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# Annual Conference Scottsdale, AZ

Using Partnerships and Other  
Pass-Through Entities in  
Corporate Groups – A  
Balancing Act

*Tuesday, October 25, 2022*

*11:00 am - 12:00 pm*



**Moderator**



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## Agenda

1. Umbrella Partnership C Corporation (“Up-C” Structures)
2. General & Procedural Aspects
3. Box & Triangle Tax Planning - Use of Partnerships in Corporate Tax Planning



# Umbrella Partnership C Corporation (“Up-C” Structures)

# Introduction

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- ▶ An umbrella partnership provides partners in a private partnership with enhanced liquidity through exchange rights into publicly traded equity
- ▶ Umbrella Partnership C Corporations (UP-Cs) provide access to public markets via a publicly-traded corporation, while retaining the tax benefits of a pass-through structure
- ▶ Tax receivable agreements (TRAs) have become an important component of umbrella partnership structures, especially in connection with IPOs

# UP-C Examples

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- ▶ Late 1990s, early 2000s:
  - [barnesandnoble.com](https://www.barnesandnoble.com), Charter Communications, Accenture and Evercore
- ▶ More recent:
  - Emdeon, Duff & Phelps, Graham Packaging, DynaVox, PBF Energy, Shake Shack, Summit Materials, Planet Fitness, and Bumble
  - Many SPAC Transactions

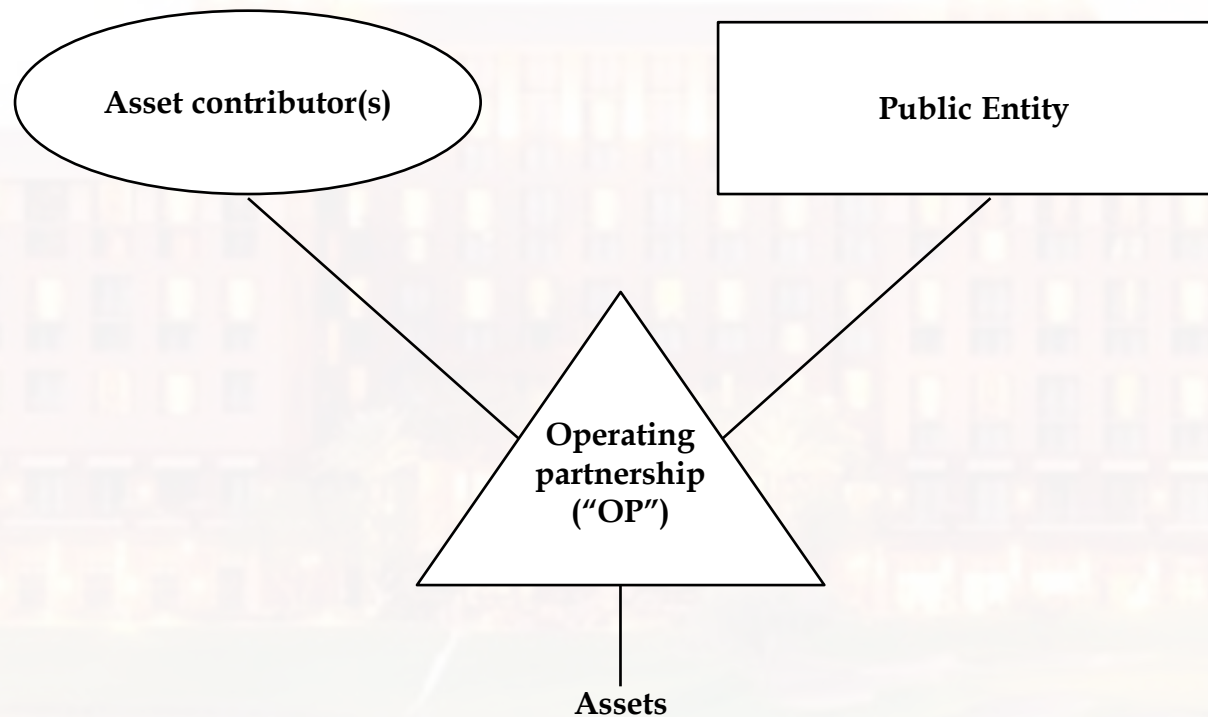
# UP-C Benefits

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- ▶ Interests in LLC held directly by sponsors not subject to corporate tax
- ▶ Parity and unit/share exchangeability provides liquidity
- ▶ C corporation receives a step-up in basis upon sponsors' exchanges of LLC units for C corporation shares
  - Benefit of the step-up often paid over to sponsors under a tax receivable agreement (TRA)



# Umbrella Partnership Structure - Basics



- ▶ Asset contributors can exchange OP equity for equivalent equity in public entity

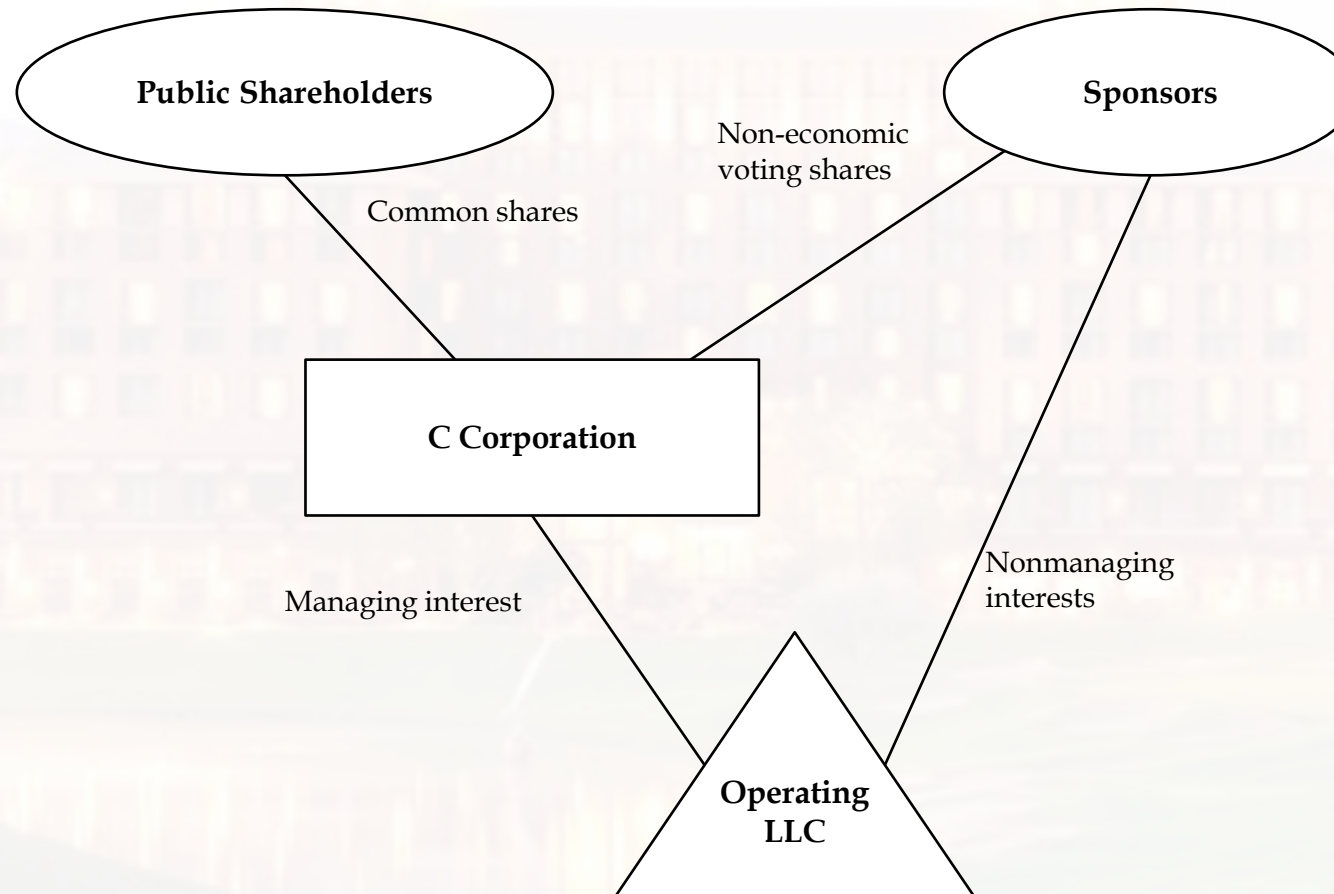


# Umbrella Partnership C Corporations ("UP-Cs")

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- ▶ UP-Cs (a/k/a "Pubcos") generally used to take public non-REIT-eligible flow-through entities
- ▶ Avoid entity-level tax on earnings allocable to the sponsors while providing liquidity through exchange rights
- ▶ Traditionally, sponsors transfer business assets to OP in a nontaxable exchange for OP units or hold OP units from prior acquisitions
- ▶ Newly formed C corporation issues shares to the public and transfers proceeds to the OP in exchange for a managing interest in the OP
  - Sponsors may receive non-economic voting shares in the C corporation.

# Resulting UP-C structure



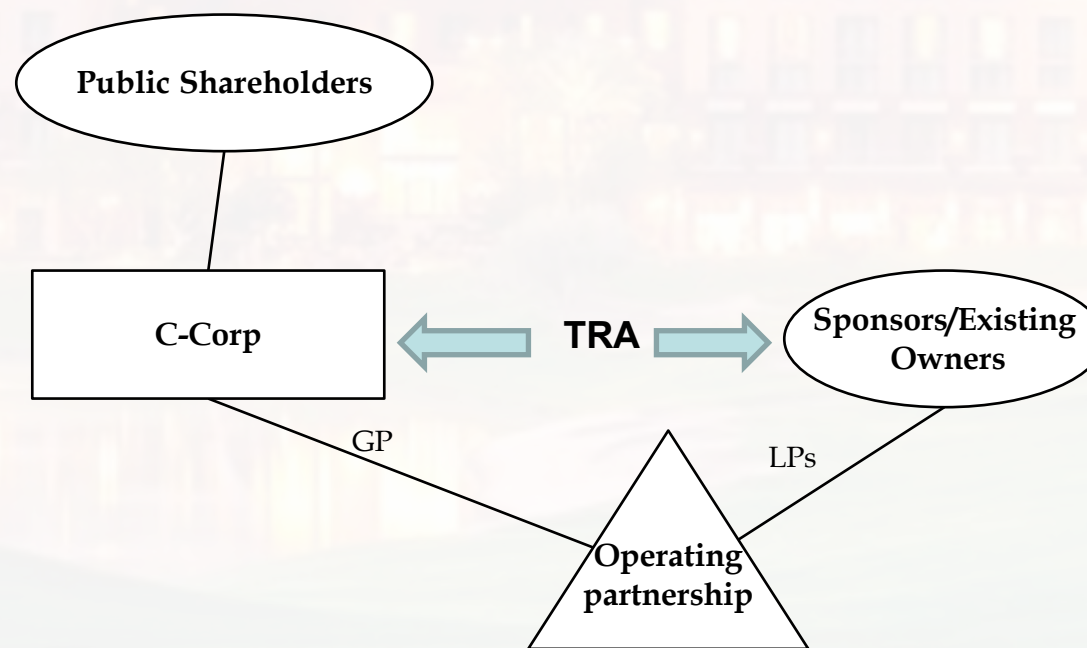
# Tax Receivable Agreements (TRAs)

- ▶ Pre-IPO investors can receive significant incremental proceeds on exit by implementing a tax receivable agreement (TRA)
- ▶ In General:
  - ▶ A TRA is a contract providing for the payment to existing/historic owners of a specified percentage (typically, 85%) of tax benefits realized over time attributable to taxable exchanges of umbrella partnership equity for public company equity (or cash)
  - ▶ These contracts usually require annual computations on a “with and without” basis to compute tax savings attributable to existing owners
  - ▶ TRAs are based on the notion that the public markets may not adequately value tax attributes



# Up-Cs and TRAs

- ▶ The parties to the TRA will typically be the public C-corp and the sponsors/existing owners
- ▶ UP-C TRAs have been used in many IPOs of businesses held in flow-through form
- ▶ The tax savings at issue in these TRAs generally arise in the public C-corp itself



# Section 754 Election

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- ▶ TRAs provide that the umbrella partnership will have a § 754 election in effect
- ▶ This will result in basis adjustments:
  - under § 743 or 732 (where an existing owner effectuates an exchange of umbrella partnership units for equity of the public company), and
  - under § 734 (where the umbrella partnership makes a taxable distribution to a partner)

# Basic TRA Terms

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- ▶ The following are common contractual provisions of TRAs:
  - Supporting Documentation
    - The public entity is required to deliver to the exchanging holder a schedule within 45-180 days of the filing of its tax return showing the “realized tax benefit” for the year attributable to exchanges
    - The schedule is subject to dispute resolution procedures



# Basic TRA Terms (cont'd)

## ■ Payment of Tax Benefits

- The public entity must pay each existing owner an amount equal to 85% of the tax benefit for the year, plus interest calculated from the due date of the applicable tax return
- The tax benefit is computed on a “with and without basis”
- Payments under the TRA itself are treated as additional purchase price, and will therefore give rise to additional basis increases and “imputed interest.”
  - The additional basis increases have a compounding effect, in that they give rise to additional tax benefits and payments
  - The imputed interest (e.g., under § 483) also gives rise to tax benefits in the form of deductions

# Basic TRA Terms (cont'd)

## ■ Termination of the TRA

- The public entity may have the right to terminate the TRA at its election, in exchange for an “early termination payment.”
  - The payment is usually drafted as a present value of future payments to be made under the TRA, using a pre-determined discount rate and certain assumptions regarding the company’s future income and activities.
- A material breach of TRA obligations is typically a termination event as well

## ■ Change of Control

- Many TRAs provide that in the event of certain significant corporate transactions (involving mergers and significant changes to board composition), TRA payments will be calculated using certain assumptions or will be accelerated
  - These assumptions are intended to avoid distortions to TRA payouts that could otherwise result from mergers, etc. See further discussion below

# Basic TRA Terms (cont'd)

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- Subordination

- TRA payments are commonly subordinated to debt of the company

- Late Payments

- Late payments under the TRA bear interest at an agreed rate

- TRA Term

- Most TRAs have a term that lasts until all relevant tax benefits have been used or have expired (or until a termination and unwind of the TRA)

- No Clawback

- TRAs usually do not require a clawback in the event of subsequent disallowance of covered tax attributes, but generally do provide for an offset against future payments



# Common TRA Variations

- ▶ As TRA arrangements have evolved, certain issues and pressure points have arisen
  - New Basis versus Historic Basis
    - While most TRAs have traditionally compensated historic owners for benefits attributable to basis *increases* resulting from taxable exchanges, some TRAs have provided for payments in respect of *all* tax basis in the umbrella partnership's assets
  - TRAs on NOLs
    - TRAs may compensate historic owners for tax attributes (most prominently, net operating losses) that exist at the time of the IPO, most often as a result of mergers involving blocker corporations.

# Common TRA Variations (cont'd)

- TRAs involving attributes such as NOLs are often used in situations where a sponsor merges a pre-existing corporate entity into the IPO vehicle in a tax-free reorganization, and the IPO vehicle inherits the attributes under § 381 for future use.
- **Change of Control Situations**
  - As described above, many TRAs provide that in the event of certain significant corporate transactions (“change of control” events), TRA payments will be calculated using certain assumptions, or accelerated and based on certain assumptions.
  - One such assumption is typically that the company will have sufficient taxable income to use the available tax attributes in future years.

# Common TRA Variations (cont'd)

- The assumption relating to sufficient taxable income has the potential to give rise to TRA obligations in excess of the company's *actual* tax savings in future years (e.g., in years when taxable income is not in fact sufficient to use all available attributes)
  - IPO disclosures typically highlight that risk.
- In fact, where a TRA covers NOLs in existence at the time of the IPO, the assumption relating to sufficient taxable income can potentially give rise to a large payment in the year following the change of control
  - Consequently, several issuers have used more refined income assumptions, including those based on actual financial projections prepared for purposes of the TRA or for other financial reporting purposes



# Tax Treatment of TRAs

- TRA payments are most naturally characterized as additional proceeds of the exchange of umbrella partnership equity
  - A portion of the payments will be recharacterized as interest for tax purposes
- Since they are treated as sale proceeds, TRA payments are generally eligible to be reported under the “contingent payment” installment method of Treas. Reg. §15A.453-1
  - These rules will determine the period over which the taxpayer recovers his basis in the umbrella partnership units exchanged
- Taxpayers may elect out of installment method (§ 453(d))
  - In this case, the exchanging holder will recognize gain at the time of the exchange based on the value of the property received and the value of the TRA rights
  - While some taxpayers argue for “open transaction” treatment, the relevant regulations state that this treatment is available only in “rare and extraordinary cases”
- Treatment of TRAs involving existing attributes is more uncertain

# General & Procedural Aspects

# IRS Enforcement of Partnerships

- Enactment of BBA (2015)
  - “[T]he IRS intends to increase the number of partnership audits for both partnerships that are subject to the centralized partnership audit regime and partnerships that have elected out of the partnership audit regime.” REG-136118-15.
- Large Partnership Compliance program (2021)
- LB&I Focus Guide (2022)
- Inflation Reduction Act funding for IRS (2022)



# BBA Procedures

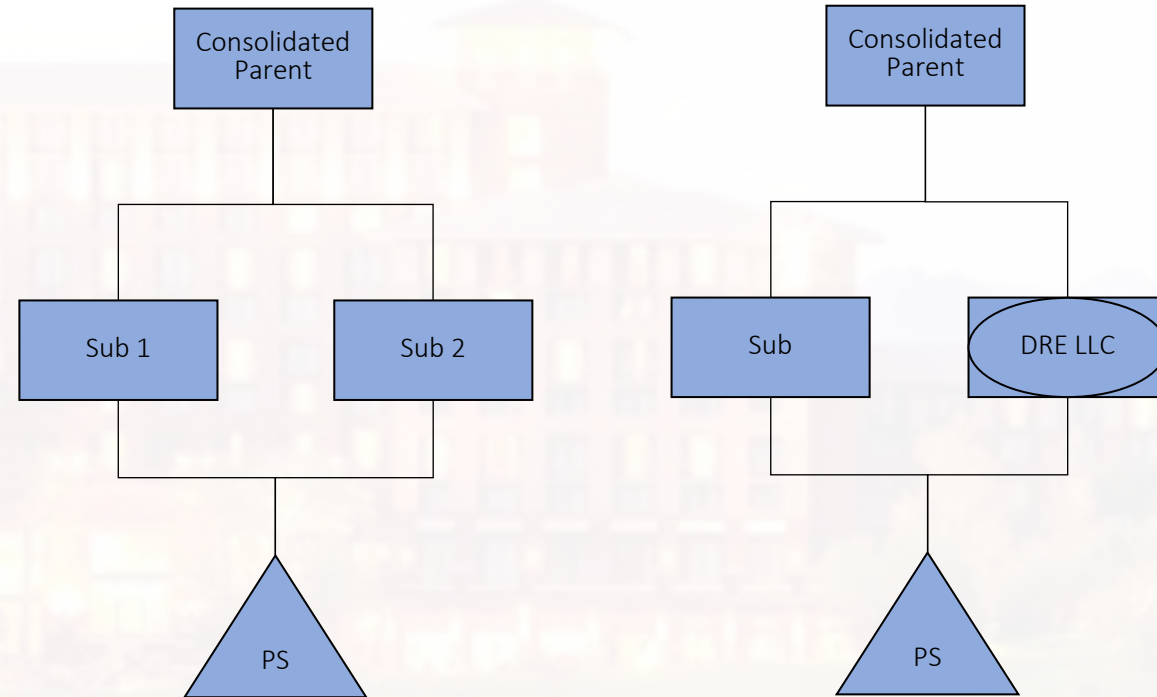
- Unified procedural regime governing partnership administrative and judicial proceedings
- Generally effective for tax years beginning after 2017
- Generally applies to all partnerships required to file a federal tax return under section 6031
  - Annual Opt-Out Election
  - Section 761(a)

# Key Aspects of BBA

- Partnership level audits and proceedings
- Partnership Representative has sole authority to act on behalf of partnership and partners
- Generally, the partnership is liable for imputed underpayments, penalties and interest resulting from adjustments to partnership-related items
  - Section 6226 Push-Out Election
  - Partnership Ceases to Exist
  - Partnership Fails to Pay Assessment
- Consistent reporting requirement

# Annual BBA Opt Out Election

- Eligibility
  - Types of Partners
  - Number of Partners
  - Annual Election





# Considerations for Taxpayers in CAP

- CAP taxpayer directly and indirectly owns 100% of a partnership
  - Transactions of the partnership can be considered in CAP before the partnership return is filed
- CAP taxpayer owns less than 100% of a partnership
  - Transactions of the partnership cannot be considered in CAP until the return is filed
- Impact of electing out of the BBA

# Computation of Imputed Underpayment

- Calculation in General
  - All adjustments to partnership-related items for the reviewed year are “appropriately” netted, and the resulting net amount is multiplied by the highest statutory tax rate applicable to an individual or corporation for the reviewed year
  - Adjustments are first separately determined (and netted as appropriate) within each category of items that are required to be taken into account as separately-stated items under section 702
- Special rules
  - Reallocations of items among partners
  - Limitations on adjustments that would reduce an imputed underpayment

# Imputed Underpayment Modifications

- The Partnership Representative may seek modifications to the imputed underpayment within 270 days from the NPA
  - Modifications that result in exclusions of certain adjustments
    - Partner amended returns or pull-in procedure alternative
    - Partners not subject to tax (e.g., U.S. tax-exempt partners, foreign partners, and state governments)
  - Rate modifications
  - Modifications to the number and composition of imputed underpayments
- Any modification requires the approval of the IRS



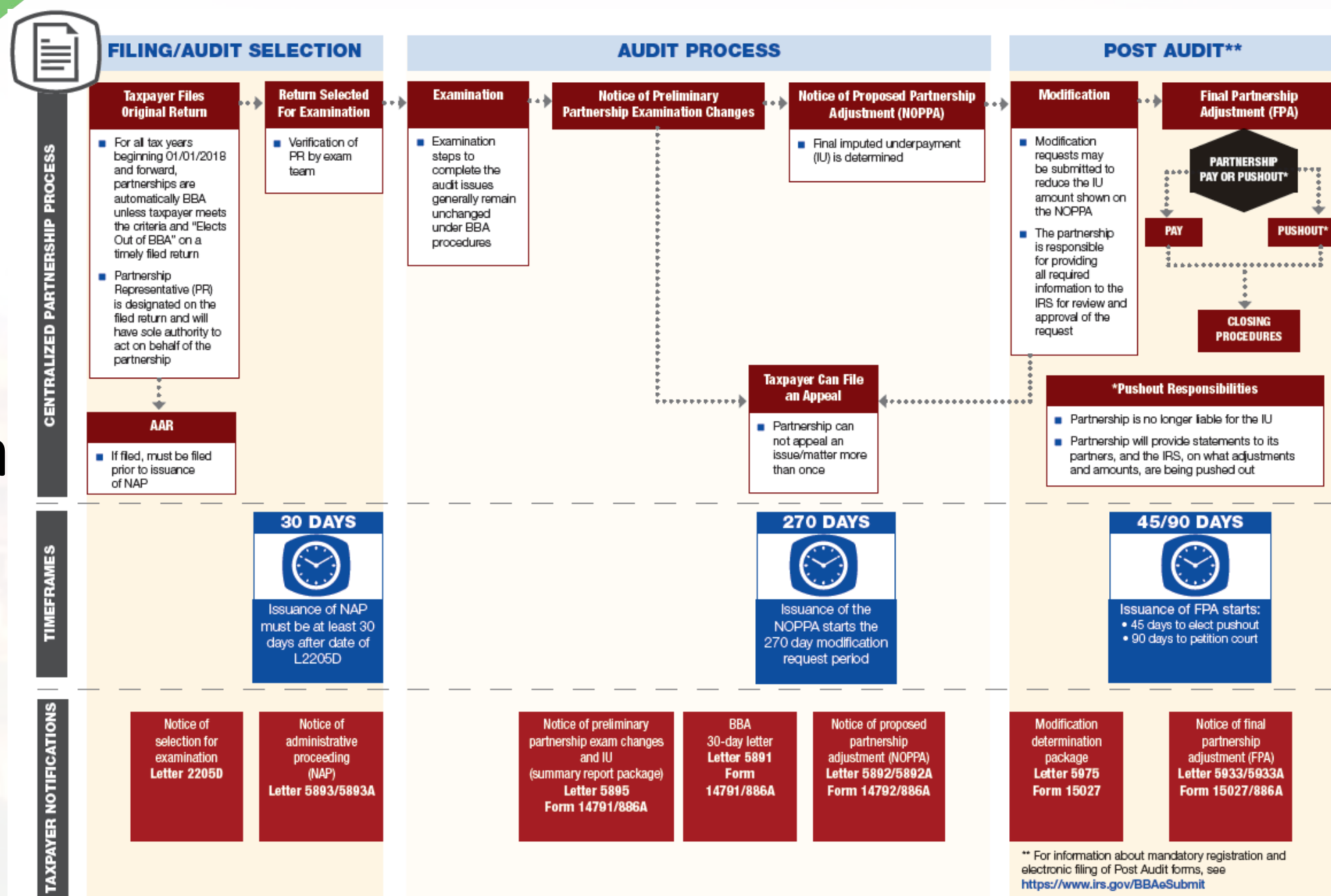
# Push-Out Election

- The partnership will not be liable for an imputed underpayment if the partnership:
  - Elects the application of section 6226 no later than 45 days after the date of the final notice of adjustment from the IRS, and
  - Furnishes a statement (“6226 Statement”) to each partner for the reviewed year AND to the IRS showing the partner’s share of any adjustment to a partnership-related item and certain other information
    - 6226 Statements are required to be furnished within 60 days after the adjustments become final

# Effect of Push-Out Election

- Effect of section 6226 election on partner tax liability
  - The tax liability of a partner for the taxable year, which includes the date of the 6226 Statement, will be increased or decreased by the sum of:
    - The amount that the partner's tax liability in the reviewed year would increase or decrease as a result of the adjustment, plus
    - The amount that the partner's tax liability would increase or decrease for all subsequent years as a result of changes in tax attributes during such years
- Interest is imposed at the partner level at the federal short-term rate plus 5% (rather than 3%)

# Timeline of a BBA Audit





# BBA Provisions in Partnership Agreements and Purchase Agreements

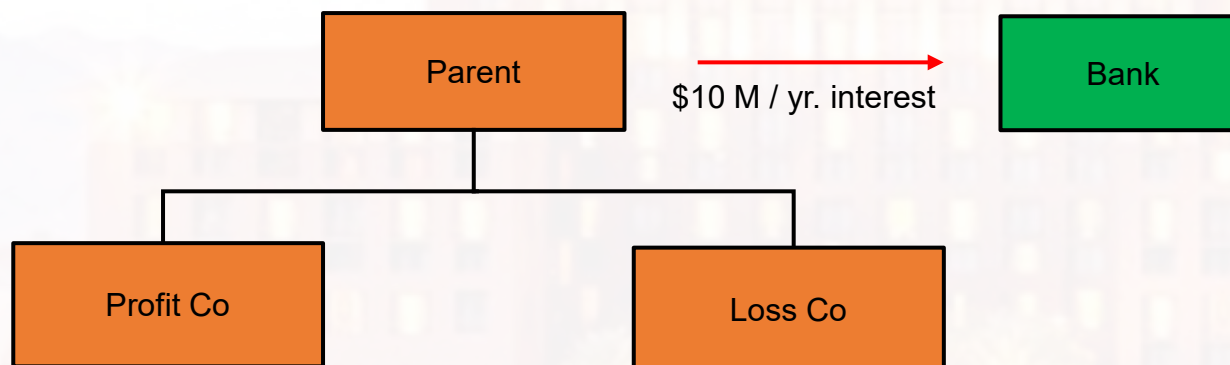
- Management Control
  - Partnership Representative
  - Statutory/Regulatory Authority vs. Contractual Authority
  - Rights and obligations of the partners
- Economic Sharing of Partnership-Level Liabilities

# Box & Triangle Tax Planning

- Partnerships wholly owned by members of a consolidated group are not members of the consolidated group
  - Treas. Reg. § 1.1502-13 will not apply to defer gains and losses resulting from transactions between partnerships and members of a consolidated group
  - Section 267 will apply to disallow losses resulting from many transactions between partnerships and members of a consolidated group
  - Contributing property from consolidated group members to a partnership wholly owned by group members will result in the acceleration of any deferred gain with respect to such property
- Each member of a consolidated group that is a partner in a partnership has its own capital account
- The interaction of subchapter K and the consolidated return regulations is often uncertain



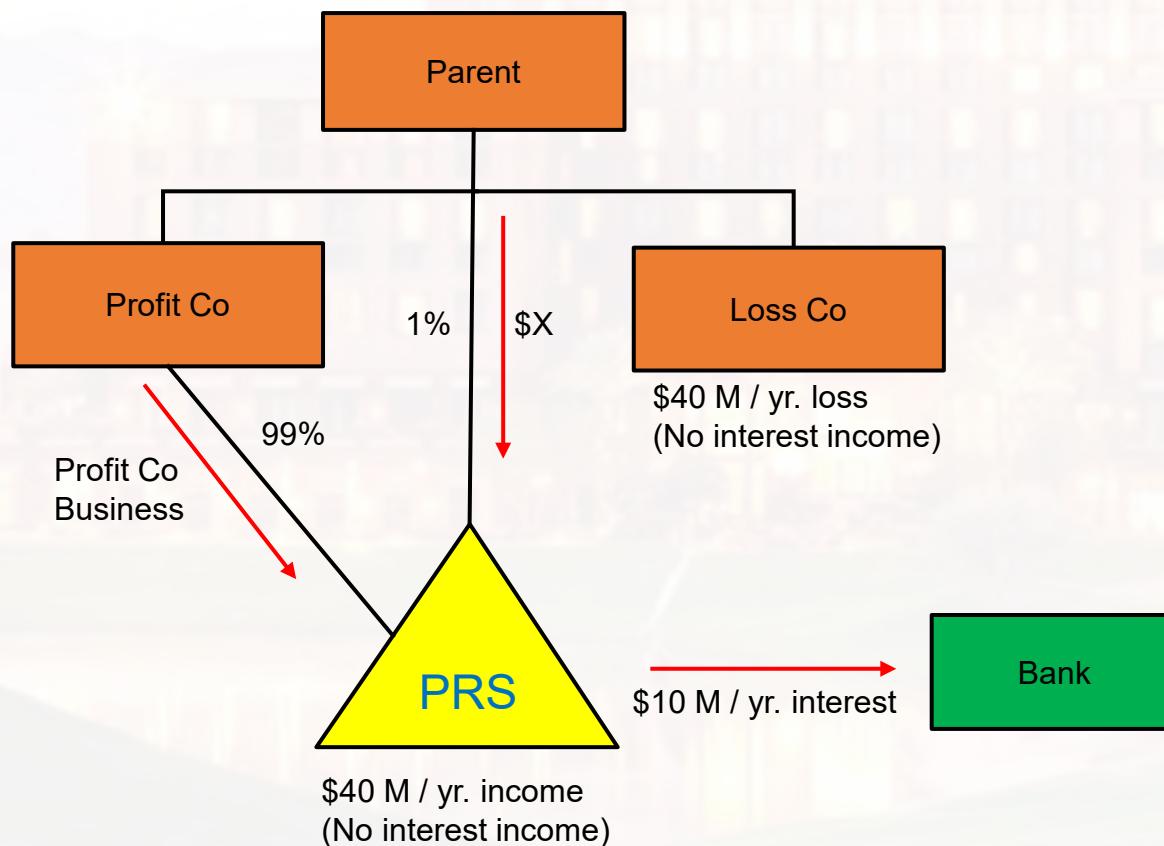
## Section 163(j) – Consolidated Returns & Partnerships



### Section 163(j) Key Considerations

- Corporations filing a consolidated return calculate the section 163(j) on a group wide basis
- Parent group ATI = \$0
- Parent group section 163(j) limitation = \$0
- Parent interest expense becomes Excess Interest Expense carried forward to the following year

## Section 163(j) – Consolidated Returns & Partnerships



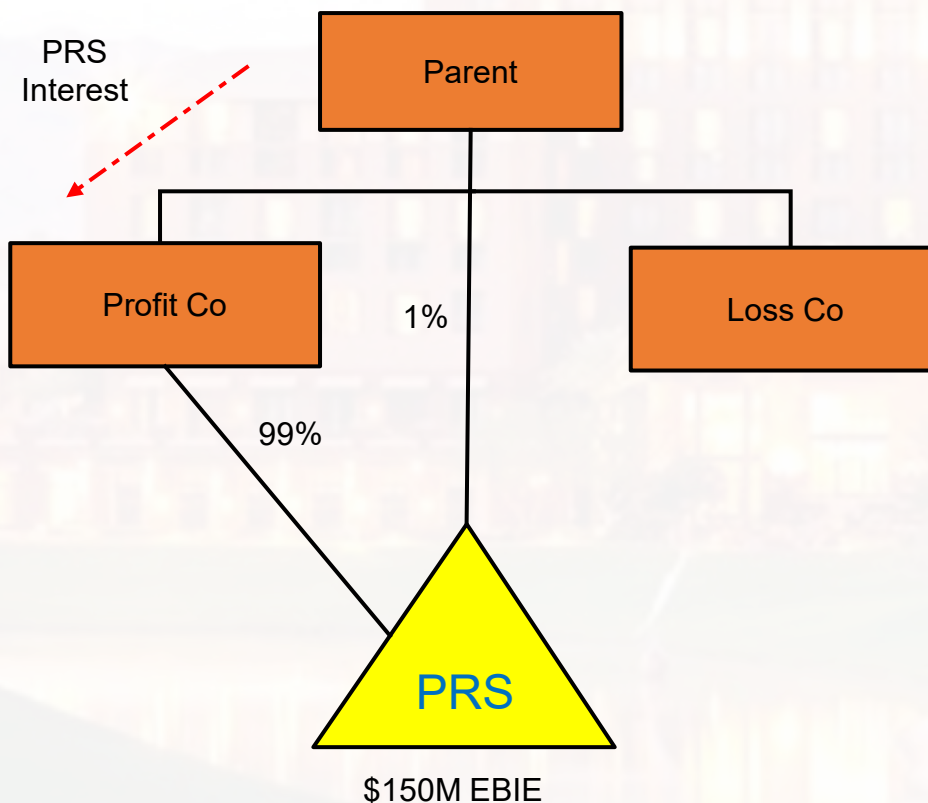
### Section 163(j) Key Considerations

- Partnerships calculate a section 163(j) limitation on an entity basis
- PRS ATI = \$40M
- PRS163(j) limitation = \$12M
- Parent has \$10M NOL carryforward

### Other Key Considerations

- Deferred intercompany gains could be accelerated as a result of the contribution of the Profit Co assets to PRS
- No deferral on taxable transactions between PRS and members of Parent consolidated group
- Treas. Reg. section 1.701-2 partnership anti-abuse rule
- Economic substance
- Impact on other attributes of freeing up current year interest deductions (e.g., section 250 deduction, foreign tax credits)

## Section 163(j) – Consolidated Returns & Partnerships

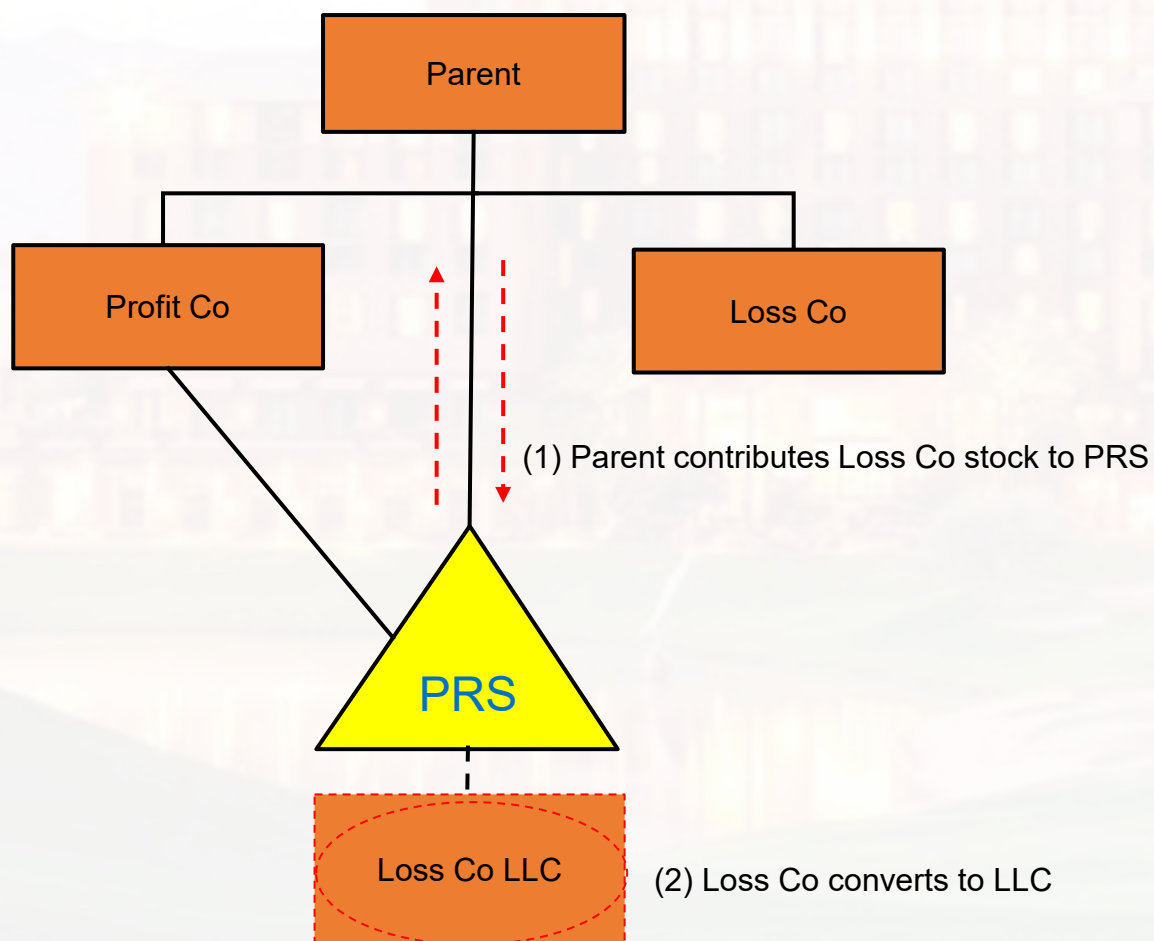


### Section 163(j) Key Considerations

- Parent and Profit Co decrease basis in PRS interests each year EBIE.
- Under Rev. Rul. 99-6, PRS is deemed to liquidate and Parent is deemed to transfer a 1% undivided interest in PRS to Profit Co.
- When the partnership terminates with unused EBIE, the basis increases are reversed subject to certain limitations. Treas. Reg. § 1.163(j)-6(h)(3).
- Under section 732(b), the increased basis is allocated to assets of PRS.



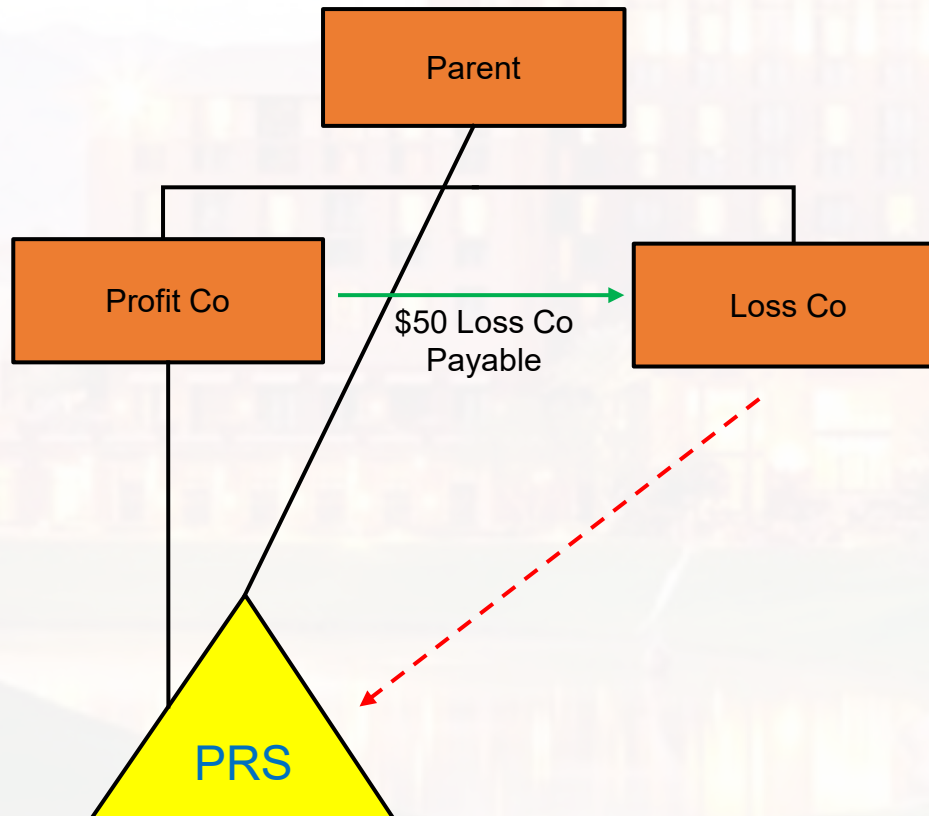
## Section 163(j) – Consolidated Returns & Partnerships



### Key Considerations

- Parent contribution of Loss Co stock to PRS is intended to qualify as tax-free under section 721
- Conversion of Loss Co LLC intended to qualify as a taxable liquidation under sections 331 and 336
- Unlike in a typical Granite Trust transaction, 100% of the stock loss would be recognized in the conversion of Loss Co LLC
- Step Transaction Doctrine
- Treas. Reg. section 1.701-2 partnership anti-abuse rule
- Economic substance
- What if PRS is newly formed?

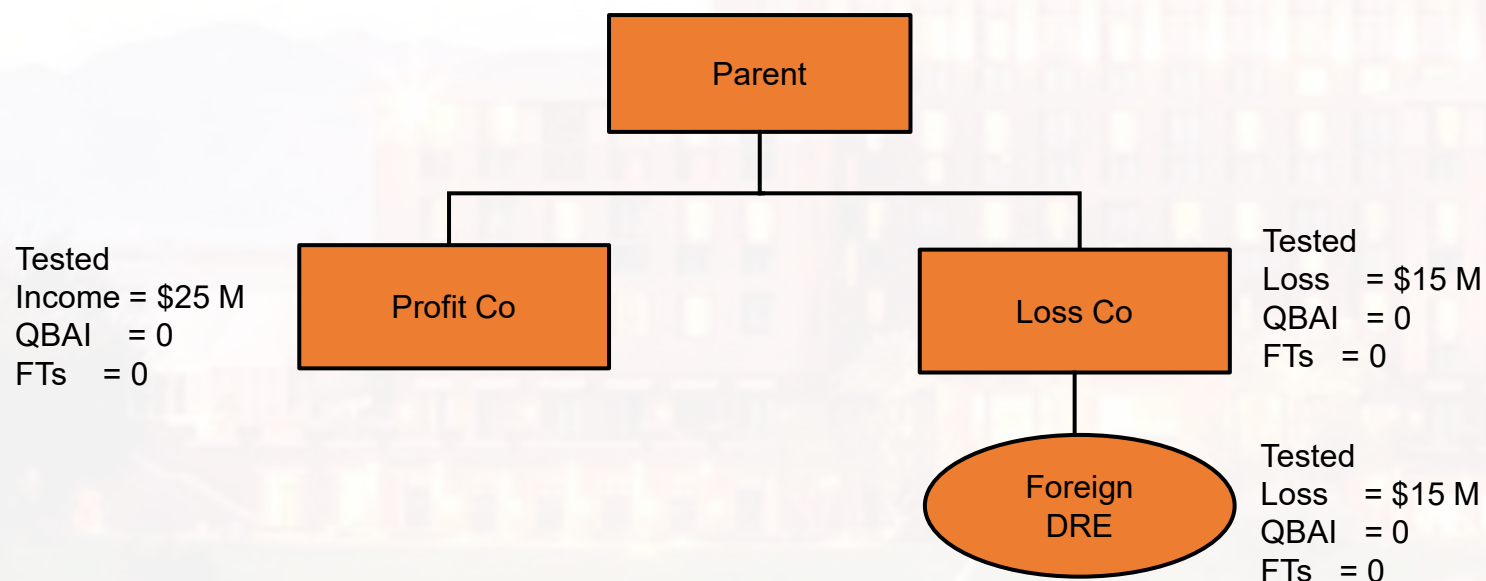
## Section 163(j) – Consolidated Returns & Partnerships



### Key Considerations

- Merger of Loss Co into PRS is intended to qualify as tax-free asset transfer under section 721
- If the Loss Co payable is good debt for federal income tax purposes, Parent could recognize a loss on Loss Co stock under section 165(g)(3)
- What if Loss Co Payable is not good debt for federal income tax purposes?
- Step Transaction Doctrine
- Treas. Reg. section 1.701-2 partnership anti-abuse rule
- Economic substance

## CFCs & Partnerships – Are you lost or GILTI?



### Section 951A Key Considerations

- GILTI is equal to net tested income over net deemed tangible income return (Net DTIR)
- Net DTIR = 10% of qualified business asset investment (QBAI) – specified interest expense
- Parent's Net tested income = \$20 M
- Parent's FTCs = \$0
- QBAI included in Net DTIR = \$0
- Parent's Incremental US Tax  

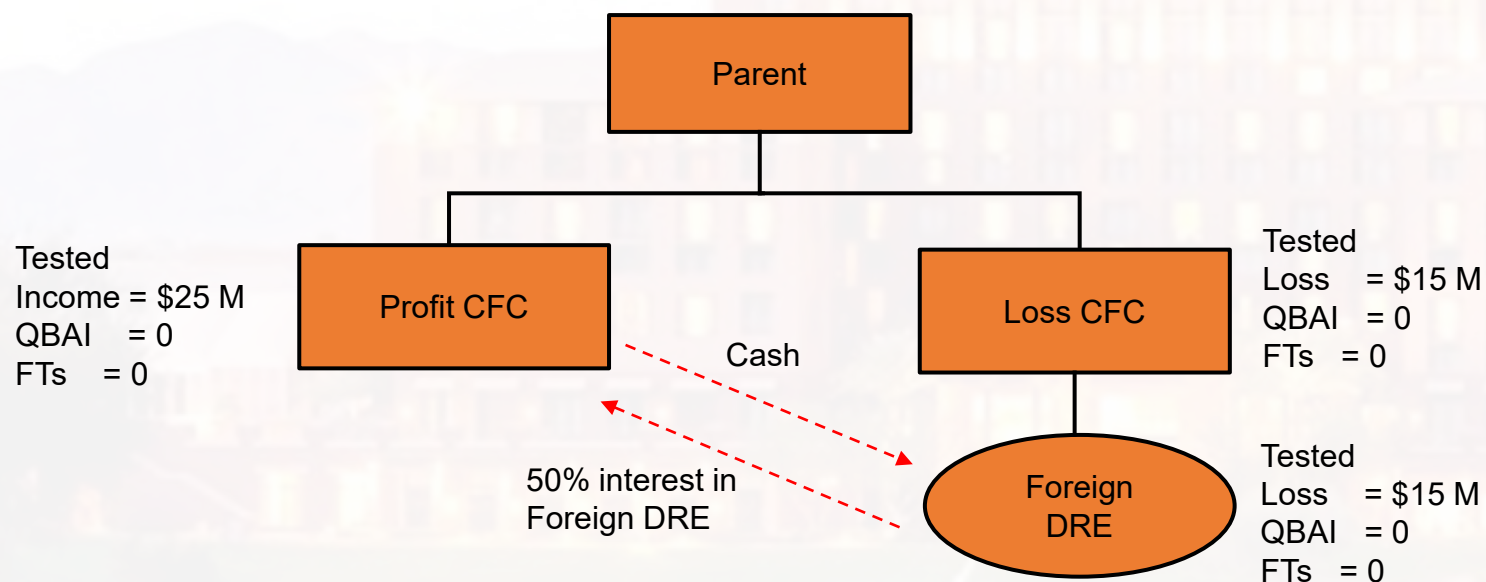
$$\text{US Tax} = \$20 \text{ M GILTI} \times 10.5\% = \$2,100,000$$

$$\text{FTCs} = \underline{(\$0)}$$

$$\mathbf{\$2,100,000}$$

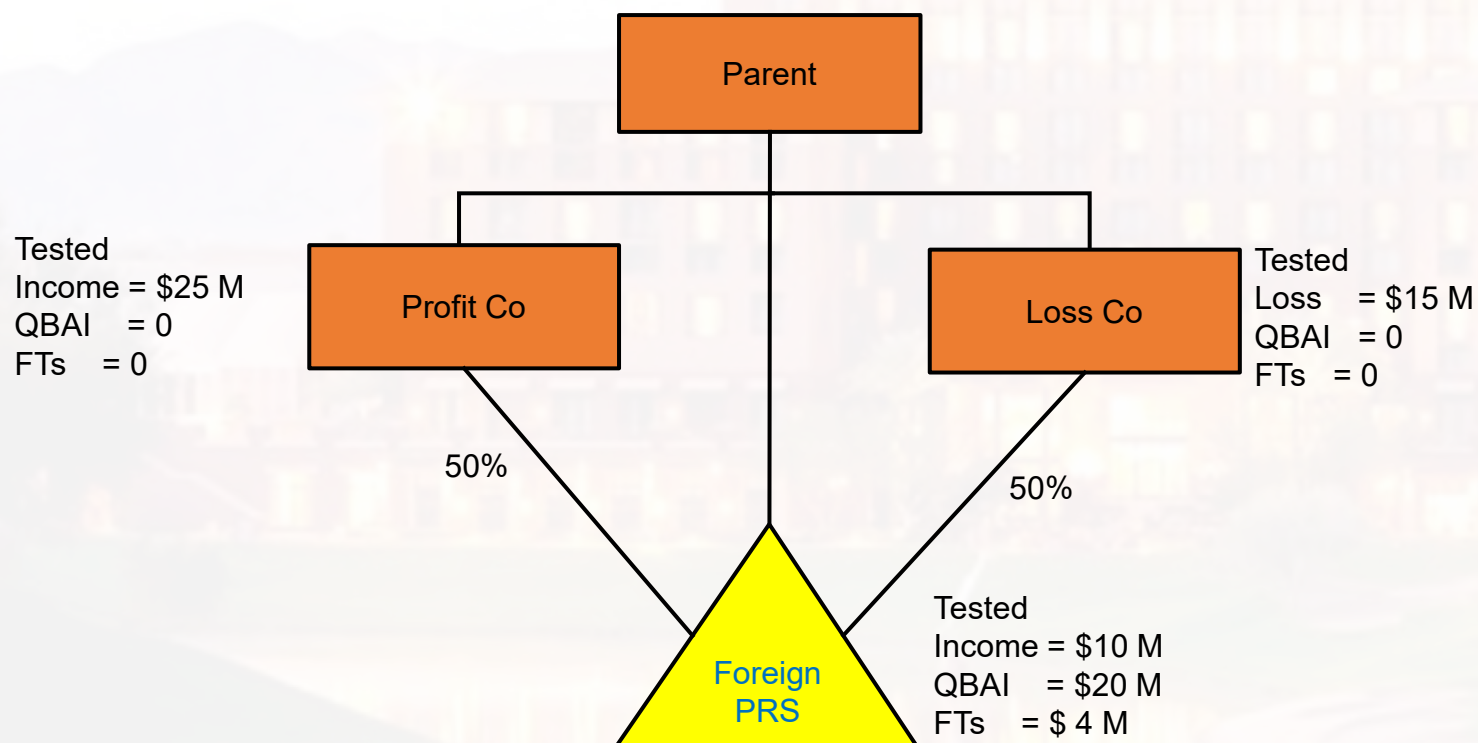


## CFCs & Partnerships – Are you lost or GILTI?



- Profit CFC contributes cash to foreign DRE in exchange for a 50% interest in foreign DRE.

## Section 163(j) – Consolidated Returns & Partnerships



### Section 951A Key Considerations

- 50% of the tested income of Foreign PRS is included in the tested income of Profit CFC
- 50% of Foreign PRS QBAI is included in Profit CFC's QBAI (\$10 M QBAI and \$1 M Net DTIR)
- 50% of Foreign PRS FTs are available to offset tax on Parent's GILTI inclusion (\$2 M → reduced by Parent's "inclusion percentage" and 20% haircut)
- Parent's Incremental US Tax  

$$\text{US Tax} = \$19 \text{ M GILTI} \times 10.5\% = \$1,995,000$$

$$\text{FTCs} = \$2 \text{ M FTs} \times 95\% \times 80\% = (\$1,520,000)$$

$$\mathbf{\$475,000}$$
- Special allocations?

