UP-C IPO Structure FAQs: Overview

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This Practice Note addresses frequently asked questions about the Umbrella Partnership – C corporation (UP-C) structure which is often used by businesses taxed as partnerships that are considering an initial public offering (IPO) and can offer pre-IPO owners of the businesses substantial post-IPO tax benefits.

This Note addresses frequently asked questions regarding the Umbrella Partnership – C corporation (UP-C) structure which is often used by businesses taxed as partnerships that are considering an initial public offering (IPO). The questions consider selected legal and tax aspects of the UP-C structure, including the substantial post-IPO tax benefits which the use of the UP-C structure and tax receivable agreements can offer to the pre-IPO owners of the businesses. For more information on the UP-C IPO structure, see Practice Note, UP-C Initial Public Offering Structures: Overview, and for more information on the taxation of partnerships, see Practice Note, Taxation of Partnerships.

1. What is an UP-C structure?

Businesses that are taxed as partnerships for US federal income tax purposes frequently employ the UP-C structure when they determine to conduct an IPO. Rather than offer to public investors a direct investment in the existing tax partnership, which would frequently result in adverse federal income tax consequences to the pre-IPO owners of the business, such businesses instead form a separate entity that is treated as a corporation for US federal income tax purposes which publicly offers its common stock to public investors and in turn acquires a corresponding equity interest in the existing tax partnership. As a result, the pre-IPO owners of the business continue to hold their equity interests directly in the tax partnership and public investors hold an indirect equity interest in the tax partnership through the corporation.

2. What are the basic features of an UP-C structure?

In an UP-C structure, the entity whose common equity is sold in a public offering and listed on a stock exchange (the Pubco) is organized as a corporation or other legal form that is treated as a corporation for US federal income tax purposes and the existing tax partnership (the Operating Partnership or OP) is organized as a limited partnership, limited liability company or other legal form that is treated as a partnership for US federal income tax purposes. The Pubco is a holding company that has no material assets other than its interests in the OP. The OP, in turn, itself holds directly or indirectly all of the material assets of the business. As the Pubco itself holds a number of units of common equity in the OP (OP Units) that is equal to the number of shares of listed common equity (Pubco Shares) that the Pubco has issued and outstanding, each OP Unit represents the same proportional interest in the assets of the business as a Pubco Share. The Pubco Shares are therefore economically equivalent to the OP Units.

OP Units are also held by persons other than the Pubco (OP Unitholders), in whose hands they are exchangeable on a one-for-one basis for Pubco Shares (or such other ratio that maintains economic parity between OP Units and Pubco Shares). The initial OP Unitholders are the pre-IPO owners of the business, who may be founders, strategic investors, management or other equityholders. Pre-IPO owners may acquire OP Units through a reclassification or conversion of their interests in an existing tax partnership which becomes the OP or in exchange for their contribution of their interests in the business to a newly formed OP.

3. How is parity between OP Units and Pubco Shares maintained in an UP-C structure?

As a general matter, maintaining the one-to-one economic equivalence between OP Units and Pubco Shares requires that the Pubco not hold any material assets other than its equity interest in the OP via the OP Units or become subject to liabilities (other than certain tax-related liabilities) 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. 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 typically borne or reimbursed by the OP.

4. How do holders of OP Units receive liquidity?

OP Units held by OP Unitholders are typically exchangeable at the option of the OP Unitholder for Pubco Shares or for the cash value thereof, as documented in an exchange agreement or in the limited partnership agreement or limited liability company agreement of the OP. In order to avoid the OP being deemed to be a "publicly traded partnership" which is generally subject to entity-level taxation, certain restrictions on exchanges of OP Units are often imposed to prevent the creation of a secondary market. Such restrictions frequently include limiting the right of OP Unitholders to exchange OP Units for Pubco Shares to only once a quarter and/or requiring exchanging OP Unitholders to provide an irrevocable election well in advance of the quarterly exchange date.

As a practical matter, OP Unitholders typically exercise their exchange rights only when they seek to exit their investment because the exchange of OP Units for Pubco Shares is generally a taxable event to the exchanging holder and ownership of the business at the OP level is generally more tax efficient for the holder.

5. Can Pubco Shares received upon an exchange of OP Units be freely resold under Rule 144?

Absent registration under the **Securities Act of 1933, as amended** (the Securities Act), Pubco Shares issued upon exchange of OP Units are restricted securities, which may not be sold in the absence of Securities Act registration unless an exemption is available. For purposes of Rule 144, however, an exchanging OP Unitholder's holding period for Pubco Shares commences upon the acquisition of the OP Units exchanged. As a result, 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) can 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. This allows the Pubco, in most cases, to avoid having to register the issuance of Pubco Shares to exchanging OP Unitholders.

6. What are the typical governance and voting arrangements of an UP-C structure?

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 correspondingly reduced. 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.

7. Does a dual class capital structure impact the Pubco's eligibility to be included in the S&P Composite 1500 Index and its component indices?

No. Although companies with more than one class of common stock had been excluded from inclusion in the S&P Composite 1500 Index and its component indices, S&P Dow Jones Indices recently reversed course and announced that effective April 17, 2023, companies with multiple share class structures are eligible for inclusion in the S&P Composite 1500 Index and its component indices. FTSE Russell still excludes companies from its indices if their "unrestricted public shareholders" do not hold at least 5% of the voting power.

8. What is a 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 the 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 by the Pubco under the tax receivable agreement.

Additional tax attributes may be covered by a tax receivable agreement in certain circumstances, including the Pubco's allocable share of existing tax basis acquired in the IPO or in subsequent exchanges of OP Units.

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).

9. What are typical distribution arrangements in an UP-C structure?

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 tax 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 often 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 also receive their pro rata share of any distribution paid by the OP.

10. How does the effective tax rate for an individual OP Unitholder compare to that of an individual stockholder of a US corporation?

Under current US federal tax law:

- Partnership business income is generally taxed at a top rate of 37% to an individual partner.
- Income earned by a corporation is taxed to the corporation at a 21% rate, and the after-tax portion (79%) is potentially taxed again to the shareholder as a dividend.

Additionally, under current US federal tax law, "qualified business income" from partnerships, which is effectively connected with a US 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 US 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%. 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.

11. What is the tax treatment of a post-IPO sale of the business?

The UP-C structure may facilitate a tax-efficient sale of the business. A sale of the business would generally be expected to take the form of a sale of OP Units and a sale of Pubco Shares. Although OP Unitholders and Pubco stockholders would generally be expected to be subject to tax on the sale at the same US federal income tax rates, only the sale of OP Units would generate a step up in amortizable or depreciable tax basis for the buyer. In contrast, the acquisition of Pubco Shares would not give rise to any step up in amortizable or depreciable tax basis.

12. What are some additional considerations in determining whether to implement an UP-C structure?

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 tax receivable agreement or (depending on the terms of the agreement) result in future payment obligations that are not conditioned upon the Pubco or successor obligor's actual realization of cash tax savings.

- A spin-off can present unique structuring considerations, such as ensuring that public investors continue to own their interest in the spun-off company (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.

- 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 in Practice Note, UP-C Initial Public Offering Structures: Overview: Exchange Rights and Liquidity, as well as additional considerations under the US federal securities laws, including Rule 144.

