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Tax Trends: Use of Partnerships in Corporate Structures and Transactions

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Partnership M&A - Introduction

- The term “partnership” refers to any entity or arrangement, including an LLC, that is properly classified as a partnership for U.S. federal income tax (referred to herein as “tax”) purposes.
- Simplest, most straightforward way for a taxpayer (“TP”) to monetize appreciated target assets is to sell them to the acquiring party (“AP”) in a fully taxable transaction.
    - TP recognizes full gain or loss for tax purposes.
    - AP takes a cost basis for tax purposes for the asset or assets acquired, rather than TP’s historical tax basis.
    - The present value of the tax on gain to TP likely is higher than the present value tax benefit of cost basis to AP. That is, in terms of overall deal economics, it rarely makes sense for TP to recognize full gain so that AP can take a fair market value basis in target assets.

Partnership M&A - Introduction

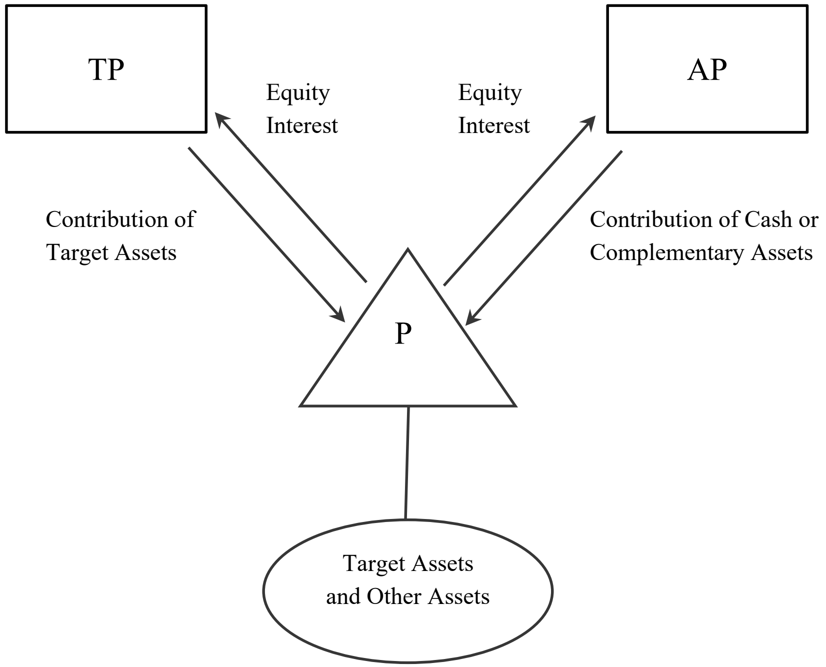
- Various corporate M&A alternatives:
  - Taxable stock sale/purchase.
  - Tax-free section 368 corporate reorganizations, subject to “boot” rules.
  - Tax-free section 351 transactions, subject to “boot” rules.
- In all of the corporate alternatives listed above, as a general matter, historical tax basis of target assets is retained.

Partnership Alternatives

- Partnership M&A alternatives can result in gain deferral for TP for tax purposes, and ultimately a basis step-up for AP.
- Various partnership alternatives may be possible, depending on context and facts.
    - Partnership leveraged distribution.
    - Partnership loan-to-partner.
    - Two-tier partnership structure.
    - In-kind redemption distribution.
    - UP-C partnership.

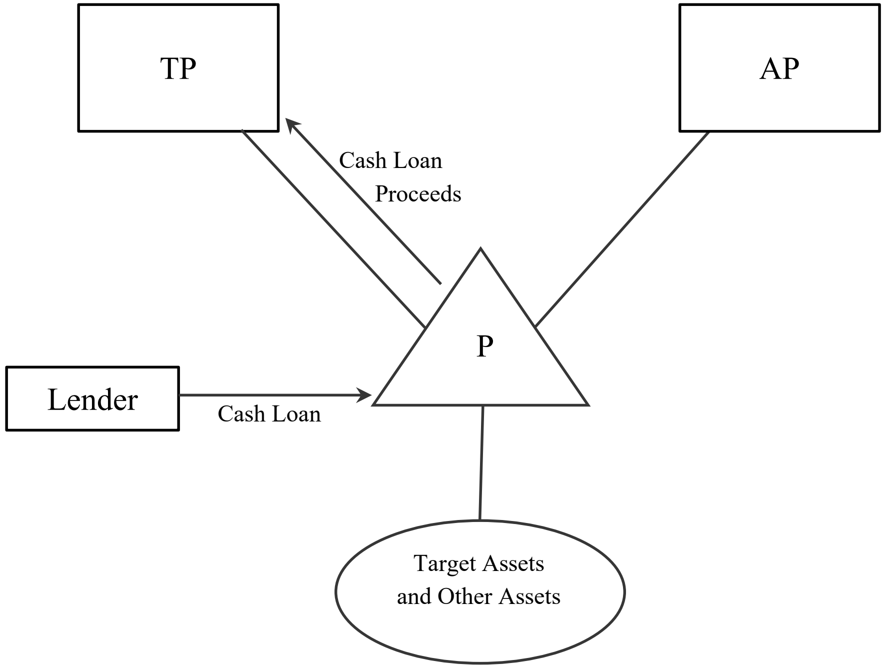
Basic Partnership Formation

- TP contributes target assets, and AP contributes cash or complementary assets, to P in each case in exchange for common and/or preferred equity.
- Intended result: As a general matter, section 721 nonrecognition of gain on partnership formation and, thereafter, continued gain deferral while TP and AP are partners, subject to:
  - Section 721(b) investment partnership rules.
  - Section 707(a)(2)(B) disguised sale rules from non-qualified liabilities, or from distributions/guaranteed payments.
  - Section 731/741/752 distributions in excess of basis.
  - Section 704(c) gain/income inclusion.
  - Section 704(C)(1)(B) or 737 gain recognition within seven years.



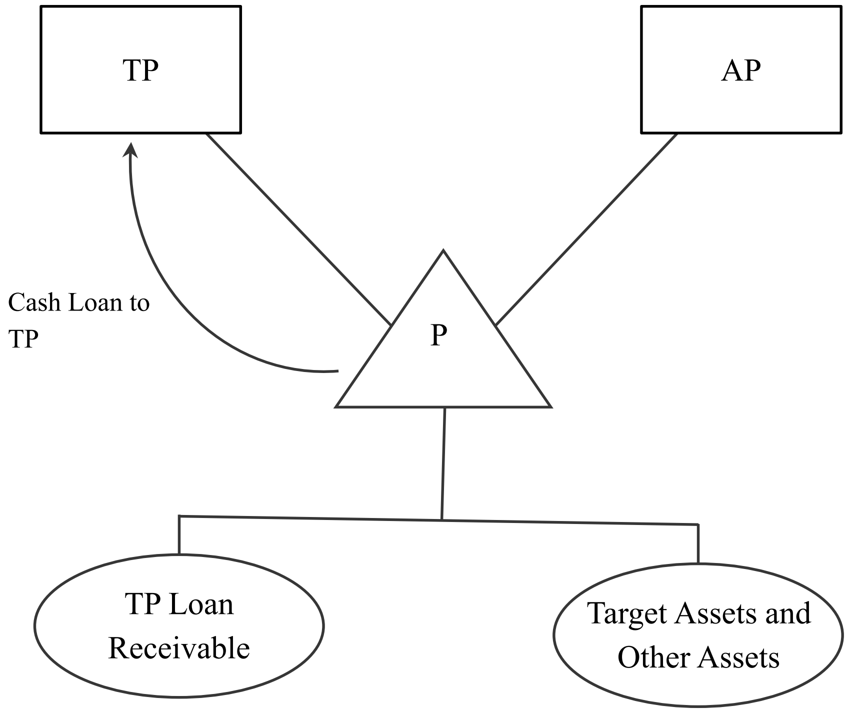
Basic Partnership With Leveraged Distribution

- P borrows cash from Lender and distributes it to TP.
- Intended results: Section 721 nonrecognition on formation of partnership followed promptly by tax-free leveraged distribution to TP under sections 707(a)(2)(B), 731, 741 and 752.
- Critical that P's loan liability be allocated to TP for purposes of section 707(a)(2)(B) (the "disguised sale" rules) and section 752.
  - Satisfied if loan is recourse to TP through a guarantee or otherwise. *But see Canal Corporation v. Commissioner*, 135 T.C. 199 (2010).
  - Otherwise, nonrecourse debt likely allocated largely to TP for section 752 purposes, but requires planning to satisfy section 707(a)(2)(B). *See* Treas. Reg. § 1.707-5(a)(2)(ii); Treas. Reg. §1.752-3(a)(3).
- Critical that distribution to TP be traceable to proceeds of loan from Lender. See Treas. Reg. §1.707-5(b)(1); Treas. Reg. §1.163-8T.



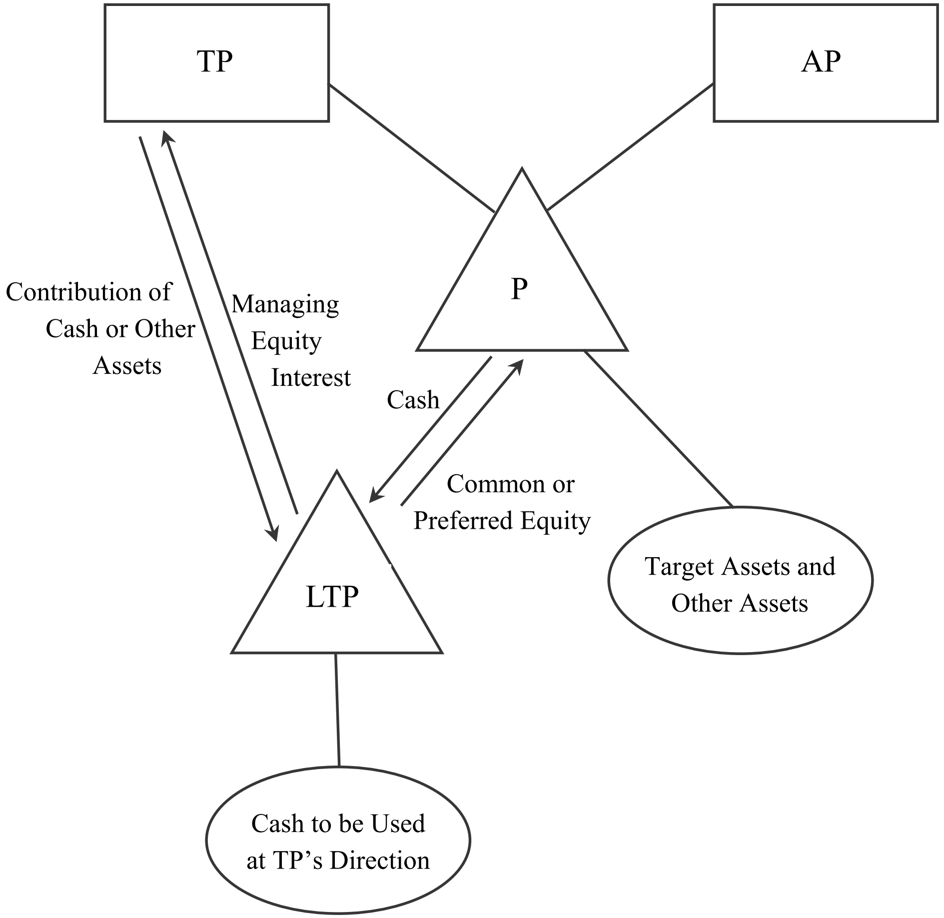
Basic Partnership With Loan to TP

- P uses cash contributed by AP to make a loan to TP.
- Intended results: Section 721 nonrecognition on formation of P, followed by tax-free transfer of cash by P to TP through a loan, subject to:
  - Recast of loan by P to TP as distribution rather than bona fide debt.
  - Substance over form recast of overall transaction as constructive sale for tax purposes. *See Anschutz Company v. Commissioner,* 664 F.3d 313 (10th Cir. 2011), *aff'g* 135 T.C. 78 (2010); *Calloway v. Commissioner*, 691 F.3d 1315 (11th Cir. 2012), *aff'g* 135 T.C. 26 (2010).



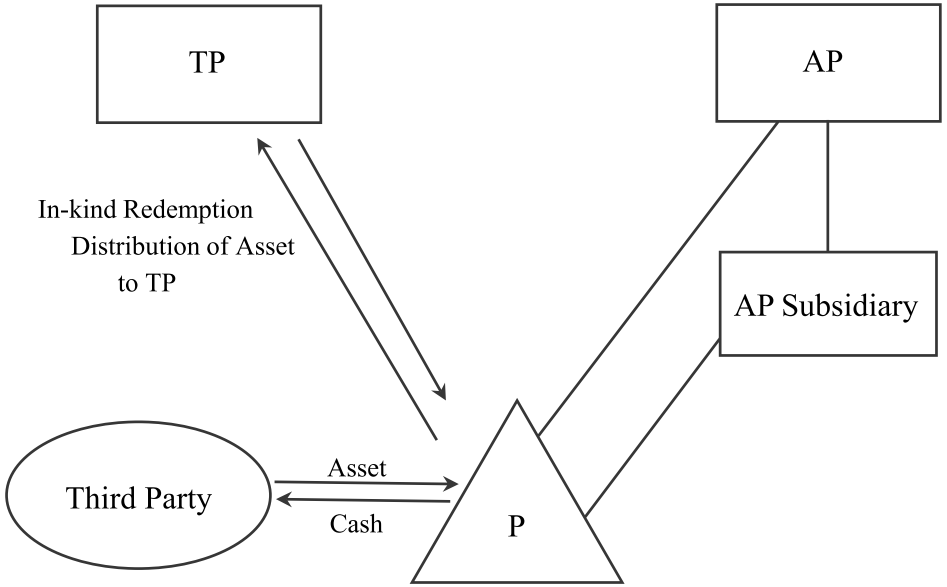
Basic Partnership With Second Tier

- P transfers cash contributed by AP to a subsidiary partnership, LTP, which TP manages and controls through a direct interest.
- Intended result: Section 721 nonrecognition on formation of P, and subsequent continuing gain deferral to TP as a partner in P, subject to:
  - Recast of overall transaction as sale by TP.
  - Recast of transaction as distribution by P of interest in LTP or cash to TP.



In-Kind Redemption of TP's Interest

- P acquires property and distributes it to TP in redemption of TP's interest in P on an FMV/mark-to-market basis, with cash true-up if necessary.
- Intended result: Tax-free to extent of in-kind distribution to TP by P under section 731, with basis step down under section 732.
  - Immediate redemption if TP and AP are historical partners, TP has not contributed to P within two years, and has not contributed appreciated property to P within seven years. *See Countryside Limited Partnership v. Commissioner*, T.C. Memo. 2008-3.
  - Otherwise, redemption distribution after two years or seven years. *See* I.R.C. §707(a)(2)(B); I.R.C. §704(c)(1)(B).
  - Section 751(b) "deemed exchange" may trigger gain recognition.
  - Section 752 considerations.
- Section 754 election by P secures section 734 basis increase for benefit of AP and AP subsidiary.



Using Up-Cs in Acquisitions

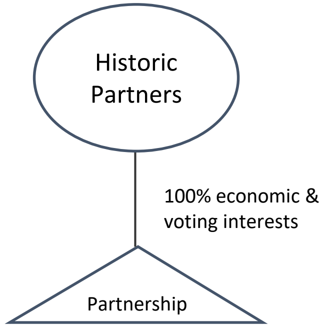
Overview – What is an UP-C?

- UP-C is an abbreviation for "<u>U</u>mbrella <u>P</u>artnership – <u>C</u> corporation."
- An UP-C is a two-tiered corporate ownership structure where public investors hold stock in a publicly traded corporation, which in turn holds interests in a partnership in which pre-IPO partners also directly hold interests.
- An UP-C structure allows existing owners of a company that operates in partnership form to access public capital markets while continuing to be subject to only a single layer of tax and without running afoul of the publicly traded partnership ("<u>PTP</u>") rules (which, if applicable, would cause the partnership to be treated as a corporation for federal income tax purposes).

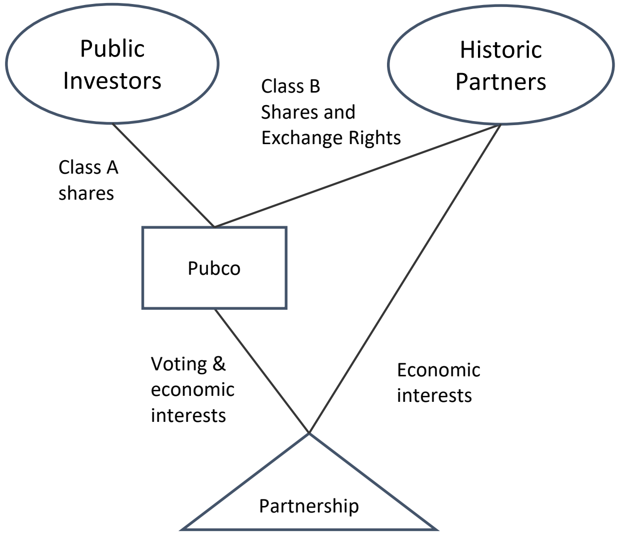
General Structure of an UP-C

- In a typical UP-C IPO, the historic partners of a business (the "Pre-IPO Owners") form a corporate entity ("Pubco") and admit it as the managing member/GP of the company (the "Partnership"). Pubco then issues (i) Class A shares (economic and voting rights) to the public in exchange for cash and (ii) Class B shares (voting rights but no economic rights) to the Pre-IPO Owners.
- Pubco then either contributes the IPO proceeds to the Partnership in return for Partnership units or uses the IPO proceeds to purchase Partnership units from the Pre-IPO owners.
- In connection with the IPO, the Pre-IPO Owners are granted rights to exchange their Partnership units and Class B shares for Pubco Class A shares on a one-for-one basis. They also enter into a tax receivable agreement with Pubco to capture a majority of the value (generally 85%) associated with Pubco's tax basis step-up resulting from the disposition of Partnership units for Class A shares.

Structure before UP-C



Structure after UP-C



Benefits of the UP-C Structure

- Similar to any other IPO, the Partnership will gain access to the public capital markets to expand, pay down debt, etc.
- Historic owners of the Partnership can sell interests in the open market.
- Pubco can use its units (or the Partnership's interests) as acquisition or compensation currency.
- Entity-level corporate tax is avoided on earnings allocable to Pre-IPO Owners of the Partnership.
- The Pre-IPO Owners will capture the majority of the value associated with any tax basis step-up delivered to Pubco through a tax receivable agreement.
- Pubco's and/or the Partnership's governing documents can provide insulation from the PTP rules by imposing limited restrictions on transferability of interests.

Costs of the UP-C Structure

- The transfer restrictions designed to prevent running afoul of the PTP rules may adversely impact liquidity for Pre-IPO Owners (as compared to a traditional IPO).
  - Examples of transfer restrictions:
    - Disallowing an exchange if it could pose a material risk that the Partnership would become a PTP;
    - Disallowing exchanges that do not exceed a specified minimum percentage threshold;
    - Only permitting exchanges at the end of a fiscal quarter; and
    - Imposing restrictions on exchanges that would conflict with the governing documents or policies of Pubco or the Partnership.
- The UP-C IPO results in additional structural complexity and documentation requirements during the IPO process.
- The UP-C IPO structure generally increases ongoing costs for accounting, securities registrations, tax reporting and compliance.

Exchange Rights in an UP-C

- In connection with the IPO, the Pre-IPO Owners are granted rights to exchange their partnership interests, together with a corresponding number of Class B shares, for either cash or Class A shares on a one-for-one basis.
- The exchange rights work because there is parity between the Pre-IPO Owners and Class A stockholders.
  - Same capital structure at Pubco level and Partnership level.
  - No assets at Pubco except Partnership interests.
  - No liabilities at Pubco outside of tax-related liabilities.

Mechanics of Exchange Rights – Structure of the Exchange

- When the Pre-IPO Owners exercise their exchange rights, the Pre-IPO Owners receive either cash or Class A shares of Pubco, generally at Pubco's election.
- The exchange itself is effected either through:
  - A direct "over-the-top" exchange between Pubco and the Pre-IPO Owners, or
  - A redemption by the Partnership of partnership interests.

Tax Treatment of Exchange Rights

- The tax consequences of the exchange differ depending on the structure of the underlying exchange rights.
  - If Pubco uses cash or Class A shares to satisfy the exchange rights, the exchanging Pre-IPO Owner will be treated as selling their Partnership units and Class B shares.
    - The resulting basis step-up for Pubco under Code Section 743(b) will adjust Pubco's share of the Partnership's underlying assets in respect of the Partnership units exchanged.
  - If the Partnership pays the exchanging Pre-IPO Owner using its own cash, then the payment to the Pre-IPO Owner will be treated as a liquidating distribution that is taxable to the extent that the cash received by the exchanging Pre-IPO Owner exceeds its basis in the Partnership interests.
    - The resulting basis step-up for Pubco under Code Section 734(b) will adjust the basis of the Partnership's entire asset base, effectively spreading out the tax benefit among all of its partners (not just Pubco's interest).

What is a Tax Receivable Agreement?

- The tax basis step-up in the Partnership’s historic assets caused by the exchange increases the amount of depreciation and amortization that Pubco can take in respect of the Partnership’s assets.
  - This can generate significant tax savings for Pubco.
- Pre-existing basis in the partnership’s historic assets may generate tax savings for Pubco
- Under the terms of a tax receivable agreement (“TRA”), Pubco agrees to pay the Pre-IPO Owners the majority of the value associated with these tax savings.
  - Market for the tax benefit percentage is 85% (with at least one recent TRA at 90%).
- To the extent that the Pre-IPO Owners invest through a blocker corporation that has tax attributes, there can also be payments for these tax attributes under the TRA.

Common TRA Terms

- Payments – 85% of any tax benefits Pubco receives from (i) any step-up in basis resulting from the exchange and (ii) other tax benefits from entering into, and making payments under, the TRA itself. There are also examples of payments for (a) pre-existing basis in assets and (b) certain step-ups in basis that occurs because of debt pay down.

- Term – The payments under a TRA customarily continue until all of the tax benefits have been used/paid under the terms of the TRA.

- Termination – Option for Pubco to exercise a right of termination by paying the remaining outstanding TRA payments calculated based on a set of valuation assumptions.

- Change of Control – Two frequently used methods:
  - The change of control event is treated as if Pubco had exercised its right of termination described above, or
  - The Pre-IPO Owners continue to receive payments under the TRA, calculated using assumptions of when and how the tax attributes would be used going forward.

Tax Treatment of TRA Payments

- From Pubco’s perspective, TRA payments are treated as additional purchase price. Pubco will receive additional basis as it makes payments under the TRA, and it will share the benefit with the Pre-IPO Owners pursuant to the TRA.
- From the exchanging partner’s perspective, payments under a TRA are generally treated as additional consideration for the sale of the Partnership interest.
- A portion of the payments under the TRA will be treated as interest.
  - The portion characterized as interest will be deductible by Pubco (and not be treated as additional purchase price) and will be includable in income to the exchanging Pre-IPO Owner (and not treated as additional consideration).
  - Pubco will generally pay 85% of the benefit of interest deductions to the Pre-IPO Owners under terms of the TRA.

Corporate Governance in an UP-C Structure

- Pubco controls the Partnership as its managing member.
- Pre-IPO Owners have voting rights in Pubco through a separate class of noneconomic voting shares in Pubco.
  - These shares are designed to provide voting power that is commensurate with the voting power the Pre-IPO Owners would receive if their Partnership interests were fully exchanged for Pubco shares.
  - As Partnership interests are exchanged for Pubco stock, the voting power is reduced proportionately (generally through a redemption, cancellation or exchange of these shares in connection with such exchange).

Funding Pubco Expenses

- Pubco does not have its own operations, so how does Pubco pay for its operations?

  The Partnership can fund Pubco's expenses with guaranteed payments.

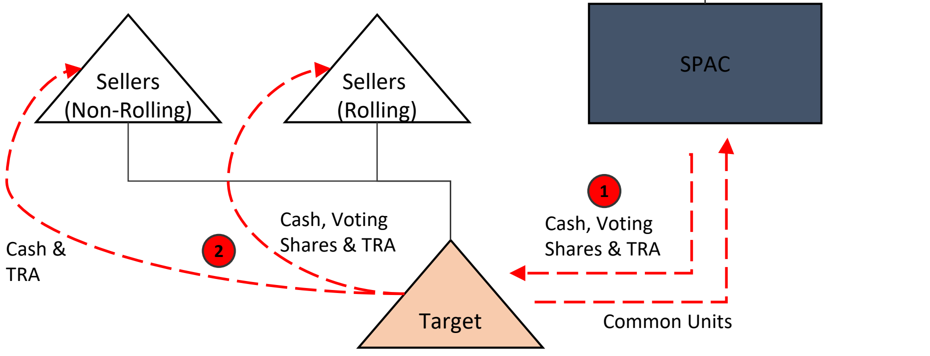
  - If not all of Pubco's expenses are deductible, then this approach would result in taxable income to Pubco, which the Partnership would also need to fund.

  Pubco's expenses can be "pushed down" to the Partnership.

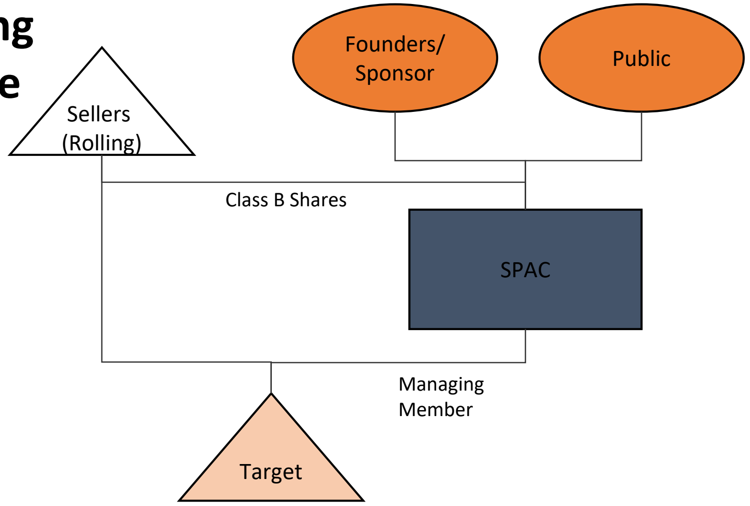
  - Under this approach, the Partnership assumes Pubco's expenses as if they were its own under the theory that Pubco is a holding corporation whose expenses are solely for the benefit of the Partnership.

SPAC Example

Transaction Structure



Operating Structure



Transaction

- Step 1: SPAC contributes the IPO proceeds to Target, as well as voting shares and TRA rights, and receives common units of Target in return. SPAC becomes the managing member of Target
- Step 2: Target distributes cash received from SPAC to the Sellers (Rolling) and Sellers (Non-Rolling). Seller (Rolling) and Sellers (Non-Rolling) also receive TRA rights. In addition, Seller (Rolling) receives voting shares of the SPAC and right to exchange its Target units for SPAC shares
- Step 3: Target may use retained IPO proceeds to pay down existing debt and for other general corporate purposes

Key Tax Considerations

- Exchanges of partnership interests for SPAC common stock in a taxable transaction and results in a stepped up asset basis to partnership (as a result of a Section 754 election)
- If Steps 1 and 2 are combined as a “disguised sale”, the transaction may also result in a stepped up asset basis
- Under the terms of a TRA, partners (or members) are compensated for the value of the stepped-up basis

Section 367 and Partnerships

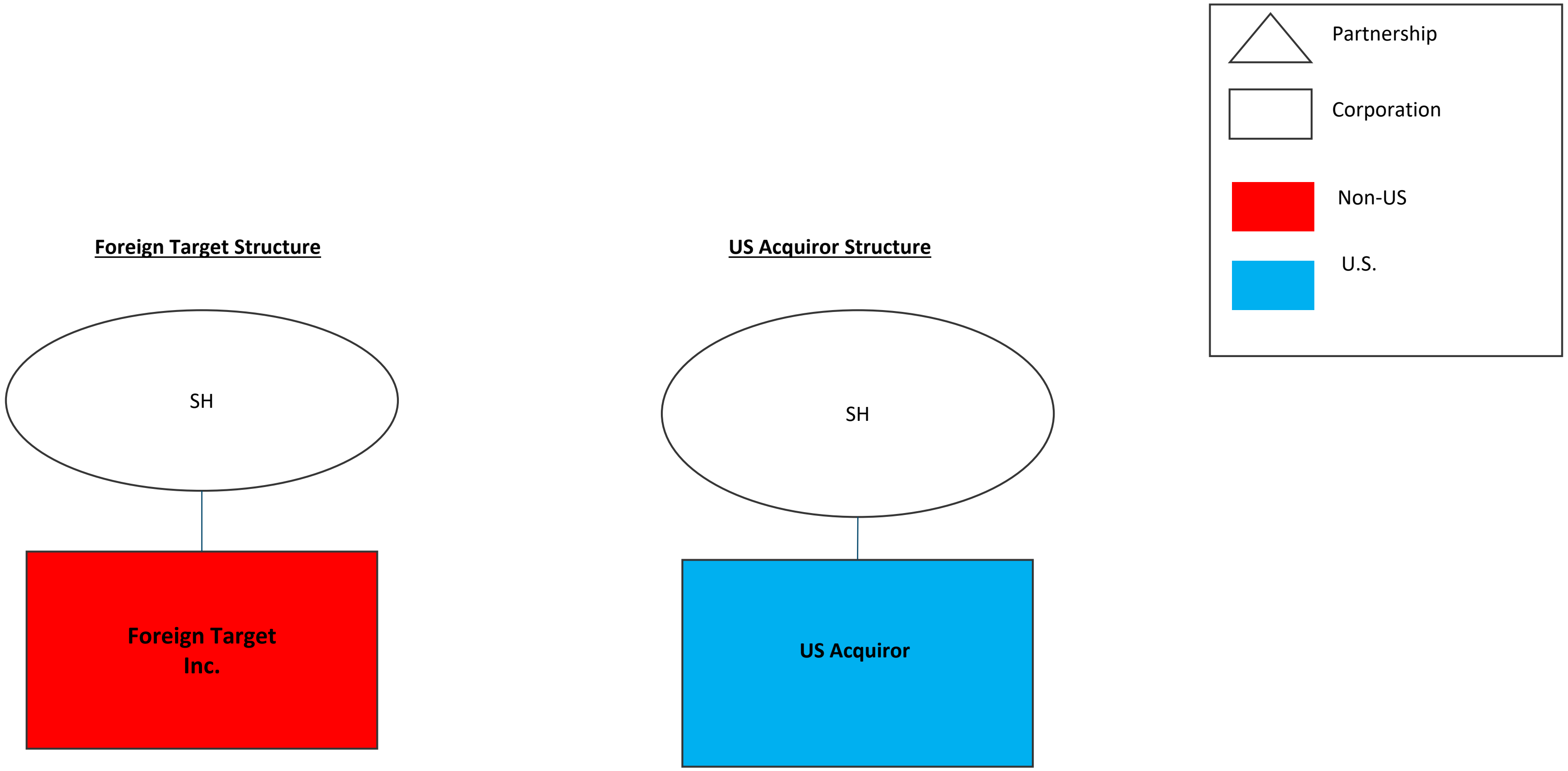
Overview of Section 367

- Tax-free treatment under the Subchapter C rules
- Section 367(a): Limits the tax-free transfer of appreciated property by U.S. persons outside the U.S.
- Section 367(b): Limits the accumulated profits of controlled foreign corporations from escaping U.S. tax
- Section 367(d): Special rules for outbound transfers of intangible assets similar to Section 367(a)
- Section 367(e): Special rules for outbound distributions generally qualifying under Section 355 or Section 332 similar to Section 367(a)

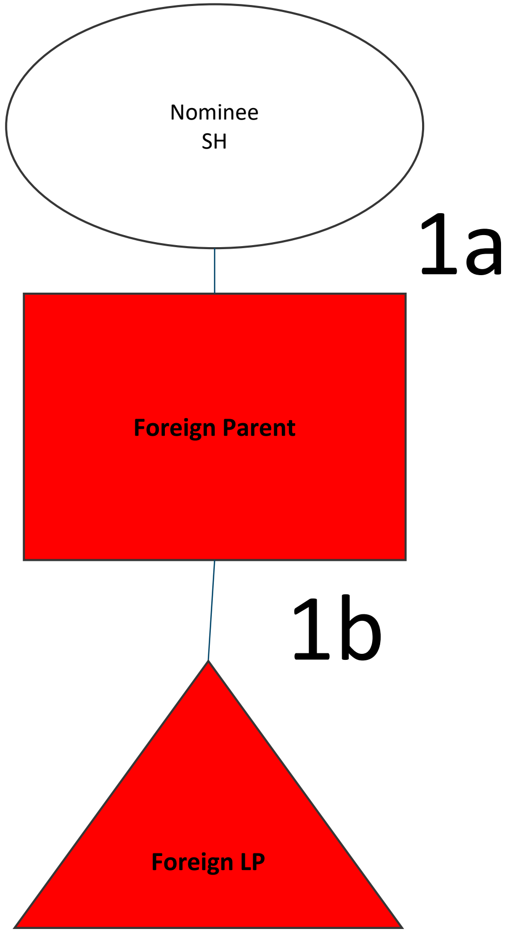
Section 367(a) and Partnerships

- Section 367(a) states "If, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a **foreign corporation**, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation."
- An outbound transfer to a partnership is not governed by Section 367(a)
  - Policy reasons behind the rule
  - Broad regulatory authority to apply to transfers to foreign partnerships?
- In contrast, under section 367(a)(3), an outbound transfer of a partnership to a foreign corporation will be treated as a transfer of the US partner's pro rata share of the assets of the partnership

Section 367(a) and Partnerships - Example

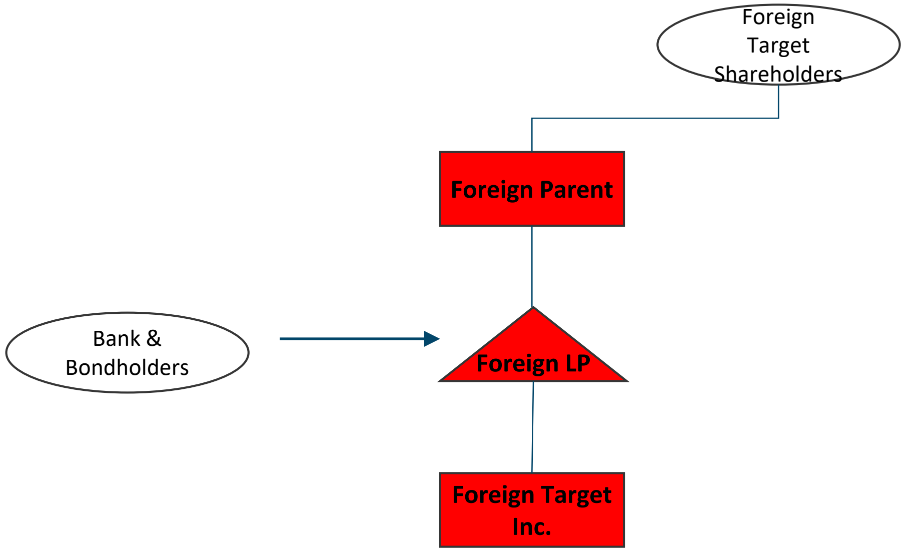


Formation of Foreign Parent and Foreign LP



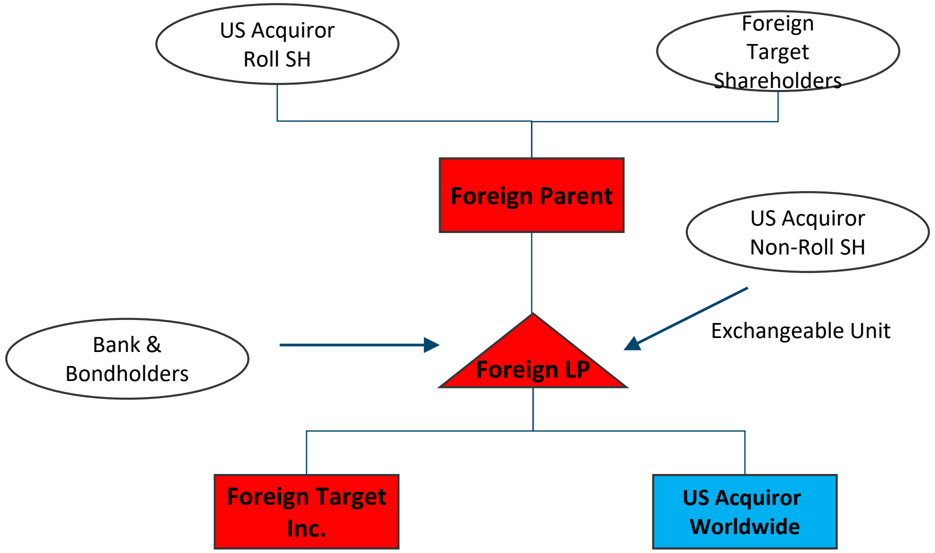
- Step 1(a): A nominee shareholder (not depicted after this slide) forms Foreign Parent, a non-US corporation. This nominal share is cancelled immediately before step 3.
- Step 1(b). Foreign Parent and a newly formed Non-US subsidiary (not depicted) form Foreign LP, a Non-US Limited partnership.

Acquisition of Foreign Target



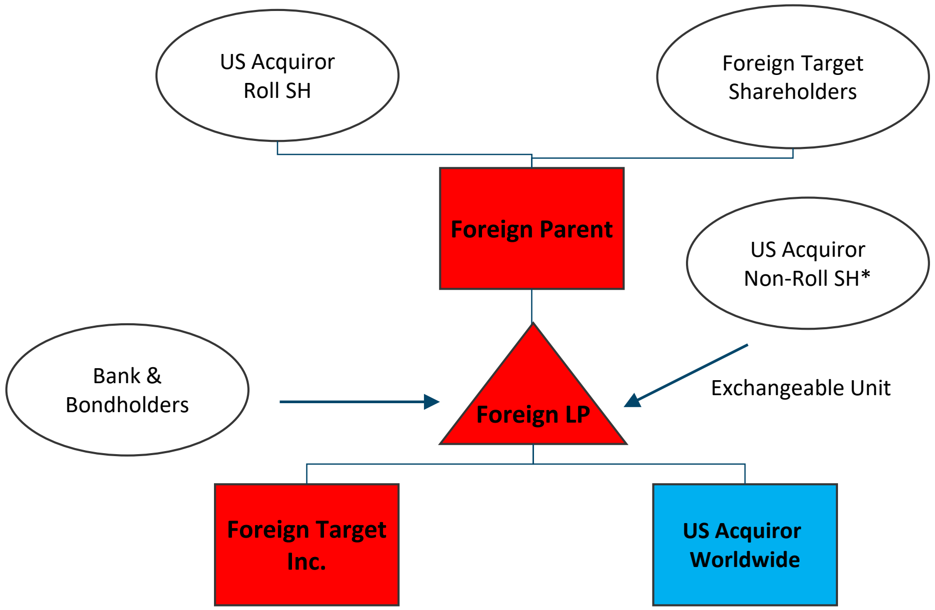
- Step 2: Foreign LP and Foreign Parent acquire 100% of the stock of Foreign Target. As a result of the transaction, Foreign Target ends up being a wholly owned subsidiary of Foreign LP.

Acquisition of US Acquiror



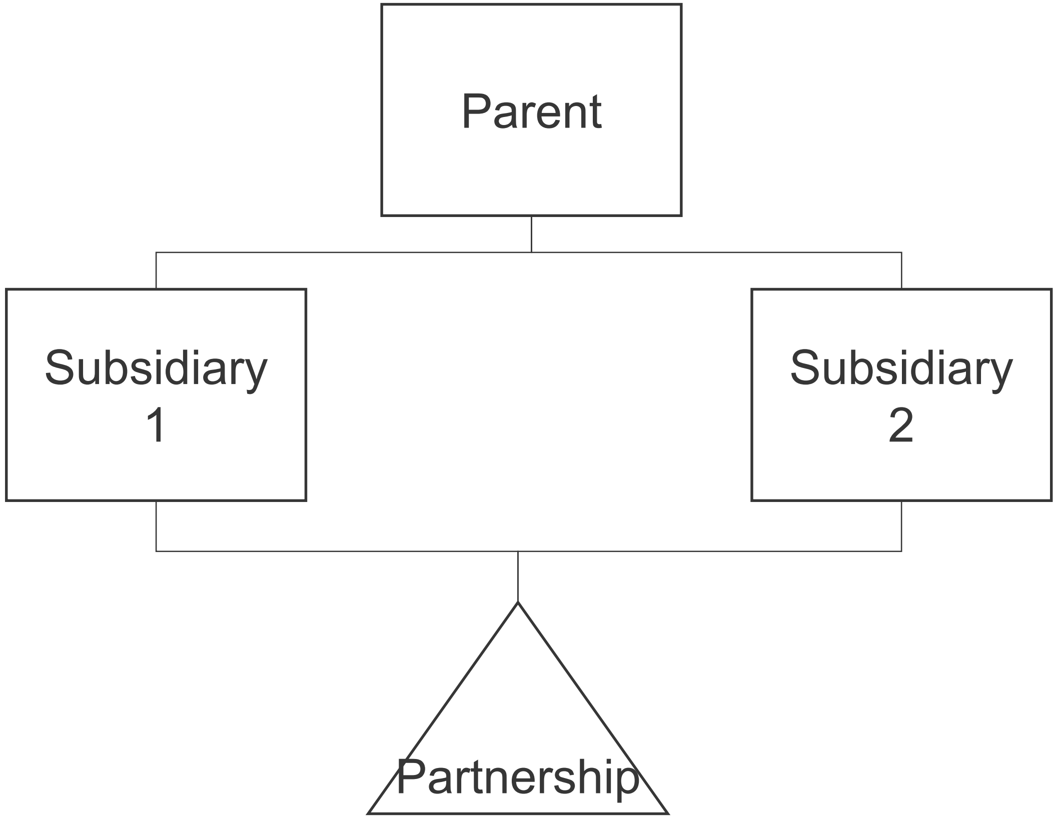
- Step 3: Foreign Parent and Foreign LP acquire 100% of the stock of US Acquiror.
- Electing shareholders of US Acquiror ("US Acquiror Non-Roll SH") transfer their shares to Foreign LP directly in exchange for (i) a common interest in Foreign LP, (ii) a noneconomic voting interest in Foreign Parent and (iii) a right to exchange their interests in Foreign LP for shares of Foreign Parent in the future (collectively, an "Exchangeable Unit").
- Nonelecting shareholders of US Acquiror ("US Acquiror Roll SH") receive as their consideration (i) Foreign Parent shares (representing 99% of the consideration received by such shareholder) and (ii) a common interest in Foreign LP (representing 1% of their consideration).
- The cash at Foreign LP (after Step 3) is used to refinance US Acquiror third-party debt).

Final Structure

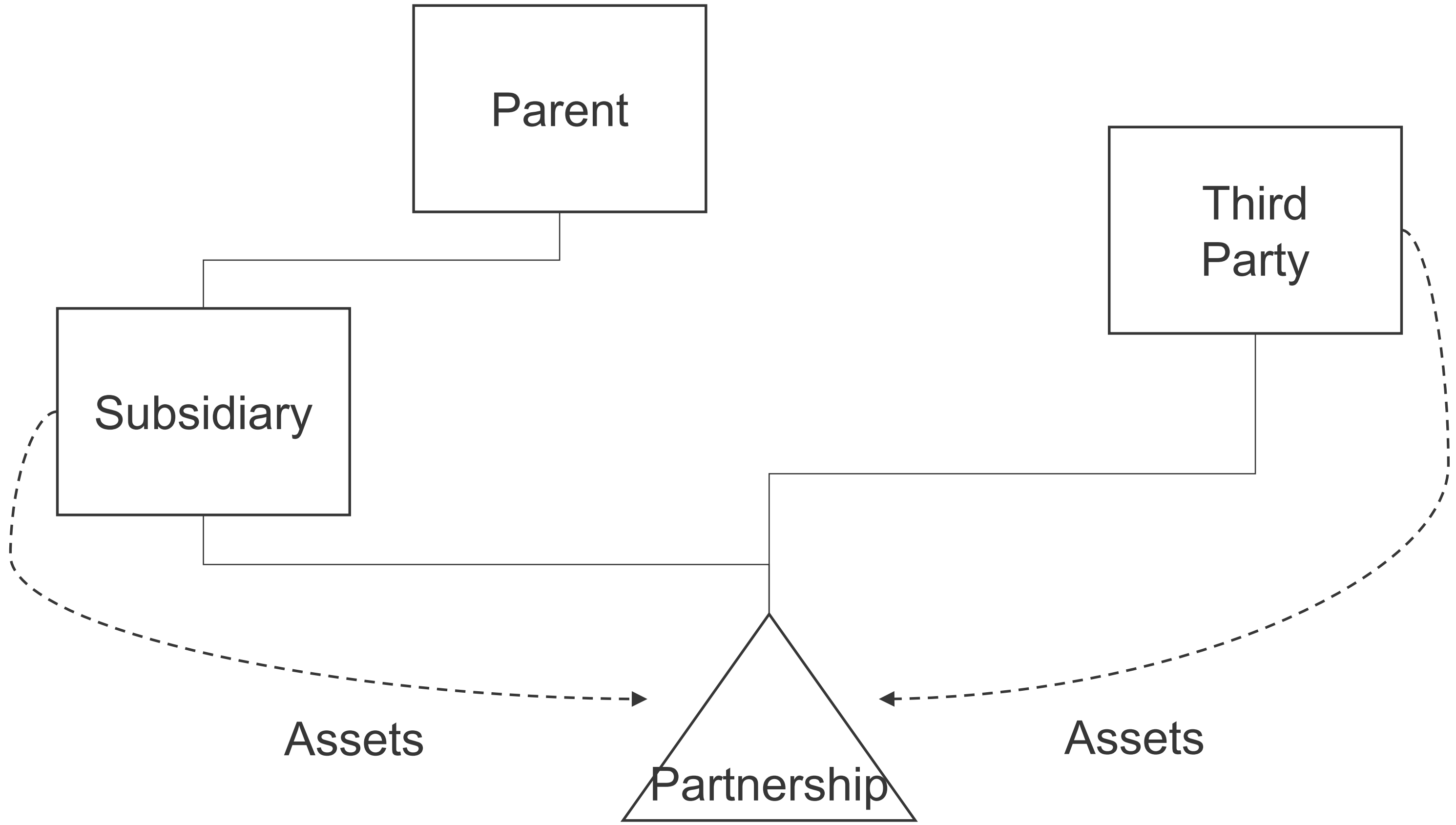


Partnerships in a Corporate Structure

Partnerships in a Corporate Structure

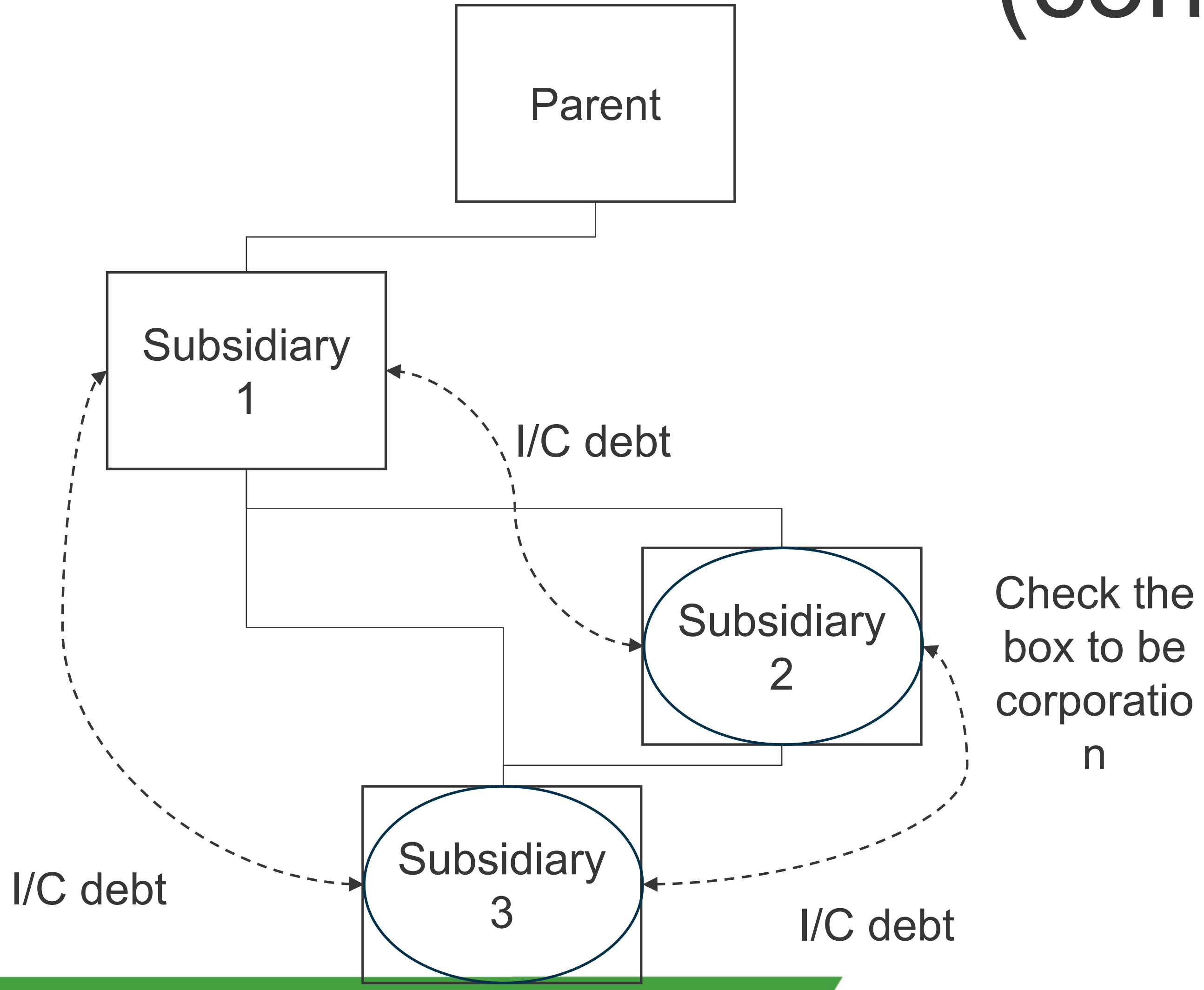


Partnerships in a Corporate Structure (cont.)



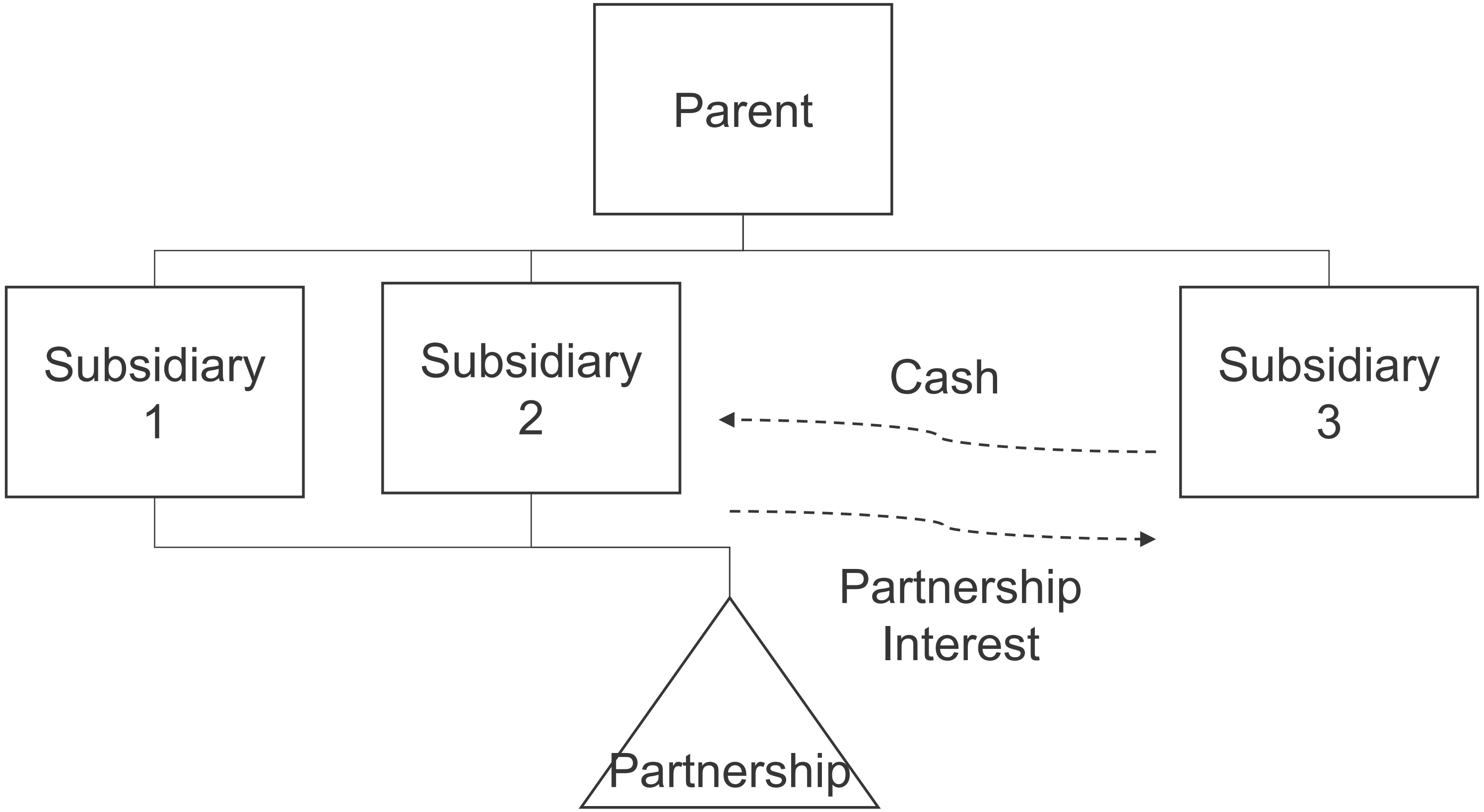
- Subsidiary and Third Party form a partnership by each transferring assets in exchange for partnership interests.
- Subsidiary's transferred assets move out of consolidation, which could implicate a number of issues (e.g., deferred intercompany transactions, acceleration rule).

Partnerships in a Corporate Structure (cont.)



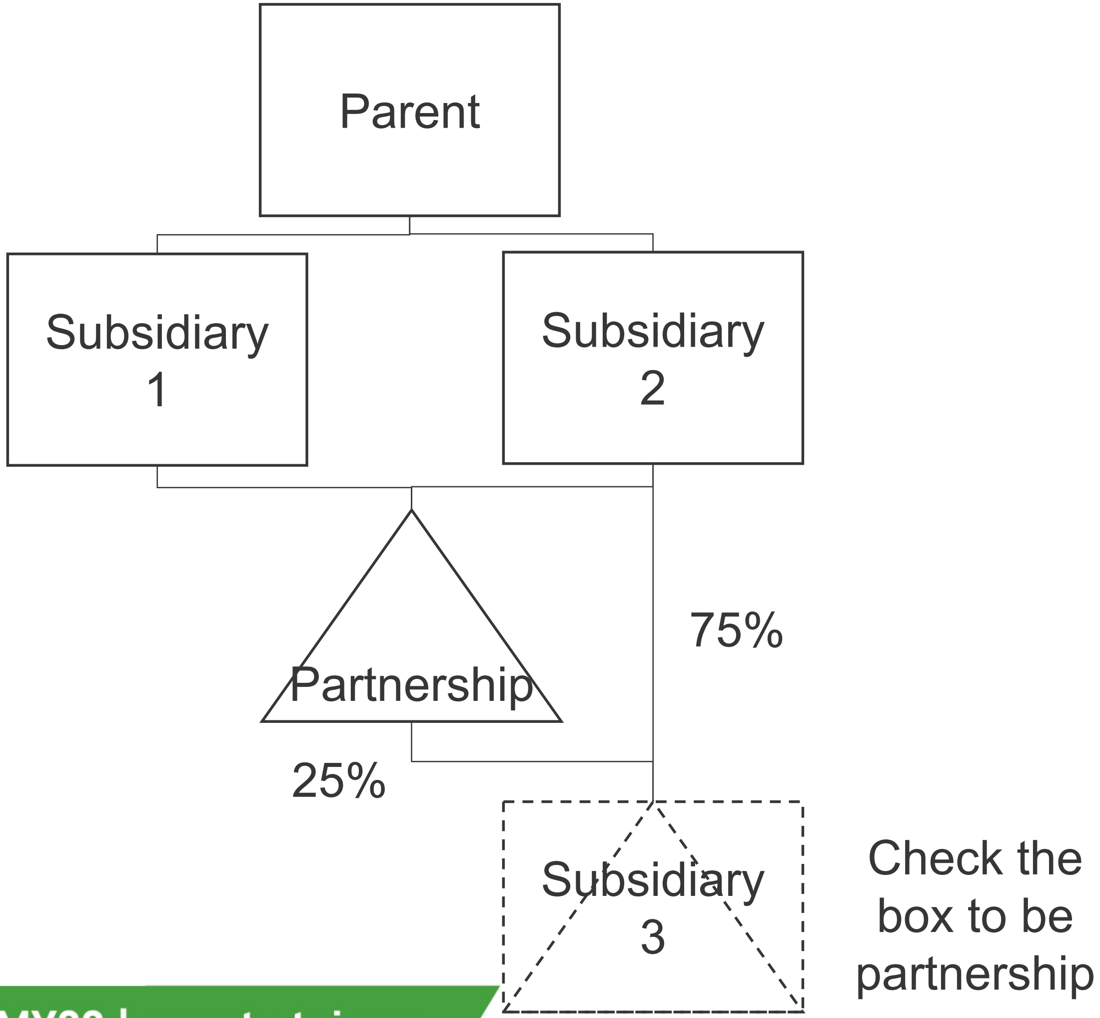
- Subsidiary 2 makes entity classification election to be treated as a corporation.
- Subsidiary 3 becomes a partnership in a transaction governed by RR 99-5 Situation 1.
- All of the previously disregarded I/C debt springs to life as a result of Subsidiary 2 and Subsidiary 3 becoming regarded tax entities, with various potential tax consequences (e.g., disguised sale issues, characterization of a contribution of a partner note to a partnership).

Partnerships in a Corporate Structure (cont.)



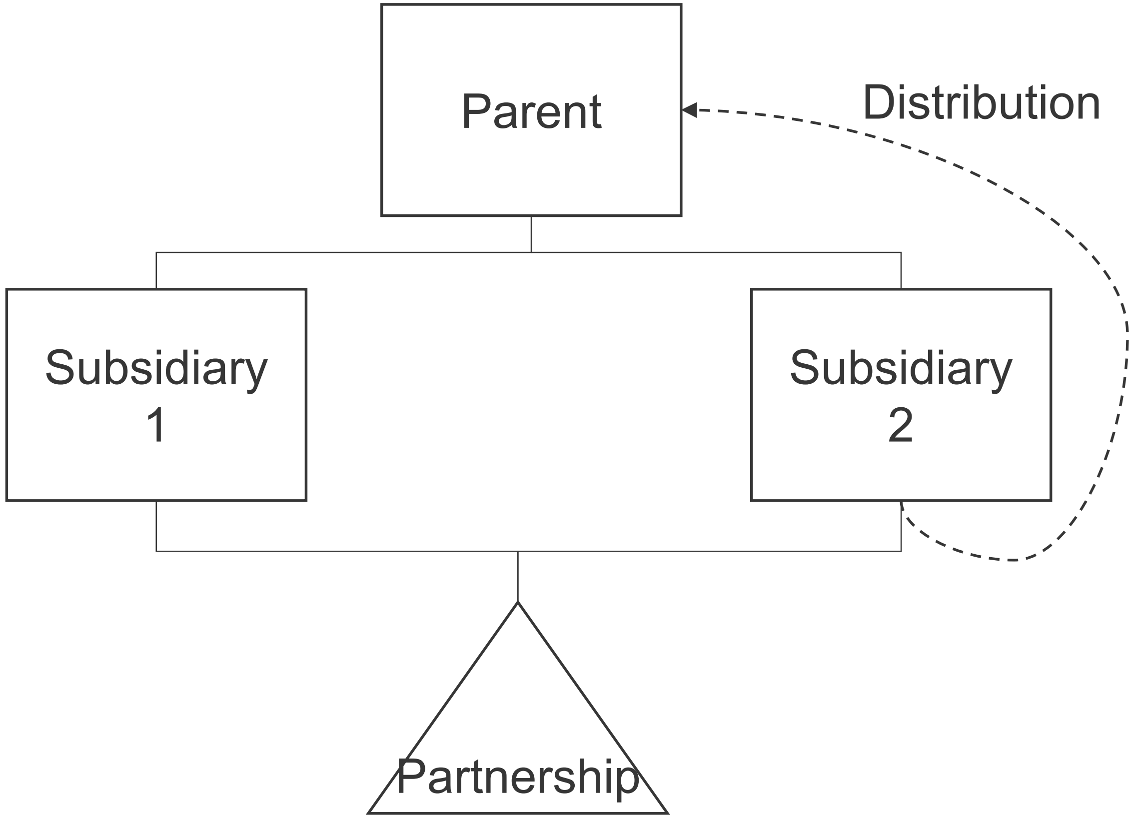
- Subsidiary 2 sells its interest in Partnership to Subsidiary 3.
- How does the result differ from a situation in which Subsidiary 2 had sold the assets of Partnership directly to Subsidiary 3?

Partnerships in a Corporate Structure (cont.)



- Subsidiary 3 makes entity classification election to be a partnership.
- Section 332 is not applicable to the liquidation of Subsidiary 3.

Partnerships in a Corporate Structure (cont.)



- Subsidiary 2 distributes interest in Partnership to Parent.
- If Partnership holds appreciated and depreciated property, is Section 311(b) applied on an aggregate or entity basis?

De Facto Tax Partnerships

De Facto Tax Partnerships

- An economic venture may constitute a de facto partnership for U.S. federal tax (referred to hereinafter as "tax") purposes despite the absence of an actual entity and also despite the parties' partnership disclaimer.
- An economic venture constitutes a de facto tax partnership if it meets the standard for a tax partnership as defined by the Code*, regulations, and courts:
    - "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meeting of [the Code], a trust or estate or a corporation." *See* I.R.C. §7701(a)(2). *See also* I.R.C. §761(a); Treas. Reg. §301.7701-1(a) (2).
    - The *Culbertson* test: Based on all facts and circumstances, do "the parties in good faith and acting with a business purpose intend to join together in the present conduct of the enterprise." *See Commissioner v. Culbertson,* 337 U.S. 733 (1949).

* References to the "Code" are to the Internal Revenue Code of 1986, as amended. References to "section" or "sections" are to sections of the Code, unless otherwise indicated, and references to "regulation" or "regulations" are to regulations promulgated by the IRS and the Department of the Treasury under the Code, in proposed, temporary or final form, as the case may be.

De Facto Tax Partnerships (cont’d)

- *Luna* Factors: The IRS and the courts often apply the *Luna* factors to discern the parties’ intent under the *Culbertson* test. *See Luna v. Commissioner,* 42 T.C. 1067, 1077-78 (1964). *See also Turner v. Commissioner*, T.C. Memo. 1965-101; Revenue Ruling 90-80, 1990-2 C.B. 170; Chief Counsel Advice 201323015 (June 7, 2013); Field Service Advice 1999835 (1999).
  - Communications and conduct regarding the parties’ agreement.
  - Contribution of capital and/or services by the parties.
  - Proprietary interests in the economics of the venture (i.e., profit sharing).
  - Filing partnership tax returns.
  - Representation of venture as partnership to third parties.
  - Shared or delegated control of management and/or operations.
  - Shared or delegated control over capital and/or income; withdrawal rights.
  - Separate books of account maintained for the venture.

De Facto Tax Partnerships (cont'd)

- Stakes: The existence of a de facto tax partnership can lead to unexpected consequences that, more often than not, are complicating at best and unfavorable at worst.
- Examples of possible consequences:
  - No tax statute of limitations.
  - Taxable year that differs from respective taxable years of all or most parties.
  - Application of partnership audit rules, without partnership representative named by parties.
  - Disguised sale under section 707(a)(2)(B).
  - Reallocation of profits and losses under section 704(b).
  - Non-U.S. parties deemed engaged in U.S. trade or business under section 875, possibly through a permanent establishment.
  - Non-U.S. parties possibly unable to claim deductions.
  - Duty to withhold tax under section 1446.
  - Application of section 721(c) to intangibles deemed contributed.
  - Application of section 704(c) to assets deemed contributed.
  - Impact on CFTE's and FTC limitation.

De Facto Tax Partnerships (cont'd)

- There are several approaches parties can consider in the planning stage to ameliorate, eliminate, or otherwise address the effects of a de facto tax partnership.
  - Avoid proprietary interest: share revenue or gross income, and possibly some costs or expenses, but not actual or effective net profits.
  - Adopt a tax partnership structure (through either an entity or a contractual arrangement) and address tax aspects.
  - Elect out of subchapter K under section 761(a). *But see* CCA 201323015 (June 7, 2013).