1-1-2018

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Research Paper Series

Paper No. 2016-40

Repository Citation

Gregg D. Polsky and Adam H. Rosenzweig, The Up-C Revolution, 71 Tax L. Rev. 415 (2018), Available at: https://digitalcommons.law.uga.edu/fac_artchop/1189

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The Up-C Revolution

GREGG D. POLSKY* & ADAM H. ROSENZWEIG**

I. INTRODUCTION

Over twenty-five years ago, the Internal Revenue Service approved the classification of limited liability companies (LLCs) as partnerships for tax purposes.1 Since then, discussions of the implications of this development on the classical corporate tax system have pervaded the literature, especially after the 1998 promulgation of the check-the-box regulations that made tax classification of LLCs elective.2 Nevertheless, despite these supposed path-breaking events, the corporate form has proven stubbornly persistent in the post-LLC era. The apparent conflict between the tax advantages of LLCs and the persistence of corporations has proven difficult for the academic literature to explain.3

This era is coming to a close. In its place is arising what we refer to as the “Up-C Revolution.” The Up-C Revolution represents a sea

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change in tax-entity selection and restructuring, combining the best attributes of corporations and LLCs into a single dominant structure. This Article provides a comprehensive overview of the Up-C Revolution, describing the Up-C structure, explaining its primary use as a tax-efficient vehicle for initial public offerings of LLCs, and exploring some of the future implications of the Up-C Revolution for tax planning.4

In an Up-C structure, a C corporation is placed atop an LLC, which is owned partially by the C corporation and partially by other investors, typically individuals and private investment partnerships such as venture capital (VC) or private equity (PE) funds. These investors also receive exchange rights that allow them to periodically tender their LLC interests for equivalent-value stock in the parent C corporation. When these exchanges occur, they are taxable exchanges to the investors and result in a stepped-up basis in a proportional part of the LLC’s assets.5 This stepped-up basis will reduce the C corporation’s future taxable income and often its future tax liability.6 The investors typically receive the benefit of such tax reductions through a tax receivable agreement (TRA) that requires the parent C corporation to pay the investors a specified percentage—usually 85%—of these future tax reductions as they materialize.7

The Up-C structure is becoming increasingly common as the choice of structure when LLCs or other flow-through entities are taken public.8 This “Up-C IPO” structure first appeared in the mid-2000’s

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5 This assumes that the LLC makes an election under § 754. See Reg. § 1.743-1 (noting methodology for LLC to step up its basis in case of sale or exchange of partnership interest).

6 If the corporation’s taxable income is negative, the stepped-up basis will result in additional net operating losses, which may or may not eventually reduce the corporation’s tax liability.

7 See Paul & Sabah, note 4, at 2.

8 See Simpson Thacher, The “UP-C” Structure: A Primer on Employing the Umbrella Partnership-C-Corporation Structure in an IPO, https://www.stblaw.com/docs/default-
before the beginning of the financial crisis, which significantly depressed the IPO market. Many attribute the first use of the now-called “Up-C IPO structure” to the 2006 initial public offering of Evercore Partners.⁹ Up-C IPOs continued to trickle out from 2007 through 2012, with two or three filings on average in each of those years.¹⁰ Beginning in 2013, the Up-C Revolution began in earnest with at least twelve Up-C IPOs filed in 2013, and at least another seventeen filings in 2014.¹¹ A slowdown in the IPO market greatly reduced the amount of going-public transactions beginning in the second half of 2015, but there were still reportedly fourteen Up-C IPOs filed that year.¹² In 2016 and 2017, there were another nineteen Up-C IPOs reported.¹³ The tremendous growth in Up-C IPOs, from two or three per year from 2006 through 2012 to over seventy since 2013 is particularly noteworthy. As explained below, while the structure is extremely attractive from a tax perspective, it also adds quite a

source/related-link-pdfsup-c-slides.pdf?sfvrsn=6; see also John LeClaire & Brad Weber, The Up-C IPO: A Structure That Keeps on Giving, Buyouts, Feb. 9, 2015 (noting that Up-C IPOs have become more common in recent years). At times this has been referred to as a “super-charged IPO” in the literature. See Fleischer & Staudt, note 4, at 312. But, as Gladriel Shobe explains, while the Up-C IPO is the most common type of supercharged IPO, the term can encompass other structures. See Shobe, note 4, at 929-39.

⁹ See Ian Fontana Brown, The UP-C IPO and Tax Receivable Agreements: Legal Loophole?, 156 Tax Notes 859 (Aug. 14, 2017). The 1999 IPO of barnesandnoble.com used a version of the Up-C structure. See id. at 862-63; Hart, note 4, at 20, 26 n.40, 40. Before the IPO, the company’s business was operated through an LLC owned equally by Barnes & Noble, Inc. (B&N) and Bertelsmann AG. See Hart, note 4 at 26. In the IPO, shares of a new holding company (formed as a corporation) were sold to the public, and the corporation used the proceeds to buy additional membership interests from the LLC. B&N and Bertelsmann had the right to exchange their LLC interests for equivalent stock interests in the holding company that went public. The transaction thus looked like a typical Up-C IPO. The parties, however, did not execute a TRA in connection with the IPO and, as discussed in the text, TRAs are core components in the modern Up-C IPO structure. Brown, supra, at 862.

¹⁰ See Brown, note 9, at 863. These counts exclude filings for companies whose IPOs never closed. See Gregg Polsky, Spreadsheet of Up-C Filings from 2012-2017(on file with the author).

¹¹ See Brown, note 9, at 863. A study by the law firm Goodwin Procter LLP found that between 2008 and 2012, only eleven Up-C IPOs were consummated, an average of approximately two per year, and then in 2013, the floodgates opened. See LeClaire & Weber, note 8, at 1. In 2013 alone, twelve Up-C IPOs were filed (and all of which were ultimately closed), followed by seventeen Up-C filings in 2014 (all but one of which closed or are still pending). Id. The trend continued in 2015 with the high profile Up-C IPOs of Go Daddy and Shake Shack closing in early 2015. See Morrison & Foerster, Practice Pointers on the Up-C Structure (2016), https://media2.mofo.com/documents/160500practicepointersupc-structure.pdf; Matt Egan, GoDaddy Races onto Wall Street, Stock Soars 30% After IPO, CNN Money (Apr. 1, 2015), http://money.cnn.com/2015/04/01/investing/godaddy-ipo-tech-danica-patrick/index.html.

¹² See Polsky, note 10.

¹³ See id.
bit of complexity. The exponential growth suggests that private investment funds, lawyers, and tax advisors are becoming increasingly aware of the structure's tax benefits and the market increasingly comfortable with its complexity. A tipping point apparently has been reached, and nothing short of radical reform of business entity taxation may be able to stop this momentum.

Despite this ongoing Up-C Revolution, the Up-C structure (and TRAs) has received scant attention in the literature. This is surprising, not only because of their trendiness but also because of their significant implications for taxpayers and the federal government even beyond the IPO context. For example, Up-Cs could impact the initial choice-of-entity analysis, and they can be used to effectuate transactions that mimic tax-free reorganizations or corporate inversions without abiding by the strict conditions that otherwise would apply.

Given this widespread impact, the Up-C Revolution seems to represent the market fulfillment of earlier predictions that LLCs would fundamentally change the role of corporations in society, albeit not in the ways originally predicted. Rather than ring the death knell of the corporate form, the markets instead will integrate the LLC into the corporate form. No longer will VC-funded start-ups need be formed as C corporations; no longer will PE funds require LLC portfolio companies to convert to C corporations; no longer will public mergers need to comply with the strict tax-free reorganization requirements of § 368; no longer will domestic companies be limited to seeking similar sized merger partners to engage in inversions. The list is potentially endless. The only constraint on the use the Up-C structure (at least under current tax law) is participant and advisor awareness and market acceptance, both of which have seemingly already turned the corner.

Part II provides background and context to the Up-C Revolution, describing the impact of tax law in traditional IPO and merger and acquisition markets. Part III explains the rise of the LLC as a business form and discusses the implications and complications that arose from the introduction of LLCs into the traditional IPO and mergers and acquisitions (M&A) markets. Part IV introduces the Up-C structure, using the Up-C IPO structure as a case study. Part V discusses some of the major implications of the Up-C revolution on tax planning, from choice-of-entity considerations to equity compensation design and the structuring of M&A and cross-border transactions. That Part also considers the normative question of whether Up-C structures should be legislatively foreclosed. Part VI concludes.

14 See Shobe, note 4, at 947 (noting high administrative costs associated with Up-Cs).
15 Id. at 917 (noting that Up-C structures have been “mostly overlooked” by scholars).
II. ENTITY TAXATION AND THE NEED FOR THE UP-C STRUCTURE

A. Overview of M&A Tax Structuring

As we explain in greater detail below, Up-C structures are tax-efficient because they allow the buyer to obtain a stepped-up basis in the selling business’s assets at minimal marginal cost.\(^\text{16}\) The stepped-up basis often reduces the business’ future tax liabilities, and because this tax reduction comes at minimal marginal cost, the effect of the stepped-up basis in the Up-C structure is akin to printing money. In traditional M&A tax planning, however, the question of whether to structure for a stepped-up basis is more complicated because there is often a significant marginal cost in doing so.\(^\text{17}\) In a traditional M&A transaction, tax planners must weigh the future tax benefits of the stepped-up basis against the immediate tax costs of generating it. Therefore, to understand why the Up-C structure is so advantageous, it is helpful to understand this critical tax planning issue in traditional M&A transactions.

In these transactions, one company, \(P\), acquires another company, \(T\), either through a merger, purchase of stock, or purchase of assets. While there may be some important nontax considerations in how the transaction is accomplished, tax considerations often drive the structure.\(^\text{18}\) There are three ways to structure the deal from a tax perspective: tax-free reorganization, taxable stock purchase, and taxable asset purchase.

1. Tax-Free Reorganization

In a tax-free reorganization, the major tax benefit is a deferral of tax owed by \(T\)’s shareholders.\(^\text{19}\) In a tax-free reorganization, any gain inherent in the \(T\) stock owned by the \(T\) shareholders generally is deferred and built into the basis of \(P\) stock received in the transaction.\(^\text{20}\) Thus, the gain (and associated tax liability) is generally deferred until the \(P\) stock is eventually sold. If, however, a \(T\) shareholder who is an individual holds the \(P\) stock until death, the gain (and associated tax liability) is eliminated through the § 1014 step-up of basis at death.\(^\text{21}\)

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\(^{16}\) See Subsection II.A.3.

\(^{17}\) See Michael L. Schler, Basic Tax Issues in Acquisition Transactions, 116 Penn St. L. Rev. 879, 888-89 (2012).

\(^{18}\) See id. at 880 (“Most importantly, it is vital for the corporate lawyer to consult a tax lawyer at every stage of an acquisition transaction.”).

\(^{19}\) Id. at 883.

\(^{20}\) IRC §§ 368, 354, 358. If the \(T\) shareholder receives cash or other property other than \(P\) stock (boot), the \(T\) shareholder recognizes the inherent gain in the \(T\) stock to the extent of the value of the boot received. IRC §§ 1001, 368, 354.

\(^{21}\) IRC § 1014.
Even if the $P$ stock is not held until death, deferral can significantly reduce the effective tax rate on the inherent gain. For example, with a 7% discount rate, a tax rate of 20% in thirty years is equivalent to a tax rate of only 2.6% today.\textsuperscript{22}

While tax-free reorganizations provide deferral for the $T$ shareholders, there are two main drawbacks. First, to qualify as a reorganization, a substantial amount of the consideration paid by $P$ must be in the form of $P$ stock and, to maximize the deferral benefits to the $T$ shareholders, the vast majority of the consideration must be in the form of $P$ stock.\textsuperscript{23} Thus, if $P$ wants to pay more than a relatively insignificant amount of cash, the tax-free reorganization structure generally either will be unavailable or ineffective in providing the desired tax deferral.\textsuperscript{24}

Second, even if the buyer is willing to pay all or nearly all of its consideration in $P$ stock, a tax-free reorganization provides $P$ with a carryover basis in the $T$ assets, whereas a taxable asset deal would provide it with a stepped-up basis.\textsuperscript{25} Because $P$ is receiving a low carryover basis, it typically will be willing to pay less for $T$ because $P$'s future tax liability often will be higher than if it was receiving a stepped-up basis.\textsuperscript{26} The amount of this discount depends on a host of factors, including the types of assets that $T$ owns, the appropriate discount rate applied to the future tax reductions, and $P$'s future tax rates. In the typical case, most of the missing stepped-up basis would be attributable to $T$'s goodwill, which would have been amortizable by $P$ on a straight-line basis over fifteen years.\textsuperscript{27} Assuming the vast majority of the step-up is attributable to goodwill (which is generally a reasonable assumption), a discount rate of 10%, and a 40% combined federal and state marginal tax rate for $P$, $P$ should be willing to pay a premium equal to approximately 20% of the amount of the step-up, if the transaction is structured to provide it with a stepped-up basis.\textsuperscript{28} Because reorganizations do not deliver $P$ with a stepped-up basis, it will not pay this premium in those transactions.

2. \textit{Taxable Stock Purchase}

If $P$ acquires all of the $T$ stock by purchase—either through voluntary sales or through a reverse triangular merger—and the transaction

\begin{flushleft}
\textsuperscript{22} \(0.026 = \frac{2}{(1 + 0.07)^{30}}\).
\textsuperscript{23} See IRC § 368; see also Schler, note 17, at 885.
\textsuperscript{24} Id.
\textsuperscript{25} IRC § 362(b).
\textsuperscript{26} See Schler, note 17, at 885.
\textsuperscript{27} See IRC § 197.
\textsuperscript{28} See Schler, note 17, at 887.
\end{flushleft}
does not qualify as a reorganization, the T shareholders generally will recognize all of the inherent gain in their stock immediately. They thus would pay immediate tax, albeit often at preferential capital gains rates.\textsuperscript{29} Compared to a tax-free reorganization, taxable stock purchases accelerate capital gains tax and eliminate the opportunity for individuals to avoid tax altogether by holding P stock until death.

While T shareholders generally are worse off in a taxable stock purchase as compared with a reorganization, P is mostly indifferent as between the two.\textsuperscript{30} P will have a carryover basis in the T assets in each case.\textsuperscript{31} Thus, as between a reorganization or a taxable stock purchase, the reorganization structure is preferred provided that it is an available option\textsuperscript{32} because the T shareholders are generally better off and P is not worse off.

3. Taxable Asset Purchase

From the T shareholders’ perspective, a taxable asset purchase of T immediately triggers two levels of tax.\textsuperscript{33} First, when T sells its assets to P, T owes corporate tax on the net gain in those assets.\textsuperscript{34} Second, when T distributes the resulting after-tax proceeds to its shareholders in complete liquidation, the shareholders pay capital gains tax on the inherent gain in their T stock.\textsuperscript{35} Under current federal and state tax rates, the combined tax burden can approach 50%, making taxable asset purchases typically unattractive for T shareholders.\textsuperscript{36}

From P’s perspective, however, taxable asset purchases provide it with a stepped-up basis, which, as discussed above, is worth a premium of approximately 20% of the stepped-up basis under realistic assumptions.\textsuperscript{37} Thus, P would prefer a taxable asset purchase. However, the cost to the T shareholders of doing a taxable asset deal is,

\textsuperscript{29} IRC § 1(h)(1)(C).
\textsuperscript{30} See Schler, note 17, at 887 (noting that “[m]ost significantly for [P], the tax basis of the Target assets will remain unchanged, rather than reflecting [P’s] purchase price for the stock.”).
\textsuperscript{31} Id.; IRC § 362(b). In a taxable stock purchase, P will take a higher basis in the T stock than it would in a reorganization, but the amount of P’s basis in the T stock is generally a trivial matter. See Schler, note 17, at 887 (tax basis will not provide P with any tax benefit until P sells the stock).
\textsuperscript{32} As discussed in note 23 and accompanying text, to qualify as a reorganization and to provide significant deferral benefits, all or mostly all of the acquisition currency must be in the form of P stock. Thus, a reorganization is generally attractive only if P is publicly traded so that the former T shareholders can easily sell their interests.
\textsuperscript{33} See Schler, note 17, at 888.
\textsuperscript{34} IRC § 1001.
\textsuperscript{35} IRC § 311.
\textsuperscript{36} For example, assuming a 26% combined state and federal corporate tax and a 30% combined state and local capital gains tax, the effective combined tax rate would be 48%.
\textsuperscript{37} See text accompanying note 28.
except in certain narrow circumstances, often higher than the benefit to \( P \) of a stepped-up basis.\(^{38}\) This makes sense because, in a taxable asset deal, while the \( T \) shareholders are bearing an immediate corporate tax on the net gain inherent in \( T \)'s assets, \( P \) is obtaining only future tax deductions in precisely the same amount of the net gain. Because of the time value of money, the tradeoff of \( x \) of current tax liability for future tax relief of \( x \) is not a good one.\(^{39}\)

As a result, taxable asset purchases generally make sense only if one of the two layers of immediate tax typically borne by the \( T \) shareholders can be eliminated or at least substantially mitigated. \( T \)-level tax will be eliminated or mitigated if \( T \) has substantial NOLs carryforwards from prior years; these NOLs will absorb some or all of the \( T \) level gain.\(^{40}\) Likewise, \( T \)-level tax is avoided if \( T \) is an \( S \) corporation.\(^{41}\) \( S \) corporations do not pay corporate tax;\(^{42}\) instead all of the gain flows through to the \( T \) shareholders, who are taxed once and only once on the gain. Finally, if \( T \) is a controlled subsidiary of another corporation, gain on the distribution of the net after-tax proceeds from \( T \) to its corporate parent is not taxed.\(^{43}\) In these three cases there is only one level of tax borne by the \( T \) shareholders.\(^{44}\) In these situations, the benefit to \( P \) from the stepped-up basis usually exceeds the cost to the \( T \) shareholders of moving from a taxable stock purchase (which also requires one level of tax) to a taxable asset purchase and, therefore, a taxable asset purchase may be the more tax-efficient structure.

In summary, tax-free reorganizations are generally the most tax-efficient M&A structure, even though they result in a carryover basis for \( P \). If a tax-free reorganization is unavailable or unattractive because \( P \) is paying too much cash in the transaction, the transaction typically is structured as a taxable stock purchase even though it leaves \( P \) with a carryover basis. This is because the immediate double taxation of \( T \) shareholders is more significant, on a present value basis, than the benefits that \( P \) would receive from a stepped-up basis. If, however, \( T \) has large NOLs, is an \( S \) corporation, or a controlled subsidiary of another corporation, a taxable asset purchase will often be tax-efficient because \( P \) receives a stepped-up basis while the \( T \) share-

\(^{38}\) Schler, note 17, at 889.

\(^{39}\) This assumes that tax rates do not change over time, among other things. See, e.g., Lee Anne Fennell & Kirk J. Stark, Taxation Over Time, 59 Tax L. Rev. 1 (2005).

\(^{40}\) Id. at 888; see IRC § 172.

\(^{41}\) Schler, note 17, at 889-90; see IRC § 1363(a).

\(^{42}\) IRC § 332(a). A controlling corporation may also sell the stock of a subsidiary and elect to treat it as a taxable asset sale. IRC § 338(h)(10); see Schler, note 17, at 890-91.

\(^{43}\) See Ginsburg et al., note 4, ¶ 105.
holders avoid the second level of tax. These conclusions are summarized in the table below.

### Table 1

**Efficiency of Reorganization, Stock Purchase, or Asset Purchase**

<table>
<thead>
<tr>
<th>Transaction Type</th>
<th>Consequences to Selling Shareholders</th>
<th>Consequences to Buying Corporation</th>
<th>Caveats</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reorg</td>
<td>Deferral of stock gains; no premium for delivering stepped-up basis</td>
<td>Carryover basis in T's assets</td>
<td>Need to have all or nearly all of the currency in the form of P stock</td>
</tr>
<tr>
<td>Stock Purchase</td>
<td>Immediate gain recognition on stock; no premium for delivering stepped-up basis</td>
<td>Carryover basis in T's assets</td>
<td></td>
</tr>
<tr>
<td>Asset Purchase</td>
<td>Immediate double taxation; receive premium for delivering stepped-up basis</td>
<td>Stepped-up basis in T's assets</td>
<td>Stepped-up basis premium is often less than the burden of immediate double taxation</td>
</tr>
</tbody>
</table>

### B. The Rise of LLCs and the Difficulties of Tax-Partnerships

1. **Partnership M&A**

   For tax purposes, a partnership includes general and limited partnerships as well as LLCs and other noncorporate limited liability entities (for example, LLPs), as long as these entities are not publicly traded.\(^{45}\) While corporate income is subject to two levels of tax—once at the corporate level when corporate income is earned and another at the shareholder level when cash or property is distributed to shareholders—partnership income is taxed once and only once, at the owner level.\(^{46}\) Partnerships pay no entity-level tax; instead their taxable income flows through the entity and is taxable at the owner level. In addition to this fundamental distinction, partnerships cannot take advantage of the reorganization provisions,\(^{47}\) and sales of partnerships (or interests therein) are generally treated, either directly or indirectly, as if there were a sale of a proportionate share of a partnership’s underlying assets.\(^{48}\) Accordingly, if an LLC is acquired by a corporation in an M&A deal, the transaction will be taxed as a taxable asset deal.\(^{49}\)

\(^{45}\) IRC § 7704; Reg. § 301.7701-1, -3.

\(^{46}\) IRC § 701.

\(^{47}\) IRC § 368(a), (b); Schler, note 17, at 882.

\(^{48}\) IRC §§ 751(a), 743(b). This assumes that the partnership has made a § 754 election.

\(^{49}\) The combination of partnerships, for example through a merger of LLCs for state tax purposes, potentially could be structured to be tax-free, depending on the circumstances. See Reg. § 1.708-1(c); Rev. Rul. 90-17, 1990-1 C.B. 119.
While the LLC owners, with careful advance planning, could first convert the LLC into a corporation and then, in a separate and independent transaction, sell the stock for cash,\textsuperscript{50} the default taxable asset purchase structure is nearly always more tax-efficient. Because of flow-through taxation, the gain inherent in the LLC’s assets will be taxed only once, and typically most of the LLC’s gains will be attributable to goodwill, which is subject to preferential capital gains rates. Thus, the buyer will pay the 20% (or so) premium for achieving a stepped-up basis, while the LLC’s owners will bear only a single level of tax, often at capital gains rates. If converted to a stock sale, the owners still pay a single level of tax but they forgo the 20% premium.

Consider a simple example where an LLC has a single asset of goodwill, a zero basis in the goodwill, and the buyer is willing to pay $100 for the LLC in a carryover basis transaction. (As mentioned above, a carryover basis transaction is in fact unavailable without the restructuring discussed in the previous paragraph, but for illustrative purposes assume that such restructuring would occur.) Because of the 20% premium, the buyer would be willing to pay $120 for the LLC if the buyer received a stepped-up basis. Assuming a 25% effective marginal tax rate on capital gains, the LLC owners would be left with $75 in the carryover basis transaction ($100 \times (1 - .25)) and $90 ($120 \times (1 - .25)) in the stepped-up basis transaction, so they would choose the stepped-up basis transaction. Matters become more complicated if some of the gain inherent in the LLC’s assets is ordinary income, such as inventory gain.\textsuperscript{51} In that case, the seller of assets will suffer some tax burden relative to the stock sale situation but on the other hand the buyer will receive a quicker (and therefore larger in present value terms) benefit from the stepped-up basis, because the basis of ordinary assets typically is recovered more quickly than the basis of capital gains. Even in these more complicated cases, the benefit to the buyer from the stepped-up basis typically exceeds the detrimental character conversion suffered by the seller, which means that the default asset sale treatment of LLCs remains preferable.

Thus, while C corporations are often practically unable to sell assets and give the buyer a stepped-up basis, LLCs (and, for that matter, S corporations) are able to do so. This means that, in the case of otherwise identical businesses with one run as a C corporation and the other as an LLC, the latter will fetch a significantly higher purchase price. This ability to obtain the stepped-up basis premium is one im-

\textsuperscript{50} To be effective, the first-step conversion and second-step sale would have to avoid the application of the step transaction doctrine. Cf. Schler, note 17, at 882 (noting that a first-step conversion and a second-step reorganization could be recast as a taxable sale if the step transaction doctrine applied to treat the two steps as a single integrated transaction).

\textsuperscript{51} See IRC § 751(a).
portant, albeit fairly subtle, advantage of partnerships over C corporations. The single level of taxation of profits and the flow-through of losses tend to be the most salient advantages of LLCs, but the effects of these are often overstated. Reinvesting (as opposed to immediately distributing) profits can blunt the impact of double taxation, and statutory limitations on losses can significantly impair their value. On the other hand, the stepped-up basis premium on exit is an unalloyed benefit that is simply unavailable in typical C corporation exits.

Another possibility to consider is whether LLC owners can engage in a transaction that is effectively a tax-free reorganization with a corporate acquirer. With some careful planning, this is possible. LLC owners would have to first incorporate the LLC by, for example, merging the LLC into a new corporation (Newco). This generally would constitute a tax-free § 351 transaction. Then, in a separate and independent transaction that is not amalgamated with the § 351 transaction under the step transaction doctrine, Newco would engage in a tax-free reorganization with the corporate acquirer. For example, T LLC would incorporate, becoming T Inc. Then, in a separate and independent transaction, T Inc. would be acquired by P (which typically would be a publicly traded corporation), the owners of T Inc. receiving exclusively (or nearly so) P stock in a reorganization. The familiar end result is that the owners of T LLC defer the recognition of their gain (which is built into the basis of the P stock), while P receives a carryover basis in T's assets.

An interesting question is whether this "LLC reorganization" transaction is tax-efficient. The step transaction doctrine can be a significant practical obstacle. That doctrine seems to require, at a minimum, that the first-step incorporation be undertaken before the second-step reorganization is negotiated. This means that the T owners would be stuck with the risk that, if the second step never takes place, T will be a stand-alone corporation, which is often quite undesirable. Leaving this very practical problem aside, the economic issue is whether the benefit to P in the form of a stepped-up basis exceeds the benefit to the T owners in the form of deferral.

Quantifying the stepped-up basis benefit will be relatively easy and, as mentioned before, will usually equal about 20% of the amount of the step-up, which equals the amount of the gain recognized by T owners. Assuming an effective capital gains rate of 25%, the after-tax

52 See Fleischer, note 3, at 143-44.
53 See id. at 151-64.
54 Cf. Schler, note 17, at 882 (noting that if the step transaction doctrine were implicated, the transaction would not be treated as a reorganization).
55 See generally Ginsburg et al., note 4, ¶ 608 (describing the requirements and applications of the substance-over-form doctrine, including the step transaction doctrine).
premium would equal about 15%. Quantifying the deferral benefit for \( T \) owners is more complicated, as it depends on when each of the \( T \) owners decides to liquidate their \( P \) stock. If a \( T \) owner sells quickly, the deferral benefit will be negligible. If a \( T \) owner dies while holding the \( T \) stock, the deferral benefit will be turned into an exclusion as all of the built-in gains will be eliminated by virtue of § 1014 step-up. To equal the after-tax 15% stepped-up basis premium, the present value of an immediate 25% capital gains tax would have to be reduced 15 percentage points, down to 10%.\(^{56}\) Assuming a 7% discount rate, the break-even holding period would be about 13.5 years, so that a 25% capital gains tax in 13.5 years would approximate a present-value capital gains tax of 10%.\(^{57}\) Thus, ignoring the possibility of \( T \) owners dying while holding their \( P \) stock, if the weighted average holding period of \( P \) stock were greater than 13.5 years, the reorganization structure would be optimal (under the assumptions above), while if the holding period were less, the simple asset purchase would be optimal. Adding in the possibility of \( T \) owners dying while holding their \( P \) stock complicates matters even further, but would certainly shorten the break-even holding period to less than 13.5 years. Another complication is that while the stepped-up basis benefit would inure to the benefit of all \( T \) owners in the form of a premium purchase price, the deferral benefit would disproportionately benefit \( T \) owners who are older and those who have longer investment horizons. And, as mentioned above, the restructuring necessary to transmute a straightforward sale of an LLC to a reorganization can be a significant obstacle.

In the end, the benefits of a straightforward LLC sale will often outweigh the benefit of trying to plan into reorganization treatment. Besides the business and tax risks and planning costs, investment horizons of investors in these deals are often relatively short. Professional investment funds have maximum terms of roughly ten years, so they typically will sell quickly. Founders and other early-stage individual investors often desire to sell a significant portion of their interests relatively quickly so as to diversify their portfolios. For these reasons, a traditional LLC sale generally would be the optimal tax structure.

These conclusions are summarized in the table below.

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\(^{56}\) In that case, the after-tax 15% stepped-up basis premium would equal the after-tax fifteen percentage point reduction in the capital gains tax in a reorganization.

\(^{57}\) For example, assume that \( P \) would pay $120 in a straightforward purchase but only $100 in a reorganization. \( T \) owners would end up with $90 after tax in the purchase ($120 less 25%). In a reorganization, a 25% tax in 13.5 years is, under the above assumptions, equal to a 10% tax today, which if imposed would leave the \( T \) owners with $90.
### Table 2

<table>
<thead>
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2. **Partnership IPOs**

In general, an LLC cannot go public while still preserving its partnership tax status. Under § 7704, once a partnership becomes publicly traded, it is taxed as a C corporation (subject to narrow exceptions, not relevant here\(^{58}\)). Because an LLC is going to be taxed as a corporation once it goes public and because the market prefers the corporate form, a new corporation (Newco) is formed to be the vehicle taken public. Before the recent proliferation of Up-C IPOs, the legacy owners of the LLC would contribute their LLC interests to the Newco in exchange for stock of Newco. In connection with the contribution, Newco would sell shares to the public for cash.\(^{59}\) The contribution of LLC interests and cash to Newco in exchange for all of Newco’s outstanding stock qualified the transaction as a tax-free § 351 transaction. Such qualification allowed the founders to “roll over” their LLC interests into Newco stock in a tax-free manner, with the inherent gain preserved in their Newco stock basis. Only if and when the Newco stock was eventually sold would the inherent gain in the LLC interests be taxed.

Viewed in isolation, this deferral of tax appears to be a nice tax feature, but on the whole the traditional transaction structure frustrated tax planners because the purchaser (here, the public Newco) was giving up the prospect of a stepped-up basis. There would be no

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\(^{58}\) The exceptions cover partnerships that generate mostly passive income. IRC § 7704(b).

\(^{59}\) Shobe, note 4, at 928; Ginsburg et al., note 4, ¶ 1602.10.1.
stepped-up basis at the time of the contribution because the transaction qualified as a tax-free §351 transaction, which provides for a carryover basis. Nor would there be any stepped-up basis when the legacy owners sold their Newco stock, despite the tax triggered by the sale, or when the legacy owners died holding Newco stock, despite the stepped-up basis in the stock basis under §1014. On the other hand, had the legacy owners sold their LLC interests, or died while holding those interests, a stepped-up basis would be generated at that time.

As described above, normally when an LLC is sold, the buyer receives a stepped-up basis and, while some restructuring (of the sort done in the traditional IPO structure) could instead have given the LLC owners tax deferral (and the buyer only a carryover basis), the stepped-up basis is typically more valuable than the owners’ deferral benefit, so the parties are happy with the default taxable-asset-purchase structure. In the IPO context, however, the parties were always intentionally structuring the transaction to provide a carryover basis. In fact, we know of no examples where the IPO of an LLC was structured as a taxable sale (with a resulting stepped-up basis), even though it easily could have.

C. Explaining the Puzzle

Historically there was a significant dichotomy between private sales of LLCs, where transactions were and continue to be commonly structured to deliver a stepped-up basis, and IPOs of LLCs, where stepped-up basis was, before the advent of the Up-C IPO, completely forgone. There appear to be three potential explanations for this inconsistency. It is not clear to us which of these fully explains the phenomenon.

First, due to peculiarities in public company valuation, the public market may systemically discount the value of the stepped-up basis in the pricing of Newco stock, whether rational or irrational. Second, due to peculiarities in the corporate tax system, the actual benefits of a stepped-up basis may be less valuable in the hands of a public company buyer than it is in the hands of the typical private company buyer. Third, in the private context, the transaction consideration is rarely in the form of stock of the acquirer; therefore, the deferral benefit delivered in the traditional LLC IPO structure may simply not be available in private transactions.

60 See note 5 and accompanying text.

61 An alternative stepped-up basis transaction could easily have been structured even if the owners of the LLC were to receive shares of Newco, as typically would be the case in an IPO. Tax planners would take care to structure the transaction as a “busted 351 transaction” to ensure that it was treated as a taxable transaction rather than a tax-free §351 transaction. See Fleischer & Staudt, note 4, at 319 n.50.
The first explanation—undervaluation of the stepped-up basis—is consistent with the conventional wisdom that in the IPO context, the buyer (that is, the public market) does not value a stepped-up basis and therefore will not pay for it in the form of a higher price. 62 Recall that in a private acquisition an LLC worth $100 in a carryover basis transaction could be worth $120 in a stepped-up basis transaction. If the LLC went public, however, the conventional wisdom is that the market would value it at $100 regardless of whether a stepped-up basis was delivered. If the public simply would not pay for the stepped-up basis, the carryover basis transaction, with its deferral for the LLC’s owners, would be the optimal structure, according to the conventional wisdom.

This conventional wisdom is itself puzzling for two separate reasons. First, why would the public markets not value a stepped-up basis? After all, a stepped-up basis delivers real future benefits in the form of tax reductions. Sure, the present value of the stepped-up basis depends on a variety of factors, such as the amount of future taxable income and future marginal tax rates, but business valuation (which is what IPO pricing is) always depends on predictions about a whole host of future events, such as the amount of future earnings of the business. It can be hard to understand what makes the valuation of tax assets so different than garden variety business valuations. Second, even if the public markets irrationally discounted a stepped-up basis, the legacy owners could still capture their value using tax receivable agreements.

1. Explaining the Mispricing of Tax Assets

The traditional account of the mispricing phenomenon relies on the public market’s use of multiples of accounting metrics, such as EBITDA, EBIT, and earnings, without taking account of deferred tax assets or book/tax differences. 63 Whether the company has a stepped-up basis or carryover basis obviously does not affect EBITDA or EBIT, because both amounts are explicitly determined without regard


to taxes. For this reason, among others, the accounting literature assumes, for the most part, that not only are tax attributes not taken into account in determining the IPO price, but that markets may actually discount the value of companies with deferred tax assets on the theory that deferred tax assets serve as negative signals regarding future earnings.64

Further, even the amount of accounting earnings, which is determined on an after-tax basis, is not affected by the existence of a stepped-up basis or carryover basis because of the way that generally accepted accounting principles (GAAP) account for income taxes. In a stepped-up basis transaction, the buyer generally will realize future goodwill amortization deductions for tax purposes but not for financial accounting ("book") purposes because under the relevant financial accounting rules, goodwill is not amortizable; instead it must be tested periodically for impairment and written down if and when impairment occurs.65 Thus, the discrepancy regarding goodwill is merely a timing difference because the book and tax goodwill amounts will eventually be reconciled on impairment or a later sale of the business. For that reason, the accounting rules require the buyer to immediately realize a deferred tax asset on the balance sheet on the closing of the acquisition. Then, for each accounting period following the acquisition, the reduction in tax liability resulting from the stepped-up basis will be offset by a reduction in the deferred tax asset. On the other hand, in a carryover basis transaction, there will be neither a reduction in tax liability from a stepped-up basis nor a reduction in any deferred tax asset (because there never was a deferred tax asset).66

To illustrate, assume that buyer purchases a company for $150, all of which is allocable to goodwill, which will not become impaired in the future. Taxable income and GAAP pretax earnings in Year 1 are $15, and the tax rate is 40%. If the transaction is a carryover bases transaction, even though the company steps up the basis of the goodwill for book purposes, it does not do so for tax purposes. And, under the accounting rules, the company does not amortize the goodwill; instead it periodically tests the goodwill for impairment. Thus, in Year 1, the company realizes $9 of after-tax accounting earnings, the $15 of pretax earnings less the $6 of income taxes payable ($15 x 40%).

64 See, e.g., Edwards et al., note 4, at 13-15.
If the transaction is instead structured as a stepped-up basis transac-
tion, the equivalent purchase price would be $180, because of the 20% 
premium. The buyer immediately realizes a $72 deferred tax asset on 
the balance sheet ($180 stepped-up basis x 40% tax rate). In Year 1, 
the company incurs $1.20 of income tax liability, 40% of $3 (the excess 
of $15 of taxable income less $12 ($180/15) of amortization deduc-
tions). In addition, the company realizes an additional $4.80 income 
tax expense resulting from the reduction in the $72 deferred tax asset 
during the year (1/15 * $72 = $4.80). In Year 1, the company realizes a 
total of $6 of tax expense ($1.20 of taxes paid and $4.80 of deferred 
tax asset amortization) and $9 of accounting earnings ($15 pretax 
earnings less $6 of tax expense), the same result in the corresponding 
carryover basis transaction.

Thus, financial accounting earnings were identical with and without 
the stepped-up basis, so a valuation of a company based on a multiple 
of earnings would yield the same amount. While the bottom line in-
come statement effects are unchanged (as are the amounts of 
EBITDA and EBIT), the balance sheets are quite different. With the 
stepped-up basis, the balance sheet on Day 1 shows a $72 deferred tax 
asset, while the carryover basis balance sheet is missing that item; ac-
cordingly, the equity on the balance sheet after the stepped-up basis 
transaction will be larger by that amount.\footnote{See Paul & Sabbah, note 4 (deferred tax asset on balance sheet not taken into account in valuation).} And, of course, the buyer 
with the stepped-up basis is more valuable on a discounted cash flow 
basis because it has greater future tax deductions and hence larger 
cash flows (assuming the buyer is not perpetually in a tax loss posi-
tion). Under the traditional account, the public market does not place 
much, if any, value on the larger equity or the greater future cash 
flows at the time in IPO valuation, instead focusing (arguably myopi-
cally\footnote{There are a number of potential reasons why this might not be completely irrational. It may simply be a form of rational ignorance, or could reflect diversification across firms 
so it should average out across the entire market, and perhaps most importantly, the use of 
price to earnings multiples by public markets may indicate that the public places a greater 
value on growth while the use of discounted cash flows in other contexts suggest a greater 
value on current cash flows. See, e.g., Amiyatosh K. Purnanandam & Bhaskaran 
tax savings not valued by the public can potentially be used to finance private takeovers of 
public companies. See Steven Kaplan, Management Buyouts: Evidence on Taxes as a 
Source of Value, 44 J. Fin. 611, 626 (1989).} on earnings, EBIT, and/or EBITDA.

One potential problem with the traditional account is that, even if 
you assume that the public market undervalues stepped-up basis, it 
does not necessarily explain the historical popularity of the traditional 
LLC IPO structure. This is because the LLC owners could have cap-

tured the stepped-up basis value directly (instead of through a premium sales price) by obtaining TRA rights, which would have allowed them to effectively retain the stepped-up basis benefits that the public market purportedly undervalued. If the value was higher than the value of deferral (both on an expected value basis) to the sellers and the market undervalued the stepped-up basis, then the optimal approach would be to negotiate for a TRA, not to choose a carryover basis structure.

Proponents of the conventional wisdom might contend that the absence of TRAs in traditional IPOs does not prove the wisdom wrong. They may argue that there was a failure of imagination regarding TRAs, such that advisors simply did not conceive of using them to capture the stepped-up basis benefit. We are dubious of this explanation, given the sophistication of advisors in IPOs. A better explanation may be that the perceived transaction costs associated with TRAs, including administrative and investor relations costs, were large enough to cause the LLC owners to prefer the “cleaner” deferral benefits over messier TRA rights.

2. Rational Discounting of the Stepped-Up Basis

While the conventional wisdom focuses on the notion that, due to valuation idiosyncrasies, public markets do not properly value a stepped-up basis, another explanation, which to our knowledge has not been explored in the context of LLC IPOs, is that the stepped-up basis may simply not be worth as much to public companies as it is to private companies. The idea here is that there are fundamental tax differences between typical private company buyers and public company buyers.

Private buyers are often flow-through entities, either partnerships or S corporations, so that additional depreciation and amortization deductions generated by the stepped-up basis are reported on the individual tax returns of their owners. In some cases, a private buyer may be a closely-held C corporation, but those private C corporations would likely tend to have purely domestic activities.

On the other hand, the income of public companies is subject to the corporate tax, which historically has been notoriously leaky. This resulted in very low effective tax rates relative to nominal statutory rates, especially for multinational companies, who were able to aggressively move income to low-tax jurisdictions. This problem was well understood, as many tax reform proposals sought to dramati-

cally lower statutory corporate tax rates while simultaneously broad-
ening the corporate tax base.\textsuperscript{70} In short, while the effective rate of tax on income was approximately the same as the statutory marginal rate for individuals,\textsuperscript{71} it was often much lower for public corporations.\textsuperscript{72} The recent 2017 Tax Act included a number of reforms that will affect both the statutory rate and the effective rates of corporations on a going forward basis.\textsuperscript{73}

The rough valuation of a stepped-up basis that we performed above assumes an effective marginal tax rate of 40\%, which was roughly the current top rates for individuals and corporations (before the 2017 Tax Act). If instead we use a 25\% effective marginal tax rate, the stepped-up basis premium drops to approximately 16\% (which approximates the combined federal and state effective corporate rate after the 2017 Tax Act). After tax, the stepped-up basis premium would be only 12\%. At some point, the stepped-up basis premium would drop below the value of the deferral benefit, in which case the traditional IPO structure would be preferred over a taxable sale. In those situations, the preference for the traditional structure over a taxable sale would be entirely rational.

3. Practical Impossibility of Deferral in Many Private Transactions

One very distinctive feature of IPO transactions is that they provide the legacy owners with publicly traded stock, which has the virtues of being both highly liquid and eligible for tax deferral. On the other hand, private deals nearly always involve nonstock consideration such as cash and debt, which makes deferral impossible.\textsuperscript{74} Thus, it may be that the deferral benefit, if available, would be pursued in some private transactions because it is greater than the stepped-up basis benefit, but this would not be observed because deferral is not available due to the nature of the acquisition currency.

\textsuperscript{70} See, e.g., id. (explaining that the 2017 Act dramatically lowered the corporate tax rate while also implementing rules intended to curb profit shifting to low-tax jurisdictions).

\textsuperscript{71} Once capital gains are considered, the effective rates for individuals change dramatically, but the future deductions for a stepped-up basis would reduce ordinary income.


\textsuperscript{73} Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2054 (2017); see Rubin, note 69.

\textsuperscript{74} The installment sale rule may allow for some deferral with respect to consideration paid in the form of the buyer’s debt instruments. See generally §§ 453, 453A.
4. Conclusion

Previous commentators have suggested that the unwillingness of the market to price tax assets explained the traditional IPO structure. By itself, this is not completely satisfying because owners of the LLC could have extracted the value of the stepped-up basis through a TRA. Other factors may have a played a much more significant role in explaining the traditional IPO structure than have been appreciated. The market may be accurately discounting stepped-up basis because of the leakiness of the public corporate tax base, especially for multinationals. Furthermore, the deferral option is, as a practical matter, never on the table in many private transactions due to the nature of their acquisition currency.

Regardless of the specific reason for the preference of the traditional LLC IPO structure, it was the dominant structure until the Up-C IPO replaced it. Leaving aside transaction costs that are peculiar to Up-Cs IPOs, these structures are more tax-efficient than traditional IPO structures because they provide the same deferral benefits to LLC owners while also providing for an eventual stepped-up basis.

III. The Up-C Structure

The Up-C structure presents a unique combination of the benefits of C corporation status (namely the ability to go public) with the benefits of flow-through taxation. But the Up-C structure is complex, with multiple components. Section A describes these components, using the Up-C IPO structure as a case study. Section B analyzes the tax issues associated with Up-Cs under current tax law.

A. The Up-C IPO: A Case Study

As described above, traditionally when LLCs went public, the transaction was structured as a tax-free § 351 transaction. The legacy owners would contribute their LLC interests into Newco in exchange for Newco stock, with the public simultaneously buying shares of Newco stock for cash. Under § 351, the legacy owners would receive the benefit of deferral, with tax due only if and when they sold their Newco shares. A major downside of this structure, however, was that Newco would take a carryover basis in its assets, rather than a stepped-up basis.

This state of affairs was troubling to transactional tax lawyers, who were structuring similar private transactions so as to deliver stepped-

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75 See Subsection II.B.2.
76 IRC § 362(b).
up basis. To these lawyers, it seemed as if perfectly good tax basis was going to waste because, according to the conventional wisdom, the buyer (that is, the public market) did not appreciate its value. While we already explained that this story may actually be far more complicated, the fact remained that stepped-up basis and its accompanying tax benefits—appreciated or not—was being left on the table. As one might expect, effectively gifting substantial amounts of money to the federal government in such deals was not something that sophisticated LLC owners and their white-shoe advisors enjoyed. Eventually, clever tax planners found a solution to this problem—the Up-C IPO. The Up-C IPO was devised to allow for a public sale of an LLC with the LLC owners deferring tax for as long as they would like (just like in the traditional structure) while, at the same time, providing for a stepped-up basis.

In an Up-C IPO, as in the traditional structure, a Newco is placed on top of the LLC, and Newco's stock is sold to the public. Unlike in the traditional structure, Newco does not own all of the LLC's interests immediately after the IPO. Instead, Newco, using cash raised from the IPO, purchases some of the LLC's interests (either all from the LLC itself or partially from the LLC's legacy owners), while the remainder of the LLC's interests continues to be held by the legacy owners. The result is that Newco owns some, but not all, of the LLC's membership interests. For tax purposes, the LLC remains a partnership, with Newco and the legacy owners as the partners.

If the transaction stopped there, the structure would not be very desirable from the perspective of the legacy owners, because they would own illiquid LLC interests. A principal purpose of an IPO is to provide legacy owners with a liquid market in which to sell their interests in the business. To deal with liquidity concerns, the legacy owners are granted the right to exchange their LLC interests for equivalent-value stock in Newco. They can thus "move up the chain" from being a member of the private LLC to being a shareholder in the public Newco. On an exchange, the economics are unaffected because Newco's only asset is its interest in the LLC, which grows commensurately when Newco receives LLC interests from an exchanging legacy owner. Because Newco stock can be readily sold

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77 See, e.g., Hart, note 4, at 50 ("These arrangements are premised on the assumption that the public does not value such tax benefits and therefore would pay the same amount for shares of a company that did not own these attributes.").

78 See generally Ginsburg et al., note 4, § 1602.10 (comparing the consequences of the traditional approach of a partnership going public to the Up-C structure).

79 Id. at 926.

80 Id. at 934.

81 Id. at 937.
on the public market, legacy owners that desire liquidity need only exchange their LLC interests for Newco stock and thereafter sell the Newco stock on the public market.

The exchange of LLC interests for Newco stock constitutes a taxable exchange, and therefore the legacy owner would owe capital gains tax immediately on the exchange. Typically, legacy owners would elect to exchange only when, and to the extent, they were ready to cash out of that portion of their interest in the company. Consequently, there would be no acceleration of tax relative to the traditional IPO structure.

From Newco's perspective, each taxable exchange by a legacy owner is treated as a purchase of a partnership interest by Newco, which results in a stepped-up basis for an allocable portion of the LLC's assets. For example, in an exchange involving 1% of the LLC's interests, the LLC would receive a stepped-up basis (to the fair market value at the time of the exchange) with respect to 1% of each and every one of its assets, including goodwill and other intangibles. In turn, the stepped-up basis results in a reduction in Newco's future corporate income tax liability. This is very similar to the stepped-up basis that would result if the IPO was instead structured as a taxable sale. The difference is timing. In the Up-C IPO, the stepped-up basis occurs periodically whenever legacy owners choose to exchange their LLC interests for Newco stock. In a taxable sale of an LLC, there would be a single stepped-up basis at the time of the sale.

The immediate stepped-up basis in a taxable sale should be taken into account in determining the sales price. Recall that, under reasonable assumptions, the stepped-up basis premium could be worth 20% of the amount of the step-up. While calculating and paying the stepped-up basis premium is relatively straightforward in a simple sale of an LLC, it is far more complicated in an Up-C IPO. Because the stepped-up basis benefits Newco, the expected benefits from the exchange should, at least in theory, be built into Newco's stock price.  

82 IRS, Publication No. 541, Partnerships 11 (2016), https://www.irs.gov/pub/irs-pdf/p541.pdf. Some of the gain recognized on the exchange of LLC interests for Newco stock could be taxed at higher ordinary income tax rates pursuant to § 751(a), whereas all of the gain would have been capital gain when Newco stock was sold in the traditional structure. Thus, while the timing of tax would be no different, the effective tax rate on the owner could be higher using the Up-C structure. However, the benefits of the tax receivable agreements would normally dwarf the costs of this higher effective tax rate. See Hart, note 4, at 25.

83 Shobe, note 4, at 918, 946, 951.

84 This assumes that the LLC makes (or already has in effect) an election under § 754 to trigger the stepped-up basis in its assets on the taxable exchange.

85 IRC §§ 743, 754; Hart, note 4, at 24-25.

86 Hart, note 4, at 24-25.

87 See Section II.A.
However, as previously discussed, the public market may not appropriately value stepped-up basis. And even if the public market did value a “one-shot” stepped-up basis, the periodic stepped-up basis resulting from Up-C exchanges would be especially difficult to value. The value would depend on the timing of future exchanges as well as the value of the company at those times. The timing would often depend on the legacy owners’ idiosyncratic desires for liquidity, which could be difficult to predict.

In light of these difficulties, instead of attempting to incorporate the future stepped-up basis into the IPO price, Up-C IPO parties instead use TRAs to, in effect, carve the stepped-up basis out of the deal. TRAs provide that as Newcos tax liability is reduced by the stepped-up basis, Newco is required to pay the exchanging legacy owner the vast majority—typically 85%—of the tax reduction. It is a win-win for the exchanging owners and Newco: valuable assets (the stepped-up basis) are created effectively out of thin air, their value is split between the parties, and no ex ante valuation of the especially hard to value future periodic stepped-up basis is required.

1. Economic Rights and Voting Power in UP-C IPOs

The Up-C IPO structure appears to be replacing the traditional IPO structure when businesses operated as LLCs are taken public. Instead of the traditional approach of contributing their LLC interests to Newco in exchange for stock, the legacy owners of the LLC in an Up-C structure retain some or all of their ownership interests in the LLC. But the legacy owners generally desire to retain effective control of the business until they substantially cash out. To accommodate the owners’ desire for control while complying with applicable securities rules, the owners’ interests in the LLC are converted to nonmanaging interests in the LLC, and they are given “noneconomic” shares of Newco. Holders of the noneconomic shares are entitled to vote, but are not entitled to any dividends or to any liquidating distributions. Thus, the legacy owners own both (1) nonmanaging membership interests, which represent a specified percentage of the economic interests (but without any voting power) in the LLC, and (2) shares of Newco stock, which represent the same percentage of voting power.

88 See Section II.C.
89 See Hart, note 4, at 25; see also Shobe, note 62, at 5.
90 In the traditional IPO structure, there would never be any stepped-up basis and there is minimal if any marginal tax burden in moving from a traditional IPO structure to an Up-C IPO. IRC §§ 721, 1032(a); see also Shobe, note 4, at 928, 935.
91 Shobe, note 4, at 934-37.
92 Id. at 936-37.
(but without any economic value). After the IPO, the ownership structure is as follows:

![Figure 1](image-url)

**Public Shareholders**
- Common shares

**Pre-Existing Owners**
- Noneconomic voting shares

**Newco**
- Managing interest

**Operating LLC**
- Nonmanaging interests

2. **Exchange Rights**

Without any additional features, the Up-C IPO structure depicted above would be deficient because the legacy owners would lack liquidity. Providing these owners with liquidity is typically a principal reason for taking a company public. To deal with the liquidity issue, the legacy owners also receive exchange rights, which allow them to exchange their LLC units for Newco stock on a one-to-one basis. On the exchange, a commensurate amount of noneconomic voting shares are extinguished. For example, if an owner elects to exchange one LLC unit, the owner would receive one share of Newco common stock and one noneconomic share of Newco held by the owner would be extinguished.

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93 Figure 1 is substantially similar to the figure found in Hart, note 4, at 24.
94 Shobe, note 4, at 926. Another primary reason is to raise money to grow the business or pay down liabilities. See, e.g., Fleischer & Staudt, note 4, at 315.
95 Shobe, note 4, at 936. Newco has the option to pay cash instead of stock on the exchange, and might do so to avoid § 382 limitations. See Hart, note 4, at 22 n.35.
96 Shobe, note 4, at 936-37. Certain steps must be taken to ensure that one LLC unit will always have the same economic value as one Newco share. On the IPO, the LLC's ownership interests are recapitalized to ensure one-to-one correspondence. Subsequent to the IPO, equity or debt transactions at the Newco level must trigger corresponding transac-
Holders of the exchange rights generally would not exercise their rights until the holder was ready to cash out of all or some of the holder’s investment in the enterprise. When the legacy owner is ready to cash out, the owner could first exchange LLC units for Newco stock and then sell the Newco stock for cash. In the traditional IPO structure, the holder would have simply received Newco stock in the first place and would hold onto the Newco stock until the holder was ready to cash out. Therefore, the Up-C structure gives legacy owners nearly the same deferral benefits as under the traditional structure.

While the deferral benefits are similar under either structure, Up-C IPOs provide two significant tax benefits unique to the structure. First, because the owners remain members of the LLC before the exchange (as opposed to immediately becoming shareholders of Newco), the LLC’s pre-exchange income or loss continues to flow through to the legacy owners (as well as to Newco). Accordingly, if the LLC realizes income before the exchange, the income attributable to an LLC unit held by a legacy owner is taxed once and only once to the legacy owner. In contrast, income earned attributable to a share of Newco stock generally would be taxed twice under the standard corporate tax regime. Likewise, if the LLC realizes losses before the exchange, the losses at the LLC level. For example, if Newco issues additional shares to the public for cash, Newco must use those shares to acquire additional LLC units; otherwise, the pre-existing public shareholders' interest would be diluted, while the legacy owners' interests in the LLC would not and, in that case, there would no longer be one-to-one economic correspondence between LLC units and Newco common stock. See Hart, note 4, at 12 (discussing the importance of these steps to ensure that “economic parity is maintained” in the context of an UPREIT, the precursor to the Up-C IPO structure).

Shobe, note 4, at 945-47. Further, if an investor in LLC units holds those units until death, the heirs will receive a step-up in basis under § 1014. This step-up would permit a tax-free exchange of the LLC interest for stock of Newco by the heirs. For many financial investors, this may prove unlikely as they have an incentive to monetize as soon as possible. For founders or other individual investors, however, it is possible that this could arise. The tax treatment to Newco should remain unchanged, because of basis adjustments under § 743 due to the step-up.

As discussed in more detail below, to achieve the intended tax characterization of the Up-C IPO structure, there are contractual provisions that provide some limitations and restrictions on the ability of the legacy owners to exercise their exchange rights. See notes 134-37 and accompanying text; see also Shobe, note 4, at 957 n.161.

A related tax benefit relates to the character of flow-through income. When income flows through the LLC to the legacy owner before the exchange, the character of the income is determined at the partnership level. IRC § 702. Thus, if the LLC recognizes a long-term capital gain, the owner would recognize his or her share of those gains as long-term capital gain, and individuals pay a much lower rate of tax on these types of gains. IRC §§ 1(h)(1)(D), 702. On the other hand, in the traditional structure, all capital gains after the IPO would be recognized by Newco and, because corporations receive no tax rate preference for long-term capital gains, these gains would be taxed at ordinary corporate rates. IRC § 11.
exchange, the loss attributable to an LLC unit held by a legacy owner flows through to the owner,\(^{101}\) whereas losses attributable to a share of Newco stock are trapped inside the corporation. In short, the structure allows the legacy owners, during the period before the exchange, to sidestep the less favorable corporate tax regime by remaining partners in a partnership.

Second, the eventual exchange of LLC units for Newco shares effectively triggers a stepped-up basis of a proportionate amount of the LLC’s assets. For example, if 1% of the LLC’s units are exchanged (for a 1% stockholding interest in Newco), the bases of 1% of each and every one of the LLC’s assets, including goodwill and other intangibles, are stepped up to their fair market value at the time of the exchange. This stepped-up basis results in additional deductions, greater losses, or lower gains\(^{102}\) for Newco in the future compared with the traditional structure, where there would never be any corresponding adjustment to the business’ tax bases, even when shares of Newco held by the legacy owners are disposed of in a taxable sale.\(^{103}\)

3. Blocker Structures

Typically, when private investment funds (for example, VC/PE funds) own interests in an LLC, a “blocker” corporation will be inserted into the ownership structure to protect the fund’s tax-exempt and foreign investors from realizing unrelated business taxable income (UBTI) or effectively connected income (ECI), respectively.\(^{104}\) Sometimes, two otherwise identical funds are set up: a main fund and a co-investment vehicle.\(^{105}\) The tax-exempt and foreign investors invest through the co-investment vehicle, which itself invests in the LLC through a corporation.\(^{106}\) Alternatively, a feeder fund structure can be used, whereby the tax-exempt and foreign investors invest in the fund through a blocker corporation, while other investors invest di-

\(^{101}\) If the owner is an individual, the losses may be subject to the passive activity and at-risk limitations. See IRC §§ 465, 469.

\(^{102}\) The stepped-up basis could also be used to offset taxable income otherwise triggered in a transaction, such as the transfer of the assets to a foreign corporation under § 367 as part of an internal restructuring.

\(^{103}\) As discussed below, this is substantially similar to the result accomplished in so-called “leveraged partnership” transactions, although a recent case has questioned the effectiveness of this structure under certain facts. Canal Corp v. Commissioner, 135 T.C. 199 (2010); see also Tom King, The Tax Court Capsizes a Leveraged Partnership in Canal Corp., 65 Tax Law. 713 (2012).


\(^{106}\) Id. at 36.
rectly in the fund. In either case, the blocker blocks the tax-exempt and foreign investors from recognizing UBTI or ECI, which would trigger undesirable U.S. tax filing obligations or consequences.

In the Up-C IPO structure, blocker corporations are usually merged into Newco in a tax-free reorganization, with the tax-exempt and foreign investors receiving the publicly traded Newco stock and Newco receiving the LLC units formerly held by the blocker. Because these investors are going from investing in a corporation (the blocker) to investing in another corporation (Newco), they avoid recognizing UBTI or ECI. If the blocker corporation has NOLs that can be used by Newco to reduce its future tax liability, the tax-exempt and foreign investors may also be beneficiaries of a separate TRA, which will allocate to them a portion (usually 85%) of the ultimate tax savings of the NOL that is inherited by Newco in the reorganization. These consequences are similar to the ones that would have resulted in the traditional LLC IPO structure.

B. Tax Issues Under Current Law

Up-C IPOs provide a combination of significant tax benefits that is unusual in the current tax system. In particular, the Up-C IPO allows for both (1) tax deferral by sellers and (2) a stepped-up basis for buyers. As discussed in Part II, in traditional corporate M&A deals, this combination is unavailable and the parties must choose one or the other. Likewise, Up-C IPOs allow for a continuation of the partnership form despite giving legacy owners the effective right to sell their LLC interests on the public market (through exchanges and subsequent sales of Newco stock on a public stock exchange). Typically, under § 7704, partnership taxation is foreclosed when ownership interests are readily tradeable on public markets. While there are exceptions to this rule, these exceptions are narrow and apply only to passive-type businesses. On the other hand, Up-C IPOs can be used regardless of the type of business.

107 Id. at 37.
108 Where the feeder structure is used, the private equity fund would first distribute the proportional number of LLC units owned by the fund up to the corporate feeder (that is, the blocker) in a tax-free partnership distribution. Thereafter, the corporate feeder would be merged into Newco on a tax-free basis.
109 The blocker corporation’s NOLs would represent the corporation’s share of the LLC’s net losses during the time the blocker owned its interest in the LLC. Because the merger of the blocker corporation and Newco is a tax-free reorganization, Newco inherits the blocker’s NOLs. IRC § 381. The utilization of these losses often will be subject to certain limitations. IRC § 382.
110 IRC § 7704.
111 IRC § 7704(c)-(d); see also Shobe, note 4, at 928 n.59.
These unprecedented tax advantages raise two separate questions. First, could the IRS challenge Up-C IPOs under current law? Second, as a matter of tax policy, should the tax benefits of Up-C IPOs be allowed? In this Section, we take up the doctrinal question. In Part V, we address the broader tax policy issues.

1. Origin of Up-Cs Out of UPREITs

The Up-C structure evolved out of the umbrella partnership real estate investment trust (UPREIT), which has been a very common structure in the real estate investment trust (REIT) world since the early 1990's. UPREITs and Up-Cs utilize the same overall structure (including similar exchange rights), but Up-Cs involve a corporate parent that is a garden variety C corporation while UPREITs involve a corporate parent that is a REIT.

A REIT is a special corporate tax classification that is available only to certain real estate related businesses. The income of REITs is taxed only once, unlike traditional corporate income, which is taxed twice. If a real estate investor wanted to contribute its property to an existing REIT in exchange for REIT stock, the contribution typically would be taxed as a sale because the requirements of § 351 would not be satisfied. The resulting immediate gain recognition significantly discouraged contributions of real property to REITs. The UPREIT was the solution to this tax planning problem.

In an UPREIT, the real estate owner contributes its real estate to a partnership owned by the REIT and the investor. Because § 721, which applies to partnership contributions, is much more liberal than § 351, the contribution would be tax-free. As part of the contribution, the real estate owner receives exchange rights to move up the chain and receive equivalent-value REIT shares. The UPREIT structure is therefore identical to the Up-C structure except for the different types of entity at the top of each structure.

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112 See Hart, note 4, at 19 ("UPREIT structure described above was a precursor to what has come to be known as an 'UP-C' . . . .").

113 Id. (noting that the “UP-C looks very similar to an UPREIT” except that an Up-C can invest in “not REIT-eligible” assets).

114 IRC § 856.

115 IRC §§ 857(a)(1), (b)(2)(B) (providing that a REIT is required to distribute at least 90% of its income (excluding net capital gain) each year to maintain REIT status and that a REIT is entitled to a deduction for dividends paid, resulting in only a single level of tax where a REIT distributes all of its profits).

116 Shobe, note 4, at 956.


118 Id. at 335.
When Treasury initially proposed the so-called partnership anti-abuse rules in 1994, the UPREIT structure was thought to be vulnerable to attack under the rules because the subsidiary partnership was used solely to circumvent the § 351 rules that would have required immediate recognition. The partnership anti-abuse rules targeted partnerships that were formed to provide a favorable tax result that was not otherwise available. Though the proposed rules were ambiguous, it appeared that the UPREIT subsidiary could be disregarded under the rules. If so, the UPREIT contribution would be treated as a simple contribution of real property to the corporate REIT, which would have triggered immediate gain recognition to the contributing real estate owner.

Such a result was thought to be potentially devastating to the real estate industry, as contributions to REITs would be greatly deterred. The final drafters of the anti-abuse regulations were apparently sympathetic to this concern and inserted a very favorable example into the final regulations. In the example, two partnerships contribute real estate to a new partnership owned by the partnerships and a REIT partner. The REIT partner goes public and contributes the cash raised in the public offering to the newly formed partnership in exchange for its interest in the partnership. The two pre-existing partnerships receive interests that are exchangeable into stock of the REIT after two years. The example also notes that the new partnership “may make other real estate investments and other business decisions, including the decision to raise additional capital for those purposes.” The example concludes that this UPREIT structure did not trigger application of the anti-abuse rules.

Proponents of Up-Cs cite this example for the proposition that Up-Cs similarly do not violate the partnership anti-abuse regulations. It is not entirely clear, however, how much comfort this regulation ought to provide. First, modern tax advisors, in both the UPREIT and UP-C contexts, have pushed the limits on what arguably are the key facts in this example. The example involved a two-year blackout period during which the exchange rights could not be exercised; in modern structures the blackout period is often shorter, or even

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120 See Hart, note 4, at 14 (noting that “viability of the UPREIT structure was briefly threatened following” the proposed rule).
121 Reg. § 1.701-2(d)(Ex. 4); see Hart, note 4, at 16.
122 Reg. § 1.701-2(d)(Ex. 4).
123 Id.
124 See, e.g., Monte A. Jackel, The Partnership Antiabuse Rule and UPREIT Structures Revisited, 150 Tax Notes 113, 113 (Jan. 4, 2016); Shobe, note 4, at 956 (arguing that the anti-abuse exception does not apply to Up-Cs).
nonexistent. In the anti-abuse regulation example, the umbrella partnership could make investments and other decisions that would upset the one-to-one correspondence in value between units and shares; in modern Up-C umbrella structures, the partnership is contractually forbidden from making investments or otherwise doing anything that would upset the one-to-one correspondence. Nevertheless, the general consensus among tax advisors is “the differences between the Example and a typical UPREIT transaction should not be a cause for concern.”

Besides these technical factual distinctions between the example and modern-day UPREITs and Up-Cs, another issue is whether Up-C advisors should be able to rely on an example involving an UPREIT. While UPREITs and Up-Cs are structurally identical, the contexts in which they arise are much different. Blessing UPREITs facilitated the formation of REITs—a special entity created and blessed by Congress to encourage real estate investment—by allowing for tax-free contributions of real property to these entities. If UPREITs were re-characterized under the anti-abuse rules, the likely consequence would be that real property that otherwise would have been contributed to a REIT would instead be retained by the investor, contributed to a partnership, or exchanged in a tax-free like-kind § 1031 exchange. Thus, if the final regulations had concluded that UPREITs were abusive, very little, if any, additional tax revenue would likely have been generated; the biggest impact would have been a reduction in the amount of real property owned by REITs. Since Congress intentionally gave a special tax break to REITs to encourage their formation, subjecting UPREITs to the anti-abuse rules would have frustrated that intent while raising little, if any, additional revenue.

The stakes involved in Up-Cs are much different. First, because Up-Cs use garden variety C corporations, the Up-C can be used regardless of the type of business activity involved while UPREITs are limited to real estate activity, which Congress intended to subsidize in enacting the REIT regime. Second, while UPREITs facilitate the avoidance of individual income tax on real property gains (which is easily avoided in other ways), UP-Cs facilitate the avoidance of corporate income tax by allowing a portion of a public company’s income to remain subject to partnership taxation. Third, the behavioral effects of applying an anti-abuse rule would likely be different. If UPREIT contributions were immediately taxable, real property owners would likely not contribute highly appreciated property to REITs, and thus

125 See Jackel, note 124, at 114.
126 See Hart, note 4, at 18.
127 See id at 19-25.
presumably there would therefore be little tax revenue gained. By contrast, if Up-Cs were effectively disallowed by characterizing them as partnership abuses, the probable behavioral response is not nearly as clear. Perhaps many LLCs that would go public via an Up-C would still go public using the traditional structure. Or perhaps many LLCs would forgo an IPO and remain private. If LLCs would still go public, disallowing Up-C IPOs would increase corporate tax revenues. But if LLCs would choose to remain private, then disallowing Up-C IPOs could actually reduce corporate tax revenues. This is because, once an Up-C IPO is undertaken, eventually (after all of the legacy owners have exchanged) all of the business's income will be subject to the corporate tax.

This discussion of revenue impacts is policy-oriented and discussed in more detail in Part V. As a matter of technical legal doctrine, it seems that there is little reason that planners should not be able to rely on the notion that what works for UPREITs also works for Up-Cs. Regardless of the merits of the reasoning behind the anti-abuse example, if there is no partnership abuse in the UPREIT context, then there should be no partnership abuse in an analogous Up-C situation. After all, the partnerships in each case are substantively identical; the differences are only in the ways that the corporate parents are taxed. Nevertheless, Gladriel Shobe has argued that the analogy is flawed, given the different contexts and stakes involved. She refers to the anti-abuse example as the "REIT regulations" and contends that they have no relevance to Up-C transactions. But the anti-abuse example is not a REIT regulation; instead it is part of a partnership regulation and the Up-C partnership is identical in all relevant respects to the UPREIT partnership. If, despite these similarities, the partnership in an Up-C is deemed abusive under the partnership anti-abuse rule and disregarded, the legacy owners would be deemed to simply own Newco stock from the outset, resulting in the same tax consequences as under the traditional structure (that is, no immediate taxation and no stepped-up basis on exchanges).

Another potential IRS attack on Up-C IPOs could be based on the publicly traded partnership rules. A partnership that is publicly traded is taxed as a corporation, subject to certain exceptions not relevant here. In the Up-C structure, the LLC interests themselves are not publicly traded. But, once the exchange rights are considered, the

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129 See Shobe, note 4, at 954-60.
130 Id. at 956-59. The incorporation transaction would qualify as a § 351 transaction.
131 IRC § 7704.
question is whether the legacy owners are "taking into account all of the facts and circumstances . . . readily able to . . . sell . . . or exchange their . . . [LLC] interests in a manner that is comparable, economically, to trading on an established securities market."\textsuperscript{132} If so, the LLC would be considered publicly traded and taxed as a corporation, negating the Up-C structure's tax benefits.\textsuperscript{133}

In an attempt to avoid this result, tax advisors place certain bells and whistles on the exchange rights to make them less liquid. For instance, legacy owners are often required to give advance notice before effectuating an exchange, exchanges may be limited to certain time periods during the year, or the number of shares exchanged during a specified period might be capped. A provision in the regulations under § 7704 specifically blesses exchanges with a safe harbor. Under that rule, exchange rights would not trigger publically traded partnership status as long as the exchange requires sixty days notice, places certain limitations on the establishment of the purchase price,\textsuperscript{134} and caps the aggregate yearly exchanges at 10% of the LLC's interests.\textsuperscript{135} Because such limitations are anathema to legacy owners who desire extreme liquidity, modern UPREIT and Up-C structures typically do not attempt to fit within the safe harbor.\textsuperscript{136} For instance, an IRS official noted that modern structures often provide for only thirty days notice or for the ability for legacy owners to cancel their notices prior to the consummation of the exchange.\textsuperscript{137} Because the safe harbor is not satisfied, the doctrinal issue is whether the less onerous bells and whistles used by modern tax planners are still sufficient to avoid publicly traded status under the general facts-and-circumstances standard of § 7704. The IRS official indicated that the IRS might be skeptical of structures that stray too far from the safe harbor on the theory that UPREIT and Up-C "structures are a bit of a gift from the government."\textsuperscript{138}
In summary, the IRS could—in theory—challenge modern Up-C structures.\textsuperscript{139} It could assert that all Up-C structures abuse the partnership form. But the specific example involving an UPREIT appears to bless umbrella structures generally, regardless of the tax character of the public parent company, notwithstanding the fact that the tax concerns at stake in the Up-C context are very different than those in the UPREIT context. Alternatively, the IRS could contend that while some umbrella partnership structures may be able to pass muster, others have strayed too far from the publicly traded partnership safe harbors.

The latter is a case-specific approach, which raises two issues. First, the facts-and-circumstances test would be extremely uncertain. Without more guidance, it would be difficult for tax planners to determine what facts are necessary to fend off IRS attack. Second, and more importantly, it would seem to be impossible for the IRS to draw doctrinal distinctions between Up-Cs and UPREITs in any coherent, rational manner. For instance, if a minimum sixty-day notice was absolutely required to avoid publicly-traded status (as opposed to merely representing a safe harbor), UPREITs would have to comply with the sixty-day rule as well, even though UPREITs are, or are at least perceived to be, less troubling policy-wise than UP-Cs. Any partnership rule that attempts to single out Up-C structures would be vulnerable to claims that it is arbitrary and capricious because the umbrella partnership structures are so technically similar. In light of this, tax advisors appear to be on reasonably solid ground in recommending Up-C structures that are very similar to modern UPREIT structures now in the market.\textsuperscript{140}

\section*{IV. Tax Receivable Agreements}

The Up-C structure, while providing significant tax benefits in the form of combining deferral and liquidity for the legacy owners and a stepped-up basis for \textit{Newco}, does not deal with the apparent valuation problems associated with the stepped-up basis. The conventional wisdom is that, because of the market's myopic focus on financial accounting earnings metrics, the IPO price (or, for that matter, the post-IPO stock price) will not appropriately reflect the true economic value

\textsuperscript{139} Another less likely potential approach could be to attempt to apply the antichurning rules under \textsection\textsuperscript{197} to prevent the step-up in basis attributable to goodwill. See DeSalvo, note 4, at 869.

\textsuperscript{140} Jackel, note 128, at 449. But this does not mean that the growth of the Up-C structure is necessarily a positive (or negative) development from a tax policy standpoint. See generally Section V.B (discussing the relevant tax policy issues).
of the stepped-up basis created by the Up-C. Even if that conventional wisdom is wrong, valuing the future "springing" stepped-up basis that arises from future exchanges, the timing of which can be very uncertain, could be particularly difficult.

To solve these valuation problems, TRAs are usually used in an Up-C IPO. In general, TRAs require the new public company to pay the legacy owners a very large percentage (often 85%) of the tax savings ultimately realized by the company as a result of the stepped-up basis triggered by any future exchanges. TRAs effectively transfer the vast majority of the stepped-up basis benefits to the legacy owners. This allows the stepped-up basis to be disregarded in setting the IPO price of the stock. Accordingly, TRA payments are viewed as "free money" for the taking because the IPO price is assumed to be unaffected, the legacy owners will receive the same deferral benefits, and the Newco would receive 15% of the ultimate cash savings from of the stepped-up basis. This is a win-win for everyone involved, except of course for the government, which no longer receives the windfall stemming from the stepped-up basis that had been left on the table in the traditional LLC IPO structure. So powerfully beneficial is this combination of an Up-C IPO and a TRA related to the stepped-up basis that it is commonly referred to as a "supercharged IPO."

A. Structure of the TRA

The two main tax advantages of the Up-C IPO over the traditional LLC IPO structure are deferral for the legacy owners and the

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141 See notes 39-43 and accompanying text.
142 See Paul & Sabbah, note 4 (arguing that "it may be that TRAs relate simply to value" because "the IPO corporation pays for a valuable tax attribute (for example, a basis step-up), just as a buyer of assets would normally pay more than a buyer of stock because of the basis step-up that a buyer obtains in an asset sale. In a stock sale, the corporation's basis in its assets generally remains unchanged."); Shobe, note 62, at 32 ("vast majority of Up-Cs use a TRA").
143 Shobe, note 62, at 11.
144 Id.
145 See BDO, note 4, at 2 ("[I]nvestment bankers and other market professionals generally do not view a step-up coupled with a TRA obligation as a factor contributing to a reduced market capitalization.").
146 Shobe, note 62, at 22.
147 See Shobe, note 4, at 914. Others involve a § 338(h)(10) election with a TRA and an Up-PTP with a TRA. See Shobe, note 4, at 916-17. Up-C IPOs are one such structure. The Up-PTP is another. In an Up-PTP, the parent is a publicly traded partnership that is exempt from corporate tax. The publicly traded partnership owns a blocker corporation, which blocks nonqualifying income from going up to the ultimate partner. When a legacy owner exchanges his rights pursuant to the exchange rights, some of his interests are contributed to the blocker corporation, which results in a stepped-up basis for the blocker corporation. The tax savings from that stepped-up basis are subject to the TRA in the Up-PTP structure. See Hart, note 4, at 27-35.
stepped-up basis from the eventual exchange of LLC units for Newco stock. Deferral directly inures to the benefit of the legacy owners. The stepped-up basis, on the other hand, inures directly to the benefit of Newco since Newco will, by virtue of receiving the stepped-up basis, eventually realize lower taxable income, which will translate into lower tax liabilities. In theory, this benefit would be priced into the IPO, and subsequent trading, prices for Newco stock. However, as discussed above, the conventional wisdom is that public markets fail to adequately price these tax assets. And this pricing problem is particularly acute in the context of the periodic stepped-up basis that results from future exchanges, due to uncertainty regarding the timing of those exchanges.

To solve the stepped-up basis pricing problem, TRAs are often used in Up-C IPOs. TRAs use a wait-and-see approach for valuing the tax benefits resulting from exchanges. The agreements allocate the vast majority of those benefits to the legacy owners, which avoids the necessity of ex ante valuations. A TRA is a contract between the public Newco and the legacy owners pursuant to which Newco agrees to make annual payments to the owners in an amount determined by reference to the tax savings generated by Newco attributable to the stepped-up basis triggered by future exchanges. The typical TRA accomplishes this by comparing Newco’s actual tax liability with a hypothetical tax liability. This hypothetical tax liability begins with the actual tax liability and then backs out the impact of stepped-up basis that resulted from exchanges by the legacy owner.

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148 Another advantage is the flow-through, single taxation of income attributable to the legacy owners’ LLC units prior to exchange. This benefit stems from a distribution of earnings as opposed to reinvestment. If income is reinvested, it is possible for the investor to be worse off, for example, because of the higher individual income tax rate as compared to the corporate tax rate. A related benefit is the flow-through of losses attributable to the legacy owners’ LLC units prior to exchange.

149 This assumes sufficient taxable income in the future to take advantage of the stepped-up basis, but regardless from a financial standpoint there is value notwithstanding this uncertainty.

150 See Shobe, note 62, at 26; Hart, note 4, at 36-37; see also Fleischer & Staudt, note 4, at 319. If pricing problems did not exist, there would be no reason to go through the complications of drafting, administering, and enforcing TRAs to carve tax assets out of the deal. See Shobe, note 62, at 26.

151 Shobe, note 4, at 939 (citing Paul & Sabbah, note 4).

152 For example, the TRA used in the GoDaddy.com IPO incorporates most if not all of these typical provisions. See GoDaddy Inc., Form of Tax Receivable Agreement (Exchanges) (Form S-1, Exhibit 10.4) (Feb. 11, 2015), https://www.sec.gov/Archives/edgar/data/1609711/000119312515042658/d728713dex104.htm [hereinafter GoDaddy TRA]. Unless otherwise indicated, TRA terms used in this Section refer to the GoDaddy TRA.

153 The hypothetical tax liability also assumes that Newco does not receive certain remedial allocations under § 704(c) that are attributable to the exchanges that are effectively the same as a stepped-up basis. See id.
The difference between the actual and hypothetical tax liabilities is often referred to in the TRA as the “realized tax benefit.”\(^{154}\) TRAs typically require *Newco* to make a cash payment to the selling shareholders of a specified percentage of the realized tax benefit. For what appears to be historical and market acceptance purposes, the standard TRA payment is 85% of the realized tax benefit.\(^{155}\) There does not appear to be any good theoretical reason for 85% to become the standard.\(^{156}\) The theory behind TRAs—that *Newco*’s stock price will not incorporate the value of the stepped-up basis—would imply that the standard could just as well be 100%. Presumably, the lesser percent is chosen for two reasons. First, *Newco* bears some significant costs in administering the TRA.\(^{157}\) For instance, *Newco* must annually calculate multiple hypothetical tax liabilities. The percentage of the realized tax benefit retained by the company may be viewed as compensation for these costs. Second, by allowing the company to retain a portion of the realized tax benefit, there is an economic incentive for the company to claim, preserve, maximize, and (if challenged by the IRS) defend the benefit. If 100% of the benefit were to inure to the legacy owners, there would be no incentive for *Newco* to care. This incentive is backstopped by fiduciary duties of directors and officers that require that they act reasonably to prevent the wasting of corporate assets and benefits.

For tax purposes, TRA payments received by legacy owners generally are treated as contingent additional purchase price received in exchange for the LLC interest that is swapped for *Newco* stock.\(^{158}\) Accordingly, when payments are made, *Newco* receives additional basis in the LLC’s underlying assets, and the legacy owners report the amounts on the installment method, characterizing the gain as capital gain.\(^{159}\) The theory underlying this approach is that the legacy owners are receiving a type of deferred “earn-out” consideration.\(^{160}\) Typically earn-outs are based on future profitability; for example, a stock seller might receive additional cash from the buyer if the business exceeds certain earnings metrics.\(^{161}\) TRA payments represent similar addi-

\(^{154}\) See Hart, note 4, at 45.
\(^{155}\) Id. at 45 n.61.
\(^{156}\) Shobe, note 62, at 11.
\(^{157}\) See GoDaddy TRA, note 152.
\(^{158}\) Because the TRA payments are received after the date of the exchange, portions of the payments are characterized as interest. See Paul & Sabbah, note 4.
\(^{159}\) Id.
\(^{161}\) See, e.g., Robert R. Wootton, Taxation of the Seller in a Multi-Year Sale or Exchange, Taxes, Mar. 2003, at 191.
tional purchase price even though the amounts are not directly related to earnings. The fact that the payments are calculated by reference to tax savings, rather than earnings, should not alter the tax character of the payments as additional proceeds for the sale of the interests. Thus, because the TRA payments themselves trigger additional stepped-up basis they will result in additional future TRA payments (assuming sufficient profitability), which triggers additional stepped-up basis, resulting in additional TRA payments, and so on.

As a result of this cascading effect, TRA payments can accrue for a very long time. In fact, many TRA contracts require payments to be made indefinitely. In turn, however, TRAs often also allow Newco, at its option, to terminate the TRA payment obligation with respect to a legacy owner’s stepped-up basis by making a single lump-sum payment. Since the termination payment cannot be with reference to actual future tax liability (because it is unknown at the time of payment), the TRA termination payment is based on the assumptions that Newco will have sufficient taxable income to fully utilize the stepped-up basis in the earliest years possible and that current tax rates remain constant. Thus, the termination payment is based on the fullest use of the stepped-up basis under current tax rules, with the assumed future tax benefits discounted to present value using a specified discount rate.

B. Common Misconceptions About TRAs

TRAs have received a fair amount of attention in both the academic and practitioner literature. There has also been proposed federal legislation directed specifically at TRAs, which would mandate that TRA payments always be characterized as ordinary income; under current law, TRA payments are generally characterized as capital gains because they represent additional purchase price received in exchange for goodwill. Despite all of this attention, the discussion has often been fraught with misconceptions about TRAs and their relationship to Up-Cs.

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162 See Hart, note 4, at 49 (noting that the TRA’s term “lasts until all relevant tax benefits have been used or have expired”).

163 See GoDaddy TRA, note 152.

164 See Amy S. Elliot, IPO Agreements That Shift the Basis of Step-Up to Sellers Proliferate, 132 Tax Notes 334 (July 25, 2011); Fleischer & Staudt, note 4; Paul & Sabbah, note 4; Howard Jones & Rudiger Stucke, A Cheaper Way to Do IPOs, Harv. Bus. Rev., Nov. 2013, at 32; see also Shobe, note 4, at 941.


166 See Fleischer & Staudt, note 4, at 311 n.10, 344; Shobe note 4, at 944. Some portion will be treated as imputed interest.
1. Myth #1: TRAs and Up-Cs Are Synonymous

A common misconception about TRAs is that they are synonymous with Up-Cs, or at least that the two are so intertwined that the policy issues implicated by one implicate the other. For example, the term “super-charged IPO” is sometimes used to refer to a combined Up-C IPO and TRA and critiques of the super-charged IPO structure tend to blur the lines between the two structures. In fact, the two structures, while often (but not always) going hand-in-hand, deal with completely different technical and policy issues. Yet some commentators have not adequately separated them in their analysis, which can lead to confusion.

TRAs are the result of tax asset pricing problems. TRAs value tax assets on an as-realized basis, allocating any cash tax savings according to a formula. This allows the parties to disregard tax assets in making an ex ante valuation of a business. As explained above, Up-C IPOs create particularly acute tax asset pricing problems because of the uncertainties regarding future exchanges. It is not at all surprising that nearly all Up-C IPOs also include TRAs. Nevertheless, tax asset pricing problems may exist outside of the Up-C IPO context, and TRAs have occasionally been used in those cases as well. For example, TRAs have been used in carveout IPOs, where a parent corporation sells a minority interest in its subsidiary corporation to the public. The transaction can include an election under § 338(h)(10), which treats the transaction as an asset sale for tax purposes, resulting in a stepped-up basis for the newly public subsidiary. TRAs have been used to allocate the eventual tax savings from the stepped-up

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167 See, e.g., Fleischer & Staudt, note 4, at 319 (“A supercharged IPO ... always involves a TRA . . . .”).
168 See, e.g., id. at 317-26.
169 See Shobe, note 4, at 948-54 (explaining how Fleischer and Staudt’s analysis of super-charged IPOs was flawed because it did not separately analyze Up-Cs from the other types of super-charged IPOs).
171 See Part IV.
173 See Hart, note 4, at 41-43.
174 Id. at 42-43. TRAs have been used in so-called Up-PTPs, which are quite similar to Up-Cs. See note 147. In an Up-PTP, the upper tier entity is not a C corporation but is instead a PTP that qualifies for the exception to the rule that such partnerships are taxed as C corporations. See IRC § 7704(c).
In general, the exception requires that substantially all of the PTP's income be passive income, such as dividends, interest, and capital gains. IRC § 7704(c)(2), (d). In order to satisfy that condition, the Up-PTP structure utilizes a blocker corporation to convert non-qualifying income (such as compensation for services) into qualifying income (dividends and interest). When the legacy owners in an Up-PTP exchange their interests in the lower tier partnership for interests in the PTP, the blocker receives a stepped-up basis, which will reduce the blocker’s corporate taxes. A TRA is typically executed that allocates most of
basis primarily to the selling corporate parent. TRAs have also been used in situations that do not involve a stepped-up basis. For example, at least one TRA has allocated the benefit of a corporate NOL existing at the time of an IPO back to the legacy owners. Yet another TRA allocated the tax benefit of deductions from compensatory stock option deductions exclusively to the historic shareholders of the company that issued the options. All of these examples show that when, for whatever reason, significant tax asset pricing problems exist, TRAs can be a solution.

There have also been Up-C IPOs without TRAs. While TRAs are motivated by tax asset pricing problems, Up-C IPOs are motivated by a desire to keep an existing partnership alive through the IPO. This motivation can be present even in the absence of any perceived tax asset pricing problem. For example, in what was apparently the first Up-C IPO—the carveout IPO of barnesandnoble.com—no TRA was used. Furthermore, as discussed below, the Up-C structure is increasingly being utilized in non-IPO acquisitive transactions where tax asset pricing problems are not as acute and are thus implemented without TRAs.

Thus, while TRAs and Up-Cs IPOs often go hand-in-hand, there have been TRAs without Up-C IPOs and vice versa. This makes senses as there is no conceptual link between the two phenomena. TRAs allocate future tax benefits on an ex post, as-realized basis between buyers and sellers, while Up-C structures allow taxpayers to keep partnerships alive in acquisitive transactions. As advisors and the market become more familiar with both TRAs and Up-C structures, we expect the current factual correlation between the two to diminish.

Finally, while the tax benefits from Up-Cs are potentially vulnerable to IRS attack under current law, the tax treatment of TRAs appears to be unassailable. As discussed immediately below, the tax treatment of TRAs has been criticized on policy grounds. If those

the resulting tax savings back to the exchanging legacy owner. See Hart, note 4, at 45-46; Shobe, note 62, at 11.

175 See Spirit Airlines, Inc., Tax Receivable Agreement (Form S-1, Exhibit 10.12) (June 1, 2011), https://www.sec.gov/Archives/edgar/data/1498710/000119312511330952/d250422dex1012.htm. Likewise, in Up-C IPOs involving blocked foreign and tax-exempt investors in private investment funds, there is commonly a TRA that allocates benefits from NOLs of the blocker corporation that is merged into Newco. See Subsection III.A.3.

176 See Endo Pharm. Holding Inc., Amendment No. 1 to Form S-4 (Form S-4/A) (June 14, 2000), https://www.sec.gov/Archives/edgar/data/1100962/0000940180000000720/0000940180-00-000720-0001.txt; Hart, note 4, at 38-39 (discussing Endo Pharmaceuticals Holdings Inc.).

177 See Shobe, note 62, at 26 (noting that six recent Up-C IPOs did not include TRAs).

178 See Hart, note 4, at 43-44.
criticisms were persuasive, a legislative response would be necessary to discourage or eliminate TRAs. On the other hand, modern Up-Cs arguably push the limits under current law, so the IRS could legitimately take steps to constrain the growth of Up-Cs, although we argued above that it would be practically difficult to do so without similarly impairing UPREITs.

2. Myth #2: TRAs Are a Form of Tax Abuse

Some have argued that TRAs represent nefarious tax strategies that need to be administratively or legislatively foreclosed.\textsuperscript{179} This argument is closely related to the argument that TRAs are the product of tax arbitrage, another myth that we debunk below. In fact, TRAs themselves do not appear to be terribly problematic from a tax perspective.

TRA transactions begin when the parties choose the optimal tax structure. This is very commonplace tax planning. For example, as discussed in Section II.A., a corporate acquisition can be structured as a taxable asset or taxable stock deal, or perhaps as a tax-free reorganization. One can surely argue that such options are bad tax policy because, among other things, they distort business decisions and result in wasteful tax planning. But once such choices are available, it is not surprising that they are exploited in all well-planned transactions. In many situations, there is no need for TRAs because buyers and sellers can agree on the ex ante value of tax assets and take them into account in determining the purchase price. In some situations, however, TRAs are needed because buyers and sellers cannot agree on tax-asset value or the valuation exercise is simply not worth the trouble. If ex ante payment for tax attributes, which goes on all the time, is not troubling, then ex post payment should not be either.

Accordingly, TRAs themselves are not the problem. If there is any tax concern, it results from the underlying tax doctrines that allow the structuring options in the first place. Eliminating or discouraging TRAs would not be a good solution to this problem. At best, it would be only a very partial fix because only a small subset of tax planning activities—those involving acute tax-asset pricing problems—would be discouraged. Furthermore, it would probably represent only a temporary fix, as the market could be expected to develop to better price tax assets or to devise another strategy for dealing with the valuation problem.\textsuperscript{180} After all, there is little reason to think that the mar-

\textsuperscript{179} See Shobe, note 62, at 5.

\textsuperscript{180} Cf. Shobe, note 62, at 26 (noting that the fact that six recent Up-C IPOs did not involve TRAs "could... mean that at least some pre-IPO owners believe that the market has learned to price in tax assets, including the assets created by the Up-C structure.")
kets would continue to persistently leave tax money on the table in perpetuity. And even if the law was able to prevent the extraction of the value of tax assets ex post, the result could be to discourage companies from going public and instead engage in strategic or private deals (where tax assets are more likely to be valued ex ante), which itself would be a worrisome tax-created distortion.

While TRAs are a symptom but not the cause of any tax concerns, they may raise other policy issues. For instance, TRAs might reasonably be questioned on distributional grounds. It may be that TRAs, which are often used in private-equity backed transactions, disproportionately benefit already wealthy private equity managers by allowing their funds (in which they receive carried interest) to effectively buy tax assets from the public market on the cheap. Considering that pension funds and endowments are very large owners of both private and public equity, TRAs can be considered a very expensive (because of carried interest) way of transferring money from one pocket to another of these public-minded institutions. Relatedly, there might be concerns that TRA obligations are not adequately disclosed to, and understood by, the public, allowing legacy owners to “pull a fast one” over on the public markets.181 But these distributional and disclosure concerns, while potentially legitimate and serious, are not tax-specific concerns.

3. Myth #3: TRAs Are a Form of Tax Rate Arbitrage

Another common misconception regarding TRAs is that they represent a unique form of tax rate arbitrage.182 That is, TRAs uniquely exploit the difference between the high tax rate on ordinary income and the lower rate on capital gains, the argument goes.183 Because they are treated as additional purchase price for the exchanged LLC interests, TRA payments are often characterized as capital gains by the legacy owner. Meanwhile, the stepped-up basis itself results in future ordinary depreciation and amortization deductions for the buyer. Some commentators view this tax rate arbitrage as the raison d’etre of the TRA.184 And, in the same spirit, federal legislation has

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181 See Fleischer & Staudt, note 4, at 311 (noting that commentators and critics have argued that supercharged IPOs are “underhanded,” “one-sided,” and “bizarre,” on the grounds that they are complicated and virtually incomprehensible). But see Shobe, note 4, at 940-41 (explaining how TRAs are prominently and exhaustively disclosed in SEC filings).

182 Fleischer & Staudt, note 4; Shobe, note 4, at 917-18, 944.

183 Shobe, note 4, at 918 (describing a “quirk in the tax code . . . that allows pre-IPO owners to pay tax on their sale at reduced capital gains rates, which generates an offsetting deduction for the corporation at higher corporate tax rates”).

184 Id.
been proposed that would eliminate the arbitrage by taxing all TRA payments as ordinary income.\textsuperscript{185}

The tax rate arbitrage argument is seriously flawed, however. Tax rate arbitrage is neither a necessary nor sufficient condition for using a TRA. Recall that TRAs arise as a result of pricing problems. Either the seller values the tax assets more than the buyer or the valuation exercise is not worth the effort, so the parties agree to exclude the tax assets from the deal. It is no more complicated than that. While tax rate arbitrage might appear to correlate with the use of TRAs, there is no inherent logical connection between the two. In other words, if a TRA makes sense to resolve valuation problems, it does so regardless of any tax rate differential between buyer and seller.

In fact, past transactions have used TRAs even in the absence of any tax rate arbitrage. Consider, for example, carve-out IPOs, where a parent corporation decides to sell a minority interest in its subsidiary to the public.\textsuperscript{186} To accomplish this, the parent corporation contributes the stock of the subsidiary to a newly formed corporation, which is then taken public. Properly structured, the contribution of subsidiary stock to the new corporation is a qualified stock purchase, which allows for a § 338(h)(10) election. If the election is made, the new public company receives a stepped-up basis in the assets of the old corporate subsidiary. This transaction has at least once been accompanied by a TRA, which allocated a very large percentage of the resulting tax benefits to the former parent.\textsuperscript{187} Yet corporations do not receive a capital gains preference, so there was no tax rate arbitrage whatsoever.\textsuperscript{188} The parent company is subject to ordinary income tax rates on the TRA payments it receives, and the new public company receives future ordinary deductions from the stepped-up basis.\textsuperscript{189} This shows that tax rate arbitrage is not a necessary condition for TRA utilization.

\textsuperscript{185} See Temporary Tax Relief Act of 2007, H.R. 3996, 110th Cong. § 613.

\textsuperscript{186} See Ugur Celikyurt, Meril Sevilir & Anil Shivdasani, Going Public to Acquire? The Acquisition Motive in IPOs, 96 J. Fin. Econ. 345 (2010).

\textsuperscript{187} See note 7 and accompanying text.

\textsuperscript{188} Shobe, note 4, at 948 n.138 (noting that the section “338(h)(10) supercharged IPO . . . does not benefit from tax arbitrage because it involves two corporations rather than a partnership and corporation, and thus does not qualify for preferential capital gains rates that allow for tax arbitrage”).

\textsuperscript{189} The § 338(h)(10) election is still tax-efficient even though there is no tax rate arbitrage. Without the election, the seller will often recognize the same (or nearly the same) amount of gain (though the character of the gains will be somewhat different), while the buyer would receive a low carryover basis. Given the lack of a capital gains preference for the seller in this context, the seller's tax liability often will not be affected by the election in any material way, while the buyer receives a significant benefit from the stepped-up basis, so overall the election is tax-efficient.
More importantly, tax rate arbitrage is not a sufficient condition for TRA utilization. The tax rate arbitrage cited by TRA critics is extremely common in sales of businesses. When any business operated as a sole proprietorship or partnership is sold, a significant portion of the sales proceeds is often allocable to goodwill. The result is low-rate capital gains for the sole proprietor or the individual partners of the selling partnership. Meanwhile, the buyer receives a stepped-up basis in the goodwill, which will generate future ordinary deductions. In the overwhelming majority of these transactions, TRAs are not necessary because buyers are willing to pay a reasonable premium for the stepped-up basis. In other words, the harshly criticized "tax rate arbitrage" actually goes on all the time in everyday transactions that do not involve TRAs.

In fact, the TRA has three other necessary and sufficient conditions: (1) there must be some tax assets transferred to, or created by, the buyer in connection with the transaction; (2) the seller must value those tax assets more than the buyer or the valuation of those assets must be costly; and (3) the seller's premium valuation of the assets, combined with the cost of valuation, must be sufficiently high to outweigh the cost of negotiating, drafting, and administering a TRA. Tax rate arbitrage proves completely irrelevant.

Consequently, the legislative proposals to recharacterize TRA payments as ordinary income were misguided. If the proposal was enacted, TRAs would continue to exist in cases where valuation problems were present. Meanwhile, tax rate arbitrage would continue to occur in the many situations where tax assets are valued ex ante. The best that can be said for the proposals is that they probably would reduce the amount of TRA utilization (because TRAs would be unduly costly in certain cases due to the higher tax rate on the payments) and very modestly reduce the amount of tax rate arbitrage. But this is a very roundabout way of tax policymaking. If tax rate arbitrage is problematic, it should be dealt with directly. One should not rely on idiosyncratic, and possibly temporary, mispricing in one segment of the market to solve a widespread problem.

4. Myth #4: TRAs Are a Quid Pro Quo for a Legacy Owner's Tax Burden

Another common myth is that TRAs compensate the legacy owners for the tax burden they incur in connection with the creation of the tax

190 Shobe, note 4, at 929.
191 See Paul & Sabbah, note 4.
192 See Fleischer & Staudt, note 4, at 334 n.102 (discussing H.R. Rep. No. 110-431 (2007) and the likelihood of other legislative proposals targeting TRAs).
assets subject to the TRA.\textsuperscript{193} For instance, in an Up-C IPO, a stepped-up basis is created each time a legacy owner exchanges an LLC unit for Newco stock. The legacy owner is taxed on the exchange at the same time. As a result, some have argued that TRAs are justified because they compensate the seller for this simultaneous tax burden. However, this argument is flawed.

First, in Up-C IPOs there are no significant marginal tax burdens on legacy owners. They generally will not exchange their LLC units for Newco stock until the time they are ready to liquidate their interests into cash, at which point a taxable event is inevitable. There is therefore no acceleration of any taxable event, as compared with the traditional IPO structure.\textsuperscript{194} It is true that the exchange may result in some ordinary income under § 751(a), while in the traditional IPO structure all of the gain would be capital gain. But the resulting marginal tax burden typically will be relatively small because the vast majority of the sales proceeds are often allocable to capital assets, such as goodwill.\textsuperscript{195}

Second, sales prices do not reflect any seller’s particular tax burdens. TRA payments are simply part of the purchase price of the legacy owners’ LLC units, which is determined by supply and demand.\textsuperscript{196} Just like a home buyer does not care whether or not a seller will pay tax on the sale of a home in determining an offer price, the buyer in an Up-C IPO (the public market) does not care about the legacy owners’ tax situation.

\textsuperscript{193} See Jeffrey J. Rosen & Peter A. Furci, Monetizing the Shield: Tax Receivable Agreements in Private Equity Deals, Debevoise & Plimpton Priv. Equity Rep., Fall 2010, at 9, 23 (TRAs have a “certain symmetry because existing owners receive tax benefits associated with a tax liability they have borne”).

\textsuperscript{194} See Shobe, note 4, at 929, 946.

\textsuperscript{195} The legacy owner will also realize some ordinary income on the ultimate receipt of TRA payments, because a portion of the payments will be characterized as imputed interest. IRC § 483. This additional ordinary income should not be considered a marginal tax burden incurred by the legacy owner (as compared to their results under the traditional structure) because the imputed interest payments compensate the owner for the delay in receiving a portion of their sales proceeds, and interest income characterization for delay payments is appropriate. In the traditional IPO structure, the legacy owner generally receives all of his sale proceeds immediately on the sale of his stock in the public company, whereas in the Up-C IPO, the legacy owner receives some of the sales proceeds over time (through TRA payments). If, in a traditional IPO, the legacy owner received some of the sales proceeds over time (for example, in an installment sale), then the portion that compensates the owner for delay generally would be taxed as ordinary income, just as in the Up-C IPO. See Shobe, note 62, at 33.

\textsuperscript{196} See Fleischer & Staudt, note 4, at 364 (“If the legislative approach is restricted to deals with TRAs, it would change the tax treatment associated with the tax benefits of amortization shared through a TRA but would not address deals that accomplished exactly the same outcome with a higher purchase price or an up-front lump-sum payment, two alternatives to the TRA.”).
V. The Up-C Revolution

We previously explained the burgeoning use of the Up-C structure when LLCs are taken public. However, the revolutionary impact of the Up-C structure goes well beyond IPOs. As detailed below, Up-Cs can be used to optimize the tax effects of almost any combination of two (or more) public companies, including inversions of U.S. public companies. While the Up-C structure is still relatively new, it seems that a tipping point has been reached regarding market acceptance and advisor awareness of the structure. Absent intervention by either the IRS, Treasury, or Congress, there is little doubt that the Up-C is here to stay.

The Up-C structure combines three attractive tax features: (1) a single level of tax on the business's income (as well as flow-through of losses) generated by the subsidiary partnership attributable to legacy owners, (2) significant liquidity for legacy owners due to the exchange rights, and (3) the absence of any limitations on the type of business activities that may be undertaken. Each feature by itself is commonplace in the U.S. tax system. Partnerships, S corporations, and REITs all provide a single level of tax, publicly traded stock provides significant liquidity for holders, and C corporations, S corporations, and partnerships—the most common tax classifications—may engage in any type of business activity.

Further, the combination of two out of these three features, while atypical, is not wholly unprecedented. For example, while most PTPs are subject to corporate tax, certain PTPs—such as public oil & gas master limited partnerships—are exempt from the tax. REITs likewise can combine public trading and single-level taxation. But exempt PTPs and REITs are strictly limited in the type of business activities in which they can engage. What is revolutionary about the Up-C is the unique combination of all three features into a single structure.

This Part considers the implications of the Up-C revolution. First, it discusses the impact of Up-Cs outside of the specific LLC IPO context. Then it addresses the normative tax policy issues raised by the Up-C Revolution.

A. Implications of the Up-C Revolution: Beyond the Up-IPO

The Up-C structure has already significantly altered the way that IPOs of LLCs are structured. The new Up-C IPO structure, in turn, should have ripple effects on earlier structuring decisions, such as initial choice-of-entity planning. In addition, given the growing familiar-

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197 See Section III.A.
198 Shobe, note 4, at 955 (noting the unprecedented tax benefits of Up-C IPOs).
ity and comfort with the Up-C structure, there is no reason to think the structure will not continue to expand into other contexts, public company combinations or inversions.

1. Choice-of-Entity for Start-Ups and VC- or PE Backed Companies

Traditionally, start-ups that sought VC funding would be initially formed as C corporations.\(^{199}\) Even if a business made it out of the start-up phase as a partnership, VC or PE funds would often require the entity to convert to a C corporation before they would invest in it.\(^{200}\) This preference for the corporate form has puzzled tax experts for some time. Outside of the VC/PE context, partnerships are overwhelmingly preferred for a number of reasons, the most important of which are: (1) the single level of tax of gains, (2) the flow-through of losses, and (3) the ability to deliver a stepped-up basis to a buyer on exit (and to receive a corresponding premium purchase price).\(^{201}\) Why then have VC- and PE-backed businesses routinely bucked this trend and insisted on the corporate form?

Traditional explanations are based on the notion that, due to unique facts in the VC/PE context, the claimed benefits were not as signifi-

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199 See Bankman, note 3, at 1750.
200 See generally note 3 and accompanying text (discussing why VC funds continue to form and fund C Corporations).
201 Levin & Rocap, note 104, ¶ 302.1.1 to 302.1.4, at 3-20–3-37. The last benefit—the ability to deliver a stepped-up basis without double taxation—can be viewed as a specific application of the first benefit—single level of tax on gain—but given its importance (to both taxpayers and this Article), we highlight it separately. The partnership form also preserves the capital gains preference as capital gains flow through the entity. IRC § 701. In contrast, there is no capital gains preference available to corporations. In addition, there are benefits to the partnership form vis-à-vis S corporations. For instance, property contributions and distributions are generally tax-free when made to or by partnerships, §§ 721 and 731, while they are generally taxable when made to or by S corporations, IRC §§ 351 and 311. In any event, S corporations cannot have owners who are partnerships, which most VC and PE funds are, so these entities would not be able to accept the funds' capital investments. Partnership characterization also preserves flexibility as to the choice of entity. It is much easier to convert from a partnership to a corporation as opposed to vice versa. Incorporation of a partnership generally is tax-free under § 351, while "decorporation" of a corporation into a partnership is a taxable event under § 311. Thus, only partnership status preserves optionality, which may prove useful in unforeseen circumstances, such as where relative effective tax rates of individuals versus corporations are altered. For example, when Congress periodically and temporarily expanded the § 1202 exclusion for certain gains on small business company stock, certain partnerships were able to exploit the expansions through timely conversions to corporate status. See Tony Nitti, With Tax Break Set To Expire, Partnerships Should Consider Converting to C Corporations Before Year End, Forbes (Dec. 18, 2013), https://www.forbes.com/sites/anthonyinnitti/2013/12/18/with-tax-break-set-to-expire-partnerships-should-consider-converting-to-c-corporations-before-year-en/#34f0acce5351.
cant as they might appear. For instance, a single level of tax is generally only important if the company, first, has profits, and second, distributes these profits to its owners. Start-up businesses (which are the province of VC funds) often do not realize profits for many years. PE-backed businesses may realize profits but they ordinarily will not distribute them; instead they generally use the profits to pay down debt or grow the business in anticipation of going public or a sale to a strategic buyer. In addition, even if a company distributed profits, to the extent those profits are attributable to foreign and tax-exempt investors, any flow-through profits would ordinarily need to be allocated to corporate "blockers" who would themselves pay corporate tax. Foreign and tax-exempt investors make up a large portion of the investment in VC/PE funds and, therefore, corporate tax is often inevitable for a significant portion of the company's profits.

Likewise, the actual benefit of loss flow-through is often smaller than it may appear. Corporate classification generally changes the character of losses from ordinary to capital losses; it does not eliminate the losses entirely. In addition, timing is often unaffected for individual investors due to the passive loss limitations in § 469. And, of course, foreign and tax-exempt investors do not care about losses, as they generally do not pay U.S. taxes.

Turning to the third major benefit—the ability to deliver a stepped-up basis to a buyer and fetch the accompanying premium—the perceived unwillingness of the public market to pay for the stepped-up basis substantially diminished the value of this benefit to VC and PE

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202 See, e.g., Bankman, note 3, at 1753 (noting that many individual VC investors would not be able to take loss deductions due to the passive loss rules under § 469).

203 Using profits to pay down debt or grow the business will increase the capital gains inherent in the owner's stock, which is a second level of tax. However, deferral and the ability to use cherry-picked capital losses to offset those ultimate gains can vastly diminish the effective rate on those capital gains. See, e.g., Noël B. Cunningham & Deborah H. Schenk, The Case for a Capital Gains Preference, 48 Tax L. Rev. 319 (1992).

204 Foreign and tax-exempt investors invest through a blocker corporation in order to avoid filing requirements and generating unrelated trade or business income, respectively. See Levin & Rocap, note 104, ¶ 1001.1, at 10-11.


206 See Johnson, note 3. When losses are generated by an operating partnership, the losses that flow through to the owners are generally ordinary losses. See IRC § 701. When losses are generated by a C corporation, the losses result in capital losses (or reduced capital gains, if the business is ultimately successful) when the investor's stock is sold. IRC § 165(f). Thus, from the owner's perspective, the losses do not evaporate when they are recognized in corporate form but instead are converted to capital losses. In theory, timing is affected, because the recognition of the losses is delayed from the time they are realized by the business to the time when the stock is sold, but the § 469 limitation on passive losses often synchronizes the timing.

207 See Fleischer, note 3, at 154.

208 See generally IRC §§ 501, 871, 881.
owners. The typical ultimate exit for VC/PE-backed businesses is either to take the portfolio company public or to sell it to a public company. In either case, the market’s perceived indifference to the stepped-up basis (because of its fixation on accounting earnings) would mean that the VC/PE fund would not get compensated in full for delivering the stepped-up basis.

Taken together, these three major benefits of initially organizing as an LLC apparently, after taking account the practical realities that diminish their value, did not outweigh the perceived problems of using that form. The perceived problems were varied. Founders, investors, and advisors are less familiar with LLCs than corporations. Perhaps most important, LLCs introduced greater transaction costs and complexity compared to corporations. Because of flow-through taxation, the activities of an LLC would directly impact the owners’ tax situation, whereas corporate owners would be affected only if and when distributions of cash or property were made to them. As a result, before owners of LLCs could prepare and file their own tax returns, the LLCs had to first file their tax returns and deliver Form K-1s to the owners. Relatedly, if an LLC did business in multiple states, each owner of the LLC generally would have to file state tax returns in each of those states; this would not be the case if the business were operated as C corporation.

Flow-through taxation also requires more complicated organizational documents, which results in greater costs in drafting and administering their provisions. LLC agreements must include complex tax accounting provisions to allocate gains and losses to the owners and minimum tax distribution provisions to ensure that owners would have the liquidity necessary to pay tax on flow-through gains. There is no comparable need for these provisions in a shareholder’s agreement for a C corporation because these concerns stem from flow-through taxation. Likewise, incentive compensation is more complex in the partnership context. Incentive compensation granted...
by C corporations is usually paid in the form of stock options or restricted stock, which are well understood and easy to effectuate. On the other hand, incentive compensation in the partnership context usually involves the periodic granting of profits interests, which are more complicated and far less well understood. In addition, because subchapter K is so notoriously complicated, intricate “tax boilerplate” provisions are required in LLC agreements. Finally, because tax-exempt and foreign investors necessitate blockers, the ownership structure of an LLC portfolio investment is more unwieldy than an analogous C corporation investment.

After weighing the pros and cons of corporate versus partnership classification, VC and PE firms traditionally preferred the corporate form. While the costs may appear pedestrian and minor (and shrinking each day, as familiarity with LLCs grows), the benefits, taking into account the practical limitations, have been considered even smaller.

The Up-C revolution could significantly alter this historical calculus, perhaps turning the preference for C corporations on its head. Up-C IPOs now allow the legacy owners (including VC and PE funds) to monetize the value of stepped-up basis in the form of TRA payments. Since this increases the returns of the legacy owners, the prospect of an Up-C IPO should put a thumb on the scales in favor of initially choosing the LLC form for start-ups and of maintaining that form when new investment is solicited. Some recent high-profile Up-C IPOs, including those of GoDaddy.com, Shake Shack, and SoulCycle, have made the benefits of remaining a partnership until and through an IPO particularly salient. It is therefore possible that the Up-C revolution will in turn spur an LLC revolution in the VC and PE worlds.

214 See Bankman, note 3, at 1751 (noting that a venture capitalist said, “[m]anagement gets spooked by partnership interests”).


216 See notes 204-05.

217 See note 3.

218 See Fleischer & Staudt, note 4, at 322-23.

219 See Hart, note 4, at 52-54.
2. **Employee Compensation Design for Start-Ups**

Even if many start-ups continue to be organized as C corporations, the Up-C revolution may influence the manner in which start-ups compensate their founders and other early employees. Traditionally, “founder’s stock” was sold to these employees for nominal value, and the parties claimed that the nominal value equaled the fair market value of the stock. Aggressive tax planning was often used to try to push down the value of the founder’s stock to reduce the price that the employee had to pay. This was done to reduce the likelihood that the transaction would be treated as a compensatory bargain sale, in which case the founder would realize immediate ordinary income on the transaction. The tax benefit of using founder’s stock is that the employee’s ultimate gain on the stock was taxed only when it was sold and then only at capital gains rates. However, the downside of founder’s stock was that the start-up would get no tax deductions attributable to the founder’s stock.

A different approach would be for the start-up to issue nonqualified stock options (NQSOs). While NQSOs would result in ordinary income to the founder on exercise, they also provide a corresponding deduction to the employer. Viewed in the aggregate, NQSOs often will be more tax-efficient than founder’s stock. Yet, the current approach is to use founder’s stock, which seems irrational. The market’s perceived unwillingness to pay for tax assets may explain this phenomenon. NQSO exercises before an IPO will add to the company’s NOLs (assuming that the company is not yet profitable on a cumulative basis at the time of the IPO), while NQSO exercises after an IPO will result in future deductions. In either case, an efficient market should price these tax attributes into the IPO price (and later stock prices). If the market does not do so, founder’s stock may be more efficient than NQSOs. The conventional wisdom that the market does not correctly price tax assets therefore may explain the seemingly tax-inefficient choice of founder’s stock over NQSOs.

With the popularity of TRAs, there is now a tried and true method to capturing the value of tax assets in IPOs (or in sales to public companies). Thus, one might expect start-up corporations to prefer to

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222 Polsky & Hellwig, note 220, at 1103-04.
223 See id.
224 See notes 63-68 and accompanying text.
225 See Paul & Sabbah, note 4.
issue NQSOs over founder's stock and then, when the corporation goes public or is sold to a public company, for the corporation's pre-IPO investors to enter into a TRA with the corporation to extract the value of the deductions that will be realized as a result of NQSO exercises.

3. Alternative to Tax-Free Reorganizations

As explained previously, corporate acquisitions can qualify as tax-free reorganizations if certain conditions are satisfied.\textsuperscript{226} Sometimes one or more of the conditions are problematic, making a tax-free reorganization unattractive. In these case, tax planners often devise other structures that provide similar if not identical tax consequences as reorganizations. Up-C structures should now be added to the tax planner's tool kit, and in fact, they can provide even better tax results than reorganizations.

For example, assume that public $P$ wants to buy certain assets of $T$ for $P$ stock. Because the assets do not constitute "all or substantially all of the assets of $T," a tax-free reorganization is not possible.\textsuperscript{227} Traditionally, planners would deal with this problem by recommending that the parties use the "horizontal double dummy" structure. In that structure, a Newco is formed to, in effect, replace $P$. $P$ shareholders contribute their $P$ stock to Newco, getting back Newco stock.\textsuperscript{228} $T$ simultaneously contributes the desired assets to Newco in exchange for Newco stock. The contributions qualify as a good § 351 transaction, and the tax consequences are similar to those resulting from a tax-free reorganization.\textsuperscript{229} $T$ defers its gain on the subject assets until it sells Newco stock, but there is no stepped-up basis in those assets.

By delinking deferral and carryover basis, however, an Up-C structure can provide even better tax results. Instead of structuring the acquisition of the subject $T$ assets as a horizontal double dummy, the acquisition can be structured using an Up-C. $P$ and $T$ would form a subsidiary LLC. $P$ would contribute all of its assets to the LLC, while $T$ would contribute only the desired assets. $P$ and $T$ would each receive LLC units commensurate with the respective value of their contributions. $T$'s LLC units would be exchangeable into $P$ stock. Prior

\textsuperscript{226} IRC § 368; See Section II.A.\textsuperscript{227} See IRC § 368(a)(1)(C).\textsuperscript{228} See Ginsburg et al., note 4, ¶ 904. Technically, these contributions will be effected using a reverse triangular merger, with Newco as the surviving parent corporation and a "dummy" corporation serving as the subsidiary of Newco that is merged with $P$, which survives the merger. In traditional horizontal double dummy transactions, $T$ would engage in another similar reverse triangular merger that would take place with a second dummy subsidiary of Newco (with $T$ surviving).\textsuperscript{229} Id.
to the exercise of those exchange rights, the transaction is taxed the same as a reorganization; in particular, $T$ recognizes no gain and its basis in the contributed assets carries over to $T$'s LLC units. However, when $T$ desires liquidity and exercises its exchange rights, $P$ will now receive a stepped-up basis in the $T$ assets. In a reorganization or horizontal double dummy structure, there is no such stepped-up basis.

This is another example, in addition to the Up-C IPO, where an Up-C structure uniquely delinks deferral and carryover basis. Rather than forcing taxpayers to choose between the two, Up-Cs allow them to provide both deferral to roll-over investors and an eventual stepped-up basis to the buyer.

4. **International Implications**

In response to the first-wave of corporate inversions, Treasury adopted § 1.367(a)-3(c) (the “anti-Helen of Troy regulations”). Under these regulations, if a U.S. corporation is acquired by a foreign corporation in which more than 50% of the shares of the foreign corporation are owned by former shareholders of the U.S. corporation, the shareholders of the U.S. target would not be able to receive the benefits of a tax-free reorganization and, accordingly, they would be taxed as if they sold the shares of the U.S. corporation for cash. These regulations effectively impeded inversions involving significant tax-sensitive shareholders (although they did little to stop inversions by public corporations with mostly tax-indifferent shareholders) by creating adversity between the tax interests of the shareholders and the tax interests of the corporation.  

An Up-C can be used to eliminate this adversity by permitting tax-sensitive shareholders who desire tax deferral to contribute their shares to a subsidiary partnership (with exchange rights to swap the partnership interests for the foreign acquirer’s stock), while other shareholders can simply receive cash from the foreign acquirer. This structure was reportedly utilized in the Burger King/Tim Hortons transaction to provide tax deferral to the U.S. shareholders of Burger King while inverting the company to Canada.

A similar structure was used in the recent Avago/Broadcom transaction. A conventional acquisition of California-based Broadcom by Avago, a Swiss company, would have triggered the anti-Helen of Troy

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231 See, e.g., Samuel C. Thompson Jr., The Cat-and-Mouse Inversion Game with Burger King, 144 Tax Notes 11 (Sept. 15, 2014).
The acquisition was instead structured as an Up-C in which shareholders of Broadcom could elect to exchange their Broadcom shares for publicly-traded stock in the new foreign parent company, for cash, or for units in the subsidiary partnership exchangeable into new foreign parent company stock. The merger was consummated in February 2016, and, because a sufficient number of Broadcom U.S. shareholders received cash or partnership interests (and not parent company stock), the acquisition avoided the application of the anti-Helen of Troy regulations.

B. Policy Issues and Fundamental Reform of Entity Taxation

Under current law, Up-C structures would probably survive an IRS challenge. The relevant doctrinal principles were developed with UPREITs, not Up-Cs, in mind and UPREITs involve dramatically different tax and policy issues. For better or for worse, REITs have been blessed by Congress to receive significant unique tax benefits because of real estate activities. UPREITs were then blessed by Treasury, through a favorable example in the partnership anti-abuse regulations and narrow interpretations of the concept of "public trading" under § 7704. These taxpayer friendly provisions were presumably intended to facilitate the formations of, and contributions to, REITs. Up-C proponents have argued by analogy that these favorable doctrines extend to Up-Cs despite the completely different context. As a matter of current doctrine, this argument is persuasive because UPREITs and Up-Cs are identical in their technical aspects. But Treasury, through regulations, or Congress, through legislation, clearly has the power to address Up-Cs prospectively. The policy question is whether they should take up this cause.

A narrow technical objection to Up-Cs would focus on the exchange rights. These exchange rights are very artificial instruments that one would not expect to see "in nature." Instead, they are completely a creature of tax planning, designed exclusively to facilitate a

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234 See Shobe, note 4, at 955-58.

235 See note 132.
favorable tax result. Such tax-only instruments are rightfully disfavored in tax. They distort business decisions, complicate transactions and structures, reward aggressive planning, and foster disrespect for the tax system, while doing nothing useful for society. Policymakers concerned by this might clarify the circumstances when exchange rights cause the subsidiary partnership to become classified as publicly traded. The regulations under § 7704 merely provide a safe harbor, one that modern planners apparently are not willing to comply with in both UPREIT and Up-C contexts.\textsuperscript{236} If the safe harbor were turned into an unsafe harbor, so that limitations on exchanges had to be at least as onerous as the ones in the regulation to avoid public trading characterization, Up-C structures would be less attractive.\textsuperscript{237} This would not solve the problem of the exchange rights being a tax-only instrument, but it would at least require a substantial change in the economics of the transaction to achieve a desired tax result. In other words, at least the tax-favored transaction would be materially different than the alternative one, and this might be enough to deter many of the Up-C transactions.

More broadly, one might object to the Up-C as "too clever by half" transactions that threaten the corporate tax base.\textsuperscript{238} Up-Cs keep a partnership alive while providing for owner liquidity akin to public trading—a heretofore unprecedented tax result in the modern tax system, where public trading is the hallmark of C corporation status for active businesses not involving real estate. At first glance, allowing the partnership to stay alive appears to reduce corporate tax revenues by subjecting some of the business's income (that is, that which is not allocable to the C corporation parent) to single-level taxation and allowing for a future stepped-up basis, which will shelter future income of the parent corporation from corporate tax.\textsuperscript{239}

The long-run consequences from the Up-C Revolution, however, are much more complicated because taxpayer behavior is dynamic. By avoiding some of the sting of the corporate tax, Up-C IPOs reduce the costs of a partnership going public. In turn, if Up-Cs were discouraged or disallowed, some partnerships that would have used an Up-C IPO to go public simply might not go public, instead preferring to remain private and maintain pass-through classification. On the other hand, if Up-Cs are unrestrained, many privately-held partnerships that might have remained private may in fact go public, meaning that eventually (for example, after all legacy owners have exchanged) all of

\textsuperscript{236} Reg. § 1.7704-1(f); see Subsection III.B.1.
\textsuperscript{238} See, e.g., Shobe, note 4, at 945.
\textsuperscript{239} See, e.g., Victor Fleischer, Taxing Blackstone, 61 Tax L. Rev. 89, 112-13 n.130 (2008).
the business’s income will be subject to the corporate tax. On the other hand, if Up-Cs are unrestrained then some start-ups might initially be formed as LLCs instead of corporations, as we previously argued, which could reduce future corporate tax revenues. The long-run net result on corporate tax revenues is unclear.

Ultimately, therefore, from a tax policy standpoint one’s take on the Up-C depends intrinsically on one’s view of the corporate tax generally. Many observers believe that the corporate tax ought to be eliminated in favor of some type of universal single-level tax of business income; they would view the Up-C as a step in the right direction. Others view the corporate tax as a necessary evil, arguing that while universal single-level taxation would be theoretically optimal, it is too difficult to administer when the number of equity holders grows too large or the capital structure too complex. Such observers would view the Up-C Revolution as a good thing as it shrinks the corporate tax base without undue complexity. Others might be agnostic on the philosophical merits of the corporate tax, but still believe that is a necessary and important revenue source. For them, the empirical question of whether Up-Cs will, over time, lead to more or less tax revenue would be critical. Regardless, the key takeaway is that many of the objections to the Up-C structure are more properly attributed to larger normative concerns about the corporate tax regime.

VI. Conclusion

The Up-C Revolution has begun. Up-Cs already appear to have become the dominant means by which LLCs go public, and Up-C structures are showing up in a host of other contexts. Up-Cs provide

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240 Subsection IV.A.1.
243 See, e.g., Jeffrey L. Kwall, The Uncertain Case Against the Double Taxation of Corporate Income, 68 N.C. L. Rev. 613 (1990). In addition, a robust literature on the pragmatic issues facing corporate integration has developed as well. See, e.g., Deborah H. Schenk, Complete Integration in a Partial Integration World, 47 Tax L. Rev. 697 (1992); Michael L. Schler, Taxing Corporate Income Once (or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Integration Models, 47 Tax L. Rev. 509 (1992); George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax L. Rev. 431 (1992).
unprecedented tax benefits, and the only real cost seems to stem from
the additional complexity of the structure. But as advisors and the
market become increasingly familiar and comfortable with the struc-
ture, this cost will rapidly diminish. Absent an intervention from
policymakers, it appears the Up-C is here to stay.

While there has been skepticism of Up-Cs in some quarters, many
of the critiques are based on misunderstandings, myths, or mispercep-
tions. Under close inspection the Up-C structure seems to be on solid
footing under current tax doctrine, which should not be surprising
given that the technical details have been adopted from existing
UPREIT structures. The more difficult question is whether the Up-C
Revolution should be concerning from a tax policy perspective. We
conclude that the answer ultimately depends on one’s view of the
modern corporate tax system rather than on the Up-C structure itself.
Skeptics of the corporate tax should embrace the Up-C as a market
solution to distortions caused, at least in part, by the corporate tax.
More surprisingly, however, even proponents of the corporate tax
should not necessarily oppose the Up-C out of hand. Instead, if rais-
ing revenue is the sole or even primary goal of the corporate tax, the
issue ultimately turns on the empirical question of whether the Up-C
would reduce or, perhaps counter-intuitively, increase total corporate
tax revenues in the long-run, once taxpayer responses are taken into
account.