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Understanding "Up-C" IPO Structures – The Tax Benefits Explained

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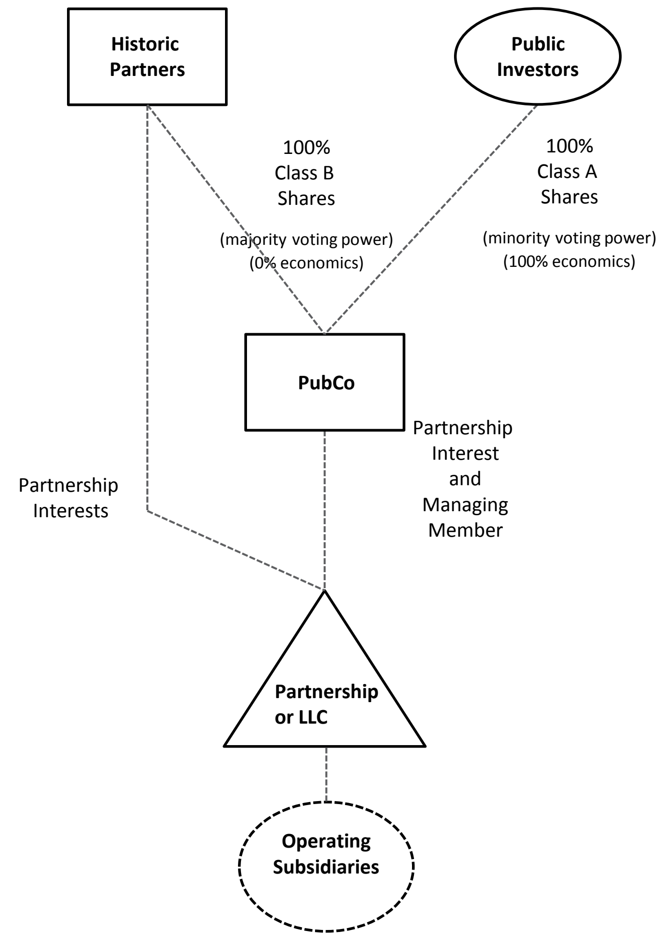
Agenda

- Overview
- Typical Pre-IPO/IPO Structures
- Up-C Structures
- Why an Up-C Structure?
- Tax Receivable Agreements
- Additional Considerations Related to Up-C Structure

Overview

- The Up-C structure has become increasingly common for IPOs of companies that have historically operated as a partnership.
- 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").

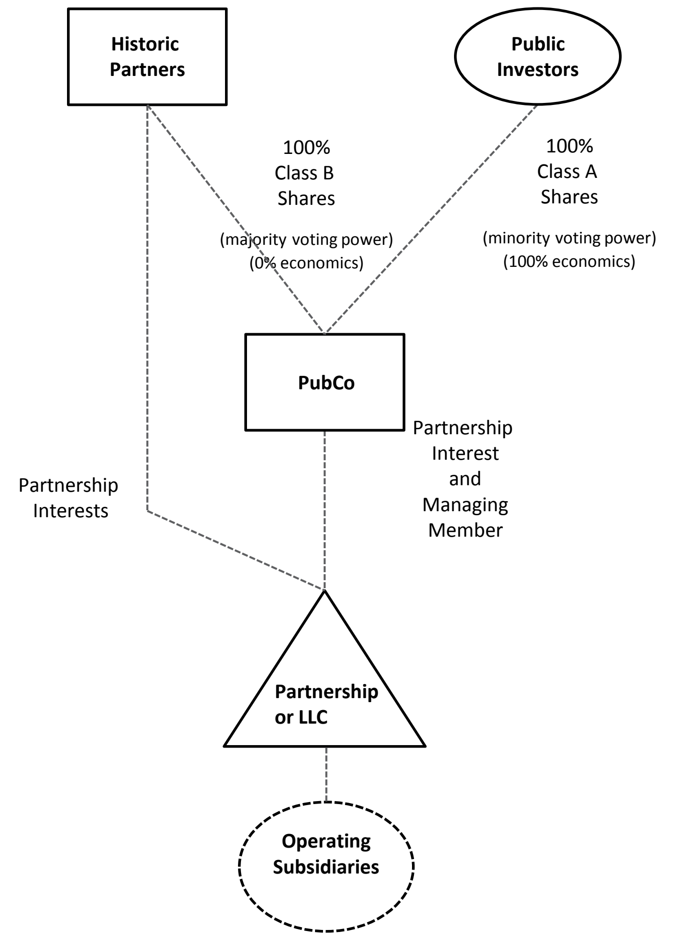


Up-C Structure Final State

Overview

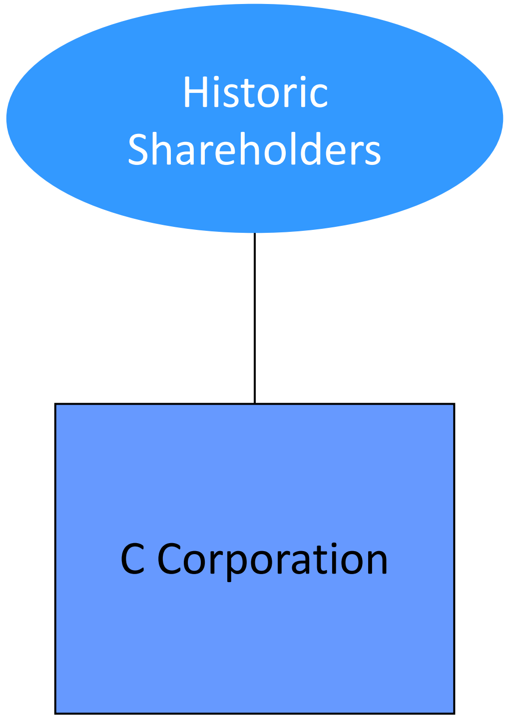
- PubCo will be a holding company and will have as its subsidiary the LLC. The principal assets/operating business will continue to be at (or below) the LLC level.

- PubCo will receive the IPO proceeds and downstream the proceeds to the LLC.



Up-C Structure Final State

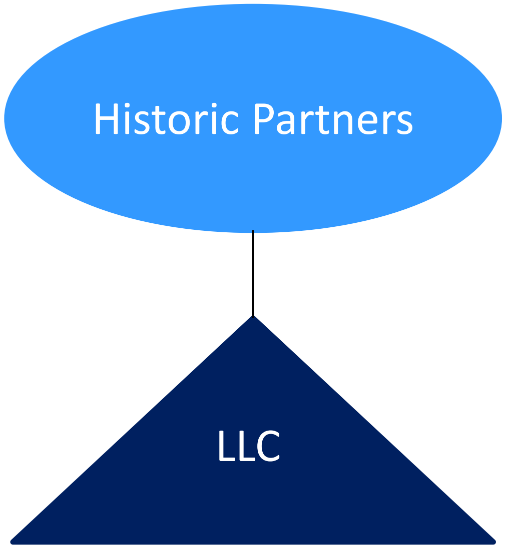
Typical Pre-IPO Structure - Corporation



Disadvantages

- 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

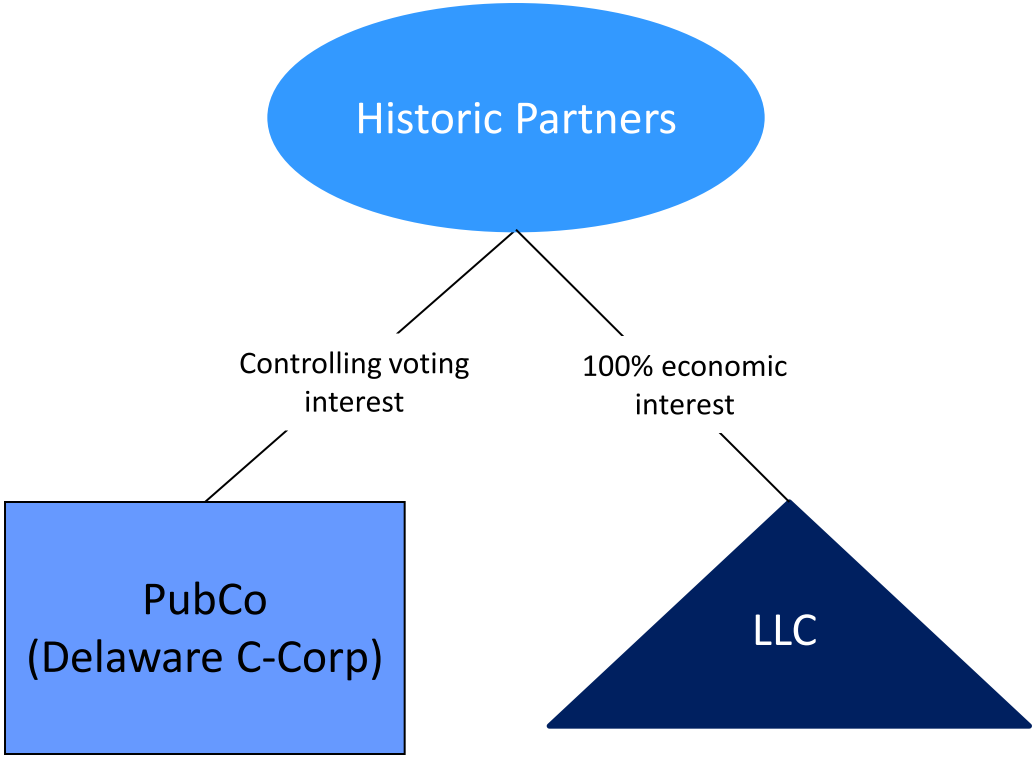
- Partnership not subject to tax; income earned by operating subsidiaries taxable directly to partners

Disadvantage

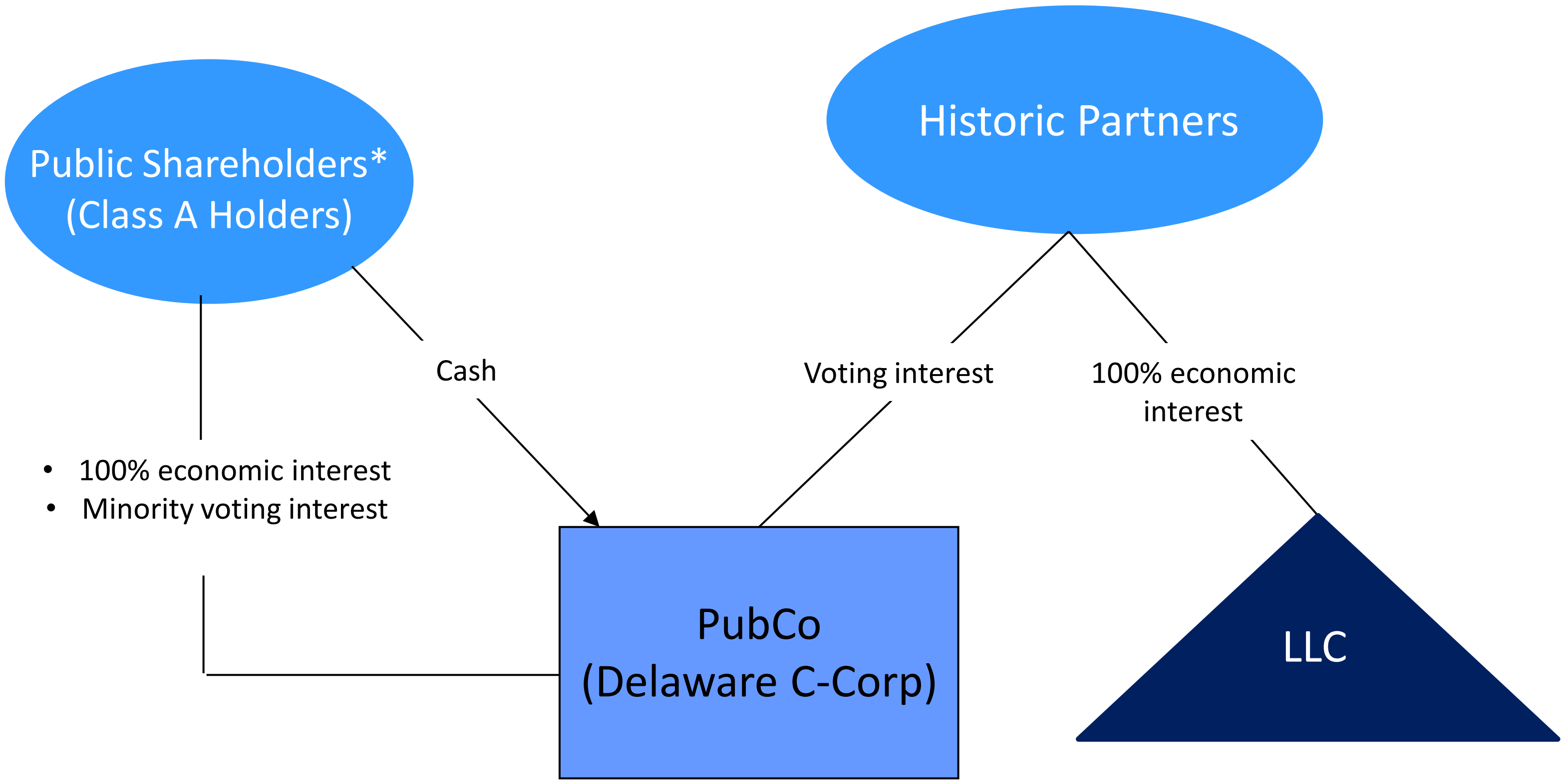
- Listing partnership when going public may result in the partnership being taxed as a corporation

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.

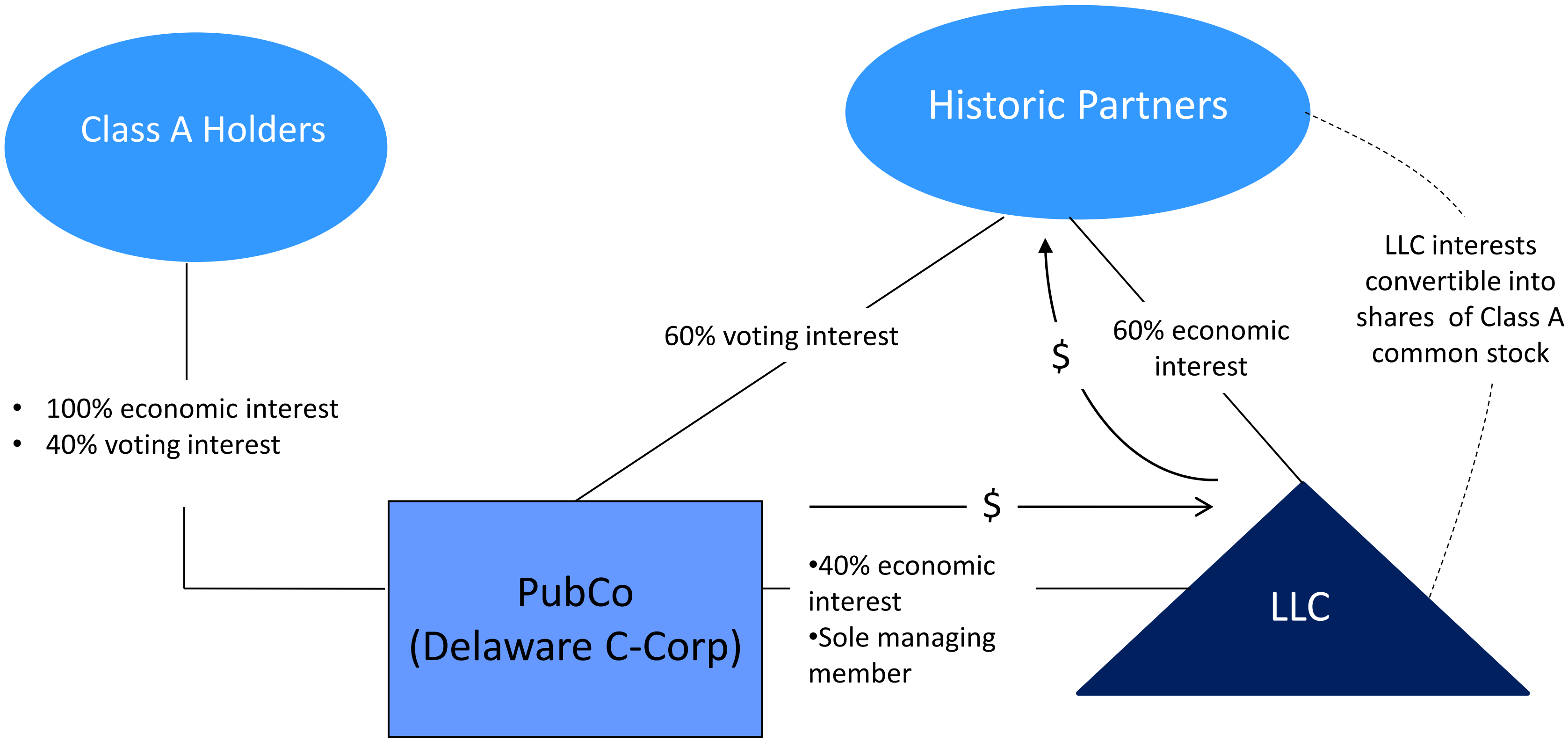


Up-C Structure: Immediately following IPO



* 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)

Why an Up-C structure?

- Prior to the IPO, the business was conducted through an LLC, which is a pass-through structure and does not pay entity-level taxes.

- Through the Up-C structure, the pass-through 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.

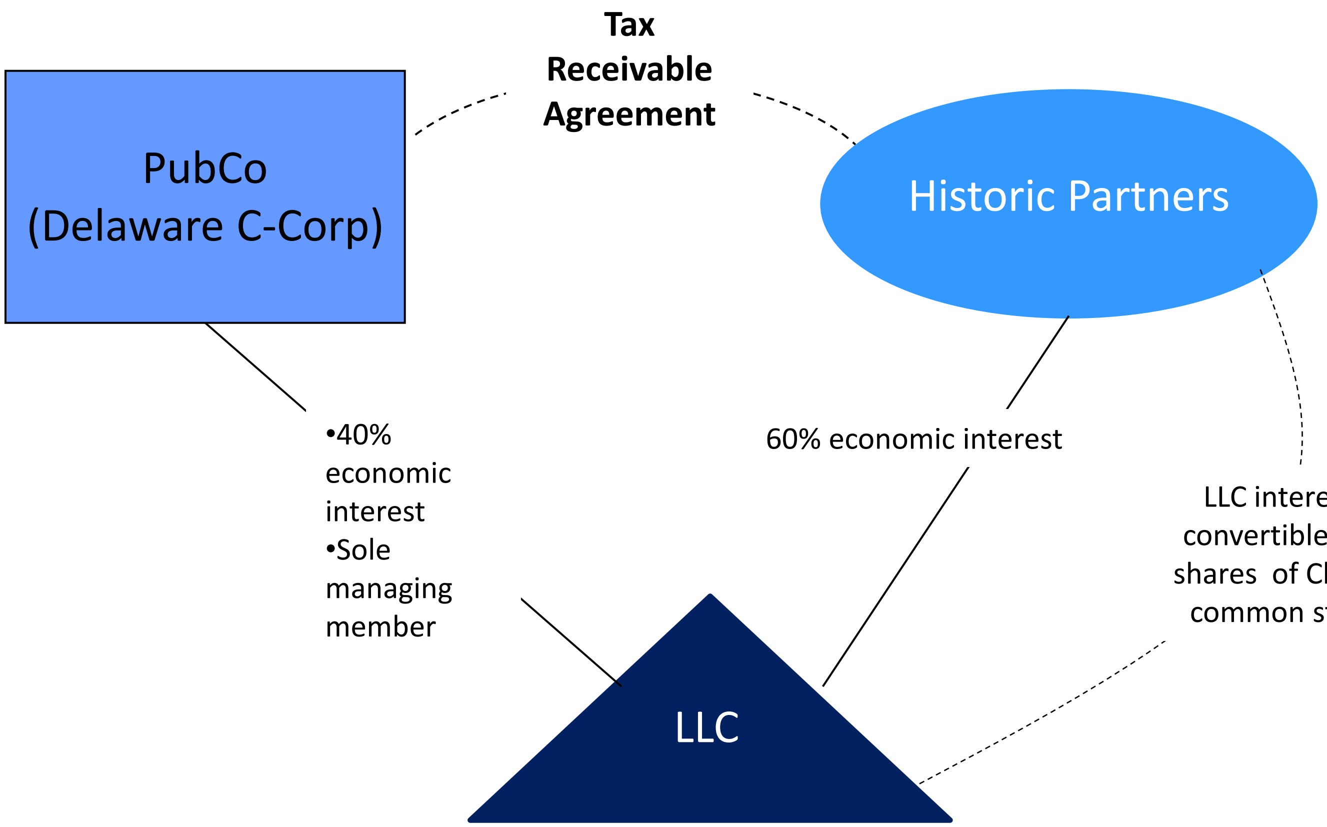
Why an Up-C structure (cont.)?

- 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.)?

- 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 for a valuable tax attribute (for example, a basis step-up).

Tax 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 “Tax Receivable Agreeement” (“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

- Under the terms of the TRA, PubCo is obligated to pay the historic partners in cash an amount equal to 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

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)	40%
• PubCo Annual Savings	$8 million
• TRA Payout Ratio	85%
• Annual Payment to Historic Partners**	$6.8 million
• Total Payments to Historic Partners	$102 million

*Any future exchanges of partnership units for Class A shares of PubCo also 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)

Additional Considerations Related to Up-C Structure

- The Up-C structure maintains continuing pass-through 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)

Additional Considerations Related to Up-C Structure

- 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

- Financial statement presentation of TRA
- 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
- Tax distributions to PubCo and historic partners

Miscellaneous Issues Related to Up-C Structure

- “Anti-churning rules” under Section 197 of the Internal Revenue Code
- Tax treatment of pre-IPO recapitalization
- Management of PubCo (typically key executives located at PubCo and a management services agreement is put in place between PubCo and historic partnership)