggered for purposes of computing future payments under the TRA. Specifically, the TRA will provide that "for each taxable year ending on or after the date of a change of control, all tax benefit payments…shall be calculated by

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[77] Several investment firms with UP-PTP structures have used a simpler definition of "change of control" in their TRAs. Specifically, the TRAs of Blackstone, Apollo and KKR define "change of control" as "the occurrence of any [person], other than a person approved by the [current general partner/manager/managing partner], becoming the [general partner/manager] of the [publicly traded partnership]." Presumably this difference is attributable to the fact that since these issuers use a partnership as the public entity, the sponsor will continue running the business so long as it (or an approved assignee) holds the general partner interest.

utilizing [the valuation assumptions]."[78] This TRA feature presumably arose because of a concern on the part of the TRA beneficiaries that future transactions undertaken by the public company (at a time when the current management and shareholders have been replaced) may disproportionately harm the rights of the TRA beneficiaries. Accordingly, upon the occurrence of a change of control, any future TRA computations assume the public company has sufficient taxable income to make use of the (compensable) tax attributes available in any given year.

The use of these valuation assumptions (specifically, the one that relates to taxable income) in change of control situations will yield an odd result in the case of TRAs that relate to pre-IPO NOLs of the public company. Since these tax attributes exist at the time of the IPO (as opposed to being created upon future

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[78] See, e.g., Fortress, Blackstone, Apollo, Duff & Phelps, Virgin Mobile, Och-Ziff, Emdeon, DynaVox, KKR, Crumbs Bake Shop. Typical SEC disclosure relating to the change of control feature will provide that "upon a merger, asset sale or other form of business combination or certain other changes of control, [Issuer's] (or its successor's) obligations…would be based on certain assumptions, including that [Issuer] would have sufficient taxable income to fully utilize the deductions arising from the increased tax deductions and tax basis."

exchanges), using the standard valuation assumptions could require the company to pay for all these NOLs in the first tax year following a change of control. For these reasons, several issuers with TRAs that cover NOLs have modified the standard change of control provision. For example, in Graham Packaging, the TRA provides for the calculation of present value assuming a stream of taxable income that is "in accordance with management's pre-existing projections" rather than an outright assumption that all attributes will be used. In this way, the change of control transaction does not give rise to inflated TRA payments, and allows the new owners to avoid ongoing obligations under the TRA.[79]

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[79] The IPO of Vantiv, Inc. implemented a different approach to the change of control situation. Under the Vantiv TRA, a change of control does not automatically terminate the TRA. On the other hand, a change of control also does not necessarily trigger the assumption that the company will earn sufficient taxable income in future periods. Instead, the TRA provides that in the event of a change of control, if the company did not have an obligation to make any actual TRA payments in the prior two years, the TRA continues to operate without any valuation assumptions, using the actual tax savings. If, however, the company did have a TRA obligation during the prior two years, then the "typical" valuation assumptions kick in, including the assumption that the company will have sufficient taxable income to use against available tax attributes. See Tax

d) Disallowance Provisions

Because TRAs relate to the use of tax attributes, the parties must consider whether their TRA should provide for clawbacks or adjustments of any sort if a previously claimed tax attribute is disallowed. Most TRAs never require their beneficiaries to repay amounts that have been previously paid under the TRA. However, various TRAs do employ certain adjustment mechanisms to mitigate the risk of disallowance to the public company. For example, the Lazard TRA provides that 20% of each payment that otherwise would be due under the TRA is to be deposited into an escrow account until the expiration of the applicable statute of limitations.[80]

Receivable Agreements (filed with the SEC as Exhibits 10.30, 10.31, 10.32, and 10.33 to Form S-1/A of Vantiv, Inc. on March 5, 2012).

80 Although the escrow provision is not common, most TRAs provide for the annual tax benefit schedule to be amended from time to time to reflect determinations by taxing authorities or tax carrybacks. See supra note 62. Each year, the TRA payment is subject to reduction if a prior year's schedule has been amended to reflect a disallowance of a tax attribute that had been previously claimed. As mentioned above, however, in no event can these negative adjustments give rise to a payment from the beneficiaries to the company.

e) Creditor Issues

As is the case with many partnership agreements, the operating agreements governing umbrella partnerships will feature a tax distribution provision to ensure that the partners have sufficient cash to pay their tax liabilities attributable to the partnership. These tax distributions, like any other distributions to be made by the umbrella partnership, are usually required to be made on a pro rata basis.

When a partnership incurs third-party debt, it is common for the restricted payment covenant to contain an exception dealing with these tax distributions. A TRA arrangement, however, presents additional issues that must be considered when negotiating a restricted payment covenant. This is because the public corporation will need funds from the partnership to pay its taxes as well as to meet its contractual TRA obligations.

Conceptually, it may be reasonable to expect that lenders would agree to allow distributions to be made to the public company to make payments under the TRA. This follows from the fact that in a "typical" IPO (without an umbrella partnership), there is no basis step-up, and in such cases the lenders would permit the company to pay its taxes on that basis. Accordingly, lenders are

arguably in the same position as would be the case in the absence of the additional tax efficiencies introduced by the umbrella partnership structure. Moreover, 15% of such savings will actually remain in the credit group. Despite this, lenders may nonetheless view the beneficiaries of a TRA no differently than unsecured creditors of the corporation.[81] Furthermore, even if a lender viewed the TRA payments as quasi-tax distributions, a blanket provision allowing the borrower to make payments that are owed under the TRA may be perceived as over-inclusive, since, as described above, there are certain scenarios (such as early terminations and changes of control) where payments under the TRA will not correlate to actual tax savings.

A tax distribution can be drafted to disregard any tax deductions resulting from adjustments to asset basis under section 743. In such cases, the amounts distributed should roughly equal the amounts needed by the public company to pay its taxes and make its TRA payments. In fact, in situations where distributions (including tax distributions) must be made pro rata, this solution

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[81] The TRA obligation is likely not indebtedness for tax purposes, but see PLR 201027035 (implying that a TRA could be indebtedness for tax purposes).

may even be necessary to ensure that the umbrella partnership's other partners (i.e., those who do not have a section 743 tax shield) receive enough cash to cover their taxes. In any event, where an umbrella partnership negotiates a credit agreement, the issues of tax distributions, pro rata economics and TRA obligations are certain to arise. Issuers often disclose to investors the risk that a company's debt obligations will prevent it from making all TRA payments when due.[82]

f) Treatment of TRA Payments to Beneficiaries

Payments received pursuant to a TRA are most naturally characterized as additional proceeds from the sale of the

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[82] See, e.g., Form S-1/A of Graham Packaging (filed with the SEC on January 15, 2010) ("Because we are a holding company with no operations of our own, our ability to make payments under the income tax receivable agreements is dependent on the ability of our subsidiaries to make distributions to us. Our credit agreement and outstanding notes restrict the ability of our subsidiaries to make distributions to us, which could affect our ability to make payments under the income tax receivable agreements."); Vantiv, Inc. S-1/A (filed with the SEC on November 30, 2011) ("There may be a material adverse effect on our liquidity if, as a result of timing discrepancies or otherwise, distributions to us by [the umbrella partnership] are not sufficient to permit us to make payments under the tax receivable agreements after we have paid taxes.").

partnership interest.[83] While there is no authority on the issue, other characterizations do not seem plausible. It is hard to see how the payments could be characterized as fees, as they are not provided in exchange for services. Another remote possibility is that the TRA payments are dividends on a special class of stock deemed issued upon the exchange.

Assuming the TRA payments are sales proceeds, and because all TRA payments will not be made within the taxable year of the exchange of the umbrella partnership interest, the sale is eligible to be reported on the installment method.[84] Due to the indeterminacy of the total amount of the TRA payments, the treatment of the sale will be governed by the intricate subset of installment sale regulations pertaining to contingent payment sales.[85] These rules allow the seller to recover basis somewhat in proportion to payments if the contingent obligation states the maximum amount of aggregate payments the seller may receive.[86]

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[83] See supra note 64.

[84] Section 453(a), (b).

[85] Treas. Reg. section 15A.453-1(c)(1).

[86] Treas. Reg. section 15A.453-1(c)(2).

Specifically, in each year, basis will be recovered in the proportion that all payments received in that taxable year bear to the maximum amount permitted to be paid. If there is no stated maximum, but there is a fixed period over which payments under the obligation may be received, basis is generally recovered ratably over the life of the obligation. If there is no such stated maximum or fixed period, as is often the case in TRAs,[87] basis is generally recovered ratably over a fifteen year period.[88]

The first method will generally allow an exchanging partner to recover his basis earliest, due to the large upfront payment in the form of corporate stock. Stating a payment limit,

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87 See discussion above at II.B.2.

88 Treas. Reg. section 15A.453-1(c)(3), (c)(4). Where there is no such stated maximum or fixed period, the IRS will closely scrutinize the obligation to determine whether a sale has realistically occurred, and may further adjust the basis recovery within the fifteen-year period if allocating basis in level amounts would "substantially and inappropriately accelerate recovery of the taxpayer's basis in early years" of the fifteen-year period. Treas. Reg. section 15A.453-1(c)(4). The IRS is not entitled to impose an adjusted schedule under this provision, however, if the taxpayer can demonstrate that the IRS's proposal is unreasonable or that the otherwise applicable schedule does not allow the taxpayer to recover basis twice as fast as the IRS's proposed schedule. Treas. Reg. section 15A.453-1(c)(7)(iii).

however, is not universal in TRAs. Nevertheless, setting such a limit, even if it is high, may be useful because it accelerates basis recovery.

A partner may be subject to an interest charge on the taxes deferred by using the installment method if the taxpayer holds installment obligations in an amount greater than $5 million;[89] this interest charge will generally eliminate the advantage of the installment method. For such a partner – or a partner with significant basis in the partnership units to be exchanged – the best solution may be to elect out of the installment method. The partner will recognize gain in the year of the exchange in the difference between the basis in the exchanged units and the sum of the fair market value of the stock received and the fair market value of the TRA obligation.[90] Some taxpayers may argue that the value of the TRA obligation cannot reasonably be ascertained, and therefore the exchange is properly treated as an "open transaction,"

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[89] See section 453A.

[90] See Treas. Reg. section 15A.453-1(d). Further income from the TRA would then be recognized under the taxpayer's regular method of accounting. The corporation will receive a basis step-up upon each payment, without regard to the method chosen by the taxpayer.

with the result that no amount in respect of the TRA obligation should be included in income until it is paid.[91] Under the regulations, however, only in "rare and extraordinary cases" will the taxpayer be entitled to assert that the transaction is "open."[92]

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[91] See *Burnet v. Logan*, 283 U.S. 404 (1931).

[92] See Treas. Reg. section 15A.453-1(d)(2)(iii). A taxpayer may also apply to the IRS for a letter ruling allowing basis recovery on a customized schedule if the available methods would "substantially and inappropriately" defer recovery of basis. Treas. Reg. section 15A.453-1(c)(7). To obtain the ruling, the taxpayer must demonstrate that his proposed method is reasonable and that it would likely result in basis recovery twice as fast as the basis would have been recovered under the otherwise applicable rules. A taxpayer whose basis would otherwise be amortized over a fifteen-year period would have a chance of a success, but may be daunted by the application process. Finally, a taxpayer may attempt to recover basis under an "income forecast" method in proportion to a projected stream of payments. This forecast method is available where the property sold is a "mineral property, a motion picture film, a television film, or a taped television show." Treas. Reg. section 15A.453-1(c)(6). A taxpayer may seek a ruling that another type of property is eligible for this method; taxpayers do not appear to have met this challenge. See PLR 9013014 (stock ruled to be ineligible).

g) Commentary on TRAs

Although Congress has considered denying capital gain treatment for sales involving a TRA[93] and journalists have complained about them,[94] TRA arrangements seem not to raise legitimate tax policy concerns. No tax policy consideration is apparent to penalize parties who sell property for a price that includes a contingent component based on the future use of tax attributes of the property. One commentator has been quoted as commenting, "Let's face it, every time you're selling assets, if you

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[93] See H.R. 3996, 110th Cong. (1st Session 2007). This legislation would have treated parties to a TRA as related persons for purposes of section 1239, resulting in gain on a partner's transfer of partnership units to a corporation being treated as ordinary income. The policy of section 1239 is to prevent net tax-reducing transactions between parties not acting at arm's length. The parties to a TRA have commercially adverse interests and their transactions do not raise these concerns.

[94] See, e.g., Johnston, David Cay. "Tax Loopholes Sweeten a Deal for Blackstone." *New York Times* July 13, 2007, A-1. The article refers to sponsors' receiving payments in respect of a corporation's tax benefits under a TRA as a "loophole" and appears to mistake the payer of those benefits for the government.

deliver a basis step-up to a buyer, you get paid more. That's all this is."[95]

III. Tax Protection Agreements

A. Standard Provisions

Tax protection agreements ("TPAs") are used in an UPREIT structure to preserve the deferral benefits to the real estate owners. As mentioned above, the primary objective of an UPREIT structure is to defer taxation of built-in gain on property contributed by the initial business owners and future contributors of property to the UPREIT. There are several ways in which this purpose may be frustrated. If the OP disposes of the contributed property, the tax on the contributor's built-in gain will be allocated to the contributor under section 704(c) and its regulations. A distribution of contributed property (to partners other than the contributing partner) would have similar results under section 704(c)(1)(B) if done within seven years of the contribution. Finally, if the contributing partner's liabilities are reduced after the

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[95] Elliott, supra note 61 (quoting Eric Sloan at a June 10, 2011 Texas Federal Tax Institute in San Antonio).

contribution,[96] the reduction will be treated as a distribution from the OP, which will be taxable to the extent it exceeds the partner's outside basis.[97]

A TPA limits the ability of the OP and its REIT general partner to take actions that would trigger these results. The basic TPA will provide that, during a predetermined "protection period"

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[96] The contributing partner's liabilities will be reduced if the partnership assumes the partner's individual liabilities or reduces the partner's share of partnership liabilities. Section 752(b).

[97] If the partnership assumes or takes property subject to a liability, the partnership's assumption of the liability may be treated, in part, as sales consideration for the contributed property under the "disguised sale" rules of section 707(a)(2) and Treas. Reg. section 1.707-5(a). Sale treatment will result in gain or loss to the contributing partner, a cost basis to the partnership in the portion of the property deemed sold, and a reduction in any built-in gain specially allocable to the contributing partner under section 704(c). A subsequent reduction of the liability (or reduction of the portion allocated to the contributing partner) may also be treated as sales consideration if the reduction was anticipated at the time of contribution and is part of a plan the purpose of which is to minimize deemed sale treatment. See Treas. Reg. section 1.707-5(a)(3), (f), Ex. 3. These rules do not generally apply if the liability is a "qualified liability," which includes a liability incurred more than two years prior to the contribution (or contribution agreement, if earlier) or otherwise not incurred in anticipation of the transfer to the partnership. Treas. Reg. section 1.707-5(a)(5), (a)(6).

(which is also sometimes called the “lock-out period” or “lock-up period”) the partnership may not dispose of the contributed property without compensating the contributing partner for the resulting tax liability. The typical damages provision will indemnify the contributing partner for the entire tax liability, but a less generous indemnity may cover only the excess of the current tax liability over the net present value of the tax liability that would be due if the partnership sold the contributed property at the expiration of the protection period. The theory behind this calculation is that the contributing partner’s benefit in the UPREIT structure is simply one of deferral; therefore the partner is only damaged to the extent the present value of the tax is increased from the acceleration of the sale.[98] TPAs may also take a middle approach by indemnifying the contributing partner on a declining percentage basis as the expiration approaches.

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[98] An economically equivalent variant, albeit one that does not appear to exist in the market, would require the partnership to indemnify the contributing partner for the entire tax liability in exchange for a note from the partner, payable at the expiration of the protection period, in the amount of tax that would have been payable had the sale occurred at that point.

The other common function of a TPA is to obligate the OP to maintain a minimum amount of nonrecourse partnership liabilities encumbering the contributed property. The amount of these liabilities that are allocated to the contributing partner will be added to the partner's basis and therefore increase the amount that may be distributed to the partner in a tax-free manner. This basis increase will be very important to a partner who has contributed property subject to a liability, as the partnership's assumption of the liability will be treated as a deemed distribution to the partner. This debt maintenance obligation will apply during a fixed duration (which may or may not be the same as the protection period for sales of the contributed property) and the OP will be required to indemnify the contributing partner for taxes resulting from breach.[99]

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[99] Liabilities allocated to an individual partner must also be "qualified nonrecourse financing," or else the contributing partner may be subject to the at-risk recapture rules of section 465(e). Qualified nonrecourse financing includes most nonrecourse debt secured by real property, but, in addition to other requirements, it must be provided by a person who is actively and regularly engaged in the business of lending money. See sections 465(b)(6), 49(a)(1)(D)(iv).

B. Points of Negotiation

Among the points to be resolved in drafting a TPA are:

The duration of the protection period. The protection period may range anywhere from a few years to the life of the contributing partner. Seven to ten years is fairly common.[100] The protection period will often expire upon the contributing partner's death.

Permitted dispositions. Typically, the partnership will be permitted to dispose of protected property in a nontaxable transaction such as a transfer of the protected property in exchange for like-kind property under section 1031, in exchange for stock of a controlled corporation under section 351(a) or in exchange for a partnership interest under section 721(a). These transactions will not trigger an allocation of income to the contributing partner.

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[100] Once the protection period has expired, the partnership may sometimes have an obligation to make efforts to redeem a contributing partner's interest with an in-kind distribution before selling the contributing partner's protected property. Assuming the redemption takes place more than seven years after the contribution, the section 704(c) gain will not be recognized on the distribution in liquidation. Section 737. Instead, the contributing partner's basis will be preserved in the distributed property. Section 732(a).

Instead, the built-in gain or loss in the protected property will be preserved in the property received in the exchange.[101] The agreement will typically provide that the property received will be subject to the same restrictions as the original 704(c) property.

704(c) allocation method. Three methods are generally available for a partnership to take account of a contributing partner's built-in gain: the traditional method, the traditional method with curative allocations, and the remedial method. The contributing partner will prefer that the TPA require the partnership to elect to use the traditional allocation method with respect to the protected properties, under which the contributing partner does not recognize any built-in gain until the partnership disposes of the contributed property. The traditional method with curative allocations and the remedial method, on the other hand, may require allocations of additional income to the contributing partner while the partnership holds the property to eliminate the disparity between the partner's capital account and his basis in the property.

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[101] Treas. Reg. section 1.704-3(a)(8), (a)(9).

State and local tax coverage. If a contributing partner is indemnified for state and local taxes resulting from a breach by the OP, and then moves to a high-tax jurisdiction, this will result in a higher than anticipated indemnification payment. The partnership may therefore insist that the state and local tax indemnity be limited to either an agreed-upon rate or to the rates imposed in an agreed-upon locality.

Federal tax rates. The parties may be inclined to compute the TPA indemnity based on assumed rates rather than actual rates. While ideal for avoiding disputes, an assumed rate may not adequately estimate actual taxes. A solution is to use a formula that is typical in tax distributions – namely, to assume the character of income but not actual rates. For example, the indemnity may assume that the protected partner will pay tax on the indemnified gain at the maximum federal, state and local rates for long-term capital gain applicable to an individual resident of a specific place in the year the gain is included in the partner's income, assuming a full deduction at the highest federal rate for ordinary income for state and local taxes.

Gross-up. A partner will incur additional tax liabilities upon receipt of a tax protect payment, and parties to a TPA must

consider whether to require the OP to pay additional amounts to cover tax on the tax protect payment itself. It may be wise to calculate the gross-up amount assuming the character of or rate imposed on the tax protect payment in light of the uncertainty over how the tax protect payment should be reported.[102]

Amount of gain on sale indemnified. The customary tax indemnity for violation of the prohibition on sale will be limited to the tax imposed on the built-in gain specially allocated to the contributing partner under section 704(c). A broader indemnity may cover tax imposed on the entire amount of gain allocated to the contributing partner, including any tax imposed on the post-contribution appreciation in the property.

An indemnity for tax on all gain attributable to protected property may be important to the protected partner if the partnership later admits new partners and revalues the protected property. The additional appreciation will create another layer of 704(c) built-in gain that is allocated among the contributing partner and the existing partners at the time the new partners are

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[102] See below at III.D.

admitted.[103] If the contributing partner is not entitled to tax distributions, he may be allocated gain disproportionate to distributions at the time the property is sold. This is particularly problematic if the new partners are large – for instance, if a REIT contributes proceeds of a public offering – and the contributing partner's right to share in the distributions of sales proceeds is highly diluted. If, however, the tax on this gain is indemnified by a TPA, the partner may receive cash from the partnership to pay the tax without even suffering an offset against future distributions.[104]

Merger Protection. A heavily negotiated item may be whether the partnership may merge with another entity without indemnifying the contributing partner for 704(c) (or other) gain

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[103] These are "reverse 704(c)" allocations. See Treas. Reg. section 1.704-3(a)(6)(i).

[104] This issue is not specific to property contributed by a founding partner. All partners will be allocated a reverse 704(c) layer at the time of a revaluation of property and therefore may find themselves in the same predicament. Partnerships do not generally indemnify partners for tax on reverse 704(c) gain. In certain circumstances, for example, to facilitate a merger into an UPREIT, a partnership may provide partners the option to redeem interests to the extent necessary to pay tax attributable to reverse 704(c) gain.

resulting from the transaction. Other transactions may raise the same issue – for example, the partnership's right to convert to a corporation or to liquidate free of tax protection payments. This type of provision is examined in detail in the discussion of the Archstone litigation below.

Nonrecourse liability allocation. Under the regulations governing allocations of nonrecourse liabilities, a liability encumbering 704(c) property is allocated to the contributing partner to the extent it exceeds the basis of the contributed property; the partnership, however, has the option of allocating liabilities encumbering the property to the contributing partner up to the partner's built-in gain with respect to the property.[105] The

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[105] A partner's share of the partnership's nonrecourse liabilities equals the sum of (1) the partner's share of partnership minimum gain, (2) the amount of gain that would be allocated to the partner under section 704(c) if the partnership disposed of property subject to nonrecourse liabilities for no consideration other than satisfaction of the liabilities and (3) the partner's share of any remaining nonrecourse liabilities ("excess nonrecourse liabilities") determined in accordance with the partner's share of partnership profits. The partnership may elect to allocate an excess nonrecourse liability encumbering 704(c) property to the contributing partner to the extent of the partner's built-in gain (and to the extent the liability was not already allocated to such partner under (2) above). Treas. Reg. §1.752-3(a).

contributing partner may request that the partnership allocate to him a portion of these liabilities, further increasing his basis and deferring taxation of distributions.

Replacement Liabilities. The stated maturity of a loan often terminates the partnership's debt maintenance obligation with respect to that liability. Some TPAs, however, may require that the partnership make reasonable efforts to replace repaid loans with new liabilities secured by the contributed property.

Guarantees. As the contributing partners' built-in gain diminishes over time,[106] the amount of nonrecourse liabilities that may be allocated to the contributing partner diminishes as well.[107] To maintain a sufficient level of liabilities allocated to him, a contributing partner may request the right to guarantee partnership

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106 Treas. Reg. section 1.704-3(a)(3)(ii).

107 Partnership nonrecourse liabilities that encumber a contributing partner's 704(c) property may generally be allocated to that partner. Nonrecourse liabilities allocated to the contributing partner also include the partner's share of partnership minimum gain and the partner's share of any remaining nonrecourse liabilities in accordance with the partner's share of partnership profits. Treas. Reg. section 1.752-3. These latter allocations will be relatively small if the contributing partner has a small interest in the partnership.

liabilities, thus making those liabilities recourse to the contributing partner and properly allocable to him to the extent he "bears the economic risk of loss."[108] To minimize the probability of loss while continuing to bear the economic risk, the contributing partner will provide a "bottom guarantee" of a liability, that is, a guarantee of only a portion of the liability and only to the extent the lender has not been able to collect the guaranteed portion from the partnership or its collateral.

Even if it is unlikely the guaranteeing partner will have to make a payment on the bottom guarantee, the guarantee will be effective in allocating the guaranteed portion of the liability to the partner. The test for determining whether a partner bears the economic risk of loss for a liability does not depend on the probability of the loss; it is a mechanical test that asks only whether the partner would be obligated to satisfy the liability if all partnership liabilities came due, the partnership's cash and assets became worthless, its properties were disposed of for no

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[108] See Treas. Reg. sections 1.752-1(a)(1), 1.752-2(a)(1).

consideration, and the partnership liquidated.[109] Because the amount guaranteed on a bottom basis would be payable by the guarantor partner in this hypothetical scenario, the guaranteed portion of the liability is properly allocable to him.[110]

In January, 2014, the IRS proposed regulations that would eliminate the use of the bottom guarantee technique.[111] Under the proposed regulations, an obligation of a partner to make a payment with respect to a partnership liability would not be recognized unless certain factors are present, including covenants related to the partner's net worth and ability to transfer assets and arm's

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[109] Treas. Reg. section 1.752-2(b)(1). The recourse liability test assumes that partners are deemed to be able to satisfy their obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Treas. Reg. section 1.752-2(b)(6). An exception to this rule provides that an obligation of a disregarded entity to satisfy a partnership liability is considered a recourse liability of the disregarded entity only to the extent of the entity's net worth. Treas. Reg. section 1.752-2(k).

[110] In addition, the regulations provide an example applying the partnership minimum gain rules to a fact pattern including a bottom guarantee without suggesting in any way that the guarantee would be disregarded. Treas. Reg. 1.704-2(m), Ex. 1(vii).

[111] Prop. Treas. Reg. section 1.752-2, 79 FR 4826 (January 30, 2014).

length consideration to the partner for assuming the payment obligation.[112] In addition, a partner's payment obligation would not be recognized unless the partner is liable "up to the full amount of [its] payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied."[113] Several examples included in the proposed regulations, as well as its preamble, confirm that this requirement would operate to disregard bottom guarantees and similar payment obligations.[114]

In any case, even under the current regulations the treatment of a bottom guarantee is less clear where further measures are taken to reduce the risk of enforcement of the guarantee – for example, where the guarantor partner has an

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[112] Id. section 1.752-2(b)(3)(ii)(A), (E).

[113] Id. section 1.752-2(b)(3)(ii)(F).

[114] Id. section 1.742-2(f), Ex. 10, 11 and 12. The proposed regulations contain a grandfather rule which would, for a period of time and with certain limitations, allow a partnership to apply the current regulations to a partner at the time the new regulations go effective. The grandfather rule would allow the partnership to retain allocations of recourse liabilities to any partner to the extent that the partner's share of recourse liabilities exceeds its outside basis on the effective date, thereby preventing an immediate income inclusion to the partner.

annually recurring option to terminate the guarantee. Such a limitation presents a risk under the recourse liability allocation regulations' anti-abuse rule, under which an arrangement may be disregarded if it merely "create[s] the appearance" of a partner's bearing the economic risk of loss "when, in fact, the substance of the arrangement is otherwise."[115]

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[115] Treas. Reg. section 1.752-2(j). The anti-abuse provision was recently invoked by the Tax Court in *Canal Corp. v. Commissioner* to disregard a partner's indemnity obligation, where the partner was a subsidiary of a consolidated group of corporations whose assets (aside from its partnership interest) had a value of approximately 21% of the guaranteed liability, and which had no obligation to retain those assets. See 135 T.C. 9 (2010). However, the tax-related motive of a guarantee, alone, should not cause it to be disregarded if it is otherwise a substantive obligation. See Treas. Reg. section 1.737-4(b), Ex. 2 (partner's tax-motivated agreement to become solely liable for repayment of a partnership debt was substantive and therefore increased partner's basis). Note, however, that treatment of guarantees is not entirely clear under proposed at-risk regulations. Compare Prop. Treas. Reg. sections 1.465-6(d) (guarantee of debt does not increase at-risk amount until guarantee is collected on and taxpayer has no remaining rights against the obligor) and 1.465-24(a) (partner's at-risk amount is increased if partner may be held personally liable for repayment of a partnership liability under state law), 44 FR 32235 (June 5, 1979). For a general discussion of liability allocation issues in TPAs, see E. Kelsey Lemaster, H. Neal Sandford and Karen F. Turk, "Tax Issues in Recent REIT Deals: Tax Protection Agreements," 596 PLI/Real 529 (2012).

C. Archstone Litigation

The drafting of the tax protection provisions requires great care. If the agreement is litigated, the tribunal may hold the drafting parties to a high standard of technical competence and may be reluctant to ignore literal provisions to effectuate the spirit of the arrangement. Take, for example, the multi-jurisdictional litigation involving the 2007 acquisition of the formerly publicly traded Archstone real estate portfolio by a private investment group led by Tishman Speyer and Lehman Brothers. The Archstone business was organized as a publicly traded UPREIT, where certain holders of OP units were subject to tax protection from the OP. The acquisition was effected through two mergers. The publicly traded Archstone REIT was merged into a new REIT formed by the acquisition parties and the public shareholders were fully cashed out. Concurrently, a subsidiary of the surviving REIT merged into the OP. Holders of OP units were given a choice of per-unit consideration: either (1) a preferred unit in the newly constituted partnership with a fixed rate dividend and a liquidation preference, or (2) an amount of cash equal to the amount the acquirers paid for each outstanding REIT share. Unitholders choosing to continue as preferred equity holders in the new

partnership would retain their rights under the existing TPAs. However, unitholders choosing cash were required to waive the right to any tax indemnification payments that might be due under the tax protection agreements as a result of the exchange.[116]

The unitholders sued the surviving REIT, the surviving OP, the deal sponsors and their advisers. The plaintiffs alleged that the newly issued preferred units did not constitute fair value for the exchanged units, that the cash consideration was also not fair value because of the resulting non-indemnified tax liability, and that, therefore, the choice between the two offers was a "Hobson's choice." The claims included breach of contract (under both the organizational agreement of the umbrella partnership and the tax protection agreements), breach of fiduciary duty, violation of the securities laws, and so on.[117]

One group of plaintiffs, who had elected to receive cash in the merger rather than the tax-deferred preferred units, pursued

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116 *Ruby et al. v. Tishman Speyer Properties, LP et al.*, First Amended Complaint at 19–34 (filed Nov. 12, 1998, Superior Court of the State of California, County of Los Angeles).

117 Id. at 41–48.

their tax protection claims in arbitration. These plaintiffs' tax protection agreements were identical, and each contained provisions under which neither the OP nor the REIT was permitted to "cause or permit a sale, transfer, exchange, distribution, or any other transaction that, for federal income tax purposes, is treated as a sale, transfer, exchange, distribution, or disposition . . . of all or any portion of the [contributed property] or any interest therein" during the protection period.[118]

The arbitration panel's decision began by stating a principle of contract interpretation: that language in an agreement is to be interpreted consistent with what a reasonable person in the position of the parties would have thought it to mean. The panel determined that, due to the sophistication of the negotiating parties, the "reasonable person" in this case was deemed to be a tax lawyer with experience in REIT and partnership tax law.[119]

The panel ruled against the unitholders, concluding that an exchange of OP units for cash pursuant to the merger agreement

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[118] Ruby/Archstone Arbitration, Arbitration Panel's Decision at 4 (Oct. 26, 2011).

[119] Id. at 6–9.

was not a sale, transfer, exchange, distribution or disposition of all or any portion of the contributed property "or any interest therein," nor was the exchange treated as one of these types of transactions for federal income tax purposes. According to the panel, the plaintiffs' OP units – which were the property interests the partners disposed of – did not constitute "contributed property" or an "interest therein." Therefore, the panel concluded, the tax protection agreements contained only property level protection. The panel added that, if merger protection had been contemplated, a "reasonable person (a tax attorney with REIT experience)" representing the company would have expected to receive an explicit request or demand for such protection.[120]

As a secondary matter, the panel agreed with the company that, in any event, it had not caused or permitted a transaction that was taxable to the plaintiffs.[121] The company had argued that it was the plaintiffs that had caused the taxable exchange by declining the tax-deferred choice of consideration. The panel essentially agreed, stating that the plaintiffs had not provided

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[120] Id. at 9–14.

[121] Id. at 5-6.

sufficient evidence to prove that the alternative consideration – that is, the tax-deferred preferred units in the surviving entity – was inadequate, as the plaintiffs had argued.[122]

D. Tax Treatment of Tax Protect Payments

There is no clear guidance on how an indemnity payment made under a tax protection agreement should be treated.[123] One possibility is that a tax protect payment is a contingent payment by the partnership in exchange for the contributed property. The case for this treatment, however, does not appear as strong as it does in the TRA context. Payments under a TRA are part of the price demanded by a selling partner in exchange for a sale of an interest in the partnership. A property-contributing partner, on the other hand, would likely view a tax protect payment as compensation for damages rather than as part of the price of the contributed property; in fact, such a partner may prefer to never receive a tax protect payment, and would be happy if the partnership simply did not breach the TPA and trigger any adverse tax consequences.

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122 Id. at 14–15, 21–25.

123 See generally Terence Floyd Cuff, "Investing in an UPREIT—How the Ordinary Partnership Provisions Get Even More Complicated," 102 J. of Tax'n 42 (Jan. 2005).

Another possibility is that a tax protect payment is treated under section 707(a)(1) as a transaction between the partnership and a partner not acting in his capacity as a partner – i.e., as a fee. The payment would therefore be ordinary income to the indemnified partner and as deductible by the partnership. Even if the partner is acting in his partner capacity, the partner would be treated as receiving ordinary income in a nonpartner capacity if the indemnification payment is treated as a guaranteed payment governed by section 707(c) – that is, a payment "determined without regard to the income of the partnership" made to a partner "for services or the use of capital."[124] This treatment is defensible because the indemnity payment is typically based on the section 704(c) allocation to the contributing partner, which, while constituting taxable income of the partnership, is not economic income or book income.

Finally, the contributing partner might be treated as a receiving the tax protect payment as a nontaxable distribution by the partnership under section 731. Presumably, this treatment would also require the partnership to specially allocate income to

[124] Treas. Reg. section 1.707-1(c).

the indemnified partner in the amount of the payment. Certain tax protection agreements, in fact, explicitly take this position, which is favorable to the contributing partner since the income allocated to him will likely be capital gain from the sale triggering the tax protect payment.

IV. Respecting the Umbrella Partnership Form and Variations

A. Respecting the Umbrella Partnership Form

As discussed above, in light of the Example in the partnership anti-abuse regulations (and Treasury's subsequent comments), practitioners generally believe the IRS will not attempt to disregard the umbrella partnership and treat its owners as owning equity in the public company from day one. Even apart from the Example, however, it seems unlikely the IRS could successfully challenge an umbrella partnership whose structural features match in substance those of a typical UPREIT transaction.[125] There appear to be few instances where the IRS has

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[125] In a DownREIT structure (mentioned above in note 22), different limited partners may own interests in different operating partnerships. Each of the operating partnerships may pay distributions to limited partners equal to distributions paid on the number of REIT shares those

attempted to recharacterize an equity interest as being in an entity other than the entity that is, in form, the issuer, and even in such cases, the IRS has generally not prevailed. For example, the IRS unsuccessfully argued that stock in a corporation should be characterized as an ownership interest in assets or business entities owned by the issuing corporation where stock rights "tracked" the performance of those underlying assets or business entities.[126]

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partners are entitled to acquire by exchange. Unlike in an UPREIT structure, however, the amount distributed to a limited partner does not depend on the particular partnership through which the limited partner participates. Depending on the specific facts, these structures might be considered to be at a higher risk of challenge than other umbrella partnership structures.

[126] In *Union Trusteed Funds v. Commissioner*, 8 T.C. 1133 (1947), a RIC issued seven different series of special stock, each linked to a separate investment fund. Dividends were payable on each class of stock from the earnings and surplus generated by the segregated assets pertaining to such class. Upon dissolution, the shareholders of each class were entitled to receive assets of such class available for distribution, and their proportionate share of any general assets not pertaining to any class. Each class of stock was charged with liabilities pertaining to such class as well as a proportionate share of the general liabilities of the corporation. The IRS asserted that the capital losses attributable to one series of stock should not be able to be used to offset capital gains attributable to a different series. In essence, the IRS argued that each series represented stock of a different corporation. The Tax Court ruled that, despite any logical

Though the arrangements at issue were quite different from umbrella partnership structures, they are nevertheless examples of respecting separate entities despite a linkage between an interest in one entity and the assets or stock of another.

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appeal to such an argument, there was no basis in law for such ruling. The holding of *Union Trusteed Funds* as applied to series funds was overturned in 1986 by the enactment of what is now section 851(g) (each segregated portfolio of assets in a RIC is treated as a separate corporation if the beneficial interests in such portfolio are owned by holders of a class of stock of the RIC that is preferred over other classes of stock in respect to such portfolio). In *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965), two investors contributed cash to an existing corporation with substantial net operating losses in return for a special class of shares. The investors hoped to use the corporation's losses to shelter the income of the corporation's real estate department, newly formed from the proceeds of the issuance of special shares. The special shares tracked the real estate assets such that the investors generally received 100 percent of the downside risk and 90 percent of the upside potential associated with the real estate department. Despite the substantial similarity between the special shares and a direct investment in the real estate assets, the court determined that absent a "sham," there was no basis for recasting shares of the corporation as a direct interest in the real estate department. See also section 1298(b)(4) (authorizing regulations to treat tracking stock as stock of a separate corporation if necessary to carry out the purposes of the PFIC regime; no such regulations currently exist). The fact that Congress has in specific instances limited the use of tracking stock perhaps indicates its acknowledgment that such interests represent equity of their nominal issuer under general tax principles.

Rev. Rul. 69-265 is an important and helpful ruling in this area. The ruling addressed a corporation's acquisition of substantially all the assets of another corporation in a transaction intended to qualify as a reorganization under section 368(a)(1)(C). The consideration used in the acquisition was voting stock that was exchangeable for stock of the parent of the issuing corporation. The issue was whether the right to exchange the stock constituted separate property from the stock itself, in contravention of the requirement of section 368(a)(1)(C) that the consideration consist solely of voting stock. The ruling held that the exchange right would constitute property separate from the stock if exercisable against the parent corporation. The ruling also held, on the other hand, that if the exchange right was exercisable only against the issuing corporation, the right would be treated no differently than the right to redeem stock for property of the issuer – that is, as a characteristic of the stock and not as a separate property right.

Read broadly, Rev. Rul. 69-265 holds that an equity interest in one entity will not be recharacterized as an equity interest in a different entity for which it may be exchanged (even where the interest received is equity in the owner of the first entity) provided that the exchange right is against the original issuer of the

stock. This holding is therefore helpful as applied to the recharacterization risk of an umbrella partnership structure. To be sure, the structure described in the ruling did not explicitly include the other features of structural parity present in typical umbrella partnership structures, and was focused primarily on the issue of whether the exchange constituted a separate property right.[127] Still, it is helpful in that it shows that the IRS will respect entities as separate and treat the nominal issuer of an exchange rights as the actual issuer despite the presence of related parties and other possible characterizations.

More general authorities on tax ownership may also provide helpful guidance in this area. Courts generally employ a

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[127] This ruling supports the view that a partner's transfer of property to an umbrella partnership in exchange for a convertible unit is not treated as a partial "disguised sale" under section 707(a)(2). Under those rules, if a partner contributes money or property to a partnership, and the partnership transfers money or property to that partner (or another partner) in a related transaction, the entirety of the transactions might be treated as a sale of a partnership interest. See section 707(a)(2)(B). Rev. Rul. 69-625 suggests that the conversion right, if exercisable only against the umbrella partnership (as it typically is), should not be viewed as money or property, but rather as part of the umbrella partnership interest that the partner may receive on a tax-free basis under section 721.

"facts and circumstances" approach to determining ownership,[128] and have focused on the power to control disposition as the most critical component of tax ownership.[129] An owner of an umbrella partnership interest generally does not have the power to dispose of an interest in the publicly traded entity until the time the initial interest is converted into public equity. In addition, umbrella partnership arrangements often include a "dry period" beginning when the structure is put in place and lasting one year (or

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[128] See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561, 573-74 (1978); *Grodt & McKay Realty Inc. v. Comm'r*, 77 T.C. 1221, 1237 (1981).

[129] See, e.g., *Richardson v. Shaw*, 209 U.S. 365 (1908); *Cepeda v. Comm'r*, T.C. Memo. 1994-62. For example, borrowers in a typical securities lending arrangement are treated as the owners of the borrowed securities for U.S. federal income tax purposes (despite the fact that lenders retain economic upside and downside of the stock) since the borrower typically possesses the right to freely transfer or rehypothecate the security. See *Provost v. United States*, 269 U.S. 443 (1926). In a repurchase agreement, on the other hand, where the seller typically has a contractual right to reacquire the same property, a court has held that the seller retains ownership of the security for U.S. federal income tax purposes, presumably based on the buyer's limited right to dispose of the security. See *Union Planters Nat'l Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir. 1970). See also Rev. Rul. 82-150, 1982-2 C.B. 110 (holding that the purchaser of a deep-in-the-money option on non–publicly traded stock was treated as the owner of the underlying stock).

potentially longer) during which the exchange right is not exercisable.[130] Moreover, the exchange right may entitle the holder of a partnership interest only to cash equal to the value of an interest in the public entity, rather than the interest itself (although the public entity generally has the right to satisfy the tender with equity in the public entity rather than cash). If a partner is never entitled to actually own an interest in the public entity, it seems even less likely that the partner would be a deemed owner of such an interest.[131]

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[130] See, e.g., Amended and Restated Limited Partnership Agreement of CNL Macquarie Growth, LP (filed with the SEC as Exhibit 10.1 to Form S-11/A of CNL Macquarie Global Growth Trust, Inc. on August 20, 2009) (one-year dry period); Form of Exchange Agreement (filed with the SEC as Exhibit 10.4 to Form S-1/A of Och-Ziff on October 25, 2007) (five-year period where exchange requests are limited at the discretion of the operating partnership); but see Form of Exchange Agreement (filed with the SEC as Exhibit 10.35 to Form S-1/A of Graham Packaging on January 22, 2010) (no dry period).

[131] Additionally, exchangeable or convertible securities are generally treated as having already been converted for U.S. federal income tax purposes only in situations where the possibility of conversion is virtually certain. In Rev. Rul. 83-98, a convertible debt instrument was treated as equivalent to the underlying equity since the conversion right was significantly in the money and there was a "very high probability" of conversion by the holder. In addition, the issuer had a right to effectively force conversion by a

Other rights that are typically considered indicative of an equity interest in an issuer are (1) the right to vote, (2) the right to participate in the issuer's current earnings and accumulated surplus, and (3) the right to share in the issuer's net assets upon liquidation.[132] In form, owners of the umbrella partnership do not generally have rights to vote the public company shares or share in the issuer's earnings on a current basis or on liquidation. In light of the strict structural parity present in typical umbrella structures, this distinction is perhaps largely one of form. Still, as Rev. Rul. 69-265 (and other guidance) demonstrates, these distinctions cannot be dismissed.[133]

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holder as it had a call right for cash beginning two years after issuance, which a holder would be forced to convert in order to avoid receiving less value for its debt. In an umbrella partnership structure, a partner may never receive equity of the public entity, and the umbrella partnership will often retain the unilateral discretion to satisfy its exchange obligation by delivering cash. Neither the umbrella partnership nor the public entity will typically have the right to force an exchange in any event.

132 See *Himmel v. Comm'r*, 338 F.2d 815, 817 (2d Cir. 1964).

133 The seminal authority for respecting entities as separate is *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943) (a corporation's sales of its real property not treated as sales made by its sole shareholder). See also, e.g., *Nat'l Carbide Corp. v. Comm'r*, 336 U.S. 422 (1949) (stating

B. Non-Public Status of the Umbrella Partnership

The exchange right of the partners of the umbrella partnership units may need to be limited to avoid any concern that the umbrella partnership will itself be characterized as a PTP. A partnership will be treated as a PTP if interests in the partnership are traded on an "established securities market" or are "readily tradable on a secondary market (or the substantial equivalent thereof)."[134] An established securities market is defined by the regulations to include only certain securities exchanges and interdealer quotation systems.[135] An interest is readily tradable on a secondary market or the substantial equivalent thereof if "taking

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that "a corporation formed or operated for business purposes must share the tax burden despite substantial identity, in practical operation, with its owner" after a taxpayer asserted that because it was acting merely as an agent of its parent, deficiencies in income and declared value excess profits taxes were not chargeable to itself, but rather to its parent); *N. Ind. Pub. Serv. Co. v. Comm'r*, 105 T.C. 341 (1995), aff'd, 115 F.3d 506 (7th Cir. 1997) (rejecting the Commissioner's arguments that the taxpayer's foreign subsidiary should be disregarded and that payments of interest by the taxpayer to foreign holders should be subject to withholding, where there is a business purpose or the corporation engages in a business activity).

[134] Section 7704(b).

[135] Treas. Reg. section 1.7704-1(b).

into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market." Such facts and circumstances include interests being regularly quoted by a person making a market or dealing in the interests, or the existence of other readily available means to facilitate exchanges of the interests.[136]

The regulations provide a number of safe harbors within which partners may transfer their interests without causing interests in the partnership to be considered readily tradable. Of potential relevance is the "private placement" safe harbor, under which interests will not be considered readily tradable if the partnership has fewer than 100 members at all times during the taxable year, and interests in the partnership are not required to be registered under the Securities Act of 1933.[137] Other safe harbors provide that certain "private" transfers of interests are disregarded in determining whether partnership interests are readily tradable, including carryover basis transfers, transfers between family

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[136] Treas. Reg. section 1.7704-1(c).

[137] Treas. Reg. section 1.7704-1(h)(1).

members, new issuances of partnership units, and “block transfers” of more than 2% of the interests in the partnership.[138]

To protect the OP from being characterized as a PTP, the OP agreement will typically place limitations on transfers of partnership units. For example, the agreement may require the general partner’s consent for any transfer of partnership units, and the general partner’s consent may be withheld if the transfer would result in the partnership being treated as a PTP. The agreements may include provisions permitting transfers to be made without the general partner’s consent if they fall within one of the safe harbors provided by the PTP regulations. In some cases, these limitations may apply not only to transfers between limited partners, but also to transfers pursuant to an exchange of OP units with the general partner for publicly traded equity. For an OP with fewer than 100 members that does not require SEC registration (thus falling within the private placement safe harbor), such restrictions may not be needed (other than to restrict a transfer that would eliminate the private placement safe harbor).

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138 Treas. Reg. section 1.7704-1(e)(1), (e)(2).

Protection against PTP characterization is particularly important in the context of UP-C and UP-PTP structures. As explained above, if a partnership is characterized as a PTP, it will be taxed as a corporation unless 90% of its income is qualifying income, as described above. The OP in an UP-C typically recognizes general income that does not meet the 90% test, so if it were characterized as a PTP, it would subject the business enterprise (including the pre-IPO owners) to an additional layer of tax. The same would be partially true if the OPs in a PTP were characterized as PTPs. The OP that reports nonqualifying income such as fees would itself be subject to a corporate level tax. There would be no additional layer of tax imposed on the "qualifying" OP, as the income flowing through the qualifying OP would be intended to satisfy the 90% test.[139]

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[139] In the case of either the UP-C or UP-PTP structure, the additional layer of tax resulting from PTP characterization of an OP would be somewhat mitigated. Individual partners would pay tax on distributions from the OP at the currently preferred rate for qualified dividend income, rather than at the general progressive rates. See section 1(h). The corporate partner would benefit from the dividends paid deduction, likely at the at the 80% rate for dividends from 20%-owned corporations, but in any case at the normal 70% rate. See section 243(a)(1), (c). In either case, the partner-level income would not be

To avoid that result, an UP-PTP or UP-C with more than 100 OP-level partners typically will provide limits on the exchange right. The exchange right may be limited to incorporate elements of the "redemption and repurchase agreements" safe harbor under section 7704. A redemption or repurchase agreement is a plan of redemption or repurchase maintained by a partnership whereby the partners may tender their partnership interests for purchase by the partnership (or another partner or related person to that other partner).[140] Exchanges of partnership interests are disregarded under this safe harbor if (1) the agreement provides that such a repurchase requires 60 days written notice by the tendering partner, (2) the agreement requires the purchase price be established either at least 60 days after receipt of such notice, or not more than four times per year, and (3) no more than 10% of the partnership's capital interests or profits interests is transferred during the year (disregarding "private" transfers described

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recognized until the time of distribution, rather than the time the income is recognized at the OP level.

[140] Treas. Reg. section 1.7704-1(e)(3).

above).[141] For example, exchanges may be offered on a quarterly basis, with 60 days' notice provided by the tendering partner, fulfilling the first two requirements above.

On the other hand, PTP status could be benign in the case of an OP in an UPREIT structure. The OP will presumably operate to satisfy the REIT requirements, including the requirement that 95% of the REIT's gross income come from certain passive sources such as such as rents from real property, capital gains, interest, and dividends, nearly all of which are sources of qualifying income under the PTP test. By ensuring that 95% of its income satisfies this REIT requirement, the OP will typically satisfy the 90% qualifying income test under which the OP will avoid characterization as a corporation even if it is publicly traded.[142]

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[141] Treas. Reg. section 1.7704-1(f). See Amy S. Elliott, "IRS Concerned by Aggressive Exchange Rights in Up-Cs, Up-REITs," 149 Tax Notes 1250 (Dec. 7, 2015).

[142] Nevertheless, it is possible for the OP in an UPREIT to recognize income that satisfies the REIT test but is not qualifying income for PTP purposes – for example, interest derived from the conduct of a financial or insurance business. Compare section 7704(d)(2) (excluding this type of interest) with section 856(f) (excluding interest only if its determination depends on the

V. Umbrella Partnership Equity Compensation

Umbrella partnerships may issue profits interests to service partners that may grow to become similar to OP units (and therefore, similar to stock of the publicly traded company) but without producing ordinary compensation income to the holder on receipt, vesting or sale. These equity interests are typically referred to as long-term incentive plan units, or "LTIP" units. LTIP units have been used by numerous UPREITs, but could be considered in any umbrella partnership structure.[143]

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income or profits of another person). See also supra note 4 (stricter related-party rent rule for PTPs). If the OP is publicly traded and fails the 90% qualifying income test, not only will the OP be taxed as a corporation – subjecting the OP to an entity-level tax – but, since the REIT's income will be comprised exclusively of dividend income from the now-corporate OP, it will fail the test requiring that 75% of a REIT's gross income be derived from certain real estate related sources. Section 856(c)(3). Therefore, if the OP is taxed as a C corporation, the REIT will be taxed as a C corporation as well, and the public shareholders will pay a third income tax when dividends are distributed.

[143] See, e.g., Sixth Amendment to Third Amended and Restated Agreement of Limited Partnership of GGP Limited Partnership dated November 12, 2013 (filed with the SEC as Exhibit 10.1 to Form 8-K of General Growth Properties, Inc., on November 18, 2013); First Amended and Restated Agreement of Limited Partnership of Empire State Realty OP, L.P., dated October 1, 2013 (filed with

When granted, LTIP units do not have any interest in the capital the OP, and thus qualify as profits interests within the meaning of Rev. Proc. 93-27. In that event, the LTIP units are not included in income upon receipt or upon vesting, assuming the units are vested or if unvested the recipient makes a section 83(b) election or meets the requirements of Rev. Proc. 2001-43.[144] The holder of an LTIP unit may be entitled to receive current distributions of operating cash flow, and corresponding allocations of income, out of profits generated after the date of grant pari passu with the OP units.[145]

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the SEC as Exhibit 3.1 to Form 10-Q of Empire State Realty Trust, Inc., on November 12, 2013).

144 See Rev. Proc. 2001-43 (requirements include that the partnership and recipient treat the recipient as owner of the partnership interest, the interest not relate to a predictable income stream and the recipient not dispose of the interest for at least two years).

145 In some cases, the holder will not become entitled to all or some of the profits distributions on unvested units until vesting, which raises the issue of whether the corresponding income should be allocated to the holder of the unvested unit on a current basis. One potential alternative is to issue additional LTIP units on the unvested LTIP units, instead of the distribution of profits, subject to the same vesting arrangements as the underlying LTIP units.

The LTIP unitholder will also receive a priority allocation of profits upon a disposition of substantially all of the OP's assets. Under this special allocation, the first dollars of gain on such a sale will be allocated to the LTIP units until each LTIP unit has a capital account equal to the capital account of an OP unit, after which any further gain will be allocated on a per-unit basis among the LTIP units and OP units. Assuming there is sufficient gain on exit to "catch up" the capital accounts of the LTIP units to the capital accounts of the OP units, the holders of LTIP units will achieve the same economics as the holders of regular OP units. None of the income recognized in respect of the LTIP units will be compensation.

There is economic risk to the LTIP unitholders under this arrangement. If, upon a sale of substantially all of the assets of the OP, there is insufficient profit to catch up the LTIP units, an LTIP unit will be distributed less of the proceeds than an OP unit. The OP limited partnership agreement will provide that upon an event permitting a revaluation of partnership property under the partnership allocation regulations,[146] any appreciation in

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[146] Treas. Reg. section 1.704-1(b)(2)(iv)(f)(5).

partnership property will be credited to the capital accounts of the LTIP units in priority to the OP units, consistent with the allocations that would be made if all of the revalued property were sold.[147] This revaluation is not a taxable event. Once the LTIP unit capital accounts are equal to OP unit capital accounts, the LTIP units are economically indistinguishable from the OP units and may be exchanged for OP units, which, in turn, may be exchanged for stock of the public company.[148] Any gain on such an exchange may result in capital gain, rather than ordinary

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[147] This manner of crediting the LTIP capital accounts may be required for the allocations to have substantial economic effect, as the applicable regulations require the capital accounts to be adjusted on a revaluation to reflect the manner in which unrealized gain or loss would be allocated to the partners upon a disposition of any property. Treas. Reg. section 1.704-1(b)(2)(iv)(f)(2). The OP limited partnership agreement may allocate gain from non-liquidating asset sales in a different manner.

[148] The OP may have the right to force the LTIP unitholder to make this exchange, which should be of no detriment to the LTIP unitholder. An LTIP unit with a positive capital account balance that is less than an OP unit's balance may be exchangeable for a fraction of an OP unit. If LTIP units were exchangeable for full OP units without regard to their capital accounts, the LTIP units would have an interest in the capital of the partnership upon grant, thus disqualifying them from being treated as profits interests under Rev. Proc. 93-27.

income, to the service partner (except to the extent of any "hot assets" held by the OP).[149]

Although any partnership could grant similar LTIP units to service partners, umbrella partnerships are particularly good candidates for the use of such LTIPs in that the fair market value of the partnership's assets in the aggregate should generally be readily available as it is implied by the trading price of the stock of the public company.[150]

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[149] See sections 741 and 751.

[150] In the simple case of a public company that has no assets other than OP units and no liabilities, the value of the net assets of the OP will equal the market capitalization of the public company divided by the public company's ownership percentage of the OP (taking into account dilution by the LTIP units).

In a notice of proposed rulemaking issued on July 23, 2015, the IRS proposed regulations concerning disguised payments for services under section 707(a)(2)(A) and included statements in the preamble regarding the interpretation of and planned changes to Rev. Proc. 93-27 relating to issuance of partnership profits interests to service providers. REG-115452-14, 80 Fed. Reg. 43,652 (July 23, 2015). Depending on the specifics of final guidance, it is possible Rev. Proc. 93-27 will no longer apply to the grant of an LTIP and/or regulations under section 707(a)(2)(A) will cause distributions on the LTIPs to be treated as fees (and thus as ordinary income) for tax purposes. For a discussion of the proposed guidance, see generally New York State Bar Association Tax Section,

Report on the Proposed Regulations on Disguised Payments for Services (Nov. 13, 2015).