The UP-C IPO and Tax Receivable Agreements: Legal Loophole?

by Ian Fontana Brown

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In this report, Fontana Brown analyzes the legality of initial public offerings that use the umbrella partnership corporation structure in combination with a tax receivable agreement. He concludes that they are grounded in good law and lead to market efficiency, as well as maximum profits.

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The use of umbrella partnership corporations (UP-Cs) combined with tax receivable agreements (TRAs) has been gaining traction in the initial public offering landscape in recent years. It allows partnership owners to maximize gains on their investment by taking advantage of the benefits of the partnership structure and the liquidity of the public market. Although most scholars have characterized the structure as questionable tax planning and as seemingly outside both the letter and spirit of the regulations, Congress and the IRS have paid it little heed.

This report shows that the UP-C and TRA are grounded in good law, including the subchapter K antiabuse rules and the economic substance doctrine, and it explains how this IPO structure leads to market efficiency and maximizes profit for all parties involved.

I. Introduction

The use of UP-Cs for IPOs continues to rise. The UP-C structure can provide many advantages to the original owners of a business, including access to the liquidity of the public market, retained control in the business, deferred recognition of taxable gain, avoidance of the

1 Although many academics call this type of financial transaction a “supercharged IPO,” supercharged IPOs encompass section 338(h)(10) and publicly traded partnership (PTP) IPOs as well. See Victor Fleischer and Nancy Staudt, “The Supercharged IPO,” 67 Vand. L. Rev. 307 (2014).
double (corporate- and shareholder-level) tax on corporate earnings, and cash from selling tax benefits created by the process.²

In a traditional IPO, a private corporation issues shares of its stock to investors in the open market in exchange for cash. If the business began as a partnership, that partnership is liquidated and disappears into a new corporate structure before the IPO.³ The IPO creates no immediate tax liability for the original owners.⁴ The corporate income is thereafter subject to both corporate- and shareholder-level tax, and the tax basis in the corporation’s assets remains unchanged.

In an UP-C IPO coupled with a TRA, the structuring process before and after the IPO is much more complex and potentially lucrative.⁵ To take advantage of the UP-C structure, the business must begin as a partnership and remain a partnership. Rather than liquidating the partnership and replacing it with a corporation, the partnership continues to operate the business, but it forms a new corporation and becomes the corporation’s original shareholder. The new corporation then goes public and receives cash for newly issued shares. The now publicly owned corporation (PubCo), of which the partnership is still part owner, uses its newly received cash to buy into the partnership. The partnership thus becomes the beneficiary of the IPO because PubCo invests virtually all the cash raised by the IPO into the partnership. Also, because it has invested all its cash into the partnership, PubCo now becomes the partner with the largest interest in the partnership. Essentially, PubCo eventually ends up owning the partnership that formed it. That purchase can be done in a way that generates tax benefits (also known as tax assets) for PubCo.⁶ Those tax assets are then contractually split between the original partners in the partnership and PubCo through a TRA.

Practitioners and scholars have been debating whether the UP-C IPO coupled with a TRA benefits both PubCo’s shareholders and the historic partnership’s owners, or whether it is instead a nefarious scheme to drain money from PubCo that could be used to benefit all shareholders, not just the original (pre-IPO) partners.⁷ That analysis has tended to focus on the economics and ethics of the structure. Some scholars and industry experts, such as Phillip Gall and Robert Willens, have labeled the UP-C and TRA structure “underhanded,” a windfall for the original partners, not well understood, and as allowing the original partners to “get paid for any tax attribute they are delivering.”⁸ However, there has been little, if any, scholarly analysis of the legal basis of the UP-C and accompanying TRA.

II. Traditional IPOs

For business owners, the IPO is one of the most appealing and lucrative ways to gain liquidity in an investment. In most cases, a company must be a corporation to undergo an IPO.⁹ The benefits of incorporating and going public in an IPO are numerous. An IPO creates a public market in the company’s shares, allowing the original owners to raise cash to keep the company operating without issuing debt or taking on new investors. An IPO also gives the owners liquidity in their investment and increases public awareness in the company.¹⁰

A. Incorporating a Partnership

Before examining the more complicated tax structuring of the UP-C IPO, it is important to first understand how a partnership traditionally incorporates into a C corporation to go public. Rev. Rul. 84-111, 1984-2 C.B. 88, identifies three ways in which a partnership can convert to a corporation: the assets-over, assets-up, and

⁴ See section 351, providing that generally, no gain or loss is recognized if property is transferred to a corporation in exchange for stock in the corporation.
⁵ Explained fully in Sections III and IV.
⁶ See Fleisher and Staudt, supra note 1, at 315-316.
⁹ In some cases, partnerships can undergo an IPO and be traded on the public markets. PTPs are governed by section 7704.
¹⁰ See Fleisher and Staudt, supra note 1, at 314.
interest-over methods. These methods often qualify as nonrecognition events under section 351. To meet the requirements for a section 351 exchange, one or more persons must transfer property to a corporation; the property must be transferred solely in exchange for stock, and immediately after the transfer, the contributors must control the corporation. In the examples from Rev. Rul. 84-111, the corporation inherits the tax basis that the partnership had, which is in stark contrast with the UP-C structure.

A partnership using the assets-over method contributes all its assets and liabilities to a newly formed corporation in a section 351 transaction in exchange for all the corporation’s outstanding stock. The partnership then distributes its interest (corporate stock) to the individual partners in the form of a liquidating distribution. The partnership is automatically terminated under section 708(b)(1)(A), which states that a termination occurs when “no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.”

A partnership using the assets-up method distributes all assets and liabilities to its partners in a liquidating distribution. The former partners then take all their distributed assets and liabilities and contribute them to a newly formed corporation in a section 351 transaction in exchange for all the corporation’s outstanding stock. The partnership is again automatically terminated under section 708(b)(1)(A).

Under the interests-over method, the partners contribute all their partnership interests to the newly formed corporation in a section 351 transaction in exchange for all the corporation’s outstanding stock. The partnership is again automatically terminated under section 708(b)(1)(A).

In all three methods, the partners may realize and recognize income if the partnership had liabilities exceeding the cash and the basis of assets. Importantly, under all three methods, the former partners are left owning stock in the newly formed corporation, which may then undergo the IPO process.

Traditionally, when a corporation goes public, shares are sold from two sources: the corporation itself and the pre-IPO owners. The shares sold by the corporation add to the outstanding shares issued and dilute the existing owners’ interest in the corporation, and the corporation may use that cash in its business. Under section 1032(a), the corporation recognizes no gain or loss on the receipt of money or other property in exchange for its stock, making the IPO a nontaxable event. When the pre-IPO owners sell their shares in the new corporation, no taxable event is created for the corporation, and the pre-IPO owners are taxed on their profit at either the ordinary income or capital gains rate.

B. Disadvantages of the Traditional IPO

Despite the myriad benefits that come with incorporating and going public in an IPO, there are also drawbacks. In a section 351 exchange, the corporation inherits a carryover basis in the assets it receives from the original partnership. Typically, the carryover basis is significantly less than the assets’ fair market value, which has been depreciated substantially. This carryover basis is detrimental in two aspects. It leads not only to the corporation missing the opportunity for depreciation deductions as a result of its newly acquired assets, but it also leads to a higher tax liability for both the original partners and the corporation down the road: The corporation is eventually taxed on the future disposition of its acquired partnership assets, and the pre-IPO owners are taxed when they sell their corporate

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11 See Bilsky and Goodman, supra note 2.
12 However, there are exceptions that cause a taxable event under section 357(c), 704(c)(1)(B), 731(c), 737, or 751(b).
13 Property includes cash, inventory, accounts receivables, patents, equipment, and goodwill and other intangibles.
14 Stock does not include stock rights, warrants, or convertible debt securities.
15 See section 368(c). Control is defined as 80 percent of the voting power and 80 percent of the number of nonvoting shares.
16 See section 351(a).
17 See section 731(a)(1).
19 See Fleischer and Staudt, supra note 1, at 321 n.50.
stock.\textsuperscript{20} Both those transactions result in a sizeable tax liability because the corporation likely has a low carryover basis in its new assets, and the original partners have a low basis in their corporate stock as a result of the exchange.\textsuperscript{21}

Another drawback is the loss of the flow-through taxation benefits that come with a partnership structure. The conversion to a C corporation results in two layers of taxation: an entity-level tax on the corporate earnings\textsuperscript{22} and a shareholder-level tax on dividends.\textsuperscript{23} The creation of an UP-C structure with an accompanying TRA is one way to avoid some of the shortfalls that accompany the traditional IPO.

### III. The UP-C IPO

Although there are many ways for founding partners to extract cash from their investment, the UP-C IPO structure may be the most economical and tax-efficient. A PwC report states that founding partners can reap additional consideration of up to 30 to 40 percent using the UP-C compared with traditional IPO structures.\textsuperscript{24}

#### A. History of the UP-C IPO

Historically, when a partnership wanted to go public, it would convert to a C corporation before issuing shares to the public in an IPO. The conversion was carried out because, except for real estate investment trusts and publicly traded partnerships (PTPs), which have many constricting and complicated rules, the corporation was the entity form that gave companies the legal right to offer shares of their stock on the public markets.\textsuperscript{25} However, the conversion causes the partnership to lose its pass-through tax treatment and inherit the double taxation of the corporate structure, potentially costing founding owners millions of dollars.\textsuperscript{26}

Although the umbrella partnership REIT (UPREIT) has been a common and highly tax-efficient structure for public REITs since 1992, it was not until 1999 that a company outside the real estate industry used a similar concept for its IPO.\textsuperscript{27} That company, barnesandnoble.com, a limited liability company, formed a corporate holding company that then went public and became the sole managing partner of barnesandnoble.com

\textsuperscript{20} See id.; and Bilsky and Goodman, supra note 2.
\textsuperscript{21} See id.
\textsuperscript{22} Section 11.
\textsuperscript{23} Section 61(a)(7).
\textsuperscript{24} See PwC, “This Month in M&A,” at 2, 9 (Oct. 2011).
\textsuperscript{25} See Elliott, “Aggressive Exchange Rights in Up-Cs, Up-REITs Concern IRS,” Tax Notes, Dec. 7, 2015, p. 1250. See also reg. section 1.7704-1.
\textsuperscript{26} See section 11.
\textsuperscript{27} See PwC, supra note 24, at 2; and John C. Hart, “The Umbrellas of Subchapter K,” Simpson Thacher & Bartlett LLP, at 3-4 (2016).
Since barnesandnoble.com’s UP-C IPO, the structure has grown increasingly popular and complex with the addition of the TRA. As Eric Sloan and Matthew Lay have observed, the UP-C structure expanded the UPREIT “beyond its real estate roots into corporate America,” where it is much more accessible to business owners looking for tax-efficient ways to gain liquidity. In 2014, 17 IPOs were filed using the UP-C structure, up from 12 in 2013 and three in 2012.

B. Initial Structuring and IPO

The UP-C IPO structure begins when an existing partnership forms a C corporation, as discussed above. The original partners remain owners of the historic partnership and are not directly issued shares of the new corporation, which differs from a traditional IPO. The historic partnership is issued Class B shares in the newly formed corporation, which carry a majority of the voting rights.

Before the corporation’s public offering, the historic partnership recapitalizes its inside partnership interest so that it aligns one-to-one with the corporation’s Class A shares, which the corporation will then issue. The original partners, under the terms of the partnership operating agreement, have the option to exchange their interests in the historic partnership for Class A shares in the corporation or redeem them for cash later. Recapitalizing the original partners’ partnership interests to align with the corporation’s Class A stock simplifies the exchange process. When the original partners decide to exchange their partnership interests for corporate stock, one “share” of partnership interest will be exchangeable for one share of Class A corporate stock, and the partnership interest and the corporate stock will have identical basis for the original partners. However, restrictions must be placed on these exchanges to not run afoul of the PTP rules or reg. section 1.701-2 (discussed in Section VI).

Also, before the IPO, documents are drafted that state that as soon as the IPO closes, PubCo will use the cash raised through its IPO to buy into the partnership and become its managing partner. The process of undergoing the IPO and then becoming the managing partner of the historic partnership happens simultaneously as a practical matter.

PubCo then raises capital through an IPO by selling its Class A stock, which carries all or most of the economic interest with few voting rights.

**Figure 2. Formation of PubCo**

![Diagram showing the formation of PubCo from a historic partnership](source: Adapted from David B. Strong and Remmelt A. Reigersman, “Understanding ’Up-C’ IPO Structures — the Tax Benefits Explained,” Morrison & Foerster, at 7 (2014). In the figure, PubCo should sit on top of Original Partnership, meaning Original Partnership owns PubCo, but technically, and to simplify the figures for the reader, since the original partners own Original Partnership, and Original Partnership owns PubCo, the original partners own PubCo (the original partners own all the class B PubCo stock in Figure 2).

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31 See Elliott, supra note 8, at 336.
32 See Bilsky and Goodman, supra note 2. Hereinafter, I will refer to both the option of exchanging for stock and redeeming for cash as simply exchanging for stock.
33 The original partners will have the same basis for the corporate stock that they did for their historic partnership interests. For example, if the partnership basis was $3 and a partner sold it at a fair market value of $10, the partner could be taxed on his $7 gain. If the partner exchanged his partnership interest for a share of corporate stock with a basis of $3, and the FMV of the corporate stock is $10, the partner would be taxed on a gain of $7. Recapitalizing merely simplifies the exchange process, making the tax accounting more straightforward.
34 See Elliott, supra note 8, at 336; and Shobe, supra note 18, at 18 n.87 and at 28 n.128. Some exchange agreements are different from and more aggressive than what is permitted by reg. section 1.701-2. Id. at 18 n.87.
Later, PubCo takes the proceeds from its IPO and buys into the historic partnership, becoming its managing partner. PubCo may purchase an interest in the historic partnership from either the partnership itself or from the original partners. However, if the interest is purchased directly from the partnership, PubCo cannot take advantage of a basis step-up adjustment in its newly purchased interest, as discussed below.

C. Basis Step-Up

Before any exchange of partnership interests to PubCo, the historic partnership must ensure it has a valid section 754 election for that tax year. The election is critical because it allows the partnership to elect for a section 743(b) basis adjustment to an incoming partner’s newly purchased partnership interest. Typically, when purchasing an interest in a partnership, a new partner inherits the previous inside basis (carryover basis) in that interest, but using sections 754 and 743(b), the partnership can increase the basis of some assets for the new partner, which is an important aspect of the UP-C structure.

In the UP-C structure, when the original partners decide to exchange their historic partnership interests for shares in PubCo, PubCo is entitled to a section 743(b) step-up to its cost basis (FMV at the time of purchase) in its share of partnership assets acquired. This basis step-up applies only to the inside basis of PubCo’s share of assets and has no effect on the capital accounts or the original partners. Also, a section 743(b) election applies only when the original partners decide to exchange or sell their existing original partnership interests to PubCo; it does not apply if PubCo purchases (by way of a contribution) interests from the historic partnership itself.

The UP-C structure usually involves a company with a lot of self-developed goodwill, which makes the deal even more lucrative. When the original partners sell their partnership interests to PubCo, a portion of the section 743(b) basis step-up is allocated to goodwill, which is an amortizable section 197 intangible asset and thus deductible. This allows PubCo to take significant deductions for what was previously a non-amortizable asset. All the stepped-up assets create future tax benefits in the form of depreciation and amortization deductions, which are contractually split between PubCo and the original partners through a TRA.

36 Interests purchased directly from the partnership are ineligible for a stepped-up basis because they are newly created interests. See Shobe, supra note 18, at 18.
D. Benefits to Original Partners

An UP-C IPO has so many benefits for the original partners that some academics have questioned why anyone would even consider not setting up an IPO using the UP-C structure. The primary benefit is that because the historic partnership remains the revenue-generating business, the original partners retain passthrough treatment of income and avoid having double (corporate- and shareholder-level) taxation. The original partners are able to keep the character of income that flows through the historic partnership, which preserves the potential benefits of a preferred capital gains tax rate and the use of excess capital losses. Also, the future tax liabilities of original partners may be reduced by their allocated partnership income. That allocation increases the individual partners’ outside basis in their partnership units, resulting in reduced gains on the future disposition of their interests.

Original partners also access enhanced liquidity from the public markets and do not have to navigate the more restrictive channels required to gain liquidity through private markets. As a result of the initial Class A and Class B stock allocation, the original partners generally maintain control over the historic partnership, even though PubCo is the largest interest holder and the sole managing partner. This is accomplished through the original partners controlling PubCo with their Class B voting shares, which allows them to control the historic partnership.

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41 See Shobe, supra note 18, at 26.
42 See id. at 21-22. Original partners are taxed at the maximum personal tax rate of 39.6 percent as opposed to the 35 percent corporate and 23.8 percent dividend tax rates, for a savings of 10.9 percent. Id.
44 See Hart, supra note 27, at 23 n.37.
45 Id. at 1. That enhanced liquidity also gives the historic partnership “a broad range of instruments available to make strategic acquisitions or compensate employees (i.e., PubCo stock, PubCo stock options, and partnership units).” PwC, supra note 24, at 2.
Arguably as important as passthrough treatment for the original partners is the stepped-up basis for the partnership assets allocated to PubCo. As detailed in Section IV, this generates tax benefits for PubCo, which are shared with the original partners through a TRA. 46

E. Disadvantages of the UP-C Structure

The UP-C structure comes with surprisingly few disadvantages. The primary (and possibly sole) drawback is the administrative costs. These come in the form of accounting and legal expenses from pre-IPO restructuring transactions, accounting costs for maintaining partnership records, and the costs of tracking specific payments if a TRA is in place. 47

IV. TRAs

First seen as a feature of the Cooper Industries Ltd. IPO in 1993, TRAs have become more prevalent, especially after being coupled with umbrella partnership structures, such as the UP-C. 48 Transferring billions of dollars back to original partners, TRAs have been a controversial topic since becoming popular in the mid-2000s, eventually leading to proposed congressional legislation (discussed in Section V). 49

A. Mechanics of the TRA

In a TRA, PubCo contractually agrees to pay the original partners a percentage (usually 85 percent) of the benefits gained from specific tax assets annually. 50 Those tax assets come from ordinary deductions in the form of depreciation, amortization of intangible assets, and the deduction of net operating losses. 51 Because TRA payments are viewed as part of the sale of partnership interest, gains from TRA payments are generally characterized as capital gains rather than ordinary income, qualifying for the favorably taxed long-term capital gains rate if the partnership interest or asset was held for more than a year. 52

For an UP-C structure, most of these tax assets are generated when the original partners exchange their historic partnership interests for PubCo stock. 53 As discussed earlier, the tax assets are created by the section 743(b) basis step-up in PubCo’s share of partnership assets acquired from the original partners. 54 Goodwill is most often the asset that is stepped up. Under the tax code and generally accepted accounting principles, an individual who creates goodwill is not permitted to deduct it, but when goodwill is sold, the new owner may amortize and deduct it because the value is assumed to erode. 55 This allows the historic partnership to convert its goodwill, often a company’s most valuable asset, from a less-valued nondepreciable asset to a valuable depreciable one. 56 Because a large portion of the tax benefits in an UP-C structure come from stepped-up amortizable partnership assets that are typically amortized on a straight-line basis over 15 years, TRA payments from PubCo to the original partners may span decades. 57

Those payments will likely be treated as additional proceeds on the earlier sale of the historic partnership interests, similar to an earnout arrangement, and are subject to section 382 limitations on the deductibility of future losses. 58

46 See Ginsburg et al., supra note 43, at para. 1602.10.2.
47 See Biskin and Goodman, “An Alternate Route to an IPO: Up-C Partnership Tax Considerations (Part 2),” The Tax Advisor (Dec. 1, 2015) (discussing the implications of the anti-churning rules, which are beyond the scope of this report).
48 See Elliott, supra note 8, at 334.
49 See Fleischer and Staudt, supra note 1, at 311 n.8 (citing Elliott, supra note 8, at 334, 338).
52 See Paul and Sabbah, supra note 50, at 8 (explaining that some TRA payments, “such as asset level gain relating to depreciation recapture or inventory,” are taxed as ordinary income).
53 In some cases, TRAs also include provisions to pay original partners historic tax assets, such as NOLs, but this report will examine only tax benefits created in connection with an IPO. See Shobe, supra note 18, at 33 (describing the different assets for which PubCo may pay the original partners in TRAs).
54 See Holmes, supra note 51, at 4.
55 See David Cay Johnston, “Tax Loopholes Sweeten a Deal for Blackstone,” The New York Times, July 13, 2007; and Financial Accounting Standards Board, SFAS 142. Under GAAP rules, management values goodwill every year and records an impairment to bring it down to FMV if the value has decreased. See FASB, “Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill.” However, a 2014 update to the GAAP rules now allows private companies to amortize goodwill on a straight-line basis over a period of 10 years. See FASB release (Jan. 16, 2014); and section 197(c)(2)
56 See Shobe, supra note 18, at 14.
57 See Paul and Sabbah, supra note 50, at 3.
453 installment sale rules. The installment payments will likely generate additional basis adjustments under section 743(b), which may result in more depreciation and amortization being allocated to PubCo and thus more TRA payments. Because of the complexity of TRAs and their payments, it is imperative to know the accounting and administrative costs of undertaking and maintaining a TRA before entering into one.

**B. Common Features of a TRA**

TRAs typically cover the payment of realized tax benefits, PubCo’s right to terminate, change of control, subordination, and reimbursements because of later-disallowed tax benefits. Usually, PubCo must pay the original partners a tax benefit payment equal to the percentage of the realized tax benefit agreed on for the year. Also, most TRAs allow PubCo to terminate the agreement if PubCo makes early termination payments to the partners. Those payments are calculated as the present value of all tax benefit payments that the partners would have received had the TRA continued as originally agreed on. The change of control provision usually states that TRA payments will continue to be made based on specific assumptions (to not distort the original planned payments) if a company inherits tax attributes as the result of merger and acquisition activities. TRAs typically state that TRA payments are subordinated to PubCo’s debt payments. Also, the agreement will include a clause stating that the original owners are not required to reimburse PubCo for tax benefits that are later disallowed by a taxing authority.

**C. Tax Arbitrage Through Use of a TRA**

Arguably as important as passthrough treatment for the original partners is the potential tax arbitrage available through the UP-C structure and TRA. Tax arbitrage occurs because of the basis step-up and the original partners’ ability to reclaim some of the cash paid in taxes on the sale of their partnership interests. Those partners pay the low capital gains tax rate on the gain from their sale or exchange of partnership interests to PubCo for Class A economic stock. PubCo can then depreciate or amortize those assets at the higher corporate tax rate and transfer 85 percent of those tax savings back to the original partners.

For example, assume an original partner sells his share of the historic partnership to PubCo for $100 million, $50 million of which is for self-created goodwill. The partner had a basis of $50 million in his partnership interest and pays a capital gains tax rate of 15 percent, which results in $7.5 million in immediate taxes. PubCo can amortize the $50 million in goodwill ratably over 15 years at the 35 percent corporate tax rate. This creates a tax savings of $17.5 million, which is then split 85 percent/15 percent, with $14.88 million being paid back by PubCo to the original partner over the 15-year period. Using the IRS’s long-term adjusted federal rate of 2.24 percent, this equates to a $12.5 million present-day lump sum amount, which, after a 15 percent capital gains tax, results in a $10.6 million after-tax profit to the original partner from the TRA payments.

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58 See Bilsky and Goodman, supra note 2.
59 Id.
60 See Hart, supra note 27, at 44-49; see also Shobe, supra note 18, at 31 (describing the consequences of later-disallowed tax benefits in the context of TRAs).
61 See Hart, supra note 27, at 45-46.
62 Id. at 49.
63 Id.
64 See Holmes, supra note 51, at 4.
65 See id. at 1.
66 Id.
This generates a net profit of $3.13 million in the transaction as a whole, because the pre-IPO partner ends up paying $9.38 million in total taxes but is repaid $12.5 million by PubCo through the TRA.

**Benefit of a Tax Receivable Agreement to a Pre-IPO Partner**

<table>
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<tr>
<th></th>
<th>Step-up/gain on sale (all goodwill)</th>
<th>Tax on sale by pre-IPO partner (A * 15%)</th>
<th>Amortizable tax deductions from goodwill (35%, 15 years) (A * 35%)</th>
<th>Goodwill deduction transferred to pre-IPO partner via TRA (85%) (C * 85%)</th>
<th>Present value of goodwill deduction allocated to pre-IPO partner via TRA (D * PV)</th>
<th>Taxes on present value of goodwill deduction allocated to pre-IPO partner via TRA (15%) (E * 15%)</th>
<th>Net after-tax present value of TRA benefits to pre-IPO partner (E - F)</th>
<th>Net tax savings for pre-IPO partner (B - G)</th>
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<td>$1,877,452</td>
<td>$10,638,895</td>
<td>$3,138,895</td>
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**D. Controversy Over TRAs**

Because of the large amount of money that TRAs channel from public corporations back to original partners, it is no surprise that these agreements have sparked controversy among practitioners and academics. Some commentators have pointed out that the agreements are fully disclosed to the public and view them as “nothing nefarious,” while others have described TRAs as “a little bit underhanded,” “unusually one-sided,” “pure gravy,” and a “bizarre siphoning off of cash.”

But why do TRAs even exist? One would think that the TRA payments back to the original partners would be reflected in the stock price and thus lower it, but that has not been the case. What leads to the tax arbitrage opportunity is not only the differing corporate and long-term capital gains tax rates but also the fact that the public does not seem to take TRAs into account when valuing a business. TRA advocates would argue that if the public refuses to pay for the assets in a business at the time of a stock purchase, it is rational for the original partners to retain that value through a TRA because doing so leads to market efficiency: Assets are transferred to people who value them, rather than being left in PubCo, where they would not be properly valued.

A few theories have emerged as to why the public markets do not factor a TRA in to the valuation of a business and its stock price. Foremost is the argument that public companies are valued in terms of multiples of their earnings before interest, taxes, depreciation, and amortization and that “accounting items like a reduction in a deferred tax asset or a tax expense aren’t reflected in EBITDA.” However, tax assets are listed on a company’s balance sheet, and the terms “tax receivable agreement” and “TRA” appear repeatedly on a company’s SEC registration statement. Some academics speculate that the lack of knowledge regarding tax assets transferred by TRAs may be attributable to the assets’ “esoteric nature or perhaps to investment banks’ choice to disregard these assets when valuing a company.” Whatever the reason, until tax assets are factored in to the valuation of business and stock prices, pre-IPO partners will continue to use TRAs to maximize the gain on their investments.

**E. A Win-Win for All Parties Involved**

Regardless of whether TRAs are properly priced, without the basis step-up that the UP-C structure enables, there would be no tax assets to divide between the original partners and PubCo. As discussed earlier, in a traditional IPO, the

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67 See Fleischer and Staudt, supra note 1, at 311.
66 See Elliott, supra note 8, at 337 and 339.
69 See Fleischer and Staudt, supra note 1, at 311 (citations omitted).
newly formed corporation inherits the same basis as the historic partnership, which does not allow the corporation to generate additional depreciation and amortization from what the historic partnership would have already been able to depreciate and amortize itself. Using the UP-C structure and a TRA, tax assets that would not have otherwise existed are created, and both the original partners and PubCo are better off as a result.

V. Temporary Tax Relief Act of 2007

A. Why

In 2007 the House Ways and Means Committee introduced the Temporary Tax Relief Act of 2007,\(^75\) in part to combat a growing public outcry against the private equity and hedge fund industries and the treatment of some payments as capital gains rather than ordinary income.\(^76\)

Many believe the bill was introduced as a result of the Blackstone IPO in 2007, which used a PTP structure and a TRA.\(^77\) That IPO allowed the original Blackstone partners to avoid paying almost any taxes on the $3.7 billion raised in the offering. A $3.7 billion step-up in basis was given to Blackstone’s goodwill in the sale, and then 85 percent of the goodwill amortization was paid back to the original partners through a TRA.\(^78\)

The 2007 legislation included a provision specifically targeting TRAs, which were usually coupled with PTPs at the time. When the bill reached the Senate Finance Committee, it was renamed the Tax Increase Prevention Act of 2007, and the House’s entire section 613, which included the partnership interests and tax sharing agreements amendment, was excluded.\(^79\)

B. Tax Results if Passed Into Law

The 2007 legislation would have amended section 1239 to treat the transferee and transferor involved in a TRA concerning any sale or exchange of depreciable property as related persons, which would have caused the original partners to recognize ordinary income rather than capital gain.

The amendments would have put a damper on TRAs. Any gain recognized by the original partners from the sale to PubCo of depreciable and amortizable assets (goodwill in most cases), TRA payments resulting from that sale, and all other income generated by the partnership interest in those assets would have been characterized as ordinary income. This would have made the UP-C and TRA structure much less lucrative and potentially not worth the structuring costs.\(^80\) The Joint Committee on Taxation estimated that the section 1239 amendment would have generated $135 million over 10 years, but that number would undoubtedly be higher today since there has been a proliferation of UP-C IPOs coupled with TRAs.\(^81\)

C. Legislative Intent

In its reasoning for the amendment, the Ways and Means Committee stated that “taxpayers should not obtain capital gain treatment for the transfer of depreciable property (including intangibles amortizable under section 197) while retaining an interest in the tax benefits of the depreciation, which may be measured by reference to a higher, ordinary income tax rate of the transferee.” The committee said it did not intend for the amendment to affect the “outright sale of assets between otherwise unrelated parties in which the fixed sales price is negotiated to be higher because of the anticipated tax benefits that will be enjoyed by the transferee.” The committee members sought to end the favorable tax treatment given to individuals selling goodwill in the context of these complex tax sharing agreements.

\(^75\) H.R. 3996, 110th Cong., section 611(a) (2007).


\(^78\) See Johnston, supra note 55.

\(^79\) Section 613(f)(2) of the bill defined the term tax sharing agreement as “any agreement which provides for the payment to the transferor of any amount which is determined by reference to any portion of the tax benefit realized by the transferee with respect to the depreciation (or amortization) of the property transferred.” That is what is referred to as a TRA in this report.

\(^80\) See Elliott, supra note 8, at 335.

\(^81\) Id.; see JCT, “Estimated Revenue Effects of the Chairman’s Amendment in the Nature of a Substitute to H.R. 3996, the Temporary Tax Relief Act of 2007,” Scheduled for Markup by the Committee on Ways and Means on November 1, 2007,” JCX-105-07 (Oct. 31, 2007).
agreements. As David Cay Johnston put it, TRAs allow pre-IPO owners to sell “the goodwill from their left pockets to their right.”

There is no doubt that the bill, if enacted, would have reduced the tax arbitrage opportunities involved in UP-C structures and TRAs. Although the bill did not specifically target the UP-C structure, focusing instead on TRAs and PTPs, which at the time were the controversial entity structure, the UP-C IPO structure would have been affected to the same degree as PTPs. However UP-Cs themselves would have continued to be permissible, and the passthrough taxation benefits of the structure would have remained.

VI. Current Regulations

Although the proposed 2007 bill would have eliminated some of the tax advantages of TRAs that are typically part of the UP-C structure, is a statutory amendment necessary to accomplish this? Could the current regulations be used to curtail those advantages?

A. Antiabuse Rules Under Subchapter K

Under subchapter K, taxpayers are allowed to conduct joint business and investment activities “through a flexible economic arrangement without incurring an entity-level tax.” To be consistent with the intent of subchapter K and meet its antiabuse rules, the following common law requirements memorialized in reg. section 1.701-2(a) must be met:

1. the partnership must be bona fide, and each partnership transaction must be entered into for a substantial business purpose;

2. the form of each partnership transaction must be respected under substance-over-form principles; and

3. the tax consequences under subchapter K to each partner of partnership operations, and transactions between the partner and the partnership, must accurately reflect the partners’ economic agreement and clearly reflect the partner’s income.

1. Reg. section 1.701-2(d), Example 4.

Under the antiabuse rules of reg. section 1.701-2, the IRS has the authority to recast a transaction as appropriate to achieve tax results consistent with the intent of subchapter K if the primary purpose of the transaction is to substantially reduce the present value of the partners’ aggregate federal tax liability in a manner that’s inconsistent with the intent of subchapter K.

Although some tax scholars and professionals have argued that this regulation is vague and confusing, the IRS has included a handful of examples clarifying various issues in contention. None of the regulations specifically discusses the UP-C structure, but in 1995 the IRS added an example that condoned the UPREIT structure, after which the UP-C is modeled.

In Example 4 of reg. section 1.701-2(d), two partnerships that held and invested in real estate contributed all their real estate to New Partnership in exchange for limited partner interests. A third partner, the managing member of New Partnership, is a REIT, which then undergoes an IPO. The cash raised from the IPO is then contributed to New Partnership in exchange for an additional interest in New Partnership. The two limited partners then have the option to exchange their limited partnership interests for cash or stock in the REIT two years after the formation of New Partnership.

The IRS explained that the UPREIT structure satisfied the antiabuse provisions of subchapter K even though, on its face, the transaction appeared to be for the purpose of reducing the partners’ federal tax liability. Although the partners’ contribution of real estate to New Partnership rather than directly to the REIT avoided potential tax consequences, the transaction was consistent
with the intent of subchapter K, according to Example 4.

Regarding reg. section 1.701-2(a)(2), the IRS said that because the partners were not required to exercise their option and exchange their limited partnership interests for cash or stock in the REIT, the form of the transaction as a separate partnership and REIT was respected under substance-over-form principles.

Similarly, the IRS explained that the UPREIT structure satisfied the “proper reflection of income” standard of reg. section 1.701-2(a)(3). Even though the partners’ federal tax liability was much less than if the transaction were collapsed and treated as if the partners had contributed their real property directly to the REIT, New Partnership and the REIT were separate entities and should be treated as such, the IRS said.88

Last, it can be surmised that the UPREIT met the business purpose prong of reg. section 1.701-2(a)(1), perhaps because the standard is relatively low.89 In Gregory,90 the landmark business purpose case, the Supreme Court refused to recognize a corporate reorganization when the taxpayer, through a series of complex transactions, created a new corporation and underwent a reorganization. The sole purpose of the transactions was to sell stock and pay the capital gains tax rate rather than the corporate tax rate and the ordinary income tax rate that comes with dividend distributions. It was clear that Evelyn Gregory’s transactions involving her newly formed corporation had no business purpose other than to avoid corporate tax. The new corporation was formed, exchanged stock with one of Gregory’s other corporations, and then was liquidated.

The transactions involved with establishing the UPREIT have legitimate purposes: to raise capital on the public markets, to gain liquidity, and to continue to operate and conduct business after the IPO. The UP-C structure mirrors the UPREIT in Example 4 in that a new entity is created and raises capital through a public offering, which is then used to buy into the historic partnership and become the managing member. The limited partners are then given the option to later exchange their limited partnership interests for cash or stock in the public corporation.

Further, an UP-C structure should meet the substance-over-form principles of reg. section 1.701-2(a)(2) because, as with the UPREIT, the UP-C limited partners do not have to exercise their limited partnership interests for cash or stock in PubCo. While a little murkier, the UP-C structure should also meet the proper reflection of income standard of reg. section 1.701-2(a)(3) because, just as for New Partnership and the UPREIT structure, the historic partnership and PubCo are separate entities. Also, there are no creative partnership allocations of income, gain, loss, deductions, or credits between PubCo and the original limited partners.91

Last, the UP-C should meet the business purpose prong of reg. section 1.701-2(a)(1) because the structure is easily distinguished from the situation in Gregory. There are no nefarious formations or liquidations of entities for the purpose of exploiting immediate tax benefits, and the historic partnership continues to operate as the main operating business. PubCo’s buying-in to the historic partnership has a definite business purpose of supplying that partnership with additional capital for its operations. Moreover, it has been observed that the antiabuse rules “operate without regard to the significance of business purpose as weighed against tax avoidance purpose, as long as the transaction at issue has at least some business purpose, economic reality or profit potential,” which indicates that the business purpose prong is not a high bar to clear.92

Although the arguments for the legality of the UP-C structure are strong, some may contend that it is illegal and should be challenged by the IRS. The concerns are primarily centered on claims

90 Gregory v. Helvering, 293 U.S. 465, 469 (1935), aff’d 69 F.2d 809 (2d Cir. 1934).
91 Assuming the historic partnership abides by section 704(a) and (b).
that Congress never intended “to allow pre-IPO owners of regular corporations that go public to enjoy both the benefits of being publicly traded and of holding their interests in a way that escapes corporate-level taxation” and that the UP-C structure violates both the letter and spirit of the UPREIT regulations.95

It may not have been Congress’s express intent to allow umbrella partnership structures to bypass corporate-level taxation, but it is almost impossible for Congress to foresee all consequences of its enacted laws. For that reason, section 7805 gives the IRS authority to create rules and regulations to enforce the code. The IRS took Congress’s partnership laws and interpreted them into more detailed guidelines laid out in reg. section 1.701-2. Those regulations, rather than Congress’s intent, should be the primary focus when analyzing the legality of the UP-C structure.

Admittedly, the UP-C structurally cannot precisely follow the rules in reg. section 1.701-2(d), Example 4, because the regulation condones only a REIT on top of a partnership, whereas the UP-C involves a corporation on top of a partnership. However, the similarities between the structures are obvious, as noted earlier. Moreover, the UP-C need not necessarily follow the letter of the law in Example 4 to be legal, as shown by the above analysis regarding reg. 1.701-2(a)(1) through (3).

As to the argument that the UP-C structure violates the spirit of the law, Example 4 shows that the IRS will consider structures used for tax savings. The IRS has given its blessing to the UPREIT structure, which “by its nature is formed solely to avoid tax.”96 The IRS has released no official rulings on the UP-C structure; however, at a corporate tax strategy conference, Clifford Warren, special counsel to IRS associate chief counsel (passthroughs and special industries), discussed ways to stay within the legal boundaries of the UP-C, implying that the IRS deems the structure legal.97 Warren did voice concern about the exchange rights between the original partners and PubCo, saying that “people are getting more aggressive on this exchange right” and that “given the spirit of C corp Up-structures, I think people should be conservative.”98 Taking Warren’s statements in context, it would appear as though the IRS deems the UP-C to meet the requirements of reg. section 1.701-2, whether that be by falling under the UPREIT example or by meeting the requirements of subparagraphs (a)(1) through (3). However, just as with all laws and regulations, there are boundaries, so an UP-C should be structured and implemented to mirror the UPREIT as closely as possible.

According to Amy S. Elliott, who has written on the subject of UP-C structures, many practitioners believe that reg. section 1.701-2(d), Example 4, “removes any risk that the IRS might not respect the form of an UP-C structure, pointing out that the regulation states that ‘subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax.’”99 With all this in mind, practitioners should feel safe from the threat of the IRS deeming the UP-C structure inconsistent with the intent of subchapter K and recasting the transaction.

B. The Economic Substance Doctrine

Congress codified the economic substance doctrine as part of the Health Care and Education Reconciliation Act of 2010.100 Much like reg. section 1.701-2, this bill originated from common law and drew language from a multitude of cases.101 The legislation added section 7701(o), titled, “Clarification of Economic Substance Doctrine.” This new section defines the economic substance doctrine as “the common law doctrine under which tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.”102 It also states that for individuals, the

95 See Shobe, supra note 18, at 30-31.
96 See Lipton and Thomas, supra note 88, at 103.
97 See Elliott, supra note 25.
98 Id. Warren specifically addressed the 60-calendar-day rule to avoid falling into the category of a PTP.
99 Id., supra note 8, at 337.
100 P.L. 111-152, section 1409.
102 See section 7701(o)(5)(A).
statute applies to transactions involving “trade or business or an activity for the production of income.”\textsuperscript{101} Section 7701(o) provides that for any transaction to which the economic substance doctrine is relevant, that transaction will be treated as having economic substance only if (1) the transaction changes the taxpayer’s economic position in a meaningful way apart from federal income tax effects (the economic substance prong), and (2) the taxpayer has a substantial purpose for entering into the transaction (apart from federal income tax effects).

Pre-statute, the economic substance doctrine was a conjunctive test in the First, Seventh, Eleventh, and Federal circuits; a disjunctive test in the Second, Fourth, Eighth, and D.C. circuits; and a “flexible inquiry” test in the Third, Fifth, Sixth, Ninth, and Tenth circuits. The codification of this doctrine cleared up these inconsistencies by making it a conjunctive test in which the economic substance prong is subjective and the substantial purpose prong is objective.\textsuperscript{102}

To add to the complexity of this test, section 7701(o)(2)(A) states that a taxpayer may rely on profit potential to satisfy the subjective and objective prongs only if the “present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.”

Regarding whether transactions should be viewed in the aggregate or separately, section 7701(o)(5)(D) defines the term transaction to include a series of transactions. Further, the IRS in Notice 2014-58, 2014-44 IRB 746, stated:

Generally, when a plan that generated a tax benefit involves a series of interconnected steps with a common objective, the “transaction” includes all of the steps taken together — an aggregation approach. This means that every step in the series will be considered when analyzing whether the “transaction” as a whole lacks economic substance. However, when a series of steps includes a tax-motivated step that is not

necessary to achieve a non-tax objective, an aggregation approach may not be appropriate. In that case, the “transaction” may include only the tax-motivated steps that are not necessary to accomplish the non-tax goals — a disaggregation approach.\textsuperscript{103}

Identifying transactions that could be characterized as falling under the economic substance doctrine is challenging, since the IRS has announced that it will not issue private letter rulings or determination letters on whether the doctrine “is relevant to any transaction or whether any transaction complies with the requirements of section 7701(o).”\textsuperscript{104} Taxpayers are thus forced to rely on the common law for guidance. To add to the potential for inconsistency and confusion, courts must still reach their own subjective conclusions on whether a specific business purpose is substantial and whether a taxpayer’s economic position is changed in a meaningful way.\textsuperscript{105}

Given the lack of case law on section 7701(o) and umbrella partnerships, one cannot say that the UP-C structure would definitely pass the statute’s two-pronged test; however, it likely would.\textsuperscript{106} The transactions involved in forming the UP-C do not share the usual characteristics of tax avoidance transactions falling under and failing section 7701(o), such as debt structurings to incur losses;\textsuperscript{107} interest rate swaps;\textsuperscript{108} lease-in, lease-out transactions;\textsuperscript{109} Custom Adjustable Rate Debt Structure transactions;\textsuperscript{110} son-of-BOSS

\textsuperscript{101} This is consistent with the definition of the term transaction in the legislative history of section 7701(o). See H.R. Rep. No. 111-443(1), at 296-297 (2010).
\textsuperscript{103} See Joshua D. Blank and Staudt, “Corporate Shams,” 87 NY L. Rev. 1641, 1657 (2012).\textsuperscript{104} Id. “Predicting whether a court will apply a particular judicial anti-abuse standard, or any standard at all, is challenging. While one court may respect the separate, independent steps of a taxpayer’s transaction, a different court may review the same transaction and determine that the steps should instead be viewed, and taxed, as one.” Id.
\textsuperscript{105} See Klamath Strategic Investment Fund LLC v. United States, 472 F. Supp.2d 890 (E.D. Tex. 2007).
transactions,\textsuperscript{111} and so-called foreign tax credit generators.\textsuperscript{112} The UP-C structure is much more straightforward and transparent than those transactions; it is designed to be tax efficient rather than deceptive.

In \textit{Countryside},\textsuperscript{113} the Tax Court held that a liquidation of interest designed to avoid the recognition of gain also served "a genuine, nontax, business purpose," which was to convert the two partners' investments into promissory notes. Similarly, in an UP-C structure, PubCo is formed so the original partners can convert their partnership interests into publicly tradable stock. This gives the original partners access to the capital markets and liquidity that they could not access before.

Again in \textit{Countryside}, the Tax Court held that the liquidation of the two partners' partnership interests changed their economic position and the economic position of the partnership, therefore satisfying the subjective prong of the economic substance doctrine. Similarly, in the UP-C structure, PubCo's buying into the historic partnership and becoming the managing partner changes not only the economic position of the original partners but also the economic position of PubCo.

Although the codified economic substance doctrine remains shrouded in uncertainty, it is meant for abusive structures and transactions, which the UP-C is not. As Judge Learned Hand famously wrote for the Second Circuit in \textit{Gregory}, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."\textsuperscript{114}

\textbf{VII. Conclusion}

Although controversial, the UP-C structure and TRAs are grounded in good law. The UP-C structure and TRA deliver one of the most tax-efficient ways for owners of a partnership to access the public markets, and unless there is legislation imposed disallowing the use of this method, partnership owners will continue to use it. The terms of these deals are completely transparent and disclosed, and as long as public investors continue to omit tax assets from their valuation process, original partners will continue to retain these tax benefits by way of the TRA and flow-through taxation by way of the UP-C structure.

\textsuperscript{112} See Principal Retired I LLC v. United States, 816 F. Supp.2d 693 (S.D. Iowa 2011).
\textsuperscript{113} Countryside Limited Partnership v. Commissioner, T.C. Memo. 2008-3.
\textsuperscript{114} Gregory, 69 F.2d at 810.