The Evolution of the UP-C

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In this report, DeSalvo describes the evolution of the umbrella partnership C corporation (UP-C) structure and discusses anticipated effects of the Tax Cuts and Jobs Act in the UP-C context.

The information in this report is of a general nature and based on authorities that are subject to change. Its applicability to specific situations should be determined through consultation with your tax adviser. The report represents the views of the author only and does not necessarily represent the views or professional advice of KPMG.

I. General UP-C Structure Characteristics

To understand why companies and their advisers continue to use the UP-C structure, it is necessary to quickly revisit some UP-C characteristics and the benefits inherent in implementing the structure. In general, a company that operates a business though an entity that is treated as a partnership for U.S. federal income tax purposes and that requires funding for some business purpose (for example,

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This report is a companion piece to another discussion on the umbrella partnership C corporation (UP-C) structure. The prior article covers the general overview of the structure as used in initial public offerings and presents the benefits and potential pitfalls of implementing and maintaining the structure. As the title of the previous article suggests, the UP-C transaction has not only persevered as a viable strategy but also evolved beyond its paradigm IPO context. During the past few years, companies have been using the umbrella partnership in other mergers and acquisitions contexts.

The ensuing discussion lays out the evolution of the UP-C structure by describing (1) the UP-C structure and its characteristics; (2) the use of the UP-C in the context of a special purpose acquisition company transaction; (3) UP-C joint ventures and carveouts (for example, a synthetic spinoff); and (4) some anticipated effects of new tax laws implemented by the Tax Cuts and Jobs Act (P.L. 115-97) (tax reform) in the UP-C context.

I. General UP-C Structure Characteristics

To understand why companies and their advisers continue to use the UP-C structure, it is necessary to quickly revisit some UP-C characteristics and the benefits inherent in implementing the structure. In general, a company that operates a business though an entity that is treated as a partnership for U.S. federal income tax purposes and that requires funding for some business purpose (for example,
paying down debt, redemption of an existing owner, or greenfield development projects) may consider using an UP-C IPO structure to maximize proceeds. While there may be other reasons to implement such a structure, the following are the key value drivers for implementing an UP-C:

- historical owners may retain their economic ownership interests in a flow-through entity for U.S. federal income tax purposes, and therefore they may benefit from one level of income tax at the partner level, a flexible ownership structure, tax-deferred cash distributions, and outside tax basis increase from income allocations, potentially reducing taxable gain on the sale of the partnership interests;
- the UP-C structure provides the historical equity owners in the operating partnership with an avenue to monetize their ownership interests by using the exchange right mechanism;
- through the tax receivable agreement (TRA), the historical owners may receive incremental proceeds in the form of TRA payments from the corporate counterparty as contingent proceeds when the corporation realizes cash tax savings resulting from tax attributes subject to the terms of the TRA; and
- the corporate entity typically retains a portion of the cash tax savings realized from the tax attributes that are delivered to the corporation either during the formation of the UP-C structure or through a subsequent event (for example, the tax basis step-up from the purchase of partnership units from a historical owner exercising its exchange right).

The benefits noted above apply to the more common UP-C IPO, but they are also desirable characteristics for other structures that may not fall squarely into the more traditional UP-C IPO profile. For example, a company might be looking to sell its business by marketing its equity in a sell-side effort. In that case, it may be prudent to target buyers that value the benefits of the partnership structure and the increased tax basis generated from the purchase of partnership units. One type of buyer that has demonstrated its desire to acquire flow-through entities and its willingness to enter into a TRA with the seller is a special purpose acquisition company (SPAC). The SPAC UP-C is a close relative of the traditional UP-C IPO and is discussed in more detail in the following section.

II. The SPAC UP-C

A transaction structure very similar to a traditional UP-C IPO is the SPAC UP-C. In this structure, the SPAC is a “blank check” company that has been established by an existing sponsor for the purpose of raising funds and acquiring a target business. The SPAC is then funded via an IPO and often a private investment in public equity (PIPE). The partnership that is the subject of the UP-C structure is the target company for the SPAC acquisition.

The resulting structure in a SPAC UP-C is comparable to a traditional UP-C IPO. An existing flow-through entity is the operating company, partially owned by an upper-tier public corporation (in this case, the SPAC) and partially owned by the historical partnership owners. Also, the structure likely contains the exchange rights noted above, whereby the historical owners retain a right to exchange or redeem operating partnership units for public company equity or cash. Finally, these structures also typically include the use of a TRA for payment to the historical owners for a percentage of cash tax savings realized at the SPAC public company from the exchanges or pre-transaction attributes subject to the TRA.

A. Unique Business and Process Considerations

While the resulting post-transaction structure looks similar (if not identical) to a traditional UP-C IPO, the SPAC UP-C has some distinct differences that can result in unique business decisions and tax consequences. The primary difference is that there are at least two parties negotiating in a SPAC UP-C in a more typical buy-side M&A process. Because of the adversarial nature of the relationship between buyers and sellers, the SPAC UP-C process takes on a much different character than its UP-C IPO counterpart. Primarily, the transaction process will include the typical buy-side financial, legal, and tax due diligence procedures that are sometimes
minimized in an UP-C IPO. The practical effect is that these processes could result in increased time and effort for the company and its advisers, and in some cases result in terminating the negotiated acquisition when diligence uncovers any material deficiencies (for example, financial, accounting, tax, or otherwise) of the operating company.²

SPAC owners are also generally sophisticated financial or strategic owners, which are well represented by other legal and accounting firms. There will likely be more strenuous negotiations surrounding various deal points in a SPAC UP-C, including target equity value; disposition and restructuring of unwanted assets; post-transaction considerations like management incentive plans and equity compensation as well as the definitive terms of the limited liability company agreement³ and the TRA. Focusing on the terms of the TRA, it is more likely in a SPAC UP-C that the parties ultimately deviate from other UP-C market precedents regarding the

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²Section 1101 of the Bipartisan Budget Act of 2015, P.L. 114-74, enacted into law a new centralized partnership audit regime (CPAR), which assesses and collects tax at the partnership level. Thus, with the prospect of potential entity-level historical tax liability, taxpayers considering partnership M&A may apply heightened scrutiny to diligence procedures than were typically imposed before the new audit regime.

³Taxpayers acquiring partnership interests should focus on the practical impact of acquiring such interests and may negotiate favorable partnership agreement terms, including which partner controls preparing and filing the partnership tax returns as well as terms connected with CPAR elections and the partnership representative.
sharing percentage and computation method when calculating tax benefit payments.4

B. Discrete Tax Considerations

In addition to the business considerations above, the SPAC UP-C brings with it unique tax issues because of the nature of the blank check entity. These entities are typically formed and raise cash through either an IPO or PIPE funding. This occurs sufficiently in advance of an acquisition so that the funds may be held in an interest-bearing account for some time. This approach certainly makes sense from a business perspective because no private equity fund or large strategic owner prefers to hold substantial amounts of cash (for example, hundreds of millions of dollars) in a non-interest-bearing account for any discernible period. The result from a tax perspective, however, could be adverse and surprising if it isn’t identified by the company or its tax adviser.

1. Personal holding company and accumulated earnings tax issues.

Potential traps to consider include the personal holding company (PHC) tax and the accumulated earnings tax (AET), both of which impose a 20 percent corporate-level tax on some undistributed income.5

A PHC is defined as a U.S. corporation for which at least 60 percent of its gross income for the tax year is PHC income (for example, passive-type income, including interest income) and more than 50 percent of the value of outstanding stock is owned directly or indirectly by five or fewer individuals at any time during the last half of the tax year.7 If a corporation is classified as a PHC for a tax year, the current tax year undistributed PHC income8 is subject to a 20 percent corporate tax, which is thus borne by all investors because it would be an entity-level cash tax liability. Taxpayers and advisers that are aware of how those rules apply may be able to mitigate or avoid PHC classification by careful structuring and deliberate planning when considering how and when to capitalize the SPAC.

If a corporation is not a PHC, it may be subject to the AET.9 Generally, the AET imposes a 20 percent tax on the accumulated taxable income of any corporation “formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.”10 Unlike the PHC tax, the AET is not self-assessed; rather, it is assessed by the IRS upon an audit.

In general, both the determination of the relevant intent and the calculation of the AET focus on whether the corporation distributes or retains earnings for reasonable business needs. A corporation that constitutes a mere investment or holding company is subject to especially strict rules.11 For purposes of determining whether a corporation is engaged in a business, the regulations provide that “the business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake.” Further, while the regulations permit an accumulation for

4 For example, most UP-C structures use an 85 percent sharing ratio when calculating the tax benefit payments within the terms of the TRA (for example, the recipient of the TRA tax benefit payments receives a payment for 85 percent of the actual cash tax savings realized by the corporation using the TRA attributes). This percentage is one of the key TRA terms that could be negotiated in the context of a SPAC UP-C, as well as an UP-C joint venture, as discussed infra.

5 Sections 541 and 531.

6 Section 543 defines personal holding company income as gross income from dividends, interest, royalties, rents, and other similar passive income type items (with specific allowed adjustments).

7 Section 542. When determining stock ownership for purposes of PHC classification, section 544(a)(4) provides constructive ownership rules for partnerships and states that “an individual shall be considered as owning the stock owned, directly or indirectly . . . by or for his partner.” Also, options to acquire stock and convertible securities may be considered outstanding stock owned by the holders of those options or convertible securities for purposes of testing PHC status. For SPAC owners in a partnership structure or that hold options and convertible securities, like many private equity and asset management funds, the constructive ownership rules could present issues, and a corporation could unwittingly fall into the definition of PHC because of constructive ownership of SPAC shares.

8 Section 544 defines “undistributed personal holding company income,” which starts with the corporation’s taxable income and then includes taxes, dividends, and net operating losses.

9 Section 532(b)(1) provides that the AET will not apply to a PHC.

10 Sections 531 and 532.

11 See, e.g., section 533(b); reg. section 1.533-3(b)(1); and ILM 201653017.
future needs of a business, the corporation should have “specific, definite, and feasible plans for the use of such accumulation.” Also, the regulations provide that a corporation may be viewed as engaging in the business of a controlled corporate subsidiary under some circumstances; case law has extended the look-through rule to some controlling interests in partnerships.

While a detailed discussion of the AET is beyond the scope of this report, taxpayers should be aware of the issue. By the time that a SPAC has earned income, if it is not already engaged in an existing business, it should document that it is actively engaged in its search for controlling interests in partnerships that themselves engage in a business.

2. The passive foreign investment company issue.

A second potential pitfall for an unsuspecting taxpayer in a SPAC UP-C structure is the application of the passive foreign investment company regime. While the PHC rules apply only to U.S. corporations, the PFIC rules set a similar trap for U.S. shareholders in a foreign corporation that holds passive income (that is, interest income). In the SPAC UP-C context, these rules should be considered when the SPAC sponsors form a foreign corporation as the corporate blank check company. A foreign corporation could be treated as a PFIC if (1) at least 75 percent of its gross income is passive income for the tax year, or (2) during the tax year, the corporation held on average at least 50 percent of its assets (measured by either value or adjusted tax basis, depending on the corporation) producing passive income or held for the production of passive income. The gross income test could result in an otherwise active business being cast as a PFIC in early years when passive types of income, like interest, make up substantially all of the corporation’s gross income.

There are a few significant issues with falling into the PFIC stock classification. First, once stock in the hands of a shareholder is considered PFIC stock, it will always be treated as such for U.S. federal income tax purposes unless active measures are taken to cleanse the PFIC taint. For example, assume a SPAC is formed and funded with cash in October 2017, and the only activity of the entity for the short tax period through December 31, 2017, included holding cash and accruing interest income from an interest-bearing account. Then, in the fourth quarter of 2018, funds are used to acquire an active trade or business. Regardless of prospective active business operations, since the corporation was likely a PFIC in 2017 (that is, it failed at least one of the passive gross income or passive asset tests and could not qualify for the start-up year exception), due to the “once a PFIC, always a PFIC” rule, a shareholder’s stock in the SPAC may always be treated as PFIC stock if the shareholder’s holding period included the short period in 2017.

Second, the penalty for being characterized as a PFIC is unduly burdensome and can have some draconian results. In general, if a corporation falls under the purview of section 1291 (that is, a PFIC), its U.S. shareholders may be taxed and charged interest on any deemed tax deferral upon receipt of an “excess distribution” from the PFIC. A U.S. investor will be liable for the PFIC tax and interest

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12 Reg. section 1.537-1(b)(1).
13 Reg. section 1.535-3(b); Advanced Delivery and Chemical Systems Nevada Inc. v. Commissioner, T.C. Memo. 2003-250 (applies look-through rule to controlled partnership).
14 The acquisition of noncontrolling interests in partnerships raises AET issues beyond the scope of this report.
15 Sections 1291 through 1297.
16 However, section 1297(d) provides for an overlap rule if a shareholder is both a PFIC shareholder and a shareholder of a controlled foreign corporation, and in this case the CFC rules will apply and the shareholder will not be subject to the PFIC regime.
17 Sponsors may decide to form a foreign corporation as the public registrant for various tax and business purposes. If, for example, the initial strategy is to acquire foreign assets, it may be more prudent to hold these assets in a foreign entity because of tax rate differences rather than subject foreign operations to U.S. tax. There may also be business and marketing considerations that could make a foreign entity more desirable than a U.S. corporation, depending on the anticipated or targeted investor base for the SPAC.
18 Section 1297. For a more detailed discussion of PFIC rules and pitfalls, see Monica Giannini, “PFICs Gone Wild!” 29 Akron Tax J. 29 (2014).
19 Section 1298 provides that stock held by a taxpayer will be considered PFIC stock if at any time during the taxpayer’s holding period the corporation was a PFIC. To cleanse itself of the PFIC taint, a taxpayer must ensure that either the corporation makes a qualified electing fund election or the taxpayer makes a mark-to-market election each year.
20 Section 1298(b)(2) excepts some corporations from PFIC status in the first tax year the corporation has gross income, but only if no predecessor corporation was a PFIC and the corporation is not a PFIC in either of the first two years after the start-up year. In the example infra, the SPAC would likely fail the passive asset test in the first year following the start-up year because it held cash (a passive asset, see Notice 88-22, 1988-1 C.B. 489) for most of the tax year.
21 See section 1291(b) for the definition of excess distribution.
upon receiving a distribution from a PFIC or on gain realized from the disposition of PFIC shares. The excess distribution that is taxed is allocated ratably to each day of the entire holding period of the U.S. shareholder and applies the highest marginal tax rate in effect for that year. Thus, when a U.S. taxpayer has held PFIC shares for many years without receiving distributions, the tax and interest liability upon sale of PFIC stock may be well in excess of the current year tax rates.

Finally, the avenues available to a U.S. shareholder to potentially avoid the excess distribution interest charges can be challenging and yield undesirable results. Under the qualified electing fund (QEF) election, each U.S. taxpayer would include in income its share of the corporation’s ordinary income earnings and capital gain for each year. Once a taxpayer elects to treat a PFIC as a QEF, this classification applies to all future tax years unless it is revoked by the taxpayer with IRS consent. Another available election is the mark-to-market election, which is available only for marketable securities. This election allows a taxpayer to mark its PFIC shares to fair market value at the end of the tax year and include the excess gain or loss (limited to prior year gain) on the PFIC shares. While those alternatives could mitigate the possibility of harsh penalties on monetizing value from PFICs, they require current inclusion on phantom income and at best mitigate the effect of the PFIC regime.

While advising clients considering the use of a SPAC UP-C, tax advisers should be sure to consider the discrete business and tax considerations listed above. These common issues might not be matters at the top of the mind for the legal, finance, or business teams driving investment and capitalization decisions. However, decisions such as choice of domestic or foreign entity and how to fund the entity can have major tax consequences. Thus, tax professionals should be sure to stay close to all facets of the transaction team early in the process to ensure all structure and tax-related matters are considered throughout the SPAC UP-C transactions.

III. The UP-C Joint Venture

A further evolution of the typical umbrella partnership structure is the use of the UP-C by two third parties to engage in a business combination using a joint venture. Unlike its UP-C IPO and SPAC UP-C brethren, which both involve a new public company and the infusion of public cash, the UP-C joint venture is implemented by established operating entities, typically in similar lines of business. Because there are two existing companies involved in an UP-C joint venture, there is likely a well-advised tax team on each side of the transaction. Like the SPAC UP-C, this will result in a more traditional M&A deal process between two third parties, including all diligence procedures typically present in the deal setting. Unlike the other UP-C structures, however, the joint venture includes merging two separate operating entities and therefore can result in more complex tax structuring, operational, and administrative challenges.

The following is a simplified example of a potential UP-C joint venture transaction: PubCo 1 operates Business 1 and is interested in acquiring Business 2, one of PubCo 2’s business lines. The parties agree that in lieu of an outright sale, they will form a joint venture while giving PubCo 1 the option to acquire PubCo 2’s equity in the newly formed partnership at some future date. The result of the agreement is to combine Business 1 and Business 2 in a partnership between PubCo 1 and PubCo 2, with the potential of a staged sell-down of equity through an exchange right agreement. As part of the business deal, PubCo 1 and PubCo 2 agree to a TRA, whereby PubCo 1 will pay PubCo 2 some percentage of actual cash tax savings realized from the tax attributes acquired as part of the eventual purchase of partnership units. (See Figure 2.)

A. Unique Business and Process Considerations

Like the SPAC UP-C, the UP-C joint venture involves at least two parties negotiating the transaction, and therefore the process should include the standard diligence process between
quasi-adversarial parties. What is different in the joint venture arena, however, is that both parties are likely to perform tax, legal, and financial diligence (among others) because each will be a partner in the partnership and share in the combined business operations. This increased scrutiny on each business may ultimately result in a longer transaction process and potentially increased costs to implement the joint venture.

In addition to heightened diligence procedures, the TRA negotiations will be between two established companies with boards looking out for the best interests of each entity’s stakeholders. As the TRA liability may be a substantial value, each party should work with the appropriate tax specialists to model the potential tax effects of prospective transactions (including those that may trigger a TRA liability), and each company should be well armed with support to argue for one value or another. Due to the significant potential TRA amount and well-advised nature of the parties, negotiations will be more closely debated and could result in TRA terms that are substantially different from a traditional UP-C IPO or SPAC UP-C. Examples of altered terms may include a reduced TRA sharing ratio (for example, 50 percent of realized tax benefits in lieu of the market precedent 85 percent), simplifying assumptions regarding value allocation of tax basis step-up and recovery of the tax basis, and one-time upfront payments of TRA liabilities at the time of an exchange (for example, incremental sales proceeds after
applying agreed-upon tax basis use assumptions and present value discount rate).

B. Discrete Tax Considerations

On top of the unique deal considerations discussed above, the UP-C joint venture brings a variety of interesting and distinctive tax issues. Unlike the UP-C IPO and SPAC UP-C, the joint venture structure includes the formation of a partnership and the potential staged acquisition of a target. Therefore, it carries with it the potential for restructuring problems in anticipation of the business combination as well as the nuances related to partnership formation transactions, including the treatment of contributed built-in gain and built-in loss property and the effect of debt and the partnership disguised sale rules. Although not an exhaustive list, the following issues are significant when considering an UP-C joint venture and are more fully discussed below.

1. Tax consequences of internal restructuring.

As discussed above, an UP-C joint venture may involve one party targeting the acquisition of a specific business unit of the other party. In the example depicted in Figure 2, PubCo 1 is interested in combining with one of the businesses held by PubCo 2 but not the unwanted assets. As there is an unwanted business segment within the structure, there is likely some form of pre-merger restructuring required by one or both partners. For example, when PubCo 2 is carving out Business 2 (“Target”), it will likely undergo some form of internal division or reorganization to ensure that Target’s business line is separated and ready for an efficient combination with the other joint venture business.

Advisers structuring these reorganizations must consider tax ramifications of the restructuring, including potential triggering of deferred intercompany gains attributable to deconsolidation, tax basis adjustments attributable to distribution of equity or assets out of a holding company, and recapture of overall foreign losses on the disposition of controlled foreign corporation shares. These few issues are merely representative examples, and companies considering a business reorganization in connection with an UP-C joint venture should carefully consider the tax consequences of the restructuring, including potential structure alternatives to mitigate unwanted results. As with most areas of tax consultation, well-advised clients should work collaboratively with their tax advisers to model out the numerical effect of the structure alternatives.

2. The section 704(c) struggle.

An issue of paramount importance when dealing with the formation of a partnership is how to apply the concepts of section 704(c). In general, the principles of section 704(c) require taxpayers in a partnership to track each partner’s share of pre-contribution built-in gain or built-in loss in partnership assets. These profiles are traced through section 704(c) layers that are created and tracked each time an event occurs that could shift the economic sharing arrangement between new or existing partners. Without this tracking, there could be potential shifting of taxable gain or loss among partners that would not reflect the historical tax posture of the partners.

As the topic relates to an UP-C joint venture, because the parties involved each contribute existing business property to a newly formed partnership, there will most likely be a “forward” section 704(c) layer created on formation from built-in gain or loss assets contributed by each partner. The regulations provide for three section 704(c) allocation methods that are generally reasonable: (1) the traditional method, (2) the traditional method with curative

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26 Sections 704(c), 707, and 752 and the regulations promulgated thereunder.
27 See reg. section 1.1502-13(d).
28 See section 732(f) (adjusting the basis of corporate assets when stock of the corporation is distributed to a controlling corporate partner).
29 See section 904(f)(3)(D).
30 Reg. section 1.704-3(a) provides that the purpose of section 704(c) is to prevent the shifting of tax consequences among partners regarding pre-contribution gain or loss.
31 In addition to forward section 704(c) layers, a partnership may have “reverse” section 704(c) layers, which are section 704(c) layers created when a partnership revalues its property for capital accounting purposes.
32 Reg. section 1.704-3(b).
allocations, and (3) the remedial method. While a discussion of the mechanics and nuances of each method is beyond the purview of this report, in most partnerships, each alternative could deliver dramatically different results to taxpayers. As with many partnership-related concepts, when one partner may benefit from a specific approach, that benefit would come at the detriment of the other partner. In other words, the partnership only has so much tax basis in the entity to allocate to its partners — if one partner receives a disproportionate share of deductions related to the partnership tax basis, the other partner bears the burden by receiving fewer tax deductions (or even a potential notional income allocation under the remedial method).

Subject to a few exceptions, the concepts of section 704(c) must be applied on a property-by-property basis. Also, taxpayers may select different section 704(c) allocation methods for different items of contributed property if, in combination, the overall method is reasonable. The afforded flexibility and complexities in calculating the effect of section 704(c) allocations drives the need for a strong modeling effort during the negotiation stage of an UP-C joint venture. Each party should engage qualified advisers that are well versed in the intricacies of subchapter K and that have the know-how to create a flexible quantitative analysis that can measure the effect of section 704(c) decisions on prospective taxable income (and therefore tax liability) allocations. In practice, partners that know how section 704(c) decisions affect prospective allocations will likely leave the negotiation table with a partnership agreement including amenable terms related to the section 704(c) allocation method.

3. Effect of debt allocations and disguised sales.

As the UP-C joint venture involves two operating businesses combining into a newly formed entity, taxpayers will likely have to address the complexities related to debt shifts and deemed distributions and contributions in the partnership context. The rules that outline how debt shifts might result in upfront tax to one or more partners are entrenched within the disguised sale regulations. Embedded in these complex rules, however, is the opportunity for taxpayers to use leverage as a means of extracting cash from the value of its business in a tax-deferred manner. The ability to use some disguised sale exceptions and plan into such a structure is extremely fact specific, and one must carefully review the rules and regulations to ensure the application of these exceptions before executing the structure.

When considering whether the assumption of debt by a newly formed partnership, such as an UP-C joint venture, could trigger a disguised sale, taxpayers must first determine whether the debt assumed is treated as “qualified” or “nonqualified” liabilities. This determination is critical because relief from nonqualified liabilities can be treated as consideration received by a transferor partner in a disguised sale for contributed property. Relief from qualified liabilities may also be treated as consideration in a disguised sale — but only if other consideration is received as part of the transfers subject to disguised sale exceptions and plan into such a structure.

The disguised sale regulations provide that debt is a qualified liability only to the extent that the liability falls into a limited set of defined categories, including:

- debt incurred more than two years before the contribution;
- some debt not incurred in anticipation of the contribution to the partnership;  

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• debt that is allocable to capital expenditures regarding the contributed property (as defined by the regulations);\(^{41}\)
• debt incurred in the ordinary course of a business if all the assets related to that business are contributed to the partnership; and \(^{42}\)
• a liability that was not incurred in anticipation of the transfer of the property to a partnership but was incurred in connection with a trade or business in which property transferred to a partnership was used or held.\(^{43}\)

In the context of an UP-C joint venture, if one of the contributing partners (for this example assume PubCo 2) has debt capacity before the partnership formation, it might want to enter into a new debt agreement in anticipation of the contribution to monetize this debt capacity and retain the cash. After considering the definitions provided in the regulations, this newly issued debt in anticipation of the partnership formation may be nonqualified debt, which in turn would be subject to the general disguised sale rules. Absent some exception, the relief of the portion of debt that shifts to the other partner (PubCo 1) upon formation of the joint venture could be considered proceeds from the sale of contributed assets. At the same time PubCo 2 is relieved of its debt, however, it might also be taking on its share of additional nonrecourse debt contributed from the other counterparty, PubCo 1. Absent some special rule, PubCo 2 could be on the hook for tax liability from debt relief as proceeds in a disguised sale, even though it is responsible indirectly through the joint venture for the same amount or more debt immediately after the transaction.

Treasury regulations, however, were issued to provide for a netting rule that allows taxpayers to aggregate their debt positions and compare the partners’ debt profile in total before and after the partnership contribution.\(^{44}\) In the UP-C joint venture example above, if there is sufficient debt assumed by the joint venture from PubCo 1, the debt shift from PubCo 2’s contributed nonqualified debt might not result in a disguised sale if its total share of debt immediately after the partnership formation is equal to or greater than the debt it held before the partnership formation.

Even if after considering the netting rule discussed above some portion of assumed debt could be treated as proceeds from a disguised sale, taxpayers should also consider the pre-contribution capital expenditure (capex) exception.\(^{45}\) This exception, often referred to as the “preformation capex exception,” excludes some contributed assets from disguised sale treatment to the extent expenses on these assets were incurred within two years of the property contribution. Although there are limits to the use of this exception,\(^{46}\) taxpayers that construct or acquire assets may avail themselves of the preformation capex exception in a joint venture structure.

Also, the disguised sale rules provide an exception that allows partners to receive money if the receipt is treated as the partner’s share of partnership operating cash flow. The regulations provide a complex set of rules applicable to calculating the amount a partner may receive as an operating cash flow distribution in a given year.\(^{47}\) This exception, coupled with a partner’s ability to treat the receipt of money received before the end of a tax year as an advance on

\(^{41}\) Reg. section 1.707-5(a)(6)(C) (referencing reg. section 1.163-8T for purposes of determining whether a liability is allocable to capital expenditures).
\(^{42}\) Reg. section 1.707-5(a)(6)(D).
\(^{44}\) Reg. section 1.707-5(a)(4). This netting rule applies to liabilities other than a partner’s share of qualified debt and does not apply to debt that was assumed by a partnership if the principal purpose of that assumption was to reduce disguised sale proceeds from a transfer of debt.
\(^{45}\) Reg. section 1.707-4(d).
\(^{46}\) Reg. section 1.707-4(d) limits the use of this exception in two notable ways. First, the amount of preformation capital expenditures qualifying for reimbursement is limited to 20 percent of the FMV of the property at the time of contribution if the FMV of the property at the time of contribution exceeds 120 percent of its adjusted tax basis (note that this limitation will likely apply on qualified property when contributing partners do not elect out of section 168(k) bonus depreciation, which allows for 100 percent bonus depreciation deduction for costs incurred on qualified assets placed in service from September 27, 2017, through December 31, 2022). Also, any capital expenditures funded by qualified liabilities will qualify for the exception only to the extent the transferring partner is allocated the liability post-transfer, or a portion thereof, that funded the preformation capital expenditure transferred (the double dip rule).
\(^{47}\) Reg. section 1.707-4(b).
partnership earnings in some situations, may be a useful tool to mitigate disguised sale treatment if the partnership is profitable during the year in which consideration subject to disguised sale treatment is distributed to a contributing partner.

The combination of the exceptions to disguised sale treatment may permit a taxpayer entering into an UP-C joint venture to use leverage and receive tax-deferred cash in advance of executing the structure. Given the complexity and mechanical nature of these rules, taxpayers should carefully consider their facts before using leverage in a partnership formation transaction. Further, it is critical that taxpayers coordinate with their tax and legal advisers early in the transaction process to model the application of these rules, ensuring that the intended outcome of a planned transaction coincides with the estimated numerical consequences when applying the disguised sale rules.

IV. Potential Effects of Tax Reform on UP-Cs

In addition to the various tax and business considerations discussed above, with the passing of tax reform, taxpayers in or considering one of the UP-C structure alternatives must analyze and address the effects of the new tax rules. While the effects will vary depending on the operating and ownership structure of the enterprise (for example, foreign operations and entities in the structure), there are changes to the tax laws that should apply to most UP-C structures. At a minimum, the 2017 tax reform will have significant implications for how new rules affect TRA tax benefits and the related payment liability as well as partnership taxable income calculations and the allocation of these items to partners.

Perhaps the most obvious anticipated result of the new tax rules in the context of an UP-C is the reduced value of the TRA because of the significant reduction in corporate U.S. federal income tax rates. The TRA payment amount is determined based on a percentage of corporate tax savings and thus wholly depends on the cash tax savings accomplished by the corporate payer from the use of TRA attributes (for example, deductions from stepped-up tax basis and use of net operating losses). With the reduction of corporate rates to 21 percent (from a top marginal rate of 35 percent immediately before the new law), the potential cash tax savings for the TRA counterparty were significantly reduced, therefore directly reducing the potential TRA liability payment.

In addition to reduced federal income tax rates, the application of new bonus depreciation rules should also significantly affect the computation of TRA payments. Under revised section 168(k), bonus depreciation expense is available for most qualified property at a rate of 100 percent for assets placed in service after September 27, 2017, and before January 1, 2023. The new law also revised the prior “original use” rule that limited bonus depreciation to business assets that had never been placed in service before by any taxpayer. Under current law, a taxpayer may now apply bonus depreciation to property acquired that was already in use (that is, used property), as long as the qualified property was not used by the taxpayer claiming bonus depreciation at any time before the acquisition.

This new bonus depreciation rule may have two effects on TRA payments:

- First, to the extent an UP-C operating partnership spends significant amounts of cash on capital expenditures and asset acquisitions, bonus depreciation deductions should reduce partnership taxable income. This reduction of taxable income could result in delayed TRA benefit payments because the corporate partner may not require TRA tax attributes to reduce its cash tax liability. In other words, because of accelerated depreciation deductions at the partnership level, the corporate partner liable for TRA payments may be in an NOL position before considering any attributes subject to the TRA. In that case, TRA payments could be delayed until the TRA attributes are used.

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48 See reg. section 1.731-1(a)(ii) (advances or drawings of money or property against a partner’s distributive share of income shall be treated as current distributions made on the last day of the partnership tax year).

49 Section 11(b).

50 Section 168(k)(1)(A). Note that some longer-lived production property may qualify for 100 percent bonus depreciation if placed in service before January 1, 2024.

51 Section 168(k)(2)(E)(ii).
Second, the new rules allowing bonus depreciation on non-original use assets could affect the recovery of section 743(b) tax basis step-ups. One of the most common tax attributes subject to TRAs is a tax basis step-up generated by a section 743(b) adjustment as the result of a sale or exchange of partnership units. If the corporate entity could accelerate deductions under section 168(k) on a section 743(b) adjustment allocated to qualified assets, it could result in earlier TRA payments and therefore increase the net present value of a TRA. Treasury recently issued proposed regulations that address the application of section 168(k) in the context of partnerships and clarify that a transaction that gives rise to a section 743(b) adjustment could satisfy the used property acquisition requirements and be subject to bonus depreciation as long as:

• the transferee (acquiring) partner at no time before the purchase held any depreciable interest in the portion of partnership property deemed acquired;

• the transfer that gives rise to the step-up satisfies the “purchase” and “cost” requirements under section 179 and its regulations (that is, not a related party or nonrecognition transaction); and

• the special section 743(b) recovery rule related to built-in gain attributable to remedial section 704(c) assets does not apply.55

The proposed regulations use an aggregate approach to determine whether partner-specific adjustments to partnership property under section 743(b) qualify for increased expensing under section 168(k).56 Applying the aggregate theory, each partner is treated as having owned and used that partner’s share of partnership property. The eligibility requirements referenced above are then tested at the partner level, between the transferor and transferee.57 Because qualification is tested at the partner level, both new partners and existing partners acquiring additional partnership interests may receive a section 743(b) adjustment to partnership property that qualifies for increased expensing under section 168(k).

For purposes of electing out of bonus depreciation, the proposed regulations specifically carve out a partner’s section 743(b) basis adjustment for each class of property of partnership assets and treat each adjustment as a separate “class of property.”58 This allows a partnership to elect out of bonus depreciation for a section 743(b) adjustment in a class of property, but it does not bind the partnership to the same election for other qualified property in that same class and placed in service in the year of the election.

Because of the potential effect that bonus depreciation could have on the timing of TRA benefit payments and the flexibility afforded to taxpayers to elect out of section 168(k) solely for section 743(b) adjustments, the corporate partners in UP-C structures may push to negotiate terms

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53. Prop. reg. section 1.168(k)-2(b)(3)(iv)(D). Note, however, that the proposed regulations also conclude that any increase in tax basis under section 734(b) does not satisfy the used property acquisition requirements because the basis adjustment is made to the basis of partnership property (partnership common basis), and the partnership used the property before the event that gives rise to the section 734(b) adjustment. Prop. reg. section 1.168(k)-2(b)(3)(iv)(C).
54. Prop. reg. section 1.168(k)-2(b)(3)(iii)(A)(2) and (3) (citing section 179(d)(2)(A), (B), and (C); reg. section 1.179-4(c)(1)(ii), (iii), and (iv); reg. section 1.179-4(c)(2); section 179(d)(3); and section 1.179-4(d)). These rules require that the property is not acquired from a related party (under section 267 or 707(b)) or from members in a consolidated group; the basis of the property acquired is not determined in a substituted or carryover basis transaction; and the tax basis adjustment is not related to property acquired from a decedent under section 1014.

55. When a partnership uses the remedial allocation method, the portion of section 743(b) basis adjustment increase that is attributable to section 704(c) built-in gain is recovered over the remaining recovery period for the partnership's excess book basis in the section 704(c) property. See reg. section 1.743-1(j)(4)(i)(B)(2).
within the TRA that require a partnership to elect out of bonus depreciation regarding section 743(b) basis adjustments that are subject to the TRA.  

In addition to the reduced corporate tax rate and new bonus depreciation rules, other changes to the tax laws may affect the “with and without” TRA calculation and the timing of TRA payments by accelerating the use of TRA attributes. Section 163(j), for example, could impose a limitation on the ability of a corporate partner to use business interest expense to otherwise offset taxable income allocations.  

Section 172(a), which limits the use of NOLs generated after December 31, 2017, to 80 percent of the entity’s annual taxable income, will also need to be considered when making the with and without calculation to determine use of TRA attributes. As with most tax-related issues, the precise quantitative effect of the new tax rules will depend on the taxpayer’s specific facts, and it may be difficult to approximate the holistic effect of the new tax law in the UP-C context without a strong modeling effort.

V. Conclusion

The use of the umbrella partnership in M&A transactions is increasingly prevalent and has evolved to now include both SPAC UP-Cs and UP-C joint ventures. While the reduction in the corporate tax rate and other new tax rules may affect the value associated with TRAs, that should not have a material effect on the decision to implement an UP-C structure. Even if TRA payments may be reduced under current law, these payments still represent the opportunity to receive incremental proceeds that are unavailable in a typical corporate structure with no tax basis step-up opportunity. Moreover, the UP-C structure continues to provide significant benefits in addition to the TRA, including all the general benefits of operating in a flow-through structure, which should continue to drive investors’ decisions to use various UP-C transaction alternatives.

59 The desire to elect out of bonus depreciation may be further exacerbated by the tax treatment of the TRA payments on section 743(b) adjustments. These payments may be treated as additional contingent purchase price for partnership interests, which would thereby increase the section 743(b) adjustment and result in additional deductions and therefore additional TRA payments (most TRAs provide for iterative payments for subsequent increases in tax basis). Prop. reg. section 1.168(k)-2(f)(2) provides that a taxpayer may claim additional bonus depreciation on an increase in basis of qualified property (for example, because of contingent purchase price in a future year if the increase is properly allocated to qualified property) in the year the basis increase occurs, but applying the applicable bonus percentage in effect for the tax year that the qualified property was placed in service by the taxpayer.

60 Revised section 163(j) generally disallows as a deduction business interest for the tax year that does not exceed the sum of a taxpayer’s (1) business interest; (2) 30 percent of adjusted taxable income; and (3) floor plan financing interest for that tax year. Any amount of business interest disallowed under section 163(j)(1) may be carried forward indefinitely as business interest paid or accrued in a succeeding tax year until used.

61 Section 172(a)(2).

62 The impact of the 80 percent limitation on a TRA does not depend on whether the NOLs at issue are subject to the TRA. To the extent an NOL is subject to the TRA, limiting use of that TRA attribute to 80 percent of taxable income in a given tax year may defer cash tax benefits to TRA holders who benefit from NOLs subject to the TRA.