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M&A Tax Talk
UP-C structures

An Umbrella Partnership—C Corporation (or UP-C structure) may be a potentially beneficial tax structure to allow owners of a pass-through legal entity access to public capital. This article provides an overview of UP-C structures, the advantages they can deliver, and the importance of proactive planning.

Right as rain – Overview of the UP-C structure

If the owners of a pass-through legal entity are considering different routes to raise capital by accessing public capital markets, an Umbrella Partnership—C Corporation (or UP-C structure) may be one potentially beneficial tax structure. An UP-C structure allows the existing owners of a company operating as a pass-through legal entity (i.e., a partnership[1]) to form a corporate entity where the partnership may (i) access public capital markets, (ii) remain subject to only a single layer of tax, and (iii) not be subject to the publicly traded partnership rules.

Historically, for a partnership to access public capital markets, it either incorporated or was taken public directly (under Internal Revenue Code Section 7704). However, both alternatives result in the C corporation and partnership (taxed as a C corporation) attracting two levels of taxation at the federal level.[2] This assumes the legacy partners retain a portion of their ownership post-transaction. Over time, the UP-C structure became a more common solution. Under the Up-C structure, a pass-through entity (i.e., the "Umbrella Partnership") might come in – out of the rain, if you will—to avoid the dual layers of tax and enable its owners to receive post-IPO benefits.

Opening the umbrella – Implementation of the UP-C structure

In general, an UP-C structure involves the following steps –

1. A corporate entity is formed (PubCo).
2. PubCo undertakes a public offering and sells Class A common shares, which have voting and economic rights, to the public in exchange for cash.
3. PubCo is admitted to the historical operating partnership as the general partner or managing member (to the extent that the partnership was formed as a limited liability company).
4. The legacy owners of the historical operating partnership receive Class B common shares of PubCo, which have voting rights but no economic rights attached to such shares (the amount of the applicable vote is based on the legacy partners' economic interests in the partnership).
5. In connection with the IPO, the legacy partners (i) are granted exchange rights whereby they may exchange their interests in the historical operating partnership for Class A shares of PubCo or cash, and (ii) enter into a tax receivable agreement (TRA) under which PubCo agrees to pay an exchanging legacy partner the majority of the value associated with tax savings resulting from such exchange.
6. PubCo may either (i) contribute all the proceeds received into the historical operating partnership or (ii) use some of the proceeds to buy out certain legacy partners of the historical operating partnership.

Save it for a rainy day – The effect of exchange rights on legacy partners' liquidity

The exchange rights issued to the legacy partners grant each of them the ability to exchange their historical operating partnership interests (in part or in whole) for either Class A common shares or cash. As a result of such exchange rights, the legacy partners have liquidity at the point in time when they may desire to monetize their partnership interests.

One way to structure such exchange rights is to grant legacy partners the ability to exchange their respective partnership interests for cash of the historical operating partnership and to grant PubCo the ability to override the exchange between the legacy partner and the historical operating partnership to use its own cash or stock. Structuring the exchange right as a "cash put" against the historical operating partnership, may be considered a feature of the historical operating partnership interests (i.e., it is not considered a separate property right that might be viewed as taxable to the legacy partner upon receipt).

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1. An existing S corporation may also utilize the UP-C structure by contributing its business to a partnership.
2. Internal Revenue Code Section 7704 contains a limited exception to the treatment of a publicly traded partnership as a C corporation for partnerships that have 90% or more passive income.

Come rain or shine – Methods to affect the exchange

If the exchange right is exercised against the partnership—with the partnership utilizing its own cash (not cash contributed to the partnership by PubCo)—the exchange will be treated as a redemption of the partnership interests. This will result in an adjustment under Internal Revenue Code Section 734. Any resulting step-up in tax basis in the assets of the partnership producing future tax benefits is shared by all partners of the historical operating partnership (including PubCo).

If the exchange is performed between a legacy partner and PubCo for either Class A common shares or cash (i.e., a partner-to-partner exchange), it will result in an adjustment under Internal Revenue Code Section 743(b). In this case, any resulting step-up in tax basis in the assets of the partnership is personal to the acquiring person (i.e., PubCo). A partner-to-partner exchange may be effectuated as a disguised sale or a direct sale. An exchange is treated as a disguised sale if a legacy partner exercises its exchange rights against the partnership but PubCo contributes cash into the historical operating partnership. This cash is then used by the historical operating partnership to affect the exchange. Alternatively, an exchange is treated as a direct sale if PubCo utilizes its own cash or Class A common shares to affect a direct purchase of the legacy partner's interests in the historical operating partnership. It should be noted that regardless of the mechanics of the exchange right, the exercise of the exchange right for either cash or Class A common shares is a taxable exchange to the legacy partner. Additionally, the tax basis adjustments under both Internal Revenue Code Sections 734 and 743(b) require that the historical operating partnership have an Internal Revenue Code Section 754 election in place.

The upside to UP-C – The TRA

As noted above, under the UP-C structure and to the extent there is a tax basis step-up in the underlying partnership assets, some or all of the tax basis step-up will be attributed to PubCo. Over time, PubCo is expected to recognize tax benefits from the resulting depreciation and amortization. The TRA determines how those tax benefits are shared between PubCo and the legacy partners exercising their exchange rights (typically 85% of the resulting tax benefits are allocated to the legacy partners).

As the benefits from the tax basis step-up are realized, a portion of the realized benefits are paid to the legacy partners as additional purchase price for the partnership interests that were exchanged. These payments—to the extent that they are not recharacterized as interest—are eligible for installment-method reporting (generally taxable as received) unless an election is made not to apply the installment sale rules.

Conclusion

An UP-C structure can be a preferred option for a pass-through entity to avoid the dual layers of tax that more traditional IPO structures may bring. However, implementing the UP-C structure requires proactive tax planning, deep tax technical analysis, and coordination between the partnership's tax and legal department, and its advisors. With careful planning, including preparation for the TRA, exchange agreement, and various tax elections, the UP-C structure may enable legacy partners to receive post-IPO benefits.

Hot topic – The interplay of SPACs and the UP-C structure

With the proliferation of Special Purpose Acquisition Companies ("SPACs"), many deals are currently being executed in the M&A arena involving SPACs. Given their prevalence in today's market, a SPAC may be included in a business' UP-C tax planning, whereby the SPAC is treated as the PubCo in the UP-C structure. Note that in this case, the PubCo formation step is not necessary because the SPAC has already been formed and the IPO has already occurred.

To learn more check out our M&A Tax Talk | Private equity insights tax talk covering IPOs and resurgence of SPACs.

Want to learn more?
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