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Up-C IPOs: Structure, Impact and Benefits

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December 13, 2018

Agenda

- When an "Up-C" structure might be appropriate for an IPO candidate
- Tax receivable agreement
- The benefits to various stakeholders
- Impact of tax reform provisions on the Up-C structure
- Life as a public company with an Up-C structure and how it impacts financial and SEC reporting
- Undertaking acquisitions using an Up-C structure
- Unwinding an Up-C structure

Overview: primer on tax pass-thrus

- Corporations are subject to 21% federal income tax; shareholders are subject to tax on dividends received at 37% maximum rate (20% for "qualified dividends")
- The U.S. Internal Revenue Code creates various pass-thru entities:
  - Partnerships (general partnerships, limited partnerships or limited liability companies under state law) that are not publicly traded
  - Publicly traded partnerships that engage in certain activities, such as oil and gas production
  - Real estate investment trusts ("REITs")—corporations for tax purposes that hold mostly real estate assets like real estate or mortgages and earn mostly passive income
  - Regulated investment companies ("RICs")—corporations for tax purposes that hold securities and earn mostly passive income

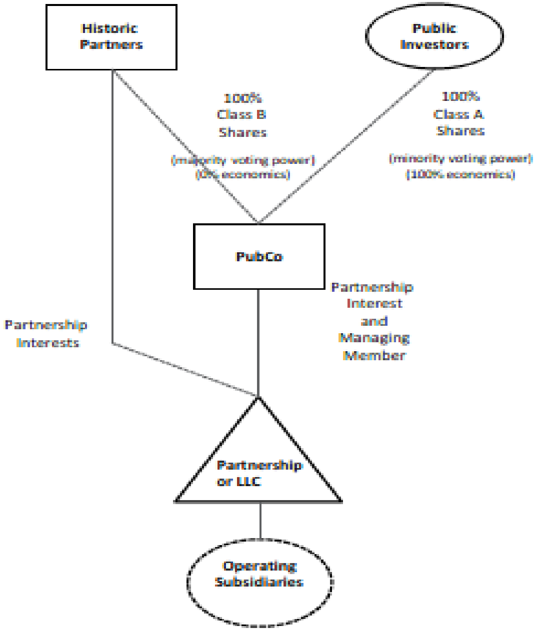
Common theme

- Taxpayers will gravitate over time to structures that optimize the different entity taxation regimes
- They will use tax pass-thrus to the extent possible, with only those activities that must be in corporate form in corporations

The Basics of the Up-C Structure

Up-C

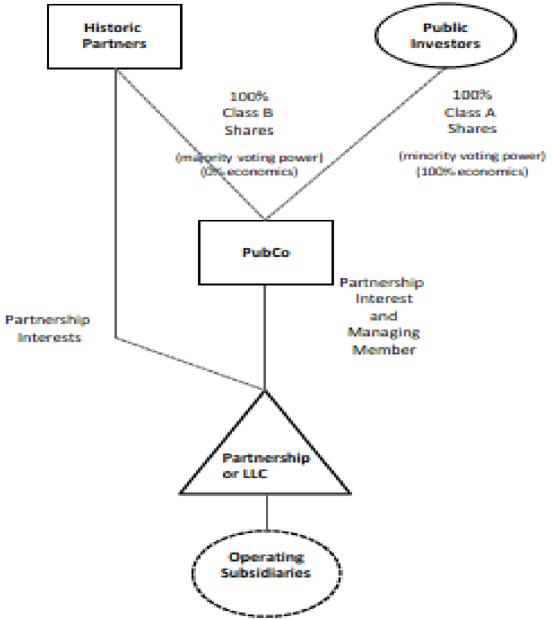
- The Up-C structure has become increasingly common for IPOs of companies that have historically operated as partnerships
- The Up-C structure derives its name from the UPREIT structure. Essentially, a newly formed corporation (“PubCo”) will be the entity that undertakes the IPO. PubCo will sit above an existing limited liability company (the “LLC”)



Up-C Structure Final State

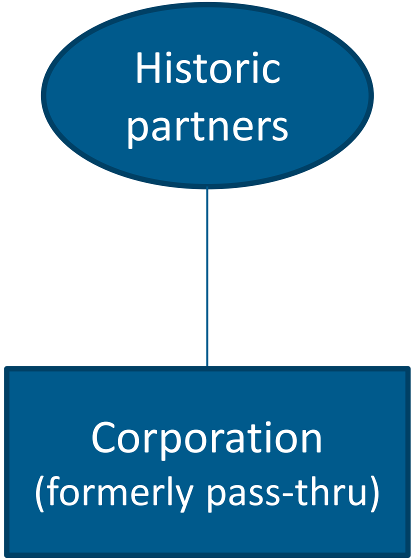
Up-C (*cont'd*)

- PubCo will be a holding company and will have as its subsidiary the LLC. The principal assets/operating business will continue to be at (or below) the LLC level
- PubCo will receive the IPO proceeds and downstream the IPO proceeds to the LLC



Up-C Structure Final State

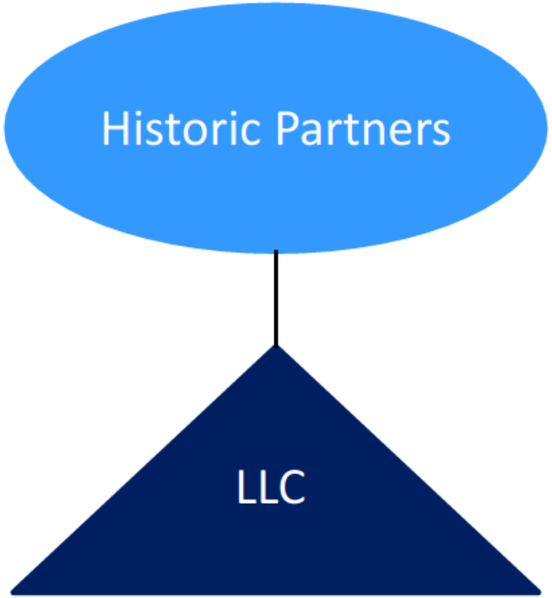
Typical pre-IPO structure – corporation



<u>Disadvantages</u>

- After pass-thru is converted to a corporation, income from operating subsidiaries subject to entity-level tax when earned by the corporation
- Historic partners (and other shareholders) subject to tax when they receive dividends

Typical pre-IPO structure – partnership



Advantage

- Partnership not subject to tax; income earned by operating subsidiaries taxable directly to partners

Disadvantage

- Listing partnership when going public may result in the partnership being taxed as a corporation

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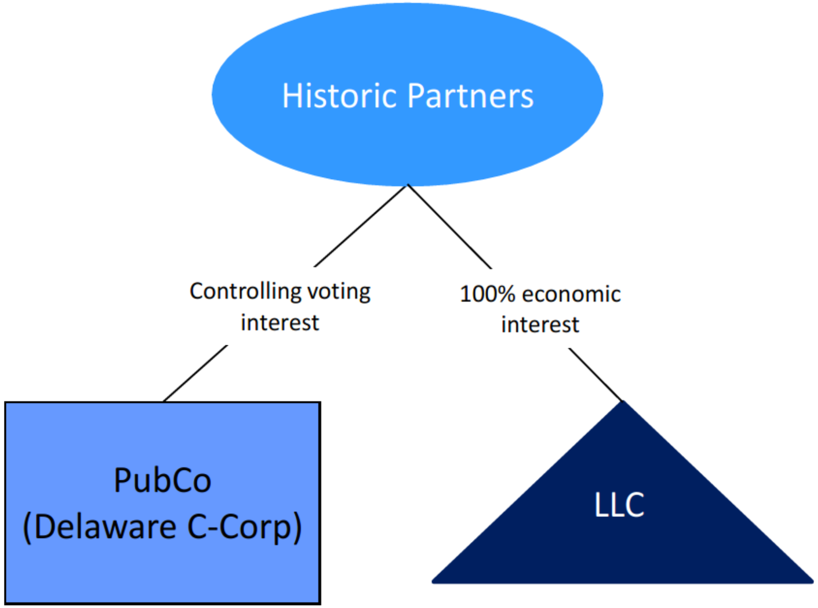
Up-C Structure: Immediately After Formation of C-Corp

- Company incorporated in Delaware with two classes of common stock, Class A and Class B.
- Class A is offered in the IPO and Class B is held by the Historic Partners and provides no economic rights, only voting rights.



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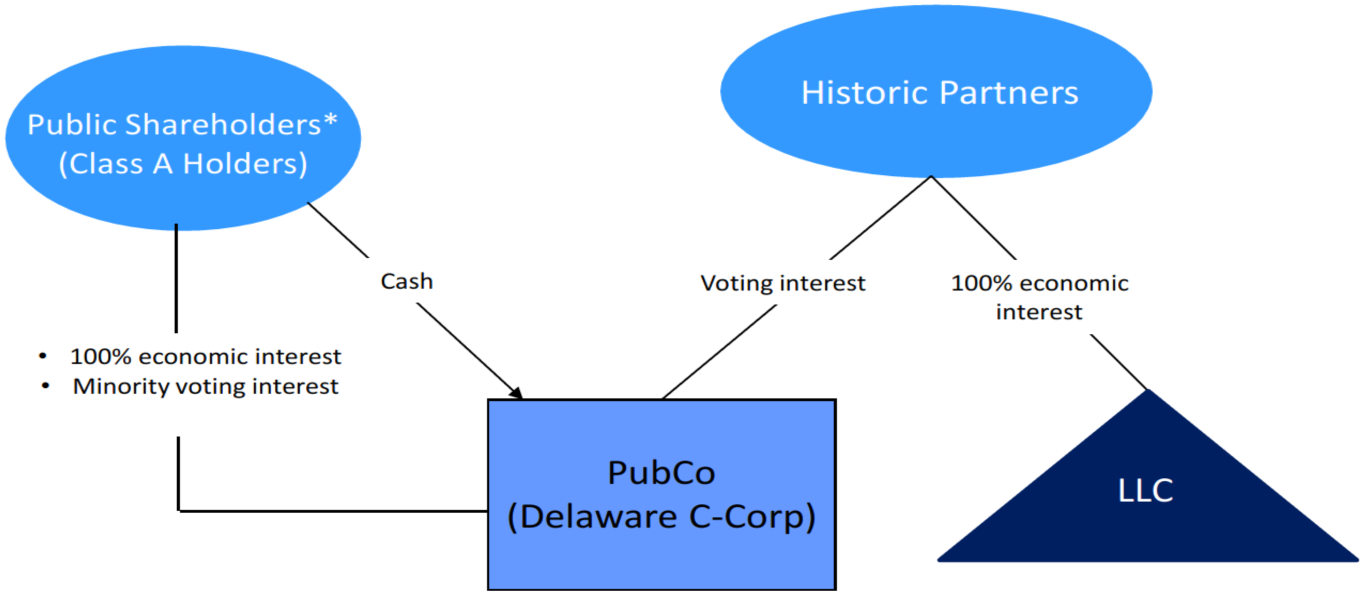
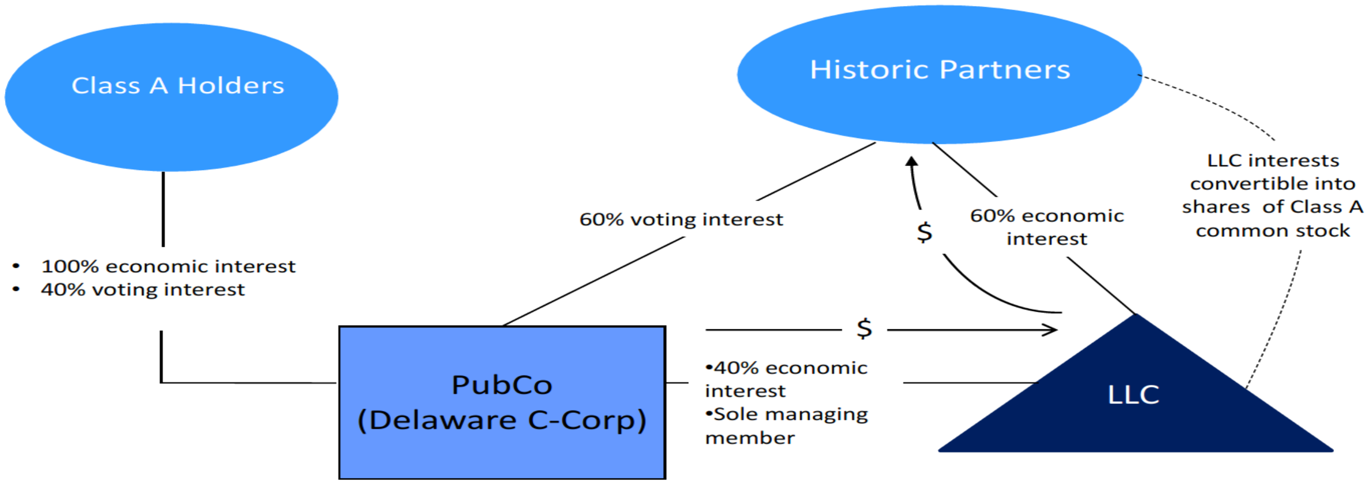
Up-C Structure: Immediately following IPO



* Public shareholders purchase their shares for cash in the IPO

Up-C Structure: Final Structure



- PubCo uses the proceeds received in the IPO to purchase LLC interests
- LLC redeems partnership interests from the Historic Partners (treated for tax purposes as a "disguised sale" or direct purchase of partnership interests by PubCo from the Historic Partners)

(percentages are included only for illustrative purposes)

Rationale for Using an Up-C Structure

Why an Up-C structure?

- Prior to the IPO, the business was conducted through an LLC, which is a pass-thru structure and does not pay entity-level taxes
- Through the Up-C structure, the pass-thru structure remains in place and PubCo pays the pre-IPO equity holders (LLC members) for the value of PubCo's tax attributes as those tax attributes are used after the IPO. This creates a market dynamic that permits value to be extracted from PubCo after the IPO, without decreasing the value of PubCo in the offering
- To effectuate the Up-C structure, PubCo will enter into various arrangements with the LLC and its members. These include an LLC operating agreement and Tax Receivable Agreement ("TRA"). Generally, TRAs do not appear to impact the valuation of a corporation in its IPO

Why an Up-C structure? *(cont'd)*

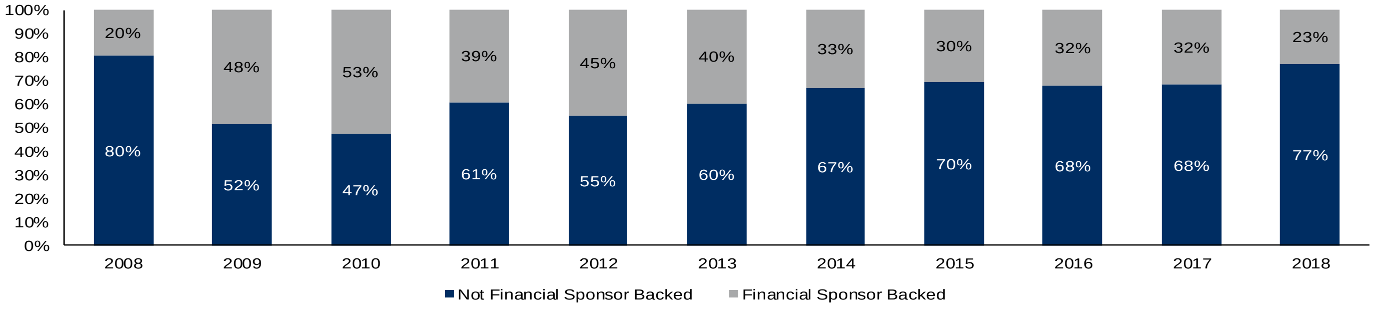
- Public stockholders often do not assign full value to the tax attributes of a corporation. Similarly, public stockholders apparently do not discount the value of a corporation to account fully for future payments to be made under a TRA. Through the TRA, the IPO corporation pays the founders for a valuable tax attribute (for example, a basis step-up)

Are certain IPO candidates more likely to choose an Up-C structure?

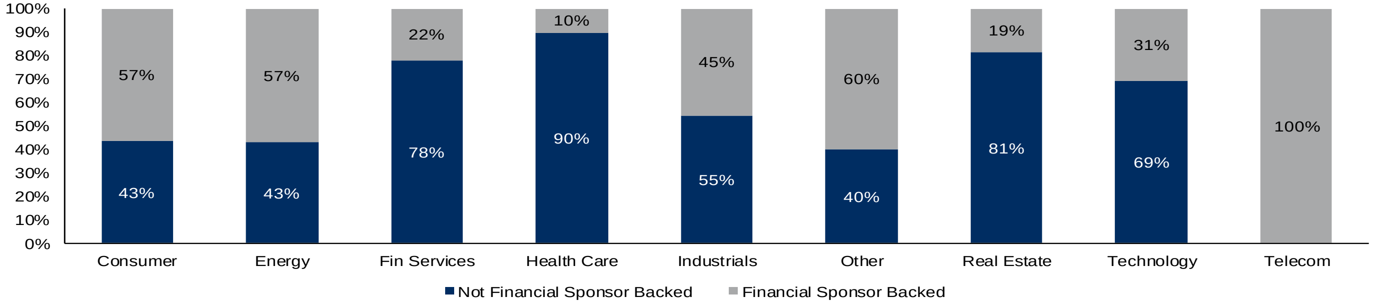
- Generally the Up-C structure has been favored by PE-backed and VC-backed entities
- PE funds and VC funds generally tend to hold their interests in their portfolio companies through pass-thru vehicles and this may lead to considering the Up-C structure when it comes true for a portfolio company IPO
- The prevalence of Up-C IPOs has corresponded to the number of VC-backed and PE-backed IPOs

Financial sponsor-backed IPOs

Financial Sponsored IPOs by Year



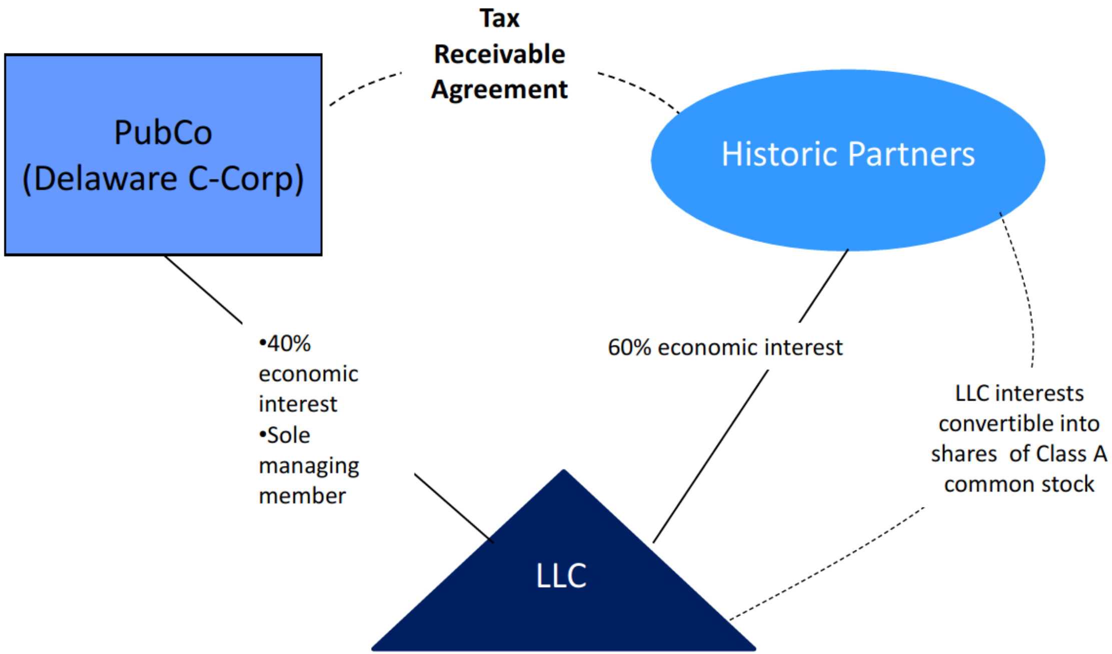
Financial Sponsored IPOs by Sector Since 2017



Source: Dealogic; as of 10/26/18.
Note: Data includes SEC registered, rank eligible, US marketed IPOs raising over $25MM for the last 10 years.
Excludes closed-end funds.

Tax Receivable Agreements

Taxable receivable agreements



(percentages are included only for illustrative purposes)

Benefits of the tax receivable agreement

- Because the historic partners sell partnership interests to PubCo (rather than stock, as in a traditional IPO structure), PubCo receives a "step-up" in the tax basis of its assets
- This tax basis step-up is allocated to PubCo's share of the historic partnership's assets, and in many cases the step-up is primarily allocable to intangible assets that are amortizable on a straight-line basis over 15 years (so-called "Section 197" intangibles)
- Through a TRA the historic partners effectively capture the majority of the value associated with the PubCo's tax basis step-up

Benefits of the tax receivable agreement *(cont'd)*

- Under the terms of the TRA, PubCo is obligated to pay the historic partners in cash an amount equal to a portion of PubCo's tax savings generated by the tax basis step-up (typically 85% of such savings)
- Payments under the TRA are effectively treated as additional purchase price paid by PubCo for its interest in the historic partnership

Benefits of the tax receivable agreement *(cont'd)*

Illustration of Potential TRA Economics

•	**Amount of PubCo Tax Basis Step-Up***	**$300 million**
•	Amortization Period	15 years
•	Annual Amortization	$20 million
•	PubCo Tax Rate (Federal & State)	25%
•	PubCo Annual Savings	$5 million
•	TRA Payout Ratio	85%
•	Annual Payment to Historic Partners**	$4.25 million
•	Total Payments to Historic Partners	$63.75 million

* Any future exchanges of partnership units for Class A shares of PubCo also may give rise to additional tax basis step-up for PubCo (thereby increasing the amounts payable under the TRA over time)

** Payments under the TRA also give rise to additional tax basis step-up for PubCo (thereby increasing the amounts payable under the TRA over time)

Other tax receivable agreement considerations

- TRAs often include provisions accelerating payments upon a change of control
- Or PubCo can elect to terminate the TRA triggering acceleration payments
  - Impact on M&A transactions?
  - Possible to “break open” or an existing TRA?

Impact of tax reform on Up-C structures

- Corporate federal income tax rate reduction from 35% to 21%
- Bonus depreciation/expensing provisions
  - 100% expensing until 2022
  - Change to original use requirement
  - This change can cut both ways
- Limit on use of “net operating loss” carryforwards
- Limits on interest deduction

Additional considerations related to Up-C structure

- The Up-C structure maintains continuing pass-thru treatment (single level taxation) for the historic partners with respect to their proportionate share of net income realized by the partnership
- The historic partners obtain liquidity through the right to exchange partnership units for Class A shares of PubCo
- The Up-C structure provides a range of options for making strategic acquisitions and compensating employees (e.g., PubCo stock, PubCo options, and partnership units)
- PubCo becomes the managing member of the historic partnership and the historic partners retain voting control through Class B PubCo shares
- PubCo consolidates the historic partnership for financial statement purposes

Miscellaneous issues related to Up-C structure

- “Anti-churning rules” under Section 197 of the Internal Revenue Code
- Tax distributions to PubCo and historic partners
- Continuing administration of TRA and determination of annual payments to be made by PubCo to historic partners (reviewed and approved by PubCo audit committee in conjunction with outside advisors)
- Investment Company Act (“40 Act”) status of PubCo

Securities Law and Corporate Governance Considerations

Securities disclosures

- The IPO prospectus will contain additional disclosures related to the Up-C structure
  - Cover page will highlight dual class of stock
  - Offering summary box usually will contain a structure diagram
  - Risk factors will highlight certain aspects of the structure
    - Only material asset of PubCo will be interest in the LLC
    - Payments to pre-IPO owners for certain tax benefits
    - Risks associated with dual class of stock and often risks associated with a controlled company
  - Formation transaction or organization description
  - Description of exchange agreement
  - Description of tax receivable agreement

Securities disclosures *(cont'd)*

- Often there may be other agreements entered into in connection with the IPO, such as a voting agreement and a management agreement

Controlled company status

- For the securities exchanges, a controlled company is one in which more than 50% of the voting power for the election of directors is held by a group
- Often the PE or VC sponsors in an Up-C structure will remain the control group
- A controlled company may rely on certain exemptions from the corporate governance requirements of the exchanges

SEC interpretive guidance

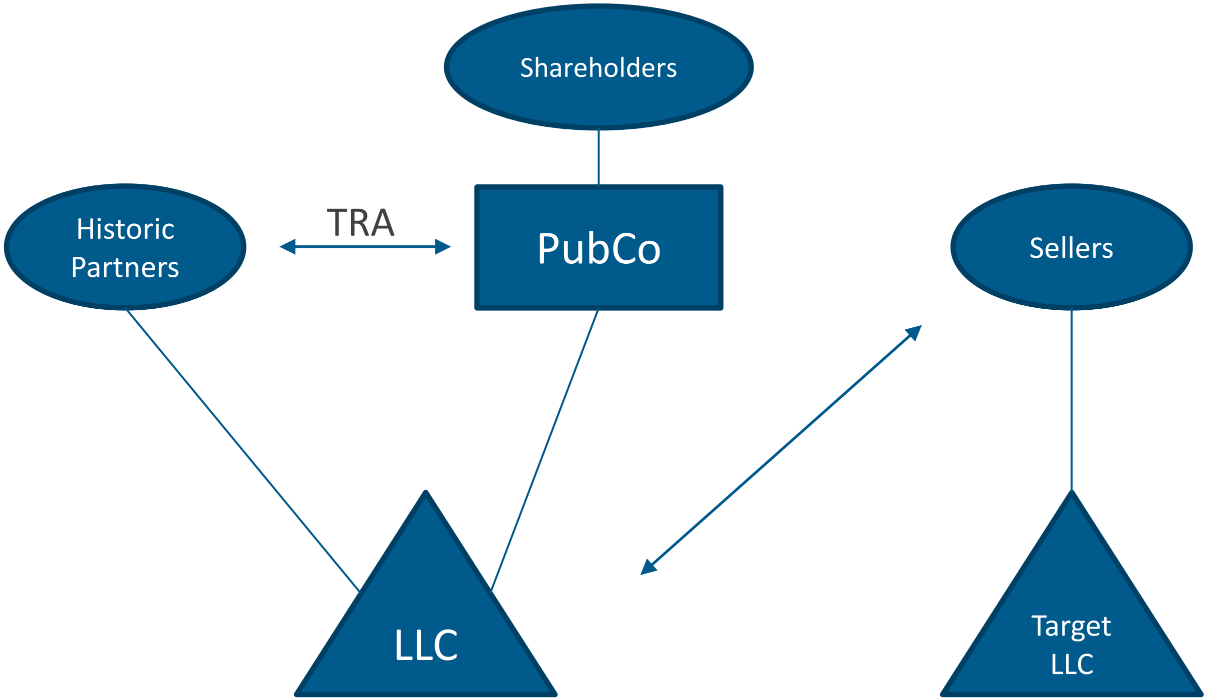
- In 2016, the Staff of the SEC's Division of Corporation Finance provided guidance regarding the application of Rule 144 in the context of the Up-C structure
- The Rule 144 holding period is deemed to commence when the holder has fully paid for its LLC interest to the extent that the exchange agreement allows LLC holders to exchange for PubCo shares with no additional consideration

Acquisition Alternatives

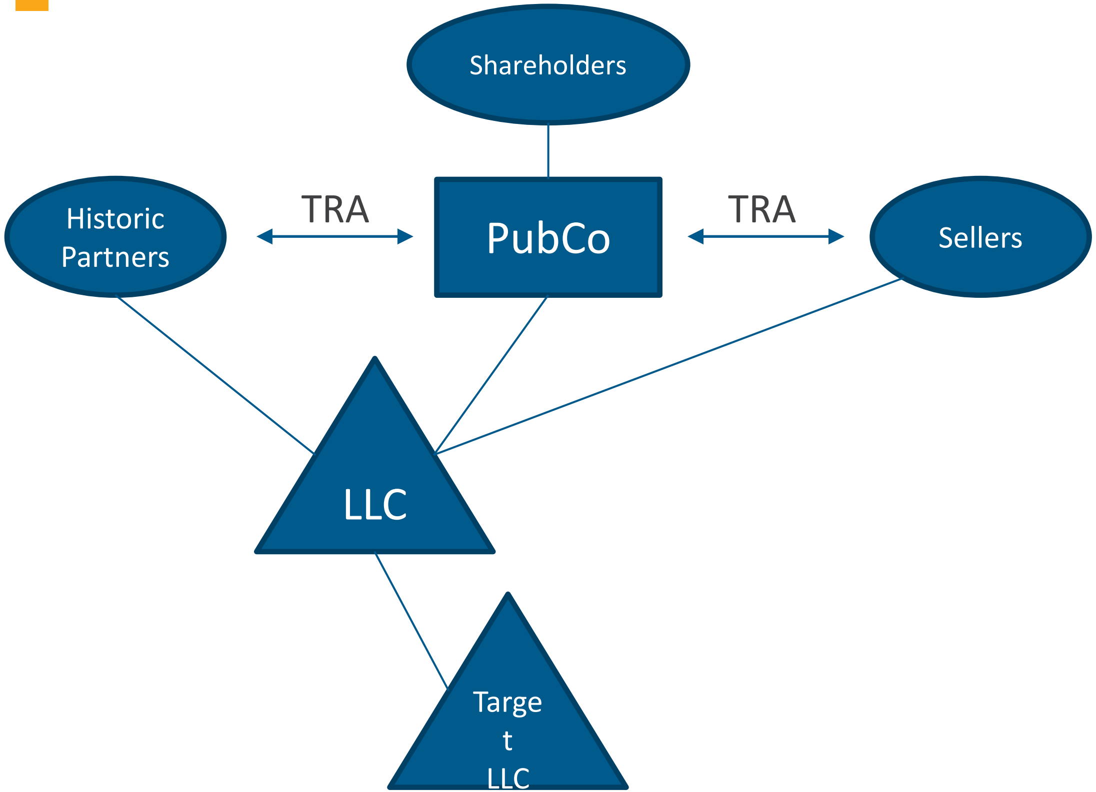
Acquisitions using an Up-C structure

- An entity that relies on an Up-C structure can use multiple forms of acquisition currency
  - PubCo stock
  - Cash
  - LLC units
- Use of LLC units provides benefits to sellers:
  - Tax deferral
  - Single layer of tax
  - Liquidity through conversion

Acquisitions using an Up-C structure *(cont'd)*



Acquisitions using an Up-C structure *(cont'd)*



- Sellers contribute Target to LLC in exchange for LLC units
- LLC units are exchanged for PubCo shares
- Sellers enter into TRA with PubCo
- Sellers continue to benefit from pass-thru treatment
- Target becomes disregarded entity for tax purposes

Unwinding an Up-C Structure

“Unwinding” an Up-C structure

- Why unwind an Up-C structure?
  - Weighing the benefits vs detriments
  - Change of control considerations
  - Decreasing PubCo stock price?
- How to unwind an Up-C structure?
  - Gain 100% ownership of underlying partnership/LLC
  - Eliminate dual class share structure
- What are consequences/costs of an unwind?
  - TRA acceleration

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