November 9, 2016

Center for Tax Law & Policy Seminar Series: Gregg Polsky

Time: 4:30pm

Location: Gittis 214, Haaga Classroom

The Center for Tax Law & Policy Seminar Series is pleased to welcome Professor Gregg Polsky to present on the topic "*The Up-C Revolution*".

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To: Participants in Penn Tax Law and Policy Workshop
From: Gregg Polsky
Re: Background for "The Up-C Revolution"

I am excited to present my co-authored paper "The Up-C Revolution" (co-authored with Adam Rosenzweig of Wash U) on November 9. Because the current draft was written with a tax specialist audience in mind, some background may be useful for participants who have not yet completed the partnership and corporate tax classes.

The paper discusses a relatively new tax structure that is becoming increasingly popular when businesses operated as limited liability companies (LLCs) are taken public in an initial public offering (IPO). LLCs are generally taxed as partnerships, while public companies are generally taxed as "C corporations." Therefore, in an IPO of an LLC, the tax character of the issuer changes fundamentally, from a partnership to a C corporation.

A partnership is not taxed as an entity; instead all of the partnership's taxable income flows through the entity and is reported on the partners' individual tax returns, in the same manner as if each partner had earned its share of the partnership income directly. This results in partnership income being taxed once and only once, when the income is earned by the partnership; when that income is subsequently distributed (in the form of cash or property distributions), those distributions are ordinarily tax-free so that there is no second level of tax. If the partnership generates tax losses, those losses also flow through the entity and are generally usable by the partners to offset income from other sources.

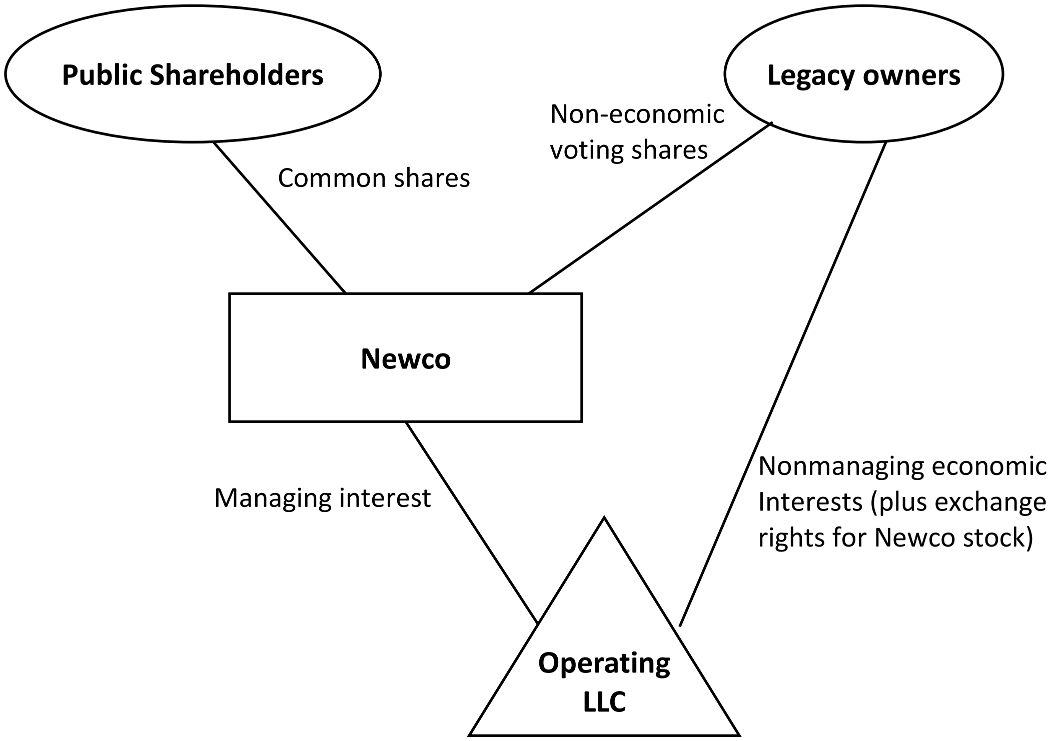
On the other hand, a C corporation (to be contrasted with an S corporation, which is taxed much like a partnership) is taxed separately as an entity. The corporation realizes income and pays tax on that income much like an individual would; that provides the first level of tax. When the corporation subsequently distributes the income (that remains after paying corporate tax) in the form of dividends, the shareholders generally pay a second level of tax on the dividend (albeit at lower rates; the top rate on dividends is currently 20 percent). If the corporation generates losses, those losses are "trapped" at the corporate level; they can only be used as net operating loss carryforwards (NOLs) to offset future income realized by the corporation and, if the corporation liquidates before all of the NOLs are used, the losses simply evaporate.

Because of these rules—single versus double taxation of gains, and flow-through versus trapping of losses—partnerships are generally the favored form among tax planners, with the following caveats. First, as mentioned, public companies generally cannot be taxed as partnerships; thus, an LLC whose interests are publicly traded is taxed as a C corporation. Second, tax-exempt and foreign investors generally will not invest directly in partnerships because the business activities of the partnership will be imputed to them, which will require them to file US tax returns and pay US taxes. To avoid these filing obligations, tax-exempt and foreign investors will generally invest through a C corporation "blocker" (which will itself report and pay U.S. tax on the income, but whose dividends will not result in tax or filing obligations for these investors) while other investors (e.g., US individuals and corporations) will invest directly. Third, investing in lots of partnerships can result in administrative difficulties. The investor, before it could file its own tax return, would have to first receive the requisite informational form (K-1) from every single investee partnership. In addition, the investor would have to file state and local tax returns in every jurisdiction in which the investee partnerships did business.

Because of the latter two reasons (the need to "block" for certain investors and the administrative headaches), the venture capital (VC) and private equity (PE) industries have traditionally preferred having its portfolio companies be C corporations rather than LLCs, despite the apparent tax leakage. Another more complicated explanation for this preference, based on the way that public companies report tax attributes for accounting purposes and the effect of that on the valuation of stock, is discussed in the paper. Tax lawyers have scratched their heads over the preference for C corporations by VC and PE managers because it seems irrational. As proof, these critics note that most closely held businesses that don't receive VC and PE money are structured as LLCs (and taxed as partnerships).

LLCs that go public are effectively forced to become C corporations; this is one cost of going public. Traditionally, LLCs going public would convert to a new C corporation (Newco) in a tax-free transaction. The historical owners (aka the legacy owners) would swap their LLC interests for Newco stock; this was tax-free and the legacy owner's low tax basis in the LLC interest would carry over to be the basis of the Newco stock. If and when the legacy owners sold the Newco stock (which could now be sold on the NYSE or NASDAQ stock exchanges) before their death, they would pay capital gains on the difference between the sales price and their basis in the stock. The public investors would buy other Newco stock for cash; this cash would be used by Newco to grow the business. Newco would inherit the LLC's assets with the same basis they had in the LLC's hands and this carryover basis was not increased when the legacy investors later sold their stock. The end result is that Newco steps into the shoes of the LLC, with carryover basis all around. The carryover basis result for Newco was not ideal because a "stepped up basis" (equal to fair market value) in the assets would have resulted in much larger future depreciation and amortization deductions and therefore lower taxes in the future, but (as explained in the paper) the public markets seemed not to care very much about the lack of a stepped up basis and therefore did not punish the stock price for its absence.

The Up-C transaction that is the focus of the paper is a newfangled structure that is starting to dominate when LLCs go public. Instead of simply converting the LLC to a Newco, a Newco is put on top of the LLC, which stays alive. The public still buys shares of Newco for cash, and the cash is dropped down by Newco into the LLC in exchange for new LLC interests. Instead of swapping out their LLC interests for Newco stock right away (as in the traditional structure), the legacy owners remain owners of the LLC (along with Newco). If we just stopped there, the legacy owners would not be very happy because they would continue to own highly illiquid LLC interests (and liquidity for legacy owners is usually a principal purpose to do an IPO in the first place). To deal with that illiquidity, the legacy owners also receive exchange rights, which allow them to, at a time of their choosing, "move up the chain" by swapping their illiquid LLC interests for publicly traded Newco stock. The swap would be a taxable event for the legacy owners. Accordingly, the legacy owners would generally choose to trigger the taxable event only when they were ready to cash out of all or part of their interests in the business (at which point they were going to have to pay tax on their gains even under the traditional structure, because cashing out would have required the legacy owners to sell their Newco stock for cash, which would be taxable event). Putting it altogether, the Up-C structure (after the IPO and before any swaps) looks like this:



When the legacy owners exchange their LLC interests for Newco stock, a commensurate amount of the non-economic voting shares of Newco held by them are extinguished.

Leaving aside taxes, the structure has the nearly identical economics and voting attributes as the traditional structure. It also has almost entirely the same <u>direct</u> tax consequences for the legacy owners, namely (i) no tax unless and until they cash out before death, and (ii) when such cashing out occurs, they recognize long-term capital gains on the difference between the sales price and their basis in the LLC interests. Likewise, the public shareholders have the same direct tax consequences.

What is very different about the tax structure is Newco's tax situation. In the traditional structure, Newco simply stepped into the shoes of the LLC with respect to its low tax basis in the LLC's assets. In the Up-C, whenever the legacy owners swap their LLC interests for Newco stock or die while holding the LLC interests, Newco receives a stepped up fair market value basis (SUB) in a proportional amount of the LLC's assets. For example, if a legacy owner holding 1% of the LLC swaps out all of her interests for Newco stock, Newco would receive a stepped up basis with respect to 1% of each and every of the LLC's assets. This SUB gives Newco more deductions and losses, and less income and gain in, the future, reducing Newco's corporate tax liability. Because everything else is held (mostly) constant, this tax reduction means that the Up-C is typically a much more tax efficient structure than the traditional IPO structure.

However, as noted above and as explained in depth in the paper, the public markets seem not to care very much about any SUB (or, in fact, future taxes generally). As a result, without something more, the legacy owners would apparently not get paid for the SUB (in the form of higher Newco stock prices) and the structure would create a good deal of complexity for nothing (at least from the legacy owner's perspective). This state of affairs gave rise to a related feature known as a tax receivable agreement (TRA). TRAs are contractual agreements between Newco and the legacy owners that require Newco to pay a specified percentage of the tax savings (usually 85 percent) realized by Newco attributable to the SUB resulting from the swaps by an owner on an if, when, and as-realized basis. So, if an SUB saves Newco $100 of taxes, Newco would pay $85 to the legacy owner who caused the SUB (by swapping or, less happily, by dying) and Newco keeps the remaining $15.

The paper discusses the Up-C in more detail, puts it into the context of traditional M&A tax planning, and addresses some common misconceptions and sloppy thinking about Up-Cs.

Thanks for reading the draft and I very much look forward to our discussion.