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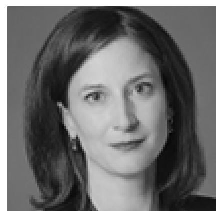
UPENDED: THE IMPACT OF TAX REFORM ON UP-C STRUCTURES



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I. INTRODUCTION [1]

Over the past 15 years, umbrella partnership structures (commonly referred to as "Up-Cs"), in which a newly-formed publicly traded C corporation ("PubCo") acquires interests in an existing business operated in flow-through form (generally, a limited partnership or limited liability company treated as a partnership for U.S. federal income tax purposes) (the "Partnership"), have become the dominant structure through which Partnerships[2] have raised equity capital through the public markets.[3] It is easy to understand why: an Up-C structure allows the Partnership to raise money (and its historic owners (the "Partners") to sell equity) through a public offering while allowing its Partners to retain flow-through economics (including a single level of tax and pass-through of tax losses) until the Partners are ready to sell. At the time of sale, the Partners have access to liquidity through the right (negotiated at the time of the IPO) to exchange their Partnership interests for PubCo stock (usually on a one-for-one basis), which stock can be sold on the open market. As a bonus, in connection with Partner liquidity, PubCo receives a step-up in its allocable portion of the basis of the Partnership's assets as a result of such an exchange, which can be used to offset future income at PubCo. In nearly all Up-Cs, the Partners negotiate for the right to receive a portion of these benefits as and when used by PubCo (or upon certain exit events) through a Tax Receivables Agreement ("TRA").[4] Because of these benefits, practitioners generally believed that Up-Cs would become the dominant IPO structure for any pass-through business.[5]

Tax reform perhaps changes the calculus, both with respect to existing Up-C structures and for Partnerships that are considering raising capital from the public markets. In December 2017, President Trump signed into law a tax reform bill commonly referred to as the Tax Cuts and Jobs Act (the "Act").[6] The Act included a number of significant changes to the U.S. federal income tax system, including meaningful changes to the calculation of an individual's income tax liability and applicable income tax rates. For example, the Act reduced the corporate federal income tax rate from 35

percent to 21 percent, without a commensurate reduction in the individual federal income tax rate (which was only reduced from a top rate of 39.6 percent to 37 percent). Additionally, the Act reduced or eliminated several tax deductions previously available to individuals who itemize deductions, including the deduction for state and local income taxes. In certain high tax states (e.g., New York and California), this has meant that individual taxpayers are subject to income tax at effective rates of over 50 percent on marginal ordinary income, while corporations are subject to effective income tax rates on average of 24 to 26 percent.[7]

As discussed further below, these and other changes meaningfully affect the value of both current and future Up-C structures. While the benefits of an Up-C structure are generally preserved under the Act, whether an Up-C structure, or certain market terms related thereto, is ideal going forward will depend on the taxpayers' specific facts. We have summarized some of these considerations (including the Act's effect on existing Up-C structures) below.[8] Section II provides a brief background of Up-C structures. Section III discusses certain provisions of the Act relevant to Up-Cs in general. Section IV describes how these provisions of the Act create opportunities and challenges for businesses operating, or considering whether to operate, as Up-Cs, such as considerations for choosing an IPO structure and retaining a TRA.

II. BACKGROUND

There is a great deal of existing literature that provides a thorough description of the historical development of, and technical issues that arise in connection with, Up-C structures.[9] To avoid duplicating this discussion and analysis, this section is limited to a general overview of Up-C structures, focused on the typical mechanics and terms. We encourage you to consult these other materials for detailed discussions of these and other structural issues.

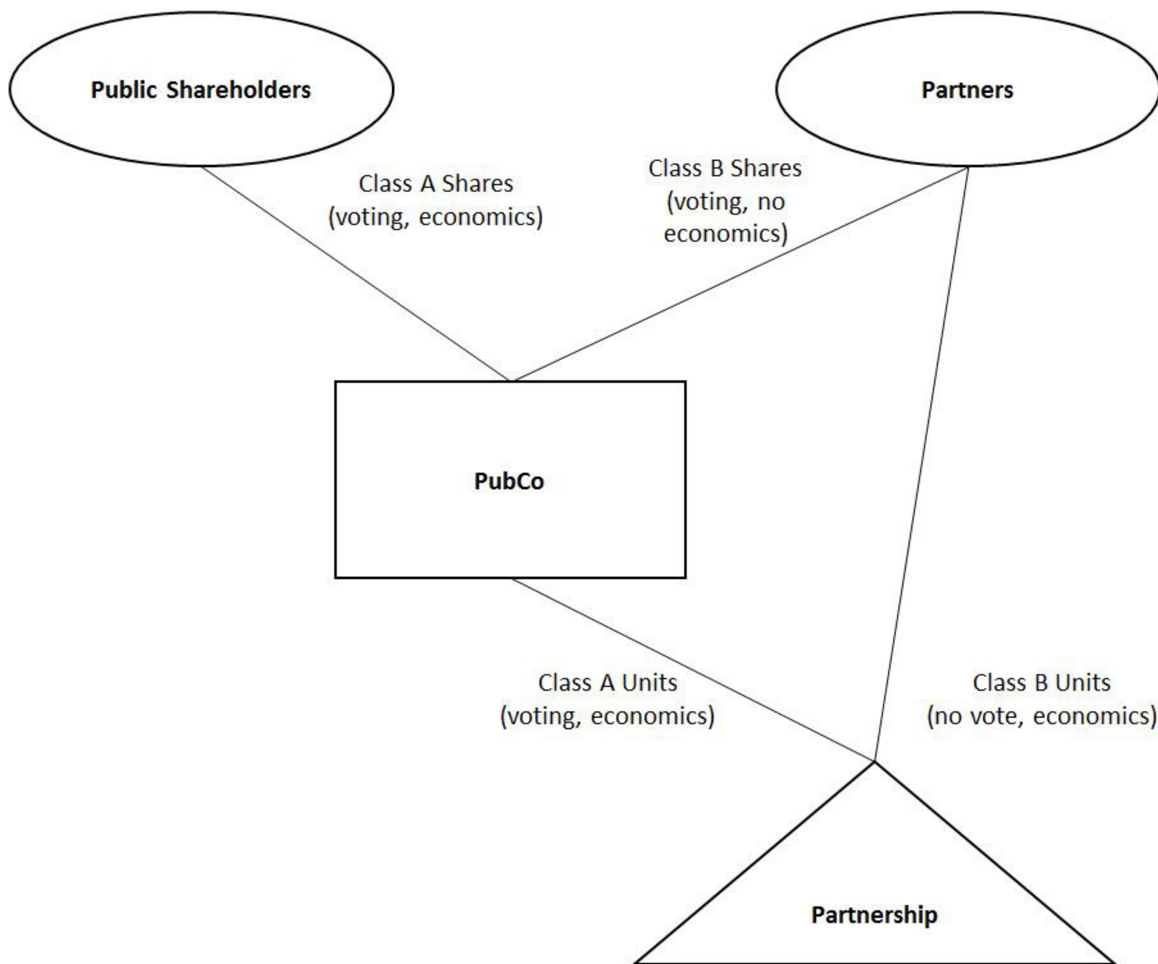
In Part A, we discuss how the Up-C structure is formed. In Part B, we discuss the mechanics for, and consequences of, a Partner's exchange of Partnership interests for PubCo stock. In Part C, we explain common terms of existing Up-C TRAs, including the payment of benefits related to the exchanges described in Part B.

A. Forming an Up-C

An Up-C structure is typically established through the following steps:

- The Partnership recapitalizes its interests so that it has two classes of units: Class A units, which have economic and voting rights, and Class B units, which have no voting rights but have the same economic rights as the Class A units.[10] Class A units will ultimately be held by PubCo. Class B units will be held by existing Partners.
- PubCo is formed with two classes of stock: Class A shares of common stock, which have voting rights and entitle the holder to its pro rata share of the assets of PubCo and will be sold to the public, and Class B shares, which have voting rights but no economic rights (except perhaps with respect to the return of a nominal par value) and will be owned by the existing Partners. In some structures, the Class B shares are "high vote" shares, which ultimately will allow existing partners to retain voting control over the business conducted by the Partnership.[11]
- PubCo issues the Class A shares to the public in exchange for cash, and contributes that cash (together with the Class B shares) to the Partnership in exchange for Class A units of the Partnership. PubCo's ownership of Class A units gives PubCo voting control of the Partnership.
- The Partnership may use a portion of the cash received from PubCo to redeem certain of the Partners' interests. This redemption is treated as a direct purchase of partnership interests by PubCo from the Partners, which gives PubCo a step-up in the tax basis of its allocable share of the Partnership's assets under Section 743 of the Code.[12]
- The Partners receive the Class B shares of PubCo on a pro rata basis in accordance with the ownership of Class B units.
- The Partnership, the Partners and PubCo enter into an exchange agreement that allows the Partners to exchange their Class B units and Class B shares for Class A common stock, typically on a one-to-one basis.[13] Certain exchange agreements allow PubCo to settle the exchange request in cash rather than delivering actual shares.[14]

The resulting structure is as follows:



Following these steps, the Partners: (1) generally retain control of the Partnership through their voting stock of PubCo, which in turn has voting control of the Partnership; (2) maintain a single-level of tax and flow-through economics through their Partnership interests; and (3) create an opportunity for future liquidity through the exchange rights.

As is typical for most flow-through entities, the operating documents of the Partnership in an Up-C structure will usually require the Partnership to make cash distributions to the Partners and PubCo to ensure that they have sufficient cash to pay their income taxes. Predominant market practice is to calculate such tax distributions by reference to the highest combined marginal federal, state and local income tax rate applicable to a corporation or individual resident in a specific jurisdiction (generally, California or New York).[15] Although some operating partnerships differ in how such payments are made, in Up-C structures, such payments are generally made pro rata, regardless of the actual tax liability of any particular partner. This is intended to preserve economic parity and to reduce administrative complexity.

B. Exchange Rights

Under a typical Up-C structure, the Partners may achieve liquidity by exchanging one Class B unit and one share of PubCo Class B stock for one share of Class A stock.[16] This transaction is generally taxable to the Partner, and for this reason (among others) the Partner generally immediately sells the Class A stock on the open market (likely for no additional gain or loss). These exchange mechanics present a number of considerations for taxpayers that are beyond the scope of this article, including common limitations on exchange rights that are designed to satisfy certain exceptions under the "publicly traded partnership" rules.[17] However, there are certain aspects of the exchange mechanics that are relevant to this article.

First, the one-to-one exchange ratio described above is premised on economic parity between a share of PubCo Class A stock and a Class B Partnership unit. Generally, there is economic parity if the Partnership unit and the PubCo common stock "represent the same right to the same proportional interest in the same underlying pool of assets."[18] Theoretically, economic parity is achieved if PubCo owns no assets, and conducts no activities, other than its ownership of the Partnership units. However, if PubCo were to own other assets, (e.g., cash from tax distributions exceeding the cash tax needs and TRA obligations of PubCo), or if there was not economic parity for other reasons, the exchange ratio might need to be adjusted.

Second, as described above, the exchange of Partnership interests for PubCo stock is treated as a taxable sale of the Partnership interests to PubCo by the exchanging Partners.[19] The Partnership is generally required to have an election in place under Section 754 of the Code for any year in which an exchange occurs so that PubCo receives a step-up in the portion of the Partnership's assets attributable to the exchanged interests. This step-up creates additional amortization and depreciation deductions that PubCo may be able to use to offset its tax liability, which in turn gives rise to TRA payments, as discussed below.

C. Tax Receivables Agreement

i. Calculation of TRA Payments

As discussed above, the initial acquisition of Partnership interests by PubCo from a Partnerand a later exchange of a Partner's Partnership interests for PubCo Class A stock results in a stepped-up basis in the portion of the Partnership's assets attributable to the acquired or exchanged units under Section 743 of the Code (provided that the Partnership has an election under Section 754 of the Code in effect.) This step-up creates additional depreciation and amortization deductions that PubCo can use to offset its tax liability. The particular impact of this step-up depends on the nature of the Partnership's assets, but is usually allocated to certain intangible assets under Section 197 of the Code (such as goodwill), which are amortizable over 15 years.

A TRA allows the Partners to benefit from the use by PubCo of any tax asset so created.[20] As a result, the Partners receive a debt-like stream of future payments based on PubCo's use of specified tax attributes.[21] The general view is that payments to the Partners for these tax assets are acceptable because, in many cases, public markets do not fully value the tax attributes of publicly traded companies.[22]

In general, for federal income tax purposes, the TRA payments are treated as additional payments by PubCo of contingent purchase price for the exchanged Partnership units.[23] This creates an additional step-up in basis, such that payments under the TRA beget additional TRA payments.

Fortunately for PubCo, it usually need only make TRA payments as and when it is actually deemed to use the tax benefits created by the step-up to reduce its cash tax burden. Typically, a TRA's terms calculate the amount of any payment for any applicable tax period by comparing PubCo's actual tax liability for "Covered Taxes," taking into account the relevant tax benefits for such period, with its hypothetical tax liability for such taxes, determined without taking into account such tax benefits but otherwise using the same methods and elections used to calculate PubCo's actual tax liability (i.e., on a "with and without" basis) (the "Realized Tax Benefit"). "Covered Taxes" is generally limited to U.S. federal, state, local and foreign income taxes (including franchise taxes).[24]

Also, PubCo need not pay over all of the benefit it receives. Most commonly, the TRA only requires payment of 85 percent of the value of the Realized Tax Benefit.[25] To accommodate the uncertainty as to the amount and timing of these payments, TRAs often have a term of a set number of years (e.g., 30 years from the date of the IPO)[26] or until all payments for tax benefits have been made.[27]

ii. Early Termination Payments

Another common feature of TRAs is an acceleration provision that requires PubCo to make a lump-sum payment (the "Early Termination Payment") to eligible Partners upon the occurrence of certain events. PubCo's payment of the Early Termination Payment extinguishes PubCo's ongoing payment obligations. Relevant events may include a change of control of PubCo,[28] PubCo's material breach of its obligations under the TRA, or PubCo's bankruptcy. Most TRAs also allow PubCo to elect to make an Early Termination Payment.[29] Alternatively, a TRA may provide that if there is a change of control, the payments are not accelerated, but PubCo is deemed to have sufficient taxable income to make the TRA payments on a go-forward basis.[30]

Typically a TRA will provide that the amount of the Early Termination Payment is equal to the net present value of the remaining payments due under the TRA from the termination date through the scheduled termination of the TRA, based on assumptions regarding PubCo's ability to use the Realized Tax Benefit, as described below, and at an agreed-upon discount rate.[31] Such assumptions often include:[32]

- PubCo will have enough taxable income to fully use the applicable tax attributes during the earliest years in which such attributes would be available, including depreciation and amortization deductions resulting from TRA payments and, if applicable, pre-IPO NOLs;[33]
- The U.S. federal income tax rates in effect for each taxable year will be those applicable to a corporation on the termination date;[34]
- Any loss carryovers or carrybacks[35] generated by the applicable tax attributes will be used ratably in each taxable year from the termination date;[36]
- Use of NOLs and deductions related to certain basis adjustments will be determined based on the tax laws in effect on the termination date;[37] and
- Any Partner that has not exchanged its Partnership interests for PubCo stock will be deemed to have exchanged all of its Partnership interests on the termination date.[38]

Due to the potentially large size of these Early Termination Payments, PubCos that are obligated to make such payments are incentivized to try to negotiate a lower lump sum payment, or to otherwise revise the terms of the TRA, so as to pay less than would have been required under the original applicable TRA.[39] Partners entitled to the Early Termination Payment may be receptive if they otherwise support the transaction creating the Early Termination Payment.

III. RELEVANT ASPECTS OF RECENT TAX REFORM

The Act has had, and will have, significant effects on the economics of Up-C structures. This section discusses certain aspects of the Act that drive these effects, but is not meant to be exhaustive. Instead, it is intended to provide a summary of certain aspects of the Act that are (or are likely to be, pending guidance from the Service implementing the Act) generally applicable to Up-Cs.

A. Changes in U.S. Federal Income Tax Rates for Individuals and Corporations

The key change imposed by the Act was the reduction of the U.S. federal corporate income tax rate from a top graduated rate of 35 percent to a flat rate of 21 percent beginning January 1, 2018.[40] The Act also reduced the top individual tax rate on ordinary income from 39.6 percent to 37 percent.[41] The reduced individual income tax rate is only in effect for tax years beginning before January 1, 2026.[42] The reduced corporate income tax rate has no sunset provision.

The existence of and difference between these rate reductions are, on their own, meaningful changes. However, the effect of these changes is amplified when coupled with certain other changes implemented by the Act, as discussed below.

B. Limitation on the Deduction for State and Local Taxes for Individuals

Prior to the Act, both individuals who elected to itemize deductions and corporations were able to deduct the full amount of their state and local taxes ("SALT") to reduce their federal income tax liabilities.[43] The Act limited SALT deductions for individual taxpayers to $10,000 per year.[44] Like the reduced individual income tax rate, this is a temporary provision, and only applies to tax years beginning before January 1, 2026.[45] The Act did not alter SALT deductions for corporations.

C. Deduction for Certain Qualified Business Income

In an effort to reduce the disparity in the tax rates for income received from businesses held in corporate solution and businesses held in flow-through form, the Act included new Section 199A of the Code, which allows non-corporate taxpayers to deduct up to 20 percent of the "qualified business income" received from certain domestic flow-through businesses (the "Section 199A Deduction").[46] The calculation and application of the Section 199A Deduction is extremely complex and uncertain. This article does not seek to explore any of this complexity and uncertainty, but rather only to discuss potential implications for individual holders of Partnership units, assuming that they are able to take advantage of the deduction.[47]

The Section 199A Deduction is generally equal to 20 percent of the net amount of qualified items of income, gain, loss and deduction with respect to each "qualified

trade or business" conducted by an individual or a relevant pass-through entity.[48] For taxpayers with income in excess of a "threshold amount,"[49] the Section 199A Deduction for any taxable year is capped at the greater of: (1) 50 percent of the individual's allocable share of the W-2 wages attributable to the applicable qualified business; and (2) the sum of (i) 25 percent of the individual's allocable share of the business's W-2 wages and (ii) 2.5 percent of the "unadjusted basis in qualified property."[50] The Section 199A Deduction only applies to tax years beginning before December 31, 2025.[51]

The Proposed Section 199A Regulations include provisions that would affect the amount of the Section 199A Deduction applicable to individual taxpayers in partnership structures. In particular, if the amount of the Section 199A Deduction turns on the amount of UBIA of qualified property allocable to an individual, partnership transactions, including transactions undertaken in connection with Up-C structures, could affect the amount of such deduction. For example, the Proposed Section 199A Regulations adjust UBIA of qualified property to its then-adjusted basis where the property is acquired in certain non-recognition transactions,[52] and allocate UBIA of qualified property in proportion to Code Section 704(c) tax depreciation rather than Code Section 704(c) book items.[53]

D. Expanded First-Year Bonus Expensing

Ordinarily, the investment cost of certain classes of personal property is recoverable through depreciation deductions over a set number of years.[54] Prior to the Act, taxpayers were able to take a bonus first year depreciation deduction equal to 50 percent of the adjusted basis of "qualified property."[55] "Qualified property" included tangible personal property with a recovery period of 20 years or less and certain computer software.[56] Bonus depreciation was only available for property that was placed into service by the taxpayer as the first user (i.e., newly purchased property).[57]

The Act expands the amount and availability of bonus first-year depreciation deductions. First, it allows taxpayers to immediately write-off 100 percent of the cost of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023 (the "Bonus Depreciation Deduction").[58] Second, the Act expanded the types of property that are eligible for the deduction by eliminating the requirement that the taxpayer be the first user of the property, meaning that qualified property now includes both new and used property.[59] Overall, together with the reduced corporate income tax rate, this deduction increases a corporation's ability to significantly reduce, or eliminate, its federal income tax liability.[60] The Bonus Depreciation Deduction applies unless the taxpayer elects out, which may be done on an asset class-by-class basis by the owner of the property.[61]

Although significantly expanded, the Bonus Depreciation Deduction remains subject to certain restrictions. Specifically, the taxpayer must not have used the asset at any time before the acquisition, acquired the asset from certain related parties,[62] or have a carry-over basis in the asset.[63] The Service recently published proposed Treasury Regulations under Section 168 of the Code (the "Proposed Bonus Depreciation Regulations") addressing, among other things, the extent of these restrictions. Specifically, the regulations address a partnership's ability to take advantage of the Bonus Depreciation Deduction for stepped-up basis created by a Section 754 election following the transfer of partnership interests.[64] Under the Proposed Bonus Depreciation Regulations, a taxpayer is considered to have "used" an asset if the taxpayer has a distinct "depreciable interest" in the applicable portion of the property.[65] Under this approach, and taking an aggregate-view of the partnership, the stepped-up basis under Section 743(b) is eligible for the Bonus Depreciation Deduction because the transferee partner did not have a depreciable interest in the portion of the partnership property that is attributable to the transferred interests (even though it may have had an existing interest in another portion of the underlying partnership property as an existing partner).[66] The Proposed Bonus Depreciation Regulations clarify that the partnership makes the election to apply the Bonus Depreciation Deduction as the owner of the qualified property, even where the basis adjustment is particular to the partner under Section 743(b) of the Code.[67]

E. Limitations on the Use of NOLs

Net operating losses ("NOLs") are created when a taxpayer's tax deductions within a specified taxable period exceed its taxable income. Under prior law, taxpayers could carry NOLs back two taxable years and forward 20 taxable years. In each case, NOLs could be used to offset 100 percent of taxable income.

The Act includes several changes to the use of NOLs. First, subject to certain specific exceptions, NOLs created after 2017 may not be carried back to offset prior years' income.[68] Second, unused NOLs generated after 2017 may be carried forward indefinitely.[69] Third, NOLs created after 2017 may only be used to offset 80 percent of a taxpayer's taxable income,[70] although NOLs created in tax years ending on or before 2017 may still be carried back and may be used to offset 100 percent of a taxpayer's income.[71]

Taken together, the changes discussed in this Section III significantly alter the tax rates applicable to, and deductions available to, corporate and individual taxpayers.

IV. EFFECT OF TAX REFORM ON UP-Cs

As previewed above, we expect that these changes implemented by the Act will significantly affect several aspects of both future and existing Up-C structures. In particular, we expect these changes will: (1) impact the calculus underlying choice of IPO structure; (2) change the value of Early Termination Payments; and (3) implicate the calculation of tax distributions, including possibly changing the existing prevailing market terms.

A. Choice of IPO Structure

As a threshold matter, the changes implemented by the Act may shift the determination of whether an Up-C structure is the best way for a flow-through entity to accomplish a public offering. The reduced corporate rate and simplicity of a traditional corporate structure should be weighed against the continuing benefits of operating in pass-through form for the Partners, including the potential for TRA payments.[72]

One option is to execute an IPO as a pure publicly-traded C corporation. Looking just at applicable income tax rates, C corporations are subject to the significantly reduced federal tax rate on operating income (21 percent), and are generally subject to lower state taxes.[73] The federal income tax rate is further reduced by a corporation's ability to deduct all of its SALT. Further, C corporations are able to defer the recognition of operating income for its owners; although a corporation's U.S. shareholders are subject to tax on dividends and on the sale of stock, they generally are not subject to tax on these amounts until there is a realization event with respect to the stockholder (e.g., declaration of a dividend or sale of stock).[74] When a corporation distributes its income or shareholders sell corporate stock, its U.S. shareholders are generally subject to tax at a rate of 20 percent.[75] This creates a blended federal income tax rate of approximately 36.8 percent.

Alternatively, a business could execute an IPO as an Up-C. In contrast to the deferral provided to C corporation shareholders, Partners are subject to tax on their allocable share of operating income, whether or not such amounts are actually distributed, usually at the highest marginal rate applicable to ordinary income. Pre-tax reform, this was a single rate for individuals, and the only variable was the level of state taxation imposed on the income. Post-tax reform, however, the rate applicable to pass-through income depends in part on whether, and to what extent, the income qualifies for the Section 199A Deduction in the hands of the particular taxpayer. If the income does not qualify for the Section 199A Deduction, it could be subject to the top individual income tax rate of 37 percent (a rate that is comparable to the blended tax rate on distributions of corporate income to corporate shareholders), but if all of the income qualifies for the full deduction, it would be subject to a blended rate of 29.6 percent.[76] In that case where income from a Partnership is eligible for the Section 199A Deduction and subject to this lower rate, an Up-C would be a very attractive IPO structure for individual taxpayers. As discussed above, whether all, or a portion, of an individual's share of income qualifies for the Section 199A Deduction is a fact-intensive analysis that must be determined on a year-by-year and taxpayer-by-taxpayer basis. In any case, however, the Partners would receive tax distributions to permit them to pay income tax attributable to their allocable share of Partnership income. Moreover, a Partner's allocable share of Partnership income increases the Partner's tax basis in its interest, thereby reducing gain or increasing loss on exit.

The applicable tax rate on operating income is not the only gating question that arises when a Partnership considers whether to pursue an Up-C structure. Another consideration is the potential value of TRA payments. Where a business expects to undertake an IPO, initially forming an entity as a corporation would eliminate the founders' ability to capture the benefit of any future step-up under a TRA.[77] However, the new 21 percent corporate income tax rate under the Act has significantly reduced the value of TRA payments. Whereas prior to the Act, Partners were able to recover their applicable percentage of 35 percent or more of the relevant tax asset, the reduced tax rate under

the Act has reduced the value of those payments by approximately 40 percent.[78] With this reduced value, parties may be less inclined to structure an IPO as an Up-C solely to capture benefits under a TRA.

The value of the pass-through taxation and TRA payments afforded by an Up-C will depend on the nature and expectations of the Partners. For example, foreign and tax-exempt investors may not be motivated to preserve an Up-C structure if they are nonetheless required to hold such interests through a blocker (and thus remain subject to corporate income tax on earnings). Similarly, Partners who expect to sell quickly after an IPO and be taxed at capital gains rates may be willing to forgo flow-through economics in favor of the simplicity of owning PubCo stock. [79]

In addition to the applicable tax rates and the ability to enter into a TRA, the specific goals of a business and its founders will strongly influence the IPO structure. For example, a Partnership is able to issue incentive equity to management in the form of profits interests, which may be more attractive than the stock-based incentive equity that may be offered by a corporation (e.g., restricted stock, restricted stock units, options). Finally, depending on the business's investor base, the founders may be influenced by the tax filing requirements of either structure, preferring the simplicity of an entity-level tax for a corporation over the Partner-specific tax returns and Schedule K-1s for a Partnership.

B. Calculation and Value of Early Termination Payments under TRAs

The reduced value of the TRA payments discussed above may encourage certain taxpayers to consider terminating TRAs by triggering the early payment mechanics, whether in the ordinary course or in connection with M&A activity involving an Up-C target.[80] Although the valuation assumptions may require PubCo to make a significant one-time payment to the eligible Partners that is significantly in excess of its actual tax savings or the ordinary course payments due under the TRA, certain PubCos may still find value in removing the overhang of a long-lived contingent liability.

For instance, a PubCo may be encouraged to trigger the Early Termination Payment in order to take advantage of currently low tax rates. The valuation assumptions generally require PubCo to use the tax rate in effect on the early termination date.[81] As such, PubCo would be able to use the current 21 percent federal rate rather than any higher rate that may have been in place at the time the TRA was entered into or any increased future rate.

Similarly, a PubCo may be inclined to terminate a TRA in order to control the use of the Bonus Depreciation Deduction. Generally, voluntary termination of a TRA triggers a deemed exchange of any remaining Partners' interests for PubCo stock,[82] which could accelerate the potential recognition of tax benefits attributable to the acquired applicable portion of Partnership assets that are eligible for the Bonus Depreciation Deduction. Provided the Partnership has a Section 754 election in place, the Bonus Depreciation Deduction would be automatic for the deemed Section 743(b) step-up unless the Partnership elects out for any or all classes of assets. (Because the Partnership would make the election, the decision to apply the Bonus Depreciation Deduction is ultimately in the hands of PubCo as the controlling member (although the Partners may have control of PubCo as a result of their Class B shares).) With this in mind, Partners in both new and existing Up-Cs may want to consider adding a covenant to the Partnership's operating agreement that prohibits the Partnership from making the opt-out election in the tax year that includes a change of control event in order to preserve the benefit of the Bonus Depreciation Deduction for accelerated TRA payments (i.e., reducing the impact of the net present value discount on the value of the depreciation deduction).

Even taking into account the reduced value of the Early Termination Payments, Early Termination Payments could resullt in a significant lump-sum obligation for PubCo. As such, parties may find significant value in retaining the TRA but renegotiating the terms in order to reduce the amount of the large lump-sum payment.[83] This approach may be valuable to a Partner that would prefer to avoid receiving payments far into the future (e.g., a fund with a finite life) and PubCo by removing a significant debt-like item from its balance sheet.

C. Calculation of Tax Distributions

The Act raises questions about how both new and existing Up-Cs should calculate tax distributions, particularly with respect to the applicable tax rate. As discussed above, prior to the Act, market practice was for Partnerships to use an assumed tax rate equal to the highest combined marginal federal, state and local income tax rate for a Partner resident in a chosen jurisdiction.[84]

Depending on the applicable language, immediately prior to the Act, this rate may have been as high as 54 percent. PubCos generally recognized that at this rate, they would receive some amount of cash in excess of their income tax liabilities, although the amounts were generally not expected to be significant because of the small difference between the individual and corporate federal income tax rates. According to the offering documents for certain of these Up-Cs, PubCos expected to use the excess cash to fund general operating costs and make TRA payments.[85] Any excess amounts could be returned to PubCos' shareholders as dividends.

However, under the Act, a Partnership that makes pro rata tax distributions at the highest assumed combined individual rate will distribute an amount of cash to PubCo that is significantly in excess of its actual tax liability.[86] Such tax distributions are likely to cause a buildup of excess cash at the PubCo level unless PubCo pays regular dividends because PubCo's tax liability likely will be far less than its receipt of cash from the Partnership. While this was a problem under law prior to the Act (i.e., the corporate rate was less than the individual rate), the difference between the corporate and individual rates has significantly increased, highlighting the significance of this issue.

Whether a Partnership wants to make such distributions of excess cash will depend on both the tax considerations discussed herein and other economic concerns (including the cash flows of the business). A distribution of excess cash to PubCo raises two tax considerations for Up-Cs: (1) the impact of such excess cash on the exchange ratio of Partners' Class B Partnership units for Class A common stock; and (2) the application of the accumulated earnings tax under Section 531 of the Code.

First, receipt of excess cash may disrupt the economic parity between Partnership units and PubCo stock. Maintaining economic parity between these equity units is essential to the exchange mechanics of the Up-C structure.[87] If PubCo receives and holds onto excess cash, exchanging Partners are able to get additional economic benefits with respect to that cash when they exchange their units for PubCo stock (e.g., the value of the PubCo stock rationally should include the value of its undistributed cash).

Tax distributions could create a second problem. If PubCo does not regularly distribute excess cash to its shareholders or use such cash to make TRA payments, PubCo's retention of excess cash could cause PubCo to be subject to the accumulated earnings tax ("AET") under Section 531 of the Code. Under the AET rules, an additional 20 percent tax is imposed on the "accumulated taxable income" (as defined in Section 535 of the Code) of an applicable corporation each year. A corporation is subject to the AET if, subject to certain exceptions, it was formed or availed of for the purpose of avoiding its shareholders' income tax by permitting earnings and profits to accumulate instead of being distributed.[88] Whether there is evidence of a purpose to avoid income tax is determined based on a number of factors, including dealings between the corporation and its shareholders, the investment of undistributed earnings in assets that have no reasonable connection to the corporation's business and the corporation's dividend practice.[89] An accumulation of earnings and profits beyond the reasonable needs of the corporation's business is, by itself, determinative of a tax-avoidance purpose unless the corporation proves otherwise by a preponderance of the evidence.[90] In addition, a corporation's status as a "mere" holding or investment company is prima facie evidence of a tax-avoidance purpose.[91] Generally, the public offering documents for an Up-C state that the PubCo is a holding company whose sole business activity will be to own interests in the Partnership.[92] Although generally not formed as or availed of for the purpose of reducing shareholder income tax, given the language in the statute, parties should consider the applicable facts to determine if the AET could apply to undistributed cash that accumulates at a PubCo.

One approach to mitigate the amount of cash distributed to PubCo, and the associated issues, would be to reduce the assumed tax rate used to calculate tax distributions. For example, the difference between corporate and individual income tax rates can be reduced in part by the Section 199A Deduction. However, as discussed above, whether a Partner qualifies for the Section 199A Deduction, and the amount of that deduction, is a fact-intensive partner-specific year-by-year calculation. As such, we expect most Partnerships to calculate tax distributions (or set a tax distribution rate) without regard to the availability of the Section 199A Deduction for any Partner.[93]

Alternatively, the Partnership could make non-pro rata tax distributions based on the Partners' actual tax liability, determined on a Partner-by-Partner basis. This would prevent the excess cash leakage to PubCo that causes both problems. As discussed above, such an

approach could be very difficult to administer. Calculating each Partner's actual tax liability would require a significant amount of information from the Partners, which they may not be willing to deliver to the Partnership. In addition, the Partnership would have to make decisions about whether or not to take into account certain Partner-specific deductions, such as adjustments under Section 743 of the Code and the Section 199A Deduction. Finally, unless such non-pro rata distributions are treated as advances of ordinary course distributions,[94] such distributions could disturb economic parity between shareholders and Partners. (One solution to this problem would be to treat any distribution above a floor rate (e.g., based on the corporate tax rate and taking into account pro rata TRA obligations) paid to PubCo as a redemption of Partnership units to Partners who receive tax distributions in excess of such floor distribution amount.) Recognizing these administrative complexities, it is likely that a Partnership would continue to make pro rata distributions based on the assumed tax rate.[95]

In the absence of non-pro rata distributions, an easy way to avoid the AET would be for PubCo to distribute cash received as tax distributions in excess of its actual tax liabilities to its shareholders.[96] Also, to account for this additional benefit, if any, or to broadly account for economic disparity between PubCo common stock and Partnership interest, the Partners could build in an exchange rate adjustment mechanism that would alter the exchange ratio to reflect the then-applicable values of the applicable equity interests. Some Up-Cs have already adopted this approach. For example, Newmark Group, Inc., which effected an IPO in late 2017, adjusts the exchange ratio to account for any cash that it receives as a cash distribution in excess of its actual tax liabilities.[97] However, because adjusting the exchange ratio would not impact application of the AET, PubCo would have to take additional actions to demonstrate that any cash accumulations are not unreasonable or otherwise indicative of a tax-avoidance status.

V. CONCLUSION

The changes imposed by the Act are complex, and taxpayers may have to stomach a degree of uncertainty while they await additional guidance from the Service. This uncertainty is exacerbated when applied to a nuanced structure such as an Up-C. Notwithstanding these changes, Up-Cs continue to allow taxpayers to achieve meaningful tax and other economic benefits, and should be carefully considered. Whether a taxpayer decides to make any changes to an existing Up-C structure, or to implement a new Up-C, will depend on the specific facts of the investors and the Partnership's business. Taxpayers should work closely with their advisors in analyzing these considerations.

Notes

1 This article represents the views of the authors alone, and does not represent the views of Kirkland & Ellis LLP, its clients, or any of its or their respective affiliates. This article is for general information purposes and is not intended to be, and should not be taken as, legal advice.

2 Specifically, this refers to Partnerships that do not otherwise qualify for the exceptions to the "publicly traded partnership" regime of Section 7704 of the Internal Revenue Code of 1986, as amended ("Code") (though even some of those businesses have used an Up-C-type structure rather than a classic publicly traded partnership structure).

3 According to a report by Deloitte, between 2005 and 2015, 47 companies went public using an Up-C structure. Positioning for Success in Private Equity: The Up-C Advantage, Deloitte, https://www2.deloitte.com/content/dam/Deloitte/us/Documents/financial-services/us-fsi-positioning-for-success-in-private-equity.pdf (last visited Aug. 25, 2018). Popular companies operating or who have previously operated through an Up-C or Up-C-type structure include Shake Shack (2015), GoDaddy (2015), Spirit Airlines (2011), Duff & Phelps (2007) and Accenture (2001), among others.

4 Historically, these tax assets have not been valued by shareholders of the public companies, so the right to these payments has been viewed as a meaningful value creator for the Partners. See Gregg Polsky & Adam H. Rosenzwieg, The Up-C Revolution, The Partnership Tax Practice Series, vol. 9, at 176B-21–176B-22 (Jan. 16, 2017). See infra note 22.

5 See Polsky, et al., supra note 4, at 176B-12 ("We have reached a tipping point, where nothing appears likely to stop this momentum."); Phillip W. DeSalvo, The Staying Power of the Up-C: It's Not Just a Flash in the Pan, Tax Notes (Aug. 8, 2016).

6 The Act's formal title is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," and was enacted pursuant to P.L. 115-97.

7 Certain of these changes may be further altered by recently proposed legislation. For example, H.R. 6760, which was introduced to the House of Representatives on September 10, 2018 and passed by the House on September 28, 2018, would remove sunset provisions for and make permanent the reduced income tax rates for individuals, the new deduction for certain qualifying income from flow-through businesses

under Section 199A and caps on deductions for state and local taxes discussed herein.

8 This article is not intended to be an exhaustive discussion of Up-Cs and their benefits. Because Up-Cs exist in a variety of industries, the discussion herein is intended to be general in nature. It does not address specific complexities that can arise for taxpayers with special circumstances, including those with foreign subsidiaries. It also does not discuss sister umbrella structures, such as Up-PTPs and Up-REITs, or certain issues related to maintaining an Up-C structure (e.g., avoiding status as a publicly-traded partnership under Section 7704 of the Code).

9 See, e.g., John C. Hart, The Umbrellas of Subchapter K, The Partnership Tax Practice Series, vol. 9, at 176A (PLI 2017); Martin D. Ginsburg, Jack S. Levin & Donald E. Rocap, Mergers, Acquisitions, and Buyouts, ¶1602.10 (Wolters Klewer 2018); Polsky, et al., supra note 4.

10 For a Partnership that is organized as a limited partnership for corporate law purposes, these two classes of interests would be equivalent to a general partner interest, in the case of Class A units, and limited partner interests, in the case of Class B units.

11 See, e.g., Fifth Street Asset Management, Inc., Prospectus (Form 424B4) (Oct. 30, 2014), 138 (Class A shares are entitled to 1 vote per share, whereas Class B shares are entitled to 5 votes per share) (hereinafter, "Fifth Street Asset Management Prospectus"); Moelis & Company, Prospectus (Form 424B4) (Apr. 17, 2014), 101-102 (hereinafter, "Moelis Prospectus") (Class A shares are entitled to 1 vote per share, whereas Class B shares are entitled to 10 votes per share for so long as the certain conditions are satisfied); Apollo Global Management LLC, Prospectus (Form 424B4) (Mar. 30, 2011), 276-277 (hereinafter, "Apollo Prospectus") (providing that Class B shares would represent 240,000,000 votes, equal to 79.7 percent of PubCo's voting control, immediately after the IPO). In other Up-Cs, the Class A shares and Class B shares have equal voting rights. See, e.g. Shake Shack, Inc., Prospectus (Form 424B3) (dated Jan. 30, 2015), 150-151 (hereinafter, "Shake Shack Prospectus"); Duff & Phelps Corp., Prospectus (Form 424B1) (dated Oct. 1, 2007), 112 (hereinafter, "Duff &Phelps Prospectus"); GoDaddy Inc., Prospectus (Form 424B4) (Apr. 1, 2015), 187 (hereinafter, "GoDaddy Prospectus").

12 See I.R.C. § 707(a)(2)(B). Receiving an asset step-up upon the redemption requires the Partnership to have an election under Section 754 of the Code in place for the relevant tax year.

13 The exchange mechanics could also be built into the Partnership's existing operating documents.

14 See, e.g., Shake Shack, Third Amended and Restated Limited Liability Company Agreement of SSE Holdings, LLC, dated as of February 4, 2015, Section 11.01(b) (hereinafter, "Shake Shack LLC Agreement"); National CineMedia, Third Amended and Restated Limited Liability Company Operating Agreement of National CineMedia, LLC, dated as of February 13, 2007, Section 9.1(b) (hereinafter, "National CineMedia LLC Agreement"); Manning & Napier Inc., Form of Exchange Agreement (filed with Registration Statement (Form S-1/A) (Sept. 26, 2011)), Section 2.1(a) (hereinafter, "Manning & Napier Exchange Agreement"); Vantiv Inc., Registration Statement (Form S-1/A) (Mar. 22, 2012), 148 (hereinafter, "Vantiv Registration Statement"); Moelis & Company, Form of Amended and Restated Agreement of Limited Partnership of Moelis & Company Group LP (filed with Registration Statement (Form S-1/A) (Mar. 24, 2014)), Section 14.1 (hereinafter, "Moelis & Co LP Agreement").

15 See, e.g., DynaVox, Third Amended and Restated Limited Liability Company Agreement of DynaVox Systems Holdings LLC, dated as of April 21, 2010 (hereinafter, "DynaVox LLC Agreement") (defining "Assumed Tax Rate" as "the highest marginal effective rate of federal, state and local income tax applicable to an individual resident in New York, New York (or, if higher, a corporation doing business in New York, New York)", which originally was set at 45 percent but would be adjusted to account for any change in tax rate); Duff & Phelps, Third Amended and Restated Limited Liability Company Agreement of Duff & Phelps Acquisitions, LLC, dated as of October 3, 2007 (hereinafter, "Duff & Phelps LLC Agreement") (defining "Assumed Tax Rate" by reference to the highest marginal rate for an individual or corporation resident in New York); Vantiv, Second Amended and Restated Limited Liability Company Agreement of Vantiv Holding, LLC (dated as of March 21, 2012) (calculating tax distributions by reference to the "highest marginal effective rate of federal, state and local income tax applicable to a corporation resident and doing all of its business in New York City"); GoDaddy, Third Amended and Restated Limited Liability Company Agreement of Desert NewCo LLC, dated as of April 6, 2015 (hereinafter, "GoDaddy LLC Agreement") (defining "Assumed Tax Rate" as "the maximum marginal federal income tax rate applicable to an individual" plus an assumed blended state income tax rate of 7 percent); Planet Fitness, Form of Second Amended and Restated Limited Liability Company Agreement of Pla-Fit Holdings, LLC (filed with Registration Statement (Form S-1/A) (June 15, 2015)) (calculating Tax Distributions by reference to the "highest combined marginal federal, state and local tax rate then applicable (including any Medicare Contribution tax on net investment income) to an individual (or, if higher, to a corporation) resident in Irvine, California"); Moelis & Co LP Agreement (defining "Annual Income Tax Liability" by assuming that the Partner is an individual or, if the rate will be higher, corporate resident in California or New York, whichever is higher). But see Manning & Napier, Amended and Restated Operating Agreement of Manning & Nappier Capital Company, L.L.C., dated as of November 23, 2011 (hereinafter, "Manning & Nappier Operating Agreement") (committing to make quarterly distributions of cash to its partners and not requiring separate tax distributions); National CineMedia LLC Agreement (requiring the Company to make distributions of available cash within 60 days of the end of each fiscal quarter, subject to certain limitations and not requiring separate tax distributions).

16 See Hart, supra note 9, at 176A-63–176A-65 for a technical discussion of considerations applicable to the exchange right.

17 For example, there is uncertainty about how much time must lapse between a Partner's exercise of its exchange rights and receipt of PubCo stock. For a discussion of these, and related, issues, see the authorities discussed in footnote 9, supra (e.g., Hart, supra note 9, at 176A-67–176A-71).

18 Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Incorporated, SEC No-Action (March 14, 2016), available at

https://www.sec.gov/divisions/corpfin/cf-noaction/2016/bankofamerica-merrilllynch-pfs-031416-144.htm. See also infra note 86.

19 As a result, an exchanging Partner will be required to recognize gain in an amount equal to the difference between its then-current tax basis in the exchanged Partnership interests and the fair market value of the acquired Class A PubCo shares.

20 In some cases, a TRA also includes the right to payment for use of other tax assets, such as the pre-IPO attributes of any corporate entities combined with PubCo in connection with an IPO, including net operating losses ("NOLs"), and the Partnership's pre-IPO asset basis (i.e., the existing amortizable basis of the Partnership's assets at the time of the IPO, regardless of any step-up achieved under Section 754 of the Code). See, e.g., Duff & Phelps Corporation, Tax Receivable Agreement by and among Duff & Phelps Corporation, Duff & Phelps Acquisitions LLC and certain other parties thereto dated as of October 3, 2007 (hereinafter, "Duff & Phelps TRA"); DynaVox Inc., Tax Receivable Agreement by and among DynaVox Inc., DynaVox Systems Holdings LLC and certain other parties thereto, dated as of April 21, 2010 (hereinafter, "DynaVox TRA"); GoDaddy Inc., Tax Receivable Agreement (Exchanges), entered into by and among Go Daddy, Inc. and certain other parties thereto, dated as of March 31, 2015 (hereinafter, "GoDaddy TRA") (TRA 1). In this regard, TRAs are not unique to Up-C structures. Parties may enter into a TRA in connection with other transactions where they have agreed to share certain future tax benefits.

21 Note that TRA payments generally are subordinated to secured debt of PubCo and rank pari passu with other unsecured obligations of PubCo. See, e.g., Shake Shack Inc., Tax Receivable Agreement by and among Shake Shack Inc., SSE Holdings, LLC and the Members of SSE Holdings, LLC, dated as of February 4, 2015, Section 5.1 (hereinafter, "Shake Shack TRA").

22 Materials discussing this topic cite a number of factors for this market perspective, including that IPO valuations are typically based on accounting concepts such as EBITDA or EBIT that, by their terms, ignore the impact of tax attributes and liabilities. See, e.g., Polsky, et al., supra note 4, at 176B-21–176B-23.

23 See Arrowsmith v. Comm'r, 344 U.S. 6 (1952). Alternative treatment of such payments could include payment for services or a special dividend to a special class of stock. Note that unless the Partner has elected out of such treatment, under the installment sale rules in Section 453 of the Code, a portion of the payments will be treated as interest under Section 483 of the Code. Further, because, as described herein, the total consideration or time period in which to make payments may not be known at the time of PubCo's initial acquisition of interests, PubCo's recovery of basis attributable to TRA payments will be determined under the contingent payment installment sales rules set out in Treasury Regulations Section 15.453-1(c).

24 See, e.g., Shake Shack TRA (defining "Covered Taxes"); DynaVox TRA (defining "Taxes"); National CineMedia, Inc., Tax Receivable Agreement by and among National CineMedia, Inc. and certain other parties thereto, dated as of February 13, 2007 (hereinafter, "National CineMedia TRA") (defining "Covered Taxes").

25 See, e.g., Shake Shack TRA (agreeing to pay the former Partners 85 percent of Realized Tax Benefits); Graham Packaging Company Inc., Income Tax Receivable Agreement by and between Graham Packaging Company Inc. and GPC Holdings L.P., dated as of February 10, 2010 (hereinafter, "Graham Packaging TRA") (agreeing to pay the former Partners 85 percent of Realized Tax Benefits); Tax Receivable Agreement by and among Manning & Napier, Inc., Manning & Napier Group, LLC, Manning & Napier Capital Company, LLC, and certain other parties thereto, dated as of November 23, 2011 (hereinafter, "Manning & Napier TRA") (agreeing to pay the former Partners 85-percent of Realized Tax Benefits); Aurora Diagnostics, Tax Receivable Agreement by and among Aurora Diagnostics, Inc. and certain other parties thereto (agreeing to pay the former Partners 85 percent of Realized Tax Benefits); Moelis & Company, Tax Receivable Agreement by and among Moelis & Company, Moelis Holdings Feeder, Inc., Moelis & Company Group LP, and certain other parties thereto, dated as of April 15, 2014 (hereinafter, "Moelis TRA") (agreeing to pay the former Partners 85-percent of Realized Tax Benefits); DynaVox TRA (agreeing to pay the former Partners 85 percent of Realized Tax Benefits); GoDaddy TRA (agreeing to pay the former Partners 85 percent of Realized Tax Benefits). But see National CineMedia TRA (committing to pay over 90 percent of Realized Tax Benefits); Spirit Airlines, Inc., Tax Receivable Agreement by and among Spirit Airlines, Inc., Indigo Pacific Partners LLC, and OCM FIE, LLC, dated as of June 1, 2011 (hereinafter, "Spirit Airlines TRA") (committing to pay over 90 percent of the Realized Tax Benefit). Parties to a TRA have likely become comfortable with allowing PubCo to retain 15 percent of the Realized Tax Benefit because that amount allows PubCo to fund costs related to effecting the TRA (e.g., preparing the hypothetical calculations, tracking exchanges) and gives PubCo enough "skin in the game" to encourage it to pursue and preserve the tax benefits underlying the TRA payments. See, e.g., Polsky, et al., supra note 4, at 176B-36.

26 See, e.g., National CineMedia TRA (30 years); Manning & Napier TRA (60 years); Spirit Airlines TRA (10 years).

27 See, e.g., Shake Shack TRA; Graham Packaging TRA; Moelis TRA; Duff & Phelps TRA; DynaVox TRA.

28 See, e.g., Graham Packaging TRA; Spirit Airlines TRA, Section 4.1(c); Shake Shack TRA, Section 4.1(b); Switch Inc., Tax Receivable Agreement by and among Switch Inc., Switch Ltd., and certain other parties thereto, dated as of Oct. 5, 2017, Section 4.1(b) (hereinafter, "Switch TRA"). A "change of control" may include, among other things, a person or group acquiring more than 50 percent of PubCo's combined voting power, liquidation of PubCo or the sale or other disposition of all or substantially all of PubCo's assets, or a merger or consolidation of PubCo, or the turn-over of a majority of the number of directors that were directors of PubCo on the date of the IPO. See, e.g., Shake Shack TRA (defining "Change of Control").

29 See, e.g., National CineMedia TRA, Section 4.01; Spirit Airlines TRA, Section 4.01(b); Shake Shack TRA, Section 4.01(a).

30 See, e.g., DynaVox TRA; GoDaddy TRA; Manning & Nappier TRA; Moelis TRA.

31 See, e.g., GoDaddy TRA, Section 4.3(b) (defining "Early Termination Rate" as the lesser of (i) 6.5 percent or (ii) LIBOR

plus 100 basis points); Graham Packaging TRA, Section 4.03(b) (defining "Early Termination Rate" as LIBOR plus 100 basis points); National CineMedia TRA (defining "Early Termination Rate" as the Applicable Treasury Rate plus 300 basis points).

32 Alternatively, the parties may decide to reach an agreement on the value of the Early Termination Payment without relying on pre-agreed upon assumptions. See, e.g., Newmark Group, Tax Receivable Agreement by and between Cantor Fitzgerald L.P. and Newmark Group, Inc., dated as of Dec. 13, 2017, Section 5.01 (hereinafter "Newmark TRA").

33 See, e.g., Shake Shack TRA (defining "Valuation Assumptions," clause (1)); GoDaddy TRA (defining "Valuation Assumptions," clause (1)); National CineMedia TRA (defining "Valuation Assumptions," clause (ii)); Moelis TRA (defining "Valuation Assumptions," clause (1)). But see Graham Packaging TRA (defining "Valuation Assumptions," clause (i), relying on income projections).

34 See, e.g., Shake Shack TRA (defining "Valuation Assumptions," clause (2)); GoDaddy TRA (defining "Valuation Assumptions," clause (2)); Graham Packaging TRA (defining "Valuation Assumptions," clause (iii)); National CineMedia TRA (defining "Valuation Assumptions," clause (iii)); Moelis TRA (defining "Valuation Assumptions," clause (2)).

35 As described herein, the ability to carry back NOLs is no longer relevant under the Act. See Section III.E.

36 See, e.g., Shake Shack TRA (defining "Valuation Assumptions," clause (4)); National CineMedia TRA (defining "Valuation Assumptions," clause (iv)); Moelis TRA (defining "Valuation Assumptions," clause (3)).

37 See Graham Packaging TRA (defining "Valuation Assumptions," clause (ii)).

38 See, e.g., Shake Shack TRA (defining "Valuation Assumptions," clause (7)); GoDaddy TRA (defining "Valuation Assumptions," clause (4)); National CineMedia TRA (defining "Valuation Assumptions," clause (i)); Moelis TRA (defining "Valuation Assumptions," clause (5)).

39 See, e.g., Vantiv, Inc., Annual Report (Form 10-K) (Feb. 12, 2015) (paying $112.5 million to settle approximately $254 million of obligations under certain TRAs); Norcraft Companies, Inc., Current Report (Form 8-K) (Mar. 31, 2017) (agreeing to pay a lump sum of $7.9 million to terminate the TRA following a change of control where such payments were estimated to be worth $37.7 million) (see also Norcroft Companies, Inc., Annual Report (Form 10-K) (Apr. 30, 2015); Sprint Nextel Corporation, Current Report (Form 8-K) (July 28, 2009) (paying a lump sum of $50 million to terminate a TRA that was estimated to have future payments of $123.9 million) (see also Virgin Mobile USA, Inc., Current Report (Form 8-K)) (see also Virgin Mobile USA, Inc., Annual Report (Form 10-K) (Mar. 17, 2008) (estimating the value of future payments under the TRA with the founding partners)); Fortress Investment Group LLC, Current Report (Form 8-K) (Feb. 15, 2017) (amending certain assumptions regarding the calculation of future payments under the TRA following a change of control). But see Tyson Foods Inc., Current Report (Form 8-K) (Apr. 28, 2017) (paying a lump sum of $223.37 million, calculated in accordance with the terms of the TRA to certain pre-IPO owners of AdvancePierre Foods Holdings, Inc., which was not organized as an Up-C, as a result of a triggering of the change of control mechanics following its merger with the company).

40 See I.R.C. § 11(b).

41 See I.R.C. § 1(j)(2)(A)-(D).

42 I.R.C. § 1(j)(1). However, as mentioned above, H.R. 6760 would remove the sunset provision so that the top individual income tax rate would indefinitely be 37 percent. See Protecting Family and Small Business Tax Cuts Act of 2018, H.R. 6760, 115th Cong. § 101 (2008) (hereinafter, "H.R. 6760").

43 I.R.C. § 164(a) (as in effect prior to amendment by the Act).

44 I.R.C. § 164(b)(6)(B). The cap does not apply to SALT that is "paid or accrued in carrying on a trade or business." I.R.C. § 164(b)(6).

45 However, H.R. 6760 would make permanent the cap on SALT deductions for individuals. See H.R. 6760, supra note 42, at § 142.

46 I.R.C. § 199A.

47 The Service recently issued proposed regulations interpreting the application of certain aspects of Section 199A. See Prop. Treas. Reg. § 1.199A-1–1.199A-6, 83 Fed. Reg. 40,884 (Aug. 16, 2018) (hereinafter, the "Proposed Section 199A Regulations") and I.R.S. Notice 2018-64.

48 I.R.C. § 199A(b)(1)(A). The Section 199A Deduction is not available for income from a trade or business that is a "specified services business," as described in Section 1202(e)(3)(A) of the Code (applied without regard to the words "engineering, architecture"), including any business the "primary asset" of which is the "reputation or skill" of one or more of its employees or owners, or involves investing, investment management, trading or dealing in securities. I.R.C. § 199A(d)(2)(B). Excluded businesses include businesses engaged in health, law, accounting, consulting, athletics and the performing arts. I.R.C. §§ 199A(d)(2)(A) & 1202(e)(3)(A); see also Treas. Reg. § 1.199A-5(b).

49 I.R.C. § 199A(b)(3) & (e)(2). The threshold amount is $157,000 for an individual taxpayer, and $315,000 for a married taxpayer, filing jointly.

50 I.R.C. § 199A(b)(2)(B). This basis amount is also referred to in the Proposed Section 199A Regulation as "UBIA of qualified property." Prop. Reg. § 1.199A-2(a)(3) & (c).

51 I.R.C. § 199A(i). However, as mentioned above, H.R. 6760 would eliminate this sunset provision and make the Section 199A Deduction permanent. See H.R. 6760, supra note 42, at § 111.

52 Prop. Reg. § 1.199A-2(c)(2)(iv).

53 Prop. Reg. § 1.199A-2(a)(3).

54 I.R.C. § 168(a)(1)-(3).

55 See I.R.C. § 168(k)(1)(A) (as in effect prior to amendment by the Act).

56 See I.R.C. § 168(k)(2)(A)(i) (as in effect prior to amendment by the Act).

57 See I.R.C. § 168(k)(2)(A)(ii) (as in effect prior to amendment by the Act).

58 See I.R.C. § 168(k)(6)(A)(i). The Bonus Depreciation Deduction is phased out for property put into service between January 1, 2023 and January 1, 2027. I.R.C. § 168(k)(2)(A)(iii) & (k)(6).

59 See I.R.C. § 168(k)(2)(A)(ii) & (k)(2)(E)(ii)(I). The Act also expanded the definition of qualified property to include certain other categories of property, including property used in qualified film and television and live theatrical productions. I.R.C. § 168(k)(2)(A)(i)(IV)-(V).

60 See Final Tax Bill Will Have Significant Impact on Business Decisions and Operations of U.S. Companies, Kirkland & Ellis LLP (Dec. 22, 2017), available at https://www.kirkland.com/siteFiles/Publications/Final_Tax_Bill_Will_Have_Significant_Impact_on_Business_Decisions_and_Operations_of_US_Companies.pdf.

61 I.R.C. § 168(k)(7).

62 A "related party" is defined as a relationship described in paragraphs (2)(A)-(C) and (3) of Section 179(d) of the Code, which includes: (1) a person whose relationship with the acquirer would result in the disallowance of losses under Section 267 or Section 707(b) of the Code; and (2) a component member of a controlled group, as defined in Section 1563 of the Code (applying a 50 percent ownership standard). I.R.C. § 179(d)(7).

63 I.R.C. § 168(k)(2)(E)(ii) (cross-referencing I.R.C. § 179(2)(C)).

64 Prop. Treas. Reg. § 1.168(k)-2, 83 Fed. Reg. 39,292 (Aug. 8, 2018).

65 Prop. Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(2).

66 Prop. Treas. Reg. § 1.168(k)-2(b)(3)(iv)(D).

67 Prop. Treas. Reg. § 1.168(k)-2(e)(iii)(B).

68 I.R.C. § 172(b)(1)(A)(i). The exception to the repeal of NOL carrybacks is limited to certain farming losses.

69 I.R.C. § 172(b)(1)(A)(ii).

70 I.R.C. § 172(a)(2).

71 See § 13302(e) of the Act. Notably, the 80 percent-limitation applies to NOLs arising in taxable years *beginning after* December 31, 2017. However, the repeal of carrybacks of NOLs applies to NOLs arising in taxable years *ending after* December 31, 2017. These effective dates may create additional complexities in administering pre-2018 NOLs for a taxpayer that is not a calendar year taxpayer. For example, where a taxpayer's tax year began on September 1, it would appear that an NOL created between September 1, 2017 and August 30, 2018 could not be carried back (because the tax year would end after December 31, 2017), but could be used to offset 100 percent of the taxpayer's income (because the tax year began before December 31, 2017).

72 Determining the applicable income tax rate for a corporation and its shareholders is a complex and fact-intensive analysis. As such, this discussion is necessarily limited in nature. Except as specifically stated herein, this analysis does not discuss the impact of state, local or non-U.S. taxes, the 3.8 percent "Medicare" tax on passive income or employment-related taxes.

73 For example, New York imposes a top state income tax rate of 8.82 percent on individuals, but only taxes corporations at 6.5 percent. NY Tax L. §§ 210(1)(a) & 601. Similarly, California imposes a top state income tax rate of 13.3 percent on individuals and an 8.84 percent income tax rate on corporations. CA Rev. & Tax Code §§ 17041, et seq. & 23151(f)(2). An entity's exact state income tax rate depends on its state of formation and allocation of its business operations. However, a corporation's ability to deduct SALT for federal income tax purposes helps to mitigate the effects of a higher state rate.

74 This deferral is subject, of course, to the potential application of the accumulated earnings tax, discussed herein.

75 This assumes that any dividends satisfy the requirements of "qualified dividends" under Section 1(h)(11) of the Code and that any gain qualifies as long term capital gain under Section 1221 of the Code. Non-U.S. shareholders are generally subject to a 30 percent rate of withholding on dividends, unless otherwise reduced by treaty or another exemption and typically pay no tax on capital gains. This is in contrast to non-U.S. persons owning interests in operating partnerships conducting U.S. businesses, who generally must pay tax on any allocated income (such income, "effectively connected income" or "ECI") at normal U.S. graduated rates. Similarly, tax-exempt investors should not be subject to U.S. federal income tax on dividends or capital gains, but again, generally must pay tax at normal graduated rates on income allocated to them from operating partnerships under the unrelated business taxable income ("UBTI") rules of Sections 512 and 514 of the Code.

76 Partners that are non-U.S. persons or are tax-exempt investors may have tax leakage if they invest through a blocker entity to manage UBTI or ECI concerns.

77 The Partners could form a corporation without incurring current tax under Section 351 of the Code, but there would be no newly created tax assets. Alternatively, the parties could structure the IPO as a broken Section 351 transaction, which would allow PubCo to obtain a stepped-up basis in the contributed assets. This structure may be beneficial where such Partners were otherwise expecting to sell their interests in the near term, as they would already expect to trigger full gain recognition and would benefit from PubCo's use of the step-up under a TRA. See also Rev. Rul. 84-111, 1984-2 C.B. 88 (describing the U.S. federal income tax consequences of the formation of a new corporation by an existing partnership in three scenarios: (1) transferring assets directly to the corporation; (2) distributing assets to its partners, who contribute those assets to the corporation; and (3) transferring partnership interests to the corporation)..

78 For example, prior to the Act, if PubCo's acquisition of interests in the Partnership gave it a $1,000.00 step-up in an asset that is depreciable over 10 years, it would have a $100.00 depreciation deduction each year. Looking at this change in isolation and assuming the Partnership has $1,000.00 of income each year, each of the Partners would have been entitled to receive their pro rata share of $35.00 of cash savings, calculated as the difference between the actual liability with the deduction ($1,000.00 income minus $100.00 deduction equals $900.00 taxable income, which multiplied by a 35 percent federal income tax rate equals $315.00) and the hypothetical liability without the deduction ($1,000 taxable income multiplied by a 35 percent federal income tax rate equals $350.00). Following the Act, the tax savings, calculated using the same methodology, are reduced to $21.00.

79 Such structures do not preclude use of a TRA, which are not particular to Up-C structures and could nonetheless be valuable if, for example, PubCo obtains a basis step-up through a broken Section 351 transaction or has other valuable tax attributes (e.g., pre-IPO NOLs).

80 Similarly, certain practitioners have suggested that the decreased value of TRA payments raises the opportunity for monetization of TRA payment streams. See, e.g., U.S. Tax Reform: Mergers and Acquisitions Considerations, Sullivan & Cromwell LLP (Jan. 2, 2018), available at https://www.sullcrom.com/blogs-us-tax-reform-mergers-and-acquisitions-considerations-2018; Adam Greenwood, et al., Considerations when Purchasing Tax Receivable Agreements, Law360 (July 27, 2018), https://www.law360.com/privateequity/articles/1067759/considerations-when-purchasing-tax-receivable-agreements?nl_pk=84a46196-3d12-4bd2-9ded-3f0401c4208c&utm_source=newsletter&utm_medium=email&utm_campaign=privateequity.

81 See supra note 34.

82 See supra note 38.

83 See supra note 39. For example, in 2017, SoftBank Group Corp. acquired all of the outstanding interests in Fortress Investment Group LLC. Fortress had a TRA in place that required it to make certain payments to its founding partners upon a change of control. The SoftBank acquisition would have triggered these change of control mechanics, requiring the company to make a significant lump-sum payment to the relevant pre-acquisition partners. To avoid this payment, the parties negotiated a waiver of certain payments payable as a result of the acquisition. See SoftBank Group Corp, Press Release, SoftBank Group Completes Acquisition of Fortress Investment Group (Dec. 28, 2017), https://www.SoftBank.jp/en/corp/news/press/sb/2017/20171228_01/.

84 See supra note 15.

85 See, e.g., GoDaddy Prospectus, at 171; Duff & Phelps Prospectus, at 63.

86 Absent any additional legislation (see supra notes 42 & 45), the difference in applicable tax rates may increase for tax years after 2025 following the expiration of the lower individual income tax rates, though this may be mitigated by the reintroduction of SALT deductions for individuals.

87 Economic parity is necessary to facilitate the overall operation and management of the Up-C structure. See Joshua Ford Bonnie & William R. Golden, Up-C Initial Public Offering Structures: Overview, Practical Law Corporate & Securities; Hart, supra note 9, at 176A-12.

88 I.R.C. § 532(a). Exempt corporations include personal holding companies under Section 542 of the Code, corporations exempt from tax under Section 501 of the Code, et seq., and passive foreign investment companies under Section 1297 of the Code.

89 I.R.C. § 533. Whether an investment has a reasonable connection to the business is a fact-intensive analysis, although the regulations under Section 537 of the Code provide that the retention of cash to facilitate an acquisition of a business through a stock or asset purchase would qualify. Treas. Reg. § 1.537-2(b)(2); see also U.S. v. Donruss Co., 393 U.S. 297 (1969) (providing that tax avoidance need only be one of the purposes, and not the sole purpose, for the excess accumulation of earnings and profits that would subject those earnings and profits to the AET).

90 I.R.C. § 533(a).

91 But see Treas. Reg. § 1.533-1(a)(2) (stating that status as a mere holding company or investment company is not "absolutely conclusive" if the taxpayer can demonstrate that the corporation was "neither formed nor availed of for the purposes of avoiding income tax with respect to shareholders"). A holding company is defined as a corporation that has practically no activities except holding property and collecting the income therefrom or investing therein. Treas. Reg. § 1.533-1(c). An investment company is a holding company whose activities include buying and selling securities or other investment property so that the corporation's income includes profits from market fluctuations. Id.

92 See, e.g., Shake Shack Prospectus, at 40 ("Upon the consummation of this offering, we will be a holding company and will have no material assets other than our ownership of LLC Interests of SSE Holdings"); GoDaddy, Prospectus, at 170 ("Upon the consummation of this offering, we will be a holding company and either directly or through our wholly owned subsidiary GD Subsidiary Inc., our principal asset will be a controlling equity interest in Desert Newco. As such, we will have no independent means of generating revenue.").

93 This approach is similar to the decision to calculate tax distributions without regard to any adjustments under Section 743 of the Code, which adjustments are generally seen as Partner-specific attributes.

94 See, e.g., Summit Materials, Inc., Fourth Amended and Restated Limited Partnership Agreement of Summit Materials Holdings L.P., dated as of March 11, 2015, Section 4.01.

95 The ability to make pro rata distributions in the first place depends on the rights afforded to a Partnership under its financing, and other relevant agreements. It is our experience that creditors are aware of these rate issues, and may require restrictions on tax leakage. As noted above, this issue existed with respect to other investors before tax reform, and creditors generally permitted pro rata tax distributions. However, any modeling shown to lenders should clearly should tax distributions at the desired rate.

96 Summit Materials, Inc., Prospectus (Form 424B4) (Mar. 11, 2015), 16, 154 (requiring PubCo to use any excess cash from tax distributions to acquire new Partnership units and make a corresponding stock dividend on Class A common stock to "maintain the relationship" between the Class A PubCo shares and Partnership units).

97 Newmark Group Inc., Prospectus (Form Form 424B4) (Dec. 15, 2017), 197. This adjustment mechanism also applies where Newmark Group Inc. contributes excess cash to the Partnership as an additional capital contribution. Id., at 198 ("[W]e will contribute such cash to Newmark OpCo as an additional capital contribution with respect to our existing limited partnership interest in Newmark OpCo."). Notably, the final Newmark prospectus was filed a week before the Act was signed into law. While not stated in public statements or the offering documents, it is likely that this adjustable exchange ratio was incorporated specifically to address the significant amount of excess cash expected to be received by Newmark as part of tax reform.

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