Simpson Thacher

Memorandum

Impacts of the Tax Reform Legislation on UP-C Structures

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Summary

With the recent enactment of H.R. 1, formerly known by the short title Tax Cuts and Jobs Act (the "TCJA"), it is a good time to review how this tax reform legislation could affect the desirability of umbrella partnership–C-corporation (UP-C) structures in initial public offerings. Our conclusion is that the UP-C structure continues to provide meaningful tax benefits to pre-IPO owners of a pass-through business.

UP-C Overview

For businesses taxed as partnerships that are considering an IPO, the UP-C structure can offer owners the liquidity and other benefits of a public listing in a more tax efficient manner than the traditional alternative of converting into a corporation at the time of an offering.

The UP-C structure is a two-tiered structure in which an entity organized as a limited partnership, limited liability company or other legal form taxable as a partnership (commonly referred to as the operating partnership or "OP") holds all of the assets and operations of a business. Public investors hold their interest in the tax partnership indirectly through an entity (the "Pubco") organized as a corporation or other legal form taxable as corporation. The pre-IPO owners continue to hold their interests directly in the OP and, accordingly, their share of the income of the business is not subject to an entity-level tax.

In order to provide the holders of OP Units with liquidity, OP Units held by persons other than the Pubco ("OP Unitholders") are typically exchangeable for Pubco Shares on a one-for-one basis (in some cases, subject to the right of the Pubco or the OP to elect to deliver instead the cash value of such shares).

When a holder of OP Units exchanges such units for Pubco Shares, this transaction may result in increases in the tax basis of the assets of the OP that increase (for tax purposes) depreciation and amortization deductions and therefore reduce the amount of tax that the Pubco is required to pay in the future. It is common in an UP-C structure for the Pubco to share a percentage (which by market practice is typically 85%) of any such tax benefits with the exchanging holder. This arrangement is typically set forth in a tax receivable agreement or "TRA."

Click here for additional information regarding the UP-C structure.

Impact of the TCJA on UP-C Structures

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

- **Prior Law.** Under prior law, partnership income was taxed to an individual partner at a top rate of 39.6% and to a corporate partner at a top rate of 35%. In a traditional corporate structure, income was taxed to the corporation at a 35% rate, and then the 65% after-tax portion was potentially taxed again as a dividend at a 20% rate for an individual shareholder (or at a 7% rate for a significant corporate shareholder). Thus, for an individual in an UP-C partnership, flow-through income (other than long-term capital gain) was taxed at a rate roughly 8 percentage points lower than the corporate alternative (assuming the corporation distributes the income as a dividend); (a) **39.6**% versus (b) 35%, plus 20% of 65% or 13%, for a total of **48**%.

- **Current Law: Operating Income.** Under the TCJA, partnership business income is generally taxed at a top rate of 37% to an individual partner; however, "qualified business income" from partnerships, which is income effectively connected with a U.S. trade or business other than capital gains, dividend income, and certain compensation-related payments, is eligible for a 20% deduction.[1] In other words, if the partnership's income qualifies for the deduction, a taxpayer would only be taxed on 80% of the partnership's income which would yield an effective rate as low as 29.6% (37% of 80%). Under the TCJA, income earned by a corporation would be taxed to the corporation at a 21% rate, and then the after-tax portion (79%) would be potentially taxed again to the shareholder as a dividend. Thus, for an individual holding an interest in a partnership eligible for the favorable deduction, the flow-through income could be taxed at a U.S. federal income tax rate roughly 7 percentage points lower than the corporate alternative (again assuming distribution as a dividend); (a) **29.6**% versus (b) 21%, plus 20% of 79% or 15.8%, for a total of **36.8**%. Even if the partnership's income is ineligible for the deduction (or partners are subject to the limitation on the amount of the deduction), individual

[1] For taxpayers with income above a certain threshold ($415,000 for joint filers) the deduction is limited to the greater of (a) 50% of the taxpayer's share of W-2 wages paid by the business, or (b) the sum of 25% of such W-2 wages plus 2.5% of the taxpayer's share of the tax basis of certain depreciable property used in the trade or business. Additionally, owners of specified service businesses (i.e., businesses in the fields of law, health, accounting, financial services or brokerage services, businesses where the principal asset of the business is the reputation or skill of its employees or owners or businesses which involve the performance of services consisting of investing and investment management) are generally excluded from the deduction if their income exceeds a certain threshold ($415,000 for joint filers). Taxpayers with incomes above $315,000 are subject to a phase-in of these limitations.

partners would still be subject to a rate (up to 37%) that is similar to the rate of the corporate alternative.

- **Capital Gains on Exit or Other Asset Sales.** Traditionally, the UP-C structure facilitates tax-efficient post-IPO sales of partnership interests or assets. In such cases, the buyer generally obtains a stepped up tax basis (reflecting its purchase price) for the assets directly or indirectly purchased and thus may pay a premium, while the sellers pay a single tax on the gain on the portion of their position still held in pass-through form, generally at favorable capital gains rates for an individual, subject to exceptions for recapture and certain other items. In a traditional corporate structure, the corporation would pay one tax on the sale of partnership interests or assets at the full rate (35% under prior law and 21% under current law), and then the shareholders would have gain and potentially a second tax on receiving sale proceeds on distribution from the corporation. For that reason, in an exit scenario, the transaction may be structured as a sale of stock of the corporation. In that case, however, the buyer would not obtain a stepped up tax basis in the underlying assets and may discount the purchase price accordingly. Under prior law, individuals paid a top tax rate on long-term capital gains of 20%, compared to the top rate for capital gains of corporations of 35%, or a double tax (corporate and shareholder) aggregating 48% as described above. Under the TCJA, the tax benefit for the UP-C structure on exits or other capital gains transactions would remain—for the pass-through portion, a single tax of 20% versus a double tax in a corporate structure aggregating 36.8% as described above for the TCJA. The buyer would obtain a stepped up tax basis for that portion of the business. Although the step up would be worth less to a corporate buyer, as deductions would produce only a 21% benefit compared to 35% under prior law, the overall effect would be similar to that applicable under prior law.

Impact of the TCJA on TRA Payments

Under the TCJA, the top corporate income tax rate has been reduced from 35% to 21%. As the top corporate income tax rate declines, the benefit of deductions to the Pubco, and accordingly the corresponding TRA payments to an exchanging OP Unitholder are reduced as well. As an example, $100 of deduction from income taxed at 35% is worth $35, while $100 of deduction from income taxed at 21% is worth only $21. Notwithstanding these reductions, given the continuing albeit lower value of the deduction we expect that TRAs will continue to be employed.

Application of Section 162(m)

Section 162(m) of the Internal Revenue Code of 1986 imposes a $1 million annual limit on deductions for compensation (other than "performance-based compensation") paid to a public corporation's chief executive officer, its chief financial officer, and its next three highest-paid executive officers. Under prior law, public corporations largely avoided the deduction disallowance under Section 162(m) by structuring annual bonuses, certain equity awards, and other incentive arrangements to qualify as "performance-based compensation." The TCJA eliminates the performance based compensation exemption to 162(m). Thus going forward, corporations will face difficulty avoiding the application of Section 162(m), and deductions for employee stock options, annual bonuses, and performance shares for covered employees will be limited if their value exceeds the annual limit. Partnerships, however, are not covered by Section 162(m); thus, in traditional UP-C structures, where all of the operating expenses of the business, including compensation, are incurred at the OP level, Pubcos have generally taken the view that Section 162(m) does not apply to limit their share of OPs' compensation deductions.

Implications for Tax Distributions in UP-C Structures

As is common in tax partnerships, the governing agreements in an UP-C structure typically require the OP to make pro rata distributions of available cash to the holders of OP Units to fund their tax obligations for the income of the OP that is allocated to them. These tax distributions are frequently computed based on an assumed highest effective marginal combined U.S. federal, state, and local income tax rate. Under the TCJA, as was the case under prior law, the highest effective marginal combined rate for individuals is generally higher than that for corporate entities. For this reason, tax distributions usually result in the Pubco receiving cash in excess of the amount it requires to pay its taxes and fund its obligations under the TRA. To avoid accumulating significant cash at the Pubco level (which may impair the one-to-one economic equivalency of OP Units and Pubco Shares), this "excess" has typically been distributed as a dividend by the Pubco to its stockholders.

The TCJA results in an even greater disparity between individual and corporate rates, which is likely to increase the amount of excess cash received by a Pubco in tax distributions from an OP. In light of this development, we expect that UP-Cs may increasingly explore alternative uses of this excess cash in a manner consistent with their particular commercial objectives and capital allocation strategies. These may include stock repurchase programs or reinvestment in the business. Simpson Thacher has developed, and can assist UP-C issuers in the design of, approaches that would facilitate these alternatives to the traditional dividend while maintaining the one-to-one economic equivalency of OP Units and Pubco Shares.

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