UP-C Initial Public Offering Structures: Overview

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This Practice Note provides an overview of the Umbrella Partnership – C-corporation (UP-C) initial public offering (IPO) structure and selected related legal and tax considerations. By implementing an UP-C structure instead of more traditional IPO structures and entering into tax receivable agreements, pre-IPO owners of businesses taxed as partnerships can receive substantial post-IPO tax benefits.

For businesses taxed as partnerships that are considering an initial public offering (IPO), the Umbrella Partnership – C-corporation (UP-C) structure can offer pre-IPO owners the liquidity and other benefits of a public listing in a more tax-efficient manner than the traditional alternative of converting into a C-corporation at the time of an IPO. Although somewhat novel even a decade ago, IPOs utilizing the UP-C structure have become increasingly common in recent years.

For information on the taxation of partnerships, see Practice Note, Taxation of Partnerships (W-000-6885). For a list of resources on IPOs more generally, see the Initial Public Offerings Toolkit (2-578-7625). For information on the UPREIT structure (which was a precursor to the UP-C structure), see REITs: Overview (8-504-7098).

BASIC FEATURES AND IMPLEMENTATION OF THE UP-C IPO STRUCTURE

The UP-C is a two-tiered structure involving one entity taxed as a partnership and another entity taxed as a corporation, in which:

- The pass-through entity (commonly referred to as the operating partnership or OP) holds all of the assets and operations of a business. The pass-through entity may be organized in any legal form that is taxable as a partnership under US tax laws, but it is most often organized as either:
  - a limited partnership (LP); or
  - a limited liability company (LLC).
- Public investors hold their interest in the tax partnership indirectly through an entity (the Pubco) organized as a corporation or other legal form taxable as a C-corporation.
- The pre-IPO owners continue to hold their interests directly in the pass-through OP and, accordingly, their share of the income of the business is not subject to an entity-level tax.

The UP-C structure is implemented through a reorganization at the time of the IPO:

- Most often, by modifying the capital structure of an existing tax partnership to reclassify the interests held by the pre-IPO owners into a single new class of common units. These common equity interests in the OP are typically referred to as OP Units.
- Where the existing business has historically been held through multiple entities, by undertaking a roll-up transaction where the pre-IPO owners contribute their interests in the business to a newly formed OP in exchange for newly issued OP Units.

Counsel must carefully consider the design and implementation of each reorganization to address the particular commercial and tax objectives of the company's owners and the facts and circumstances of the transaction.

UP-C IPO MECHANICS

To effect the IPO, a newly formed Pubco offers shares (Pubco Shares) to the public and uses the cash proceeds from the offering to acquire a number of OP Units in the OP equal to the number of Pubco Shares sold in the offering. In a primary offering, the cash proceeds are invested by the Pubco directly in the OP in exchange for newly issued OP Units. If there is a secondary component, all or a portion of the cash proceeds may be used by the Pubco to acquire outstanding OP Units from the pre-IPO owners. The Pubco always holds a number of OP Units in the OP equal to the number of Pubco Shares it has issued and outstanding. Therefore, **each Pubco Share represents the same proportional interest in the underlying business as, and is economically equivalent to, an OP Unit** (see Maintaining Parity between OP Units and Pubco Shares).

EXCHANGING OP UNITS FOR PUBCO SHARES

To provide the holders of OP Units with liquidity, OP Units held by persons other than the Pubco (OP Unitholders) are typically exchangeable for Pubco Shares on a one-for-one basis, subject to customary conversion rate adjustments for stock splits, stock dividends, and reclassifications. Certain UP-C structures provide that the Pubco or the OP may elect to deliver the cash value of the Pubco Shares otherwise deliverable in exchange for the OP Units based on the market price of the Pubco Shares. These arrangements are typically documented in an exchange agreement or in the limited partnership agreement or limited liability company agreement of the OP.

GOVERNANCE AND VOTING

The Pubco controls the OP, typically by serving as its general partner or managing member. It is common in an UP-C structure for OP Unitholders to also hold a separate class of non-economic, voting securities in the Pubco that afford them with voting power in the Pubco. Often, these voting securities are designed to provide the OP Unitholders with voting power in the Pubco that is commensurate with the voting power they would receive if their OP Units were fully exchanged for Pubco Shares, although high vote/low vote structures are sometimes implemented. As OP Units are exchanged for Pubco Shares, the voting power in the Pubco afforded to OP Unitholders is typically reduced proportionately. While the exact mechanics vary, this may be accomplished in several ways, including:

- The redemption by the Pubco of an exchanging OP Unitholder's non-economic, voting securities of the Pubco at the time the holder's OP Units are exchanged for Pubco Shares.
- The concurrent surrender or exchange by the OP Unitholder of non-economic, voting securities of the Pubco together with the OP Units.
- A formulaic reduction in the voting power afforded the exchanging OP Unitholder by the holder's non-economic, voting securities of the Pubco.

The S&P Dow Jones has recently announced that companies with multiple share classes will no longer be eligible for inclusion in the indices comprising the S&P Composite 1500, including the S&P 500, S&P MidCap 400, and S&P SmallCap 600. While seemingly aimed at excluding high vote/low (or no) vote structures like the one that garnered attention in the March 2017 offering of Snap Inc., S&P Dow Jones recently clarified that the new policy will exclude multiple share class structures even where there is no disparate voting power, as is the case in UP-C structures that provide for voting power commensurate with economic ownership.

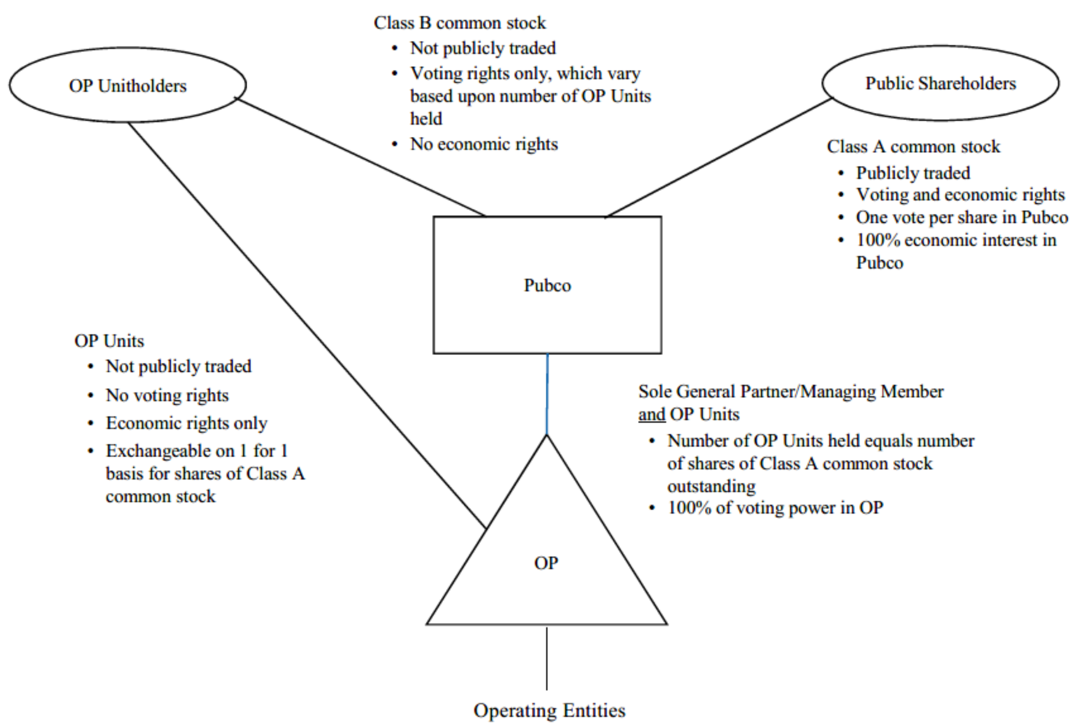
TAX BENEFITS

As noted above, the UP-C structure permits the pre-IPO owners to continue to hold their interests directly in the pass-through OP and, accordingly, their share of the income of the business is not subject to an entity-level tax. In addition, the Pubco's acquisition of OP Units from OP Unitholders, including under the exchange rights described under Exchanging OP Units for Pubco Shares, may result in tax benefits to the Pubco and therefore reduce the amount of tax that the Pubco must pay in the future. The Pubco usually shares a significant portion of these tax benefits with the exchanging OP Unitholder under a tax receivable agreement (see Tax Receivable Agreement).

While the recent enactment of U.S. tax reform legislation, including the permanent reduction of the U.S. corporate income tax rate, does impact the cost/benefit analysis, the UP-C structure continues to confer advantages over traditional alternatives. See Box, Impacts of the Tax Reform Legislation on UP-C Structures.

UP-C ORGANIZATIONAL STRUCTURE CHART

This simplified diagram depicts a typical UP-C structure following the reorganization and IPO:



EXCHANGE RIGHTS AND LIQUIDITY

There is no public market for OP Units. The agreements governing the OP generally contain significant restrictions on their transferability. However, UP-C governing documents typically provide OP Unitholders with the right to exchange OP Units for publicly traded Pubco Shares on a one-for-one basis (see Exchanging OP Units for Pubco Shares). It is often advisable for the Pubco to regulate the exchange process using internal policies and procedures to:

- Ensure compliance with insider trading rules and policies.
- Facilitate an orderly introduction of Pubco Shares into the market.

Under applicable federal income tax rules, an OP that is deemed to be a "publicly traded partnership" is also generally subject to entity-level taxation, unless the nature of its income and operations make it eligible for continued pass-through treatment under applicable rules, notwithstanding that it is publicly traded (as is the case with listed master limited partnerships). A partnership is "publicly traded" for this purpose if, among other things, its interests are "readily tradable on a secondary market or the substantial equivalent thereof." For more information on the taxation of publicly traded partnerships, see Practice Note, Taxation of Publicly Traded Partnerships (9-501-0947).

However, there is an exemption from these rules for partnerships:

- Whose interests were issued in a private placement not required to be registered under the Securities Act.
- That have no more than 100 partners.

When this exemption is unavailable (because the OP has more than 100 partners), additional restrictions on exchanges may be imposed to prevent the creation of a secondary market or the substantial equivalent in the OP Units. These additional restrictions may include:

- Limiting a holder's right to exchange OP Units for Pubco Shares to only once a quarter.
- Requiring exchanging holders to provide an irrevocable election well in advance of the quarterly exchange date.

OP Unitholders typically exercise their exchange rights only when they seek to exit their investment because:

- The exchange of Pubco Shares for OP Units is generally a taxable event to the exchanging holder.
- Ownership of the business at the OP level is generally more tax efficient for the holder.

Absent registration under the Securities Act, shares issued on exchange of OP Units are restricted securities. These restricted securities may not be sold in the absence of Securities Act registration unless an exemption is available, such as the exemption from registration in Rule 144.

The SEC has recently issued interpretive guidance, however, that an exchanging OP Unitholder's holding period of Pubco Shares for purposes of Rule 144 may generally include (or tack) the holding period in the corresponding OP Units exchanged. This guidance:

- Permits holders holding OP Units for the requisite holding period under Rule 144 (which is commonly satisfied by the time the customary IPO lock-up agreement with the underwriters expires) to rely on that rule to immediately publicly resell the Pubco Shares received in an exchange, subject to the limitations of Rule 144 applicable to affiliates of the Pubco.
- Allows the Pubco, in most cases, to avoid having to register the issuance of Pubco Shares to exchanging OP Unitholders, which had previously been a common and costly feature in UP-C IPO structures.

Customary registration rights, however, may still be useful for affiliates of the Pubco to enable them to resell Pubco Shares received in exchange for OP Units without being required to comply with the volume and manner of sale limitations of Rule 144 that otherwise apply. As a result, registration rights agreements will remain a common feature of UP-C IPOs as they are with other IPOs. For more information on resales under Rule 144, see Practice Note, Resales Under Rule 144 (4-382-8769). For an overview of registration rights, see Practice Note, What Are Registration Rights Agreements? (3-386-4395).

TAX RECEIVABLE AGREEMENT

When an OP Unitholder exchanges OP Units for Pubco Shares, the transaction may result in increases in the tax basis of the assets of the OP. The stepped-up basis increases depreciation and amortization deductions available to the Pubco. As a result of these increased deductions, the Pubco owes less tax in the future. In a typical UP-C IPO structure, the Pubco shares with the exchanging OP Unitholder a percentage (customarily 85%) of any tax benefits Pubco receives due to the stepped-up basis from the exchange of the holder's OP Units. This arrangement is typically documented in a tax receivable agreement.

A tax receivable agreement commonly provides for the payment by the Pubco to an exchanging OP Unitholder of 85% of the benefits, if any, that the Pubco is deemed to realize from:

- The increases in tax basis.
- Certain other tax benefits related to its entering into the tax receivable agreement, including tax benefits attributable to payments under the tax receivable agreement.

The term of the tax receivable agreement customarily continues until all of the tax benefits have been used or expired (a period which can be upwards of 15 years from the time of the applicable exchange), unless the Pubco exercises its right to terminate the agreement by paying a formulaic amount based on the remaining future payments required under the agreement (assuming, among other things, a hypothetical exchange of all outstanding OP Units for Pubco Shares).

Under generally accepted accounting principles (GAAP), at the time of an exchange transaction, the Pubco typically records on its consolidated balance sheet:

- A deferred tax asset in the amount of the total estimated realizable tax benefit of the exchange.
- A liability representing the total estimated amounts payable under the tax receivable agreement in respect of the exchange (typically 85% of the value of the deferred tax asset recorded).

Accordingly, the net effect of an exchange transaction is typically a net increase in stockholders' equity of 15% of the Pubco's estimated realizable tax benefit. Absent changes in enacted tax rates or in the estimated realizable tax benefit in periods following the exchange, subsequent monetization of the deferred tax asset and payments under the tax receivable agreement are not ordinarily included in net income. As a result, IPO investors have not historically viewed the UP-C structure and related tax receivable arrangements as impacting an IPO issuer positively or negatively. The managing underwriters of a company contemplating an UP-C IPO structure should still always be consulted to determine whether they expect the structure to impact the pricing or successful completion of the offering.

For more information on tax receivable agreements, see Article, Understanding Tax Receivable Agreements (7-530-5945).

DISTRIBUTIONS AND DIVIDEND POLICY

The owners of the OP, including OP Unitholders and the Pubco, generally incur US federal, state, and local income taxes on their proportionate share of any taxable income of the OP. As is common in tax partnerships, the governing agreements typically require the OP to make pro rata distributions of available cash to the holders of OP Units to fund their tax obligations for the income of the OP that is allocated to them. These tax distributions are frequently computed based on an assumed highest effective marginal combined US federal, state, and local income tax rate.

Because the highest effective marginal combined rates for individuals are generally higher than those for corporate entities, these tax distributions usually result in the Pubco receiving cash in excess of the amount it requires to pay its taxes and fund its obligations under the tax receivable agreement. To avoid accruing significant cash at the Pubco level (which then impairs the one-to-one economic equivalency of OP Units and Pubco Shares), this "excess" cash is usually distributed as a dividend by the Pubco to its stockholders.

The Pubco can also establish a dividend policy that contemplates a payout that is higher than the minimum amount required to pay taxes, in which case the Pubco causes the OP to distribute cash in excess of the mandatory tax distribution. OP Unitholders other than the Pubco also receive their pro rata share of any distribution paid by the OP.

As discussed below, we anticipate that one impact of U.S. tax reform legislation is that UP-Cs may increasingly explore alternative uses of this "excess cash" in a manner consistent with their particular commercial objectives and capital allocation strategies, such as stock repurchase programs or reinvestment in the business. See Box, Impacts of the Tax Reform Legislation on UP-C Structures.

MAINTAINING PARITY BETWEEN OP UNITS AND PUBCO SHARES

The UP-C structure is almost always designed and operated to maintain a one-to-one economic equivalence of OP Units and Pubco Shares. This parity makes the structure easier for investors to understand and for the company to administer and account for in its financial reporting.

Accordingly, as noted above, the Pubco generally holds a number of OP Units that is equal to the number of Pubco Shares it has outstanding, and maintains this relationship by taking mirroring actions in respect of its interest in the OP when it issues or repurchases Pubco Shares.

Maintaining one-to-one equivalence also requires that, as a general matter, the Pubco not:

- Hold any material assets other than its equity interest in the OP via the OP Units.
- Become subject to liabilities (other than liabilities for taxes on its share of the income of the OP or under the tax receivable agreement) as to which it does not have a "mirroring" claim against the OP.

In this regard, the OP and its subsidiaries are typically the primary credit support for the company's debt rather than the Pubco. In addition, substantially all operating expenses incurred by or attributable to the Pubco (such as outside director fees, audit fees, and expenses incurred in connection with capital markets transactions) are also typically borne or reimbursed by the OP.

CERTAIN CONSIDERATIONS

The UP-C structure can be an attractive, tax-efficient option for businesses taxed as partnerships that are considering an IPO. Practitioners and their clients should be mindful, however, of certain considerations specific to this structure particularly in the context of strategic transactions, capital raising, and insider liquidity programs. For example:

- A sale or other change of control transaction may accelerate payment obligations under the TRA or (depending on the terms of the agreement) result in future payment obligations that are not conditioned upon the obligor's realizing cash tax savings.
- A spin-off can present unique structuring considerations, such as ensuring that public investors continue to own their interest in the Spinco through an entity taxable as a corporation while OP unitholders continue to own their interest in the Spinco business through a partnership for tax purposes.
- A primary securities offering by the Pubco must generally be attended by the issuance by the OP to the Pubco of a mirroring security to maintain the economic equivalence of OP Units and Pubco Shares.
- A registered debt offering can present certain financial reporting considerations given that the OP (which, as the 100% owner of the business, is typically the primary credit support) is generally ineligible to rely on the exception to the requirement to provide separate financial statements under Rule 3-10 of Regulation S-X available to 100% owned subsidiaries of the registrant.
- In addition to the customary policies and procedures regarding insider trading applicable to any public company, the design and implementation of exchange rights and liquidity programs for OP unitholders may also need to integrate features that address the publicly traded partnership rules described under Exchange Rights and Liquidity, as well as additional considerations under the federal securities laws, including Rule 144.

IMPACTS OF THE TAX REFORM LEGISLATION ON UP-C STRUCTURES

The enactment of H.R.1, formerly known by the short title Tax Cuts and Jobs Act (the "TCJA"), in December 2017 may impact the cost/benefit analysis of issuers considering an UP-C IPO. On balance, however, we anticipate that the structure continues to confer the following advantages over traditional alternatives:

- Preservation of tax benefits.
- Impact on tax receivable agreement payments.
- Application of Section 162(m).
- Implications for tax distributions in UP-C structures.

PRESERVATION OF TAX BENEFITS

The major benefit of the UP-C structure—allowing the pre-IPO owners to continue to hold their interest in pass-through form—is preserved and continues to yield benefits under the TCJA.

Operating Income. Under the TCJA, (a) partnership business income is generally taxed at a top rate of 37% (rather than 39.6% under prior law) to an individual partner and (b) income earned by a corporation is taxed to the corporation at a 21% rate (rather than the 35% rate under prior law), and the after-tax portion (79%) is potentially taxed again to the shareholder as a dividend. Additionally, under the TCJA, "qualified business income" from partnerships, which is effectively connected with a U.S. trade or business other than capital gains, dividend income, and certain compensation-related payments, is eligible for a 20% deduction. In other words, if the partnership's income qualifies for the deduction, a taxpayer would only be taxed on 80% of the partnership's income, which would yield an effective tax rate as low as 29.6% (37% of 80%). For an individual holding an interest in a partnership eligible for the favorable deduction, the flow-through income could be taxed at a U.S. federal income tax rate roughly 7 percentage points lower than the corporate alternative (assuming distribution as a dividend); (a) **29.6**% versus (b) 21%, plus 20% of 79% or 15.8%, for a total of **36.8**% (rather than (a) **39.6%** versus (b) 35%, plus 20% of 65% or 13%, for a total of **48%** under prior law). Even if the partnership's income is ineligible for the deduction (or partners are subject to the limitation on the amount of the deduction), individual partners would still be subject to a rate (up to 37%) that is similar to the rate of the corporate alternative.

Capital Gains on Exit or Other Asset Sales. Traditionally, the UP-C structure facilitates tax-efficient post-IPO sales of partnership interests or assets. Under prior law, individuals paid a top tax rate on long-term capital gains of 20%, compared to the top rate for capital gains of corporations of 35%, or a double tax (corporate and shareholder) aggregating 48% as described above. Under the TCJA, the tax benefit for the UP-C structure on exits or other capital gains transactions remains – for the pass-through portion, a single tax of 20% versus a double tax in a corporate structure aggregating 36.8% as described above under the TCJA. The buyer would obtain a stepped up tax basis for that portion of the business. Although the step up would be worth less to a corporate buyer, as deductions would produce only a 21% benefit compared to 35% under prior law, the overall effect would be similar to that applicable under prior law.

IMPACT ON TAX RECEIVABLE AGREEMENT PAYMENTS

Under the TCJA, the top corporate income tax rate has been reduced from 35% to 21%. As the top corporate income tax rate declines, the benefit of deductions to the Pubco and the corresponding tax receivable agreement payments to an exchanging OP Unitholder are reduced. Nevertheless, given the continuing (albeit lower) value of the deduction, tax receivable agreements likely will continue to be employed.

APPLICATION OF SECTION 162(M)

The TCJA eliminates the performance-based compensation exemption to Section 162(m) of the Internal Revenue Code of 1986, which imposes a $1 million annual limit on deductions for compensation paid to a public corporation's chief executive officer, chief financial officer and next three highest-paid executive officers. As a result, corporations will face difficulty avoiding the application of Section 162(m) and deductions for employee stock options, annual bonuses, and performance shares for covered employees will be limited if their value exceeds the annual limit. Partnerships, however, are not covered by Section 162(m); thus, in traditional UP-C structures, where all of the operating expenses of the business, including compensation, are incurred at the OP level, Pubcos have generally taken the view that Section 162(m) does not apply to limit their share of the OP's compensation deduction.

IMPLICATIONS FOR TAX DISTRIBUTIONS IN UP-C STRUCTURES

The TCJA results in a greater disparity between individual and corporate rates, which is likely to increase the amount of excess cash received by a Pubco in tax distributions from an OP. In light of the increased disparity, UP-Cs may increasingly explore alternative uses of this excess cash in a manner consistent with their particular commercial objectives and capital allocation strategies, such as stock repurchase programs or reinvestment in the business. Such alternatives to the traditional dividend should be designed in a way that would maintain the one-to-one economic equivalency of OP Units and Pubco Shares.

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