SUPERCHARGED IPOS AND THE UP-C

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The "supercharged IPO," a new and increasingly popular financial transaction, has fundamentally changed the nature of IPOs for many companies. Traditionally, an IPO was a tax nonevent for the company and the owners, meaning it created no tax liability for either. Through creative but questionable tax planning, companies have found a way to do better than this by effectively generating a negative tax liability for the company and its owners. These transactions have received substantial attention from practicing lawyers, investment bankers, and journalists, and even briefly caught the attention of Congress, yet they have attracted surprisingly little scrutiny from scholars. The attention they have received has failed to consider the different types of supercharged IPOs, resulting in misguided analyses and conclusions regarding these transactions. This Article examines the costs and benefits of the different types of supercharged IPOs to show that some of these transactions have greater tax benefits than scholars have realized. It places a particular emphasis on the Up-C, a structure with the greatest tax benefits, which scholars have overlooked even though it is by far the most common, and increasingly popular, form of supercharged IPO. A closer examination of the Up-C reveals that this structure produces tax benefits that are not justified by the regulations that supposedly allow them.

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INTRODUCTION

Supercharged IPOs are relatively recent and controversial financial transactions that have dramatically increased in popularity over the past few years.[1] These transactions allow owners of a company to create and extract additional value in an initial public offering (IPO) through the use of beneficial tax structuring. Owners who supercharge an IPO can earn significantly more than they would have in a traditional IPO, and the extra money comes in part from the government (in the form of a reduction of taxes) and in part from the public investors through a contractual arrangement between the public company and the pre-IPO owners.[2] Although these

1. *See* Victor Fleischer & Nancy Staudt, *The Supercharged IPO*, 67 VAND. L. REV. 307, 307 (2014) ("A new innovation on the IPO landscape has emerged in the last two decades, allowing owner-founders to extract billions of dollars from newly public companies. These IPOs—labeled supercharged IPOs—have been the subject of widespread debate and controversy. . . .").

2. *See* Amy S. Elliot, *IPO Agreements that Shift Basis of Step-Up to Sellers Proliferate*, 132 TAX NOTES 334, 337 (2011); *infra* section I.D.

transactions have become a significant part of the IPO market—transferring billions of dollars from the government and the public to pre-IPO owners[3]—they have received surprisingly little attention from scholars.

Where did the supercharged IPO come from, and why, in the past few years, has it spread so quickly across the financial marketplace? This Article attempts to answer these questions by examining the various types of supercharged IPOs, the different sets of costs and benefits associated with each, and the laws that are used to justify them. Existing academic literature poorly addresses the differences between supercharged IPOs, which has resulted in misguided explanations of why and whether they should exist, both as a legal and as a normative question. Through a closer look at the various types of supercharged IPOs, this Article explores the legal and normative justifications for them, and develops explanations and conclusions that expand upon and challenge the existing literature.

First, some background on IPOs is necessary. When the owners of a company want to take their company public, they traditionally structure the IPO in a way that, from a tax perspective, is a nonevent.[4] This is good, in a way, for the owners because they avoid a current tax liability. However, just because no tax was due does not mean that this is the most tax efficient way to structure an IPO. The idea behind the supercharged IPO is that there are ways to structure an IPO that go beyond just avoiding taxes to actually saving on taxes—essentially creating a negative tax liability rather than just no tax liability.[5] This is done by using complicated tax planning to structure the IPO in a way that increases the tax basis of the

3. *See* Howard Jones & Rudiger Stucke, *A Cheaper Way to Do IPOs*, HARV. BUS. REV., Nov. 2013 (showing that in just five supercharged IPOs, the pre-IPO owners netted an additional $1 billion from supercharging).

4. *See* I.R.C. § 1032(a) (2000) ("No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation."); Rev. Rul. 84-111, 1984-2 C.B. 88 (ruling that incorporating a partnership does not trigger tax liability).

5. For an example of the benefits of supercharging an IPO, see Robert Cyran, *Supercharged IPO Tax Spoils Needs Splitting*, REUTERS BREAKINGVIEWS (Jul. 8, 2014), http://blogs.reuters.com/breakingviews/2014/07/08/supercharged-ipo-tax-spoils-need-splitting/ [https://perma.cc/P656-M28V] ("GoDaddy's PubCo equivalent has about $2.4 billion of goodwill and intangible assets. Assuming 15-year amortization and a 40 percent tax take at the federal and local level, that's a potential tax reduction of more than $60 million a year altogether. . . .").

assets of the new public company and turns the company's goodwill, which was previously non-depreciable, into a depreciable asset.[6] This tax structuring allows for significant tax deductions against future income.[7] The creation of these tax assets, like any asset, increases the value of the company in an IPO.

Supercharged IPOs received little scholarly attention until quite recently, when Professors Fleisher and Staudt conducted an extensive empirical study examining why owners supercharge an IPO.[8] Professors Fleischer and Staudt's study is an important first step in beginning to analyze supercharged IPOs and helping to bring scholarly attention to this new transaction. However, because their study failed to disaggregate the various types of supercharged IPOs, their analysis conflates the three types of supercharged IPOs. By treating the three types of supercharged IPOs as one, Professors Fleisher and Staudt based their analysis on a hybrid supercharged IPO with both a timing cost and tax arbitrage, which, as this Article will show, does not exist.[9] This error caused them to reach misguided conclusions about why owners choose to supercharge an IPO.

This Article differentiates between the three very different types of supercharged IPOs: a Section 338(h)(10) IPO, an "Up-C", and a publicly traded partnership IPO.[10] Although each supercharged IPO increases a company's tax assets by stepping up the basis of the underlying assets, other costs and benefits are unique to each particular type of supercharged IPO; therefore, there is no single reason why an owner would choose to supercharge an IPO. By disaggregating the different types of supercharged IPOs, this Article shows that many of Professors

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6. *See infra* note 66.

7. Technically, goodwill is "amortizable," which is essentially depreciation for intangible assets. I.R.C. § 197 (2004). *See* David Cay Johnston, *Blackstone Devises Way to Avoid Taxes on $3.7 Billion*, N.Y. TIMES (July 13, 2007), http://www.nytimes.com/2007/07/13/business/worldbusiness/13iht-blackstone.4.6652202.html?_r=0 [https://perma.cc/FAL7-6SQX] (describing the Blackstone supercharged IPO and explaining that "[i]ndividuals who create goodwill through their skill at running a business cannot deduct it. But when goodwill is sold to someone else, the new owners get to deduct it because its value is assumed to erode.").

8. *See* Fleischer & Staudt, *supra* note 1.

9. *See infra* section II.B.2.

10. *See infra* Part II. *See also* Elliot, *supra* note 2, at 334–37 (noting the three types of supercharged IPOs).

Fleischer and Staudt's conclusions are flawed or incomplete.

This Article focuses especially on the Up-C, a structure that scholars have mostly overlooked[11] even though it is by far the most common and increasingly popular form of supercharged IPO.[12] Even though the Up-C is a relatively new form of supercharged IPO, the Up-C now represents a significant portion of the overall IPO market.[13] This Article argues that the answer to Professors Fleischer and Staudt's question—"why do owners supercharge?"—is to take advantage of the many benefits of the Up-C.[14] In an Up-C, pre-IPO owners in a partnership form a new corporation, and the new corporation uses the money it receives in the IPO to buy

11. Professors Polsky and Rosenzweig recently posted the only other academic article to focus on the Up-C. *See* Gregg D. Polsky & Adam H. Rosenzweig, *The Up-C Revolution* (Univ. of Ga. Sch. of Law Legal Studies Research Paper No. 2016-40, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2851872 [https://perma.cc/8WAU-6Y9D]. Professors Fleischer and Staudt cite to a practitioner's article that discusses the Up-C, and state that "the deals often involve a partnership and a corporation, rather than two corporations," but do not mention the Up-C by name or go into further detail about its structure. *See* Fleischer & Staudt, *supra* note 1, at 322.

12. *See, e.g.*, Phillip W. DeSalvo, *The Staying Power of the UP-C: It's Not Just a Flash in the Pan*, 152 TAX NOTES 865, 865–66 (2016) ("[A]s more companies operate in entities treated as a partnership, there may be more companies eyeing public offerings that hold business operations in partnership form and are thus ripe for UP-C structures . . . . In fact, many private equity sponsors intentionally invest in operating companies through partnership structures to lay the foundation for an UP-C IPO to be considered as a potential exit strategy."). *See also* Chelsea Naso, *Wilson Sonsini-Led GoDaddy Draws $460M in Upsized IPO*, LAW360 (Apr. 1, 2015, 10:33 AM), http://www.law360.com/articles/638102/wilson-sonsini-led-godaddy-draws-460m-in-upsized-ipo [https://perma.cc/FG84-VGJZ] ("The use of the Up-C structure has become more common as partnerships carving out business units look to get the most bang for their buck in an IPO, with GoDaddy's anticipated offering and the recent public debut of beloved burger chain Shake Shack Inc. drawing attention to the structure. Summit Materials Inc., a cement company backed by The Blackstone Group LP, also recently opted to list using the Up-C structure for its $400 million debut.").

13. Approximately fifty companies have gone public using the Up-C structure, representing an aggregate deal value of $30 billion. J. LYNETTE DEWITT, DELOITTE CTR. FOR FIN. SERVS., POSITIONING FOR SUCCESS IN PRIVATE EQUITY: THE UP-C ADVANTAGE (2015), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/financial-services/us-fsi-positioning-for-success-in-private-equity.pdf [https://perma.cc/FSX3-8G3E].

14. Although this Article refers to pre-IPO owners generally, it is interesting to note that "64 percent of the IPO assets raised using [the Up-C] to date have been private equity backed. Financial services companies tend to use Up-Cs more than other industries, representing 44 percent of companies originating Up-Cs." *See id.*

interests in the historic partnership.[15] Through a quirk in the tax code, this allows the 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.[16] This exchange of a smaller tax liability for a greater tax benefit creates tax arbitrage.[17] A second important benefit of the Up-C is that it allows pre-IPO owners to continue to hold their interests in a historic partnership. Publicly traded companies are generally subject to corporate tax, but the Up-C structure allows owners to retain their interests in a partnership, giving them all the benefits of being publicly traded without having to hold their interests in an entity subject to corporate tax.[18] A third benefit of the Up-C is that owners do not have to pay tax any sooner than they would in a traditional IPO.[19] This is different than the Section 338(h)(10) supercharged IPO, which triggers an immediate tax liability for the owners even if they do not sell any of their interests in the IPO.[20]

When the various types of supercharged IPOs are viewed separately, it becomes clear why the Up-C has become so popular—it creates substantial tax benefits with little downside. This also shows why the Section 338(h)(10) supercharged IPO is rarely used. It creates additional tax

15. MARTIN D. GINSBURG ET AL., MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 1602.10.2 (2015) (explaining the mechanics of the Up-C).

16. The pre-IPO owners pay tax at the capital gains rate except to the extent of any "hot" assets. *See* I.R.C. § 751 (2005).

17. *See* Fleischer & Staudt, *supra* note 1, at 344 ("We know that many IPOs involve individuals who sell partnership shares to Public Co. and that this sale generates a 15 percent capital gains rate on subsequent [tax receivable agreement] payments but a 35 percent deduction rate for Public Co.").

18. GINSBURG ET AL., *supra* note 15, ¶ 1602.10.2 ("Two significant tax benefits can be achieved by using an Up-C structure as an alternative to simply incorporating the old partnership/LLC in a tax-free Code § 351 transaction: (a) Newco-C obtains a stepped-up tax basis in its share of the old partnership/LLC's assets under Code § 743(b)" and "(b) The portion of old partnership/LLC's future taxable income allocated to its equity owners other than Newco-C is not subject to corporate-level tax and therefore is taxed only once at the old partnership/LLC equity owner level.").

19. *See* Robert Willens, *How IPO Founders Keep Their Taxes Low*, CFO (July 26, 2011), http://ww2.cfo.com/tax/2011/07/how-ipo-founders-keep-their-taxes-low/ [https://perma.cc/8AU4-NGP6] ("The Up-C structure enables companies to acquire assets by issuing operating partnership units. Those units may make it possible for the founding owners from whom the company acquires assets to defer recognizing taxable gains until the company disposes of those assets.").

20. *See infra* section I.C.1.

assets, but triggers immediate tax for the pre-IPO owners without providing the benefits of tax arbitrage or enabling the pre-IPO owners to avoid corporate level tax.[21]

Although owners were skeptical of the Up-C in its early years, its rising popularity is an indication that the market has become comfortable with the transaction, likely because the transaction has gone unchallenged even as it has become more popular.[22] This Article argues that the regulations commonly relied on to justify the Up-C do not in fact justify it, and that scholars have missed this because they have not considered the types of supercharged IPOs separately. The Up-C is based on regulations that specifically allow a real estate investment trust (REIT), a special kind of corporation that is generally not subject to corporate taxation, to be the parent of a partnership.[23] These regulations do not support the Up-C structure because the Up-C involves creating a regular C corporation as the parent of a partnership.[24] When a C corporation is substituted for a REIT, the substance of the transaction becomes entirely different because it allows pre-IPO owners to get the benefits of being publicly traded while avoiding corporate tax in perpetuity. Congress has never allowed pre-IPO owners of regular C corporations to go public in a way that allows them to avoid corporate taxation, and it seems highly unlikely that regulators would have intended to hide such a significant and costly policy change to the nature of IPOs inside REIT regulations that must be applied by analogy. The legal basis of the Up-C is questionable at best.

This Article proceeds as follows. Part I explains the

21. *See, e.g.*, Allan Sloan, *GE Perfects the Fine Art of Tax Savings*, WASH. POST (Dec. 13, 2005), http://www.washingtonpost.com/wp-dyn/content/article/2005/12/12/AR2005121201510.html [https://perma.cc/Z7SE-S8C4] (explaining the mechanics of a Section 338 supercharged IPO and noting that GE paid $1.1 billion in taxes as a result of making a Section 338(h)(10) election in connection with its IPO of Genworth Financial).

22. *See, e.g.*, Todd Gluth, *Exit of Partnership Investments*, N.Y.U. ANN. INST. ON FED. TAX'N § 24.07, § 24.07[2][e][i] n.212 (2015) ("[M]any practitioners . . . take comfort in the proliferation of UPREIT (and now Up-C) structures that apparently have not been challenged by the IRS."); *see also* Chelsea Naso, *5 Must-Know Facts for Launching an Up-C IPO*, LAW360 (Apr. 8, 2015, 5:06 PM), http://www.law360.com/articles/639656/5-must-know-facts-for-launching-an-up-c-ipo [https://perma.cc/8J42-V6SR] ("[A]s more companies utilize the structure and perform well following their IPO, the more comfortable both companies and their potential investors have become with the structure. . . .").

23. Treas. Reg. § 1.701-2(d) (1995), ex. 4.

24. *See infra* section I.C.2.

differences between traditional IPOs and the three different types of supercharged IPOs, and discusses the tax receivable agreements that generally accompany supercharged IPOs. Part II examines the tax benefits created by the various types of supercharged IPOs—focusing on the Up-C (which is by far the most popular of these transactions)—it also explains why the Up-C is not justified under existing law, and responds to Professors Fleischer and Staudt.

I. TRADITIONAL IPOS AND SUPERCHARGED IPOS

Supercharged IPOs are poorly understood. This stems from the fact that scholars have neither examined the origins of supercharged IPOs nor separately examined the multiple types of supercharged IPOs. This Part explores the origins of the various types of supercharged IPOs and why they have only recently grown in popularity. This Part then explains the basic mechanics of the three types of supercharged IPOs and the tax benefits they create as compared to a traditional IPO. When the different types of supercharged IPOs are considered separately, it becomes clear that a pre-IPO owner's decision whether to supercharge is dependent on the structure of the company they are planning to take public, which determines which type of supercharged IPO they can pursue. This Part provides a framework for understanding these transactions, which this Article uses to begin to draw more complete normative conclusions about them.

A. *The Invention and Spread of the Supercharged IPO*

The supercharged IPO is an interesting case of financial innovation. While the supercharged IPO first appeared just over twenty years ago, the majority of these transactions have taken place over the past five years.[25] What caused the market to "invent" this transaction, and why has it become so popular only recently?[26]

25. *See* DEWITT, *supra* note 13.

26. Professors Fleischer and Staudt propose and test several theories about what drove the innovation of the supercharged IPO and conclude that tax arbitrage was the reason. *See* Fleischer & Staudt, *supra* note 1, at 351–61. As discussed in Part II, there are other benefits to supercharging, particularly in connection with the Up-C, and tax arbitrage is only a benefit of some

There are three types of supercharged IPOs: a Section 338(h)(10) IPO, an Up-C, and a publicly traded partnership IPO.[27] Supercharged IPOs were invented in response to legislative and regulatory changes that supposedly permitted their structures,[28] though the different types of supercharged IPOs originated from different legislative sources and followed different paths from inception to eventual acceptance in the financial market.

The Section 338(h)(10) supercharged IPO, the earliest of the three types of supercharged IPOs, was first seen in 1993. This type of supercharged IPO was not permitted prior to the Section 338(h)(10) regulations that were promulgated in 1986.[29] One relevant requirement of a Section 338(h)(10) election is that a purchaser must "purchase" at least 80 percent of the stock of the target corporation.[30] A purchase does not include certain types of transactions, and it was initially unclear whether a purchase could be made in connection with an IPO.[31] However, from 1991 to 1997, the IRS issued several

supercharged IPOs. *See infra* section II.A. Either way, these benefits existed long before the recent rise in popularity of supercharged IPOs, so explaining what the benefits are is not the same as explaining why the transaction only recently came into existence.

27. *See infra* section I.C.

28. *See infra* section II.C (arguing that the Up-C is not supported by the legislation that supposedly allows it).

29. *See* Treas. Reg. § 1.338(h)(10)–1T, T.D. 8068, 1986-1 C.B. 165 (implementing I.R.C. § 338(h)(10)); *see also* H.R. REP. NO. 97-986 (1982) (stating that I.R.C. § 338(h)(10) was not to be effective until the issuance of implementing regulations). The regulations went through several revisions that broadened the scope of when companies are eligible to make a Section 338(h)(10) election. T.D. 8515, 1994-1 C.B. 89. Among other things, these regulations added affiliated but nonconsolidated domestic subsidiaries as eligible targets for making an I.R.C. § 338(h)(10) election.

30. I.R.C. § 338(h)(3).

31. The details of a Section 338(h)(10) transaction are beyond the scope of this Article. However, a purchase does not include an acquisition if the party acquiring the stock is "related" to the person selling the stock. I.R.C. §§ 318(a), 338(h)(3)(A)(iii). In an IPO with a Section 338(h)(10) election, the selling parties make a binding commitment to sell at least 51 percent to an underwriter. The underwriter then sells the stock to the public, thus avoiding the related party rules that would cause the transaction to fail the Section 338(h)(10) "purchase" requirement. *See, e.g.*, Mark Silverman, *Section 338(h)(10)*, PRAC. L. INST. 1, 19 (2013), http://www.steptoe.com/assets/attachments/3167.doc [https://perma.cc/M6AE-DMTR] ("Under the old regulations, it was not clear when the relationship between the parties should be tested."); *see also* John C. Hart, *The Umbrellas of Subchapter K*, STBLAW 42 (2016), http://www.stblaw.com/docs/default-source/related-link-pdfs/umbrellas-of-subchapter-k.pdf?sfvrsn=6 [https://perma.cc/G5Q9-NY28] ("[B]y committing to

rulings permitting owners to make Section 338(h)(10) elections in connection with IPOs, and in 2001 Treasury proposed regulations confirming the IRS's earlier rulings.[32]

Similarly, the Up-C supercharged IPO, which was first seen in 1999,[33] was made possible by regulations promulgated in 1995. Prior to 1992, people generally thought that an Up-C structure ran afoul of the partnership anti-abuse rules, which state that partnership transactions "must be respected under substance over form principles," and that each partnership transaction "must be entered into for a substantial business purpose."[34] Between 1992 and 1995, several companies received the IRS's blessing to form "umbrella partnership real estate investment trusts" (UPREITs),[35] and in 1995 Treasury promulgated regulations that allowed the UPREIT structure.[36] The Up-C, which is short for "umbrella partnership corporation" (and which derives its name from the UPREIT), is essentially the same as an UPREIT, except with a different type of entity.[37] In the UPREIT structure a REIT (a special

reduce its ownership in Genworth to below 50 percent, the transfer of assets to Genworth could be treated as a QSP under section 338."). For a detailed explanation of how parties make a Section 338(h)(10) election in connection with an IPO, see GINSBURG ET AL., *supra* note 15, ¶ 206.5, and Fleischer & Staudt, *supra* note 1, at 319–22.

32. Treas. Reg. § 1.338-3(b)(3)(ii) (detailing the time for testing a relationship and confirming prior rulings, including Tech. Adv. Mem. 9747001 (July 1, 1997); Priv. Ltr. Rul. 9541039 (July 20, 1995), as modified by Priv. Ltr. Rul. 9549036 (Sept. 12, 1995), Priv. Ltr. Rul. 9142013 (July 17, 1991)); *see* Mark L. Yecies, Presentation at William & Mary Annual Tax Conference: Section 338(h)(10*),* at 11 (1999), http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1201&context=tax [https://perma.cc/NK6N-CRDR] ("As a result, the proposed regulations confirm prior ruling position that Section 338(h)(10) may be utilized in a going public transaction.").

33. In 1999, barnesandnoble.com was the first company to use the Up-C structure in connection with an IPO. *See* Elliot, *supra* note 2, at 337.

34. Treas. Reg. § 1.701-2(a)(1)–(2).

35. *See* Hart, *supra* note 31, at 13 ("In late 1992, Taubman Centers, Inc., became the first public REIT to operate through an UPREIT structure. Six other public UPREITs were formed in 1993: General Growth Properties, Carr Realty, Manufactured Home Communities, Mark Centers Trust, Trucker Properties Corp., and Spieker Properties, Inc.").

36. Treas. Reg. § 1.701-2(d), ex. 4 (1960). UPREITs became a common REIT structure for those who wanted to participate in a REIT but wanted to hold their REIT interests through a partnership. *See* Dean Starkman & Robin Sidel, *Mall Brawl: Why Bid Marks Turning Point for All REITs*, WALL ST. J. (Apr. 28, 2003), http://www.wsj.com/articles/SB105148937292145000 [https://perma.cc/P57Q-XF9E] (describing the early UPREITs).

37. *See* Elliot, *supra* note 2, at 336. The "Up" in both the Up-C and UPREIT

type of tax-advantaged real estate corporation) is placed on top of a partnership, while in the Up-C, a standard C corporation is placed on top of a partnership.[38] Soon after the regulations expressly permitted the UPREIT structure, practitioners created the Up-C.[39]

Although the first Up-C appeared in 1999, it did not gain significant popularity until around ten years later, likely due to the uncertainty surrounding the transaction. The UPREIT regulations do not explicitly allow an Up-C structure, so reluctance was understandable.[40] Robert Willens, who coined the phrase "supercharged IPO," explained that he presented the supercharged IPO to many clients, but "no more than 1 in 10 signed on" because "[t]hey felt it might not elicit very good publicity."[41] However, the Up-C steadily gained popularity after a handful of companies performed successfully following an Up-C.[42]

names is short for "umbrella partnership." *See, e.g.*, Chadwick M. Cornell, Comment, *REITs and UPREITs: Pushing the Corporate Envelope*, 145 U. PENN. L. REV. 1565 (1997) (describing UPREIT structures and their benefits); Russell J. Singer, Note, *Understanding REITs, UPREITs, and Down-REITs, and the Tax and Business Decisions Surrounding Them*, 16 VA. TAX. REV. 329 (1996) (explaining different REIT structures); Ezra Dyckman & Daniel W. Stahl, *Opportunities and Pitfalls in Structuring UPREIT Transactions*, 142 TAX NOTES 95 (2014) (explaining the UPREIT structure).

38. *See infra* section I.C.2 and accompanying text.

39. As discussed in section II.C, *infra*, the Up-C structure is distinguishable from the UPREIT structure.

40. Clients' uncertainty appeared to be well founded. In 2007 the publicity surrounding a few prominent supercharged IPOs of publicly traded partnerships generated sufficient controversy to prompt Congress to propose legislation that would have eliminated some of the transactions' tax benefits, though the legislation was never enacted. H.R. 3996, 110th Cong. (2007). Although Congress focused on publicly traded partnerships, the proposed legislation would have also eliminated many of the tax benefits of the Up-C. *Id.* In 2009, Congress introduced, but again chose not to pass, legislation that would have eliminated some of the tax benefits of supercharged IPOs. *See* H.R. 1935, 111th Cong. (2009). In particular, the proposed legislation would have used Section 1239 of the Code to eliminate tax arbitrage benefits for transactions containing a tax receivables agreement. *Id.* Under current law, Section 1239 of the Code taxes the sale of property at ordinary income rates if the property is depreciable or amortizable in the hands of the purchaser. *See* I.R.C. § 1239. For example, if a parent sells a family business to his or her child, then Section 1239 causes the parent to recognize ordinary gain on the sale of the business, to the extent the assets of the business are depreciable or amortizable, even though the gain on the sale would otherwise have been taxable as capital gain (except to the extent of any "hot" assets under I.R.C. § 751). *See id.*

41. *See* Elliot, *supra* note 2, at 334 (quoting Robert Willens).

42. *See* Naso, *supra* note 22 ("[A]s more companies utilize the structure and

The supercharged IPO appears to show that, at least in the tax context, innovation is commonly driven by new legislative or regulatory guidance. Taxpayers prefer tax certainty, so the influential tax bar and lobbyists press Congress or Treasury for guidance blessing a transaction they want to pursue. Once the guidance comes out, practitioners look for other ways to exploit the guidance to make transactions more tax efficient for their clients. It appears that the regulations that supposedly allow the Up-C structure were not specifically targeted at this structure, but that practitioners reasoned by analogy that the regulations could be extended to IPOs.[43] This perhaps explains the relatively slow adoption of these structures, since Treasury never officially blessed them, but they instead grew out of similar situations in different contexts. Likewise, the regulations that allowed the Section 338(h)(10) supercharged IPOs were an extension of prior rulings that could only be relied on by the parties to which the ruling was specifically issued. Aggressive practitioners and their clients were willing to take a gamble early on, but others waited to see if the structures withstood scrutiny from regulators and the public. There appears to have been a snowball effect; as more transactions have been completed without raising issues, the more the market has become comfortable with these transactions, to the point that they have now become commonplace.[44] The market reached this point only recently, and the result is that supercharged IPOs, and especially the Up-C, have rapidly spread. As one commentator said, "investors have relaxed as the Up-C structure has gained favor."[45] It appears that practitioners and owners of companies are no longer concerned about negative media attention or the possibility of Congress or Treasury introducing legislation or regulations aimed at these transactions. Once investors become comfortable generally, it is easy for a financial transaction to be adopted throughout the market.

Of course, pre-IPO owners must know that the

perform well following their IPO, the more comfortable both companies and their potential investors have become with the structure. . . .").

43. *See infra* section II.C (discussing whether the UPREIT regulations should be extended to the Up-C).

44. *See* Gluth, *supra* note 22, § 24.07[2][e][i] n.212 ("[M]any practitioners read the example broadly, and take comfort in the proliferation of UPREIT (and now Up-C) structures that apparently have not been challenged by the IRS.").

45. Naso, *supra* note 22.

supercharged IPO exists in order to benefit from it. However, the diffusion of knowledge about these transactions is unlikely to be an issue in most cases because of the way IPOs work. As discussed in section I.B, the first step in virtually every IPO is to hire an investment bank. The investment bank fills a wide range of roles, including letting the owners know how much they will likely receive from their various exit options, such as a sale to a strategic buyer, a sale to a private equity firm, a traditional IPO, or a supercharged IPO.[46] The vast majority of IPOs are done by just a handful of investment banks, and information about the supercharged IPO spreads easily among these few key players.[47] This diffusion of knowledge did not happen overnight (which could partly explain why these structures took time to gain popularity), but knowledge has become much less of an obstacle in recent years due to the supercharged IPOs' supercharged popularity.[48] Today, it is almost certain that a company planning to engage in an IPO will be represented by bankers and lawyers who understand supercharged IPOs well, so a lack of information should not be an obstacle.[49]

B. Traditional IPOs

Before exploring the mechanics and benefits of supercharged IPOs, it is helpful to have a basic understanding

46. Professors Fleisher and Staudt tested several theories regarding the spread of the supercharged IPO, including lawyers' roles in the process, and concluded that parties were 1.4 percent more likely to supercharge if they hired elite lawyers. *See* Fleischer & Staudt, *supra* note 1, at 339, 357. However, they did not analyze the role of investment bankers, the key players in helping clients understand and price their various exit options.

47. PETER KOSLOWSKI, THE ETHICS OF BANKING: CONCLUSIONS FROM THE FINANCIAL CRISIS 162 (Wim Dubbnik et al. eds., Deborah Shannon, trans., 2009) ("It is striking that the IPO business, which was especially lucrative for the investment banks and accounted for the bulk of their profits, is concentrated in the hands of very few investment banks. The IPO business, because it is conducted by a very select number of major banks, has a pronounced oligopolistic structure.").

48. *See* Jones & Stucke, *supra* note 3 (noting that TRAs have been used in several high-profile IPOs).

49. Tom Zanki, *Up-C IPOs Quietly Gaining Traction During Market Lull*, LAW360 (Feb. 23, 2016, 6:26 PM), http://www.law360.com/articles/761721/up-c-ipos-quietly-gaining-traction-during-market-lull [https://perma.cc/HV64-TXE9] (quoting Kirkland & Ellis LLP partner Joshua Korff as saying "There is not an IPO we do for a company, where it's a partnership pre-IPO, where we don't think about whether an Up-C makes sense . . . . Everyone is considering it.").

of traditional IPOs. An IPO permits a company to sell its shares to the general public on a stock exchange for the first time, converting what was a private company into a public company.[50] An IPO allows a company to access capital markets, enabling the company to raise money without issuing debt, which in turn allows it to invest in its infrastructure, expand its business, and increase its public exposure.[51] IPOs also give the pre-IPO owners, which typically include the founders, early employees, and early investors (such as angel investors and venture capital firms), a way to monetize their investments, either by selling a percentage of their shares or by exiting the company altogether.[52]

An investment bank also helps a company price its shares. A company that undervalues its shares forfeits capital it could have raised in an IPO,[53] while a company that overvalues its shares may raise a lot of money but damage its shareholder relations and employee morale.[54] Investment banks look to

50. A company looking to go public will generally hire an investment bank to assist in the process. Although a company could theoretically sell shares on its own, in practice, companies almost always hire investment banks to fill a wide range of important roles in the process of going public. These roles include gauging public demand for the company, marketing the company's shares to potential buyers, and assisting in the company's compliance with complicated Securities and Exchange Commission (SEC) rules. *See* Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711 (2004) (describing the various and extensive roles investment bankers play in the IPO process); Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001) (describing the importance of investment banks' reputations and the various roles they play in the IPO process).

51. *See, e.g.*, PATRICK J. SCHULTHEIS ET AL., THE INITIAL PUBLIC OFFERING 1–11 (3d ed. 2008) (explaining the process, costs, and benefits of going public); Jay Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1796–1802 (2002) (exploring theories for why companies choose to go public).

52. *See* SCHULTHEIS ET AL., *supra* note 51, at 5–6.

53. For example, in the Twitter IPO, the shares surged from an offering price of $26 to an opening price of $45.10. If Twitter had set the price at $45, it could have raised nearly twice as much money, assuming investor demand was the same. Telis Demos et al., *Twitter IPO: Relief, Riches and a $25 Billion Finish*, WALL ST. J. (Nov. 7, 2013), http://www.wsj.com/articles/SB10001424052702303309504579182403432312182 [https://perma.cc/N7TT-ZDST]; *see also* Tim Loughran & Jay Ritter, *Why Has IPO Underpricing Changed Over Time?*, FIN. MGMT., Autumn 2004, at 5 (discussing why parties underprice IPOs).

54. *See* SCHULTHEIS ET AL., *supra* note 51, at 187 (noting that "[a] higher price raises more money for the company," but that "[a]n unsustainably high price, however, can harm the company and the underwriters[]" and that a "[d]isappointing aftermarket performance may cause investors and analysts to

several factors to determine the appropriate IPO price, including the amount of stock being sold in the IPO, the current profitability of the company, the potential growth of the company, the current stock price of similar public companies, and the company's assets and liabilities.[55] A company's assets include its "tax assets," which are credits, exemptions, and deductions that are expected to reduce the company's future tax liability.[56] A company with more tax assets should, theoretically, see a corresponding increase in the amount an investor will be willing to pay for its shares in an IPO.[57] After a company has the relevant information about going public, including how much its shares will sell for in an IPO compared to how much it would likely sell for in a merger or acquisition, the company can then make an educated decision about whether going public is worth the additional burdens of being a publicly traded company.[58]

lose interest[.]"); *see also* Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965 (1995) (discussing IPO overpricing). For example, Facebook's disappointing post-IPO performance resulted in bad publicity for the company. *See, e.g.*, Tim Worstall, *The Failure of Facebook's IPO*, FORBES (May 20, 2012, 7:54 AM), http://www.forbes.com/sites/timworstall/2012/05/20/the-failure-of-facebooks-ipo/#38f38d535c2f [https://perma.cc/B7QX-M5T8].

55. *See* SCHULTHEIS ET AL., *supra* note 51, at 187–89.

56. For example, when a company sells a product with a one-year warranty, there is an expectation that the company will have future return or repair expenses associated with that warranty. A company that sells $10 million in products in year one, at a pre-tax profit margin of fifty percent, would therefore have pre-tax income of $5 million in that year. If that same company expected that its warranty expense would be five percent of the $10 million in sales in today's dollars, its expected warranty expenses would be $500,000. Therefore, the company would have expected net income of $4.5 million in the current year. However, the Code does not allow companies to deduct expenses for warranties until the warranty expense actually occurs, so if the one-year warranty was sold in year one, but the company realized all of the expected $500,000 in warranty expenses in year two, then the Code would require the company to pay tax on the full $5 million of pre-tax earnings in year one, which, calculated at a rate of 35 percent, would equal $1.75 million. The $500,000 expense, which reduces the company's taxes by $175,000 (in other words, $500,000 times 0.35), is recorded on the company's balance sheet as a deferred tax asset in year one, and therefore only reduces the company's tax liability by the $175,000 (to the extent the company in fact has taxable income) in year two. *See* Rev. Rul. 2012-1, 2012-2 I.R.B. 255.

57. *See infra* note 77 (discussing whether the step-up does in fact increase the amount public investors are willing to pay for shares in a corporation in an IPO).

58. Once public, the company will be subject to additional regulations (for example, the Sarbanes-Oxley requirements) and the company's performance will be subject to greater public scrutiny. As a result of the increased scrutiny, the

Understanding the basic taxation of a traditional IPO lays the foundation for understanding the tax benefits of a supercharged IPO. To illustrate the taxation of a traditional IPO, suppose Startup LLC, a successful start-up business, is an LLC taxed as a partnership with only one asset, self-developed goodwill (an intangible asset measured by the established reputation of a business). Since Startup LLC is operated as a partnership, and generally, partnerships do not go public in an IPO,[59] Startup LLC converts into a corporation, Traditional Co., in a tax-free reorganization.[60] When Traditional Co. goes public in an IPO, it will sell two types of shares to the public in the primary offering. The first type is newly issued shares that dilute the ownership of existing shareholders. The proceeds from the sale of these shares go to Traditional Co. for use in its business. From a tax perspective, the creation and sale of new dilutive shares is a nonevent.[61] In other words, neither the investors nor the pre-IPO owners recognize any taxable gain or loss on the sale of these shares. This makes sense because the pre-IPO owners do not receive cash as a result of the transaction. Instead, their ownership is diluted, but the asset that they own is more valuable because it has received an infusion of cash from the public. The second type of shares that can be sold in an IPO are the privately held shares of pre-IPO owners. The proceeds from the sale of these shares do not benefit the company because the proceeds go directly to the pre-IPO owners.[62]

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company may be able to issue debt at a lower rate, but management will have additional burdens and responsibilities. *See* SCHULTHEIS ET AL., *supra* note 51, at 190–218.

59. GINSBURG ET AL., *supra* note 15, ¶ 1602.10.1 (explaining why entities originally formed as partnerships or LLCs traditionally incorporate before going public). When partnerships are publicly traded, they are generally taxed as a corporation unless they qualify for certain exceptions. Emily Cauble, *Taxing Publicly Traded Entities*, 6 COLUM. J. TAX L. 147, 153–54, 155–60 (2015) (discussing the qualifying income rules for publicly traded partnerships).

60. *See* Rev. Rul. 84-111, 1984-2 C.B. 88.

61. *See* I.R.C. § 1032(a) ("No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.").

62. For tax purposes, this type of sale does not affect the company, but is treated like any other stock sale by the owners, meaning they are taxed on their profit at capital gains rates, except to the extent of any hot assets under Section 751(a). The pre-IPO owners' ability to sell their shares is limited by share lockup arrangements, which typically last 180 days. *See* Laura Casares Field & Gordon Hanka, *The Expiration of IPO Share Lockups*, 56 J. FIN. 471 (2001). The IPO is

C. Three Ways to Supercharge an IPO

The traditional IPO structure is comparatively inefficient from a tax perspective because, although it does not generate a tax liability for the company, it can be "supercharged" in a way that increases the basis of the assets of the new public company. This in turn increases the amount of depreciation deductions the new company can take against its future taxable income. Most importantly, supercharging an IPO allows the new company to convert what is often its most valuable asset, its goodwill, from a non-depreciable asset to a depreciable one.[63] The ability to depreciate these assets over a number of years reduces a company's future taxable income, and therefore, its tax liability, without a corresponding actual cash expense. This significant tax asset increases the value of the company and, in theory, increases the amount public investors should be willing to pay for shares of a company in an IPO.[64] The primary reason why a change in structure is needed to realize this tax benefit is that under the Internal Revenue Code, self-developed goodwill is not depreciable to the company that created the goodwill.[65] In a traditional IPO, the historic company becomes the publicly traded company, and the self-developed goodwill therefore remains non-depreciable. However, if a different entity purchases the historic company, the tax code allows the purchaser to depreciate that same goodwill over a fifteen-year period, generating a substantial tax benefit to the purchaser.[66]

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therefore often followed by a secondary offering, where shareholders are able to liquidate some of their holdings. The cash from the secondary offering goes to the individual shareholders (rather than the company) and is a taxable event to the selling shareholders, but not to the company. *Id.*

63. *See* Michael L. Schler, *Basic Tax Issues in Acquisition Transactions*, 116 PENN ST. L. REV. 879, 887–88, 896 (2012) (explaining the mechanics of a step-up and depreciation and amortization deductions).

64. *See infra* note 77 (discussing whether the step-up does in fact increase the amount public investors are willing to pay for shares in a corporation in an IPO).

65. *See* I.R.C. § 197(c)(2)(B) (stating that intangibles created by the taxpayer are not amortizable under § 197).

66. *See* I.R.C. § 197(a), (d)(1)(A) (explaining that certain intangibles, including goodwill, are ratably amortizable "over the 15-year period beginning with the month in which such intangible was acquired"). For example, if a company has self-developed goodwill worth $100 million and sells that goodwill to a new entity in the process of going public, then, since goodwill is deductible over fifteen years, the deduction would reduce the purchaser's tax liability by $2.3 million per year, assuming a 35 percent tax rate, for a total tax benefit of $35 million over fifteen

The supercharged IPO is designed to take advantage of this tax benefit, and to make sure the benefit accrues to the pre-IPO owners, by adding two additional steps to a traditional IPO. First, the owners structure the IPO as a sale so that the public company gets a step-up in the basis of its underlying assets, including self-developed goodwill.[67] And second, the company and the pre-IPO owners usually enter into a contract called a "tax receivable agreement," an agreement whereby the new public company makes payments to the pre-IPO owners for tax assets, including the tax assets created by the taxable sale.[68] By taking these two steps, the supercharged IPO makes the "pie" larger than it would be in a traditional IPO by creating tax assets that the company would not otherwise have, and divides that larger pie in a way that benefits the pre-IPO owners.

A company can use one of three "supercharged" structures in an IPO so that it is treated as a sale such that the purchaser gets a stepped-up basis in the assets of the company: a Section

years. If the goodwill remained with the company, and was therefore non-depreciable, the company would never be able to access this $35 million tax benefit. This calculation assumes that Traditional Co. had sufficient taxable income to fully offset the tax deductions. For an example of the benefits of supercharging an IPO, see Cyran, *supra* note 5 ("GoDaddy's PubCo equivalent has about $2.4 billion of goodwill and intangible assets. Assuming 15-year amortization and a 40 percent tax take at the federal and local level, that's a potential tax reduction of more than $60 million a year altogether . . . .").

67. The step-up is created through either making an election under Section 338(h)(10) of the Code, in the case of a corporation, or through making an election under Section 754 of the Code, in the case of a partnership. *See infra* sections I.C.1–I.C.3.

68. *See infra* section I.D. Some scholars claim that a supercharged IPO always involves a TRA. *See* Fleischer & Staudt, *supra* note 1, at 319 ("A supercharged IPO . . . *always* involves a [tax receivable agreement] that calls for the parties to share the value of the company's underlying tax assets."). However, in some transactions, owners step-up a company's tax basis by using a supercharged structure but choose not to enter into a TRA. For examples of transactions that created a step-up in connection with an IPO under the Up-C structure, but did not include a TRA, see Taylor Morrison Home Corporation, Exchange Agreement (Exhibit 10.5) (June 24, 2014), http://www.sec.gov/Archives/edgar/data/1562476/000119312513141356/d480129dex105.htm [https://perma.cc/5H5Y-9SHR]; TerraForm Power, Inc., Exchange Agreement (Exhibit 10.5) (May 28, 2014), http://www.sec.gov/Archives/edgar/data/1599947/000119312514262438/d672387dex105.htm. [https://perma.cc/BNV5-LRLS]; and NRG Yield Inc., Exchange Agreement (Exhibit 10.3) (June 21, 2013), http://www.sec.gov/Archives/edgar/data/1567683/000104746913007323/a2215812zex-10_3.htm [https://perma.cc/NSC4-YX7T].

338(h)(10) IPO, an Up-C, or a publicly traded partnership (PTP) IPO.[69] Which structure a company is able to use depends on whether the company has been historically operated as a corporation or a partnership, and, if the company is a partnership, whether it meets certain rules governing publicly traded partnerships.[70] If the historic company is a corporation, then only the Section 338(h)(10) IPO is available because the other two structures require that the historic operating company be a partnership. If the historic company is a partnership, then it can step-up the basis of the company's assets through an Up-C or a PTP IPO. However, the PTP IPO is only available in a small number of IPOs where the historic company meets very specific tests to qualify as a publicly traded partnership, so usually the Up-C is the only option to supercharge the IPO of a company that has been operated as a partnership. This section attempts to clarify each of the three types of supercharged IPOs, with particular emphasis on the Up-C, by illustrating the way in which each one creates additional tax assets for the company.

1. Section 338(h)(10)

The Section 338(h)(10) supercharged IPO was the first of the three supercharged IPOs.[71] Recall from above that in a traditional IPO, the public corporation issues new shares that dilute the interests of pre-IPO owners and generate cash for the company without any tax liability to the company or the pre-IPO owners. Pre-IPO owners are not required to sell their shares in the IPO, which allows them to defer recognizing gain and paying tax until a later date. In contrast, if a company structures an IPO as a Section 338(h)(10) IPO, the pre-IPO owners are treated as selling their entire interest (even the portion an owner continues to hold), and are taxed accordingly.[72] On its face, the Section 338(h)(10) option does not seem logical since it intentionally triggers an immediate tax in exchange for a benefit that will only be realized over

69. *See* Elliot, *supra* note 2, at 334–39.
70. *Id.*
71. *Id.* at 334.
72. For an explanation of the Section 338(h)(10) rules, see Douglas A. Kahn, *Section 338 and its Foolish Consistency Rules—The Hobgoblin of Little Minds*, 14 QUINNIPIAC L. REV. 31, 45–50 (1994).

time.[73] However, the Section 338(h)(10) rules provide benefits that, in some cases, outweigh these timing costs.[74]

A Section 338(h)(10) election essentially treats the purchase and sale of the stock of a corporation as a purchase and sale of that corporation's assets.[75] The sellers only pay tax on the asset-level gain while the buyers receive benefits as if sellers had paid tax on both the asset and stock-level gain. The result is that even though the transaction is not a true asset sale, the buyers get a stepped-up basis in the corporation's assets and are able to turn the non-depreciable goodwill into depreciable goodwill.[76] The stepped-up basis creates new tax assets for the corporation, increasing the corporation's value.[77]

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73. *See* Yair Listokin, *How to Think About Income Tax When Interest Rates Are Zero*, 151 TAX NOTES 959 (2016) (explaining the "time value" of money and discussing how the time value of money is less when interest rates are lower).

74. A Section 338(h)(10) election is typically made when the benefit to the buyer exceeds the tax cost to the seller. The benefit to the buyer is measured by the amount of built-in gain in the target company's assets and how quickly the buyer will be able to realize the benefits of the step-up. The cost to the seller is measured by the difference between the amount of built-in gain in the target company's assets and the built-in gain in the target company's stock, as well as whether the target company is able to offset any of the gain with other losses. *See* Schler *supra* note 63, at 890–91 (explaining when it is beneficial for parties to make a Section 338(h)(10) election).

75. I.R.C. § 338(h)(10)(A) ("[T]he target corporation recognizes gain or loss with respect to the transaction as if it sold all of its assets" and "no gain or loss will be recognized on stock sold or exchanged in the transaction.").

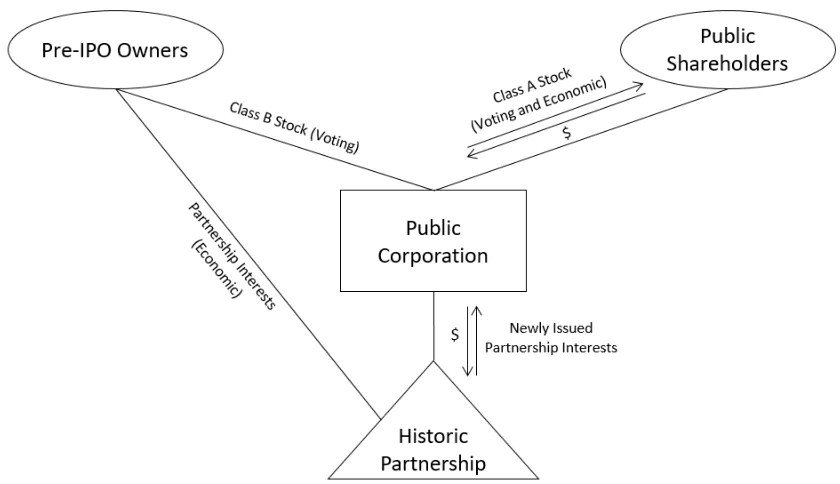
76. For a detailed explanation of how parties make a Section 338(h)(10) election in connection with an IPO, see GINSBURG ET AL., *supra* note 15, ¶ 206.5, and Fleischer & Staudt, *supra* note 1, at 319–22.

77. This increase in the corporation's value should increase the amount that shareholders would be willing to pay for shares of the corporation in an IPO. *See* Merle Erickson & Shiing-wu Wang, *The Effect of Transaction Structure on Price: Evidence from Subsidiary Sales*, 30 J. ACCT. & ECON. 59 (2000) (empirically showing that purchase prices are higher in transactions where parties made a Section 338(h)(10) election in connection with an M&A deal). *But see* Deborah L. Paul & Michael Sabbah, *Understanding Tax Receivable Agreements*, PRAC. L., June 2013 (explaining that although tax assets are recorded on a company's balance sheet and, theoretically, a company's valuation should increase in relation to the value of its tax assets, "[i]t has become conventional wisdom" that the market does not price tax assets into the value of stock in an IPO). One reason experts believe tax assets may not be priced into an IPO is that public company valuations are often based on "earnings before interest, taxes, depreciation, and amortization," commonly referred to as EBITDA, which specifically excludes taxes, including tax assets, from its calculation. *See* GINSBURG ET AL., *supra* note 15, ¶ 405 (explaining that "where (as is often the case) Newco's IPO price is based on estimates of Newco's future GAAP earnings (rather than estimates of Newco's future after-tax cash flows), structuring for asset [stepped-up basis] may produce little or no incremental sales proceeds for transferors . . . selling Newco stock in

2. Up-C

Even though the Up-C is the most common of the three types of supercharged IPOs by far and is gaining popularity,[78] until this Article it had never been discussed in the academic literature.[79] This section provides a detailed analysis of the Up-C's structure, its mechanics, and its effect on the pre-IPO owners' economic and voting rights.

FIGURE 1. THE UP-C



The first step in an Up-C is to create a new C corporation that will become the publicly traded company.[80] A key

the IPO").

78. *See, e.g.*, Elliot, *supra* note 2, at 335; Naso, *supra* note 12 ("The use of the Up-C structure has become more common as partnerships carving out business units look to get the most bang for their buck in an IPO, with GoDaddy's anticipated offering and the recent public debut of beloved burger chain Shake Shack Inc. drawing attention to the structure. Summit Materials Inc., a cement company backed by The Blackstone Group LP, also recently opted to list using the Up-C structure for its $400 million debut."). For statistics on the number of entities that have gone public using the Up-C structure, see *supra* note 13. For a list of Up-C filings from 2010 to 2014, see John LeClaire & Brad Weber, *The Up-C IPO: A Structure that Keeps on Giving*, BUYOUTS (Feb. 9, 2015), http://www.goodwinprocter.com/~/media/7BE5CF865E864647BA2309795BC60C2F.pdf [https://perma.cc/2AHS-XD7C].

79. *See supra* note 11 and accompanying text.

80. The new parent is a C corporation for tax purposes, but may be organized under state law as a corporation, a limited liability company, or a limited partnership. If the historic partnership itself had converted to a corporation and

structural difference between a traditional IPO and the Up-C is that the Up-C uses this new C corporation as the publicly traded company while a traditional IPO of a partnership converts the historic partnership into a C corporation and uses that converted entity as the publicly traded company.[81] In an Up-C, the new C corporation has two classes of stock, Class A stock with voting and economic rights typical of common stock, and Class B stock with voting rights, but no economic rights. Creating and maintaining two classes of stock is complicated, but is essential to generating the Up-C's significant tax benefits (discussed in detail in section II.A) while also allowing pre-IPO owners to maintain control of the new publicly traded company.

In the second step of an Up-C, the pre-IPO owners recapitalize the partnership, which is a multi-step process. First, the partnership typically admits the new C corporation as the sole managing member of the partnership and gives this C corporation voting control over the partnership.[82] Second, in connection with admitting the new C corporation as the sole managing member of the partnership, the pre-IPO owners relinquish their voting and management rights (but not their economic rights) in the historic partnership.[83] Third, the recapitalization aligns the value of each partnership unit with the value of each share of Class A stock.

After the recapitalization, the C corporation issues the Class A stock to public investors who subscribe in the IPO in exchange for cash.[84] The C corporation also issues the Class B stock to the pre-IPO owners in accordance with their ownership

gone public, the public company would not receive a step-up in the basis of the underlying partnership assets because the conversion would have been a Section 351 transaction and the public company would have taken a carryover basis in the partnership assets. *See* Rev. Rul. 84-111, 1984-2 C.B. 88.

81. *See supra* notes 59–60 and accompanying text. Because partnerships that are publicly traded are generally subject to corporate-level tax, it is almost always more efficient for a publicly traded entity to be structured as a corporation. *See supra* note 59 and accompanying text. Prior to the invention of the Up-C, this meant that when owners of a partnership wanted to take their company public, the pre-IPO owners would convert the partnership into a corporation and sell the shares of the newly-converted corporation to the public (in other words, the historic partnership ceased to exist). *See supra* section I.B.

82. *See* Hart, *supra* note 31, at 21.

83. Making the C corporation the sole managing member of the partnership allows the public company and the historic partnership to be consolidated for financial purposes.

84. *See* Naso, *supra* note 22.

in the historic partnership, which means they receive one share of Class B stock for each unit of the underlying partnership they continue to own.[85] The pre-IPO owners receive the Class B stock in what is essentially an exchange of their voting and management rights in the historic partnership (which they transferred to the C corporation in the recapitalization) for equivalent *voting* rights in the historic partnership in the form of the new Class B shares of the C corporation.[86] The pre-IPO owners retain their *economic* rights through a direct interest in the underlying partnership units, which allows them to maintain certain tax benefits, discussed in the following Part.

Immediately after issuing the Class A and Class B shares, the C corporation uses the cash it receives in the IPO to purchase interests in the historic partnership from either the pre-IPO owners or from the historic partnership itself.[87] This means that the newly public C corporation holds no assets other than interests in the underlying historic partnership, because all of the business operations still occur in the underlying partnership. Any interests purchased from the partnership are newly issued interests that dilute the ownership of the pre-IPO owners, and the proceeds from the sale of those interests go to the historic partnership to use in its operations. Just like in the traditional IPO described above, the issuance and sale of new shares or interests in an Up-C is not a taxable event to the company or the pre-IPO owners.[88] The transaction is taxable to pre-IPO owners only to the extent they sell their interests in the historic partnership.

85. *Id.*

86. As the sole managing member of the historic partnership, the publicly traded C corporation controls the voting and management rights of the historic partnership. Since the pre-IPO owners do not own any direct economic interests in the C corporation, the Class B stock acts as a mechanism for keeping the voting rights with the pre-IPO owners in proportion to their interests in the historic partnership. Small blocks of Class B shares hold little value, so pre-IPO owners who own a smaller interest in the entities (and who receive a smaller block of Class B shares) would be unlikely to trigger much taxable income upon receipt of the Class B shares. However, pre-IPO owners who own a significant amount of equity in the historic partnership (and who therefore receive a significant portion of the vote/Class B shares) may be taxed upon receipt of the Class B shares.

87. After the C corporation purchases interests in the historic partnership, the number of Class A shares outstanding will be equal to the number of partnership units owned by the public C corporation, creating symmetry between what the public owns in the C corporation and what the C corporation owns in the historic partnership.

88. *See* I.R.C. § 721(a); *see also* Willens, *supra* note 19 and accompanying text.

The result of these steps for the public shareholders is that they hold Class A shares of the C corporation, which represent their interest in the voting and economic rights in the underlying partnership. Because of the recapitalization, each share of Class A stock typically represents an interest in one unit of the underlying partnership, so that a shareholder who owns fifteen shares of Class A stock would effectively own fifteen underlying partnership units with both voting and economic rights. The end result of these steps for the pre-IPO owners is they hold Class B shares of the publicly traded C corporation that represent their voting rights in the underlying partnership while they continue to hold their remaining economic interests directly in the underlying partnership.[89] A pre-IPO owner who retained forty partnership units would receive forty Class B shares, and thus voting control over forty partnership units, while maintaining its economic interest directly through its forty partnership units.[90] In this way, the Class B shares allow the pre-IPO owners to access public market capital while keeping their economic interests in the flow-through historic partnership.[91]

All of these steps would be of limited benefit to the pre-IPO owners if they were unable to monetize their economic interests in the underlying partnership. If that were the case, then a traditional IPO, in which the pre-IPO owners receive shares of a publicly traded corporation that they are free to sell on the public market at any time, would be much-preferred over the Up-C. The Up-C solves this problem by giving the pre-IPO owners the right to exchange their (voting) Class B shares together with a corresponding number of (economic) partnership units on a one-for-one basis for (voting and

89. *See* GINSBURG ET AL., *supra* note 15, ¶ 1602.10.2 (illustrating the Up-C structure).

90. Each share of Class B stock generally has the same voting power as each share of Class A stock. Since the pre-IPO owners typically retain ownership of at least 50 percent of the partnership units and corresponding Class B stock, the Class B stock operates as a mechanism for the pre-IPO owners to retain control of the publicly traded company and therefore the historic partnership. Alternatively, the pre-IPO owners sometimes structure the Class B stock to have a greater than one-for-one vote (i.e., the Class B stock is "high-vote" stock), meaning that the pre-IPO owners can own less than a majority of the underlying partnership interests and still retain voting control over the publicly traded company.

91. *See infra* section II.A.1 (discussing how the Up-C allows pre-IPO owners to effectively own an interest in a publicly traded entity while avoiding corporate level taxation on distributions from the historic partnership).

economic) Class A shares.[92] For example, if a pre-IPO owner wanted to liquidate 100 shares/units, she would exchange 100 Class B shares and 100 partnership units for 100 Class A shares that she can sell on the public markets.[93] This provides the pre-IPO owners liquidity similar to the liquidity they would have in a traditional IPO,[94] although there are some limitations to avoid running afoul of the publicly traded partnership rules.[95] When pre-IPO owners sell their interests

92. Although the exchange is often structured as a direct exchange of the historic partnership interests for Class A shares in the public corporation, there are other ways companies can and have structured the exchange right. The exchange may also be structured as a direct exchange of the pre-IPO owners' historic partnership interests for cash sourced from the public C corporation in an amount equal to the value of the Class B shares plus the partnership interests exchanged by the pre-IPO owner. Alternatively, the exchange may be structured as: (a) a redemption of the pre-IPO owner's partnership interests for cash sourced from the historic partnership; (b) a disguised sale with cash contributed to the historic partnership from the public C corporation (e.g. from cash raised in a public offering of Class A shares); or (c) a disguised sale with Class A shares contributed by the public C corporation to the historic partnership. An exchange right could also be structured as a mix of the various rights. For example, parties could make either the direct-exchange right or the redemption right the default, while giving the C corporation the option to override the default right and force an alternative method of exchange. The receipt of an exchange right that is structured as a redemption against the partnership should not be taxable to a pre-IPO owner, but the receipt of a direct exchange right against the public C corporation could be taxable to a pre-IPO owner because the IRS is more likely to view a direct exchange right as other property. *See* Rev. Rul. 69-265, 1969-1 C.B. 109.

93. The pre-IPO owners recognize gain when they exchange (or redeem) their partnership interests for economic shares of the public corporation, so, in practice they will only do this when they plan to sell their shares because the conversion is taxable and removes the benefit of holding their interest in a flow-through entity subject to only one level of tax. *See infra* section II.A.1.

94. DeSalvo, *supra* note 12, at 866 ("Another significant advantage of the UP-C structure is that it provides equity owners in a private partnership a path to liquidity via the put right (often called a redemption right) provision of the amended partnership operating agreement.").

95. The pre-IPO owners' rights to exchange (or redeem) their partnership interests for economic shares in the public corporation are limited to minimize the risk of triggering the PTP rules (for example, the pre-IPO owners may only be able to exchange their partnership interests for shares in the public corporation a few times per year, or they may be required to give sixty days' notice before any such exchange). However, sometimes the parties will structure the exchange (or redemption) rights in a manner that is more likely to trigger the PTP rules than alternative ways of structuring the exchange (or redemption) rights in order to impose minimal restrictions on the pre-IPO owners. *See* Amy S. Elliot, *Aggressive Exchange Rights in Up-Cs, Up-REITS Concern IRS*, 149 TAX NOTES 1250, 1250 (2015) (discussing how the IRS has expressed concern over aggressive exchange rights and quoting Clifford Warren, IRS Associate Chief Counsel (Passthroughs and Special Industries), as saying, "I think people may be straying—we're

in the underlying partnership the sale is taxable at capital gains rates.[96]

Importantly, the partnership makes an election under Section 754 of the Code, which provides the public company with a stepped-up basis in the assets of the underlying partnership when it acquires partnership interests from the pre-IPO owners.[97] The Section 754 election also turns the historic partnership's non-depreciable, self-developed goodwill into depreciable goodwill, meaning that the corporation is able to significantly reduce its future tax liability as it deducts for the goodwill.[98]

3. Publicly Traded Partnership

A third type of supercharged IPO is a PTP IPO, first seen in 2005 when Lazarus Ltd. went public.[99] This is the only type of supercharged IPO where interests in a partnership itself are offered to the public, and it is only available in very limited circumstances where a partnership meets certain passive-income requirements.[100] The result of this structure is that the vast majority of the partnership's income is subject to only one

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hearing—from some of the limitations . . . . [G]iven the spirit of C corp Up-structures, I think people should be conservative."); Polsky & Rosenzweig, *supra* note 11 (discussing how Up-Cs have "pushed the limits on what seemed to be the key facts" in Treas. Reg. § 1.701-2(d), Example 4, which provides a safe harbor to the PTP rules if there are certain restrictions on owners' ability to sell their partnership interests).

96. The pre-IPO owners pay tax at the capital gains rate, except to the extent of any "hot" assets under I.R.C. § 751. I.R.C. § 751.

97. The step-up benefit received by the public company is equal to the amount of gain recognized by a selling pre-IPO owner.

98. *See* I.R.C. § 754. The Section 754 election results in basis adjustments under either Section 743(b) or Section 734(b), depending on the structure of the pre-IPO owners' exchange or redemption rights. *See infra* note 164.

99. *See* Elliot, *supra* note 2, at 334. Perhaps the most famous example of a PTP supercharged IPO is the Blackstone supercharged IPO, which caused Congress to propose legislation that would have curtailed many of the benefits of the PTP supercharged IPO. *See, e.g.*, Emily Cauble, *Was Blackstone's Initial Public Offering Too Good to Be True?: A Case Study in Closing Loopholes in the Partnership Tax Allocation Rules*, 14 FLA. TAX REV. 153 (2013); Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008) [hereinafter *Taxing Blackstone*]; Victor Fleischer, *The So-Called Blackstone Bill, Resurrected*, N.Y. TIMES: DEALBOOK (Feb. 27, 2014, 6:30 AM), http://dealbook.nytimes.com/2014/02/27/the-so-called-blackstone-bill-resurrected/ [https://perma.cc/T69Z-RYC8].

100. *See* I.R.C. § 7704(c), (d); Cauble, *supra* note 59 (discussing the qualifying income rules for publicly traded partnerships).

level of tax for both public purchasers and pre-IPO owners in perpetuity.[101] Although this structure is the most tax efficient of the three supercharged IPOs because it provides all of the benefits of the others while also allowing the historic company to continue to operate as a partnership (thus avoiding corporate-level tax for both pre-IPO owners and public shareholders), it is unavailable to most companies because very few are able to meet the PTP qualifying income requirements.[102]

Like the historic company in an Up-C, the PTP makes a Section 754 election, with the result that when the pre-IPO owners sell their interests in the PTP to the public, the PTP gets a stepped up basis in the underlying partnership assets and converts its self-developed goodwill into depreciable goodwill.[103]

D. *Tax Receivable Agreements*

So far, this Article has focused on the "supercharging" (meaning the step-up) aspect of supercharged IPOs, but supercharged IPOs also usually include a second feature that distinguishes supercharged IPOs from traditional IPOs. This second feature, called a "tax receivable agreement" or "TRA," is a contract between the newly public company and the pre-IPO owners that requires the newly public company to pay pre-IPO owners for the tax assets created by the step-up.[104] Recall that the step-up in basis that a supercharged IPO creates allows the newly public company significant depreciation deductions in subsequent years that will reduce taxable income.[105] A TRA requires the public company to pay the pre-IPO owners as it

101. The partnership uses a corporate subsidiary to "block" non-qualifying income. To the extent income passes through the corporate subsidiary, that income will be subject to two levels of tax—corporate tax at the blocker level and shareholder tax at the shareholder level.

102. Hart, *supra* note 31, at 31 ("There is . . . an exception to the general rule treating PTPs as corporations for companies 90 percent or more of whose income constitutes 'qualifying income' within the meaning of section 7704(d) and applicable Treasury regulations.").

103. *See supra* note 66.

104. *See* Paul & Sabbah, *supra* note 77, at 74–75; *see, e.g.*, Shake Shack Inc., Registration Statement (Form S-1) (January 20, 2015), http://d1lge852tjjqow.cloudfront.net/CIK-0001620533/01cff16f-cb4e-4193-a476-3b99962da1b3.pdf [https://perma.cc/8UWS-YE9N].

105. *See supra* notes 63, 65–66, 77 and accompanying text.

realizes tax savings from these depreciation deductions in the post-IPO period.[106] The vast majority of TRAs entered into in connection with a supercharged IPO require the public company to pay the pre-IPO owners 85 percent of the tax savings, with the company retaining the remaining 15 percent.[107]

Today, TRAs channel billions of dollars from public companies back to pre-IPO owners, sparking controversy over the nature and terms of the agreements.[108] TRAs attract this controversy despite the fact that the issuing company prominently discloses the details of, and any risks associated with, the TRA in its SEC disclosure and includes a copy of the TRA as an attachment to the company's SEC filings. For example, in the recent supercharged IPO for Shake Shack, which used an Up-C structure, the SEC registration statement uses the term "tax receivable agreement" seventy-three times

106. *See* GINSBURG ET AL., *supra* note 15, ¶ 1602.10.2 ("Newco-C often agrees (in a so-called tax receivables agreement) to pay to the old partnership/LLC's selling equity owners a percentage (e.g., 85 percent) of any tax benefits Newco-C realizes from the asset basis step-up produced by these sales of old partnership/LLC common units to Newco-C, with such payments made as tax benefits are realized.").

107. Although the vast majority of TRAs adhere to the 85 percent standard, some supercharged IPOs use a different formulation. *See, e.g.*, Virgin Mobile USA Inc., Registration Statement (Form S-1) (May 1, 2007), https://www.sec.gov/Archives/edgar/data/1396546/000119312507097779/ds1.htm [https://perma.cc/8A7N-C3JH] (containing a TRA with a 100 percent standard).

108. *See* Fleischer & Staudt, *supra* note 1, at 311; Elliot, *supra* note 2, at 334 (explaining that some people describe tax receivable agreements as "underhanded") (quoting Robert Willens); Lynnley Browning, *Squeezing Out Cash Long After the I.P.O.*, N.Y. TIMES: DEALBOOK (Mar. 13, 2013, 6:26 PM), http://dealbook.nytimes.com/2013/03/13/private-equity-squeezes-out-cash-long-after-its-exit/ [https://perma.cc/7J2H-T374] (claiming that a tax receivable agreement "drains money out of the company that could be used for purposes that benefit all the shareholders") (quoting Robert Willens); Keith Bedford, *Blackstone Partners May Avoid Tax on IPO Gains*, REUTERS (June 13, 2007, 7:02 PM), http://www.reuters.com/article/2007/07/13/us-blackstone-tax-idUSN1325038320070713 [https://perma.cc/B4VB-37NN] (calling tax receivable agreements "a one-sided relationship") (quoting Lee Sheppard); Yves Smith, *Another Private Equity Scam—Tax Receivable Agreements*, NAKED CAPITALISM (Aug. 3, 2015), http://www.nakedcapitalism.com/2015/08/another-private-equity-scam-tax-receivable-agreements.html [https://perma.cc/V5JE-WFWW] (describing tax receivable agreements as a "tax scheme . . . that it does not pass the smell test"); PEU REPORT, *Carlyle's "Cash Tax Savings" Won't Go to Unit Holders* (May 5, 2012, 10:28 AM), http://peureport.blogspot.com/2012/05/carlyles-cash-tax-savings-wont-go-to.html [https://perma.cc/MTS5-6ZCC] (stating that tax receivable agreements create a "bizarre siphoning of cash").

and the term "TRA" twenty-four times.[109] The registration statement also explains risks associated with the TRA. These risks include the fact that pre-IPO owners are not required to reimburse the public company for tax benefits that are later disallowed by a taxing authority;[110] that the payments under the TRA will be "substantial" and reduce the overall cash flow to the public company;[111] and that if the public company takes certain actions, such as a merger or an election to terminate the TRA, it could be required to make payments to the pre-IPO owners that are greater than the benefit the public company ultimately receives in respect of the tax assets.[112]

Although tax receivable agreements are an important and controversial aspect of most supercharged IPOs, including the Up-C, their mechanics and normative desirability are complicated enough to warrant a separate discussion, and thus are not central to the focus of this Article. For this Article it is sufficient to note that tax receivable agreements ensure that the pre-IPO owners receive the majority of the benefit of the Section 338(h)(10) and Section 754 step-ups created by the three types of supercharged IPOs described above. It is also important to note that this benefit is in addition to the other benefits inherent in the Up-C, which are discussed in the following Part.

II. THE (TOO GOOD TO BE TRUE) UP-C

Part I laid out the basic mechanics of the three types of supercharged IPOs and showed that each produces tax benefits that can reduce future tax liabilities. This Part explores the additional tax benefits of structuring a supercharged IPO as an Up-C. When Up-Cs are viewed separately it becomes clear why

109. *See* Shake Shack Inc., Registration Statement (Form S-1) (Jan. 20, 2015), http://d1lge852tjjqow.cloudfront.net/CIK-0001620533/01cff16f-cb4e-4193-a476-3b99962da1b3.pdf [https://perma.cc/8UWS-YE9N].

110. *Id.* at 42 ("We will not be reimbursed for any cash payments previously made to the Continuing SSE Equity Owners under the Tax Receivable Agreement in the event that any tax benefits initially claimed by us and for which payment has been made to a Continuing SSE Equity Owner are subsequently challenged by a taxing authority and are ultimately disallowed.").

111. *Id.* at 41 ("The Tax Receivable Agreement with the Continuing SSE Equity Owners requires us to make cash payments to them in respect of certain tax benefits to which we may become entitled, and we expect that the payments we will be required to make will be substantial.").

112. *Id.* at 41–42.

the Up-C now accounts for a significant portion of the overall IPO market and makes up the vast majority of all supercharged IPOs in recent years.[113] This Part then responds to Professors Fleischer and Staudt, showing that their empirical study is an important first step at examining supercharged IPOs, but that it reached misguided conclusions about why people supercharge IPOs. This Part shows that the reason most parties choose to supercharge is because of the many benefits of the Up-C. This Part then critically examines the Up-C's legal underpinnings to show that the structure used in the Up-C conflicts with both congressional intent and the regulations that supposedly allow it. It turns out that the substantial tax benefits of the Up-C may be too good to be true.

A. The Many Benefits of the Up-C

Understanding the Up-C, which has been overlooked in the academic literature despite its importance, is necessary to understand why this transaction has recently become so popular, and whether it is justified by the laws that supposedly allow it.[114] Because commentators have neither focused on the Up-C nor understood the differences between the different types of supercharged IPOs, they have not had a framework within which to clearly answer why owners engage in supercharged IPOs.[115] As described in Part I, the three types of supercharged IPOs have one thing in common—they each produce a step-up benefit that increases the value of certain tax assets in the public company. However, as this Part will show, other than the step-up, the costs and benefits of each type of supercharged IPO are unique. This section shows how

113. *See supra* note 13 and accompanying text. Up-Cs have made up between five to six percent of all IPOs from 2012 to 2015. *See also* Zanki, *supra* note 49.

114. *See supra* note 11 and accompanying text.

115. Recall that almost all companies looking to engage in an IPO have only one option available to them to supercharge. A company that is a corporation can only engage in a Section 338(h)(10) supercharged IPO, while a partnership will generally only be able to engage in an Up-C. As explained above, which supercharged IPO structure a company uses depends on whether the company has been historically operated as a corporation or a partnership and, if the company is a partnership, whether it meets certain rules governing publicly traded partnerships. This means that the question of "why" owners supercharge an IPO is not a question of why owners choose one type of supercharged IPO over the other; rather, it is a question of why, when choosing between a traditional IPO and a supercharged IPO, owners choose a supercharged IPO.

the Up-C is significantly more tax advantaged than the other types of supercharged IPOs (which explains why the Up-C is so popular), and shows that the majority of these benefits are not available in the Section 338(h)(10) supercharged IPO. Because the PTP supercharged IPO is rarely an option, since it has very strict requirements that few companies meet, this section focuses primarily on comparing the Up-C to the Section 338(h)(10) supercharged IPO.

1. Corporate Tax Avoidance

One significant benefit of the Up-C is that it allows the pre-IPO owners to retain their interests in the historic partnership, rather than converting their partnership interests into shares in a corporation as they would in a traditional IPO.[116] This benefit is not available to public purchasers in the IPO, who must purchase shares in a corporation. This means that the structure of the Up-C allows for disparate treatment of pre-IPO owners and the public, even though they are shareholders of the same underlying assets. This benefit is significant because it means that the pre-IPO owners are able to avoid corporate-level tax on their retained stake, and will therefore only pay individual income tax on their allocable share of the partnership's income and distributions at a maximum federal rate of 39.6 percent[117] This benefit is also not available in a 338(h)(10) supercharged IPO because the historic shareholders already hold an interest in a company that is taxed as a corporation. In a traditional IPO, the pre-IPO owners' interest in the company becomes subject to two levels of federal tax, one on income earned within the corporation at a maximum rate of 35 percent, and a second on earnings distributed out of the corporation at a maximum rate of 23.8 percent,[118] for a maximum combined rate of 50.5 percent.[119] In

116. *See* DeSalvo, *supra* note 12, at 866 (explaining that the Up-C imposes "only a single level of tax [on the pre-IPO owners], which is assessed at the investor level (no entity level income tax)"); GINSBURG ET AL., *supra* note 15, ¶ 1602.10.2.

117. *See* Zanki, *supra* note 49 ("The Up-C avoids the double taxation associated with a standard C corporation, which is taxed at the corporate level and again at the shareholder level when individuals collect dividends or sell investments.").

118. Glenn Ruffenach, *Navigating the Dividend Storm*, WALL ST. J. (Jan. 10, 2013), http://www.wsj.com/articles/SB10001424127887323689604578219952168695148

contrast, under the Up-C structure, the historic partnership makes distributions directly to the pre-IPO owners, so the pre-IPO owners pay a single level of individual income tax at a maximum rate of 39.6 percent, for a federal tax savings of up to 10.9 percent.[120]

2. Tax Arbitrage

Tax arbitrage is an additional reason to engage in an Up-C.[121] Tax arbitrage arises in an Up-C because when pre-IPO owners sell their partnership interests to the public corporation, they recognize gain on the sale and pay tax on that gain at a 23.8 percent rate.[122] As discussed above, this sale of

[https://perma.cc/VS9V-3LX4] ("For the highest wage earners, the tax on dividends is 23.8 percent (20 percent plus 3.8 percent." (quoting Charles Farrell, chief executive of Northstar Investment Advisors LLC)).

119. To illustrate this difference with an example, if the pre-IPO owners retain a 50 percent interest in Traditional Co. and Traditional Co. earns $200 million before tax, then, assuming Traditional Co. pays out 100 percent of its profits as dividends, the pre-IPO owners' share of the profit before any taxes are imposed would be $100 million. Traditional Co. would pay $35 million in corporate tax on the $100 million, and the pre-IPO owners would pay approximately $15.5 million in shareholder tax on their $65 million dividend, for a total after-tax dividend of $49.5 million. Of course, to the extent Traditional Co. chooses not to distribute out its profits, it would not incur the second level of tax.

120. Following the example above in note 119, the pre-IPO owners in an Up-C would pay a single individual income tax of $39.6 million on the $100 million of profit. The PTP structure also benefits from only one level of tax, but this is generally true of any PTP structure (to the extent it meets the qualifying income requirements) and not something unique to a PTP supercharged IPO. The PTP structure imposes only one level of tax on distributions to both the pre-IPO owners and the new public partners, whereas the Up-C imposes one level of tax on distributions to the pre-IPO owners but two levels of tax on distributions to the new public shareholders. Therefore, in this example, the flow-through benefit would have been on the full $200 million (assuming it was all qualifying income), and, overall, the parties would have saved double the amount, or $21.8 million.

121. The PTP structure also benefits from tax arbitrage. When the pre-IPO owners sell shares to public investors, the sale of the shares steps up the basis in the underlying partnership assets and turns the previously non-depreciable, self-developed goodwill into purchased, depreciable goodwill. Because the amortization generates deductions for the PTP's corporate, blocker subsidiary at a 35 percent rate, while the sale of the PTP units generally generates capital gain at a 23.8 percent rate (except to the extent of any "hot" assets under I.R.C. § 751), the rate differential creates the opportunity for tax arbitrage.

122. This number was calculated by adding together the 20 percent capital gains rate plus the 3.8 percent net investment income rate. For a critique of taxing gain on the sale of business goodwill and business intangibles as capital gain, see Calvin Johnson, *Sale of Goodwill and Other Intangibles as Ordinary Income*, 118 TAX NOTES 321 (2008).

partnership interests to the public corporation results in a step-up in the basis of the partnership's assets, which the corporation is then able use to its advantage by depreciating the stepped-up assets at a 35 percent corporate rate, generally over a fifteen-year period.[123] The net result is that the historic partners pay tax at a preferential capital gains rate of 23.8 percent while the public company gets an offsetting deduction at a 35 percent corporate rate.[124] The resulting tax arbitrage generates a net tax benefit on the transaction at the expense of the federal government. This is where understanding the differences between the three types of supercharged IPOs is important. Because the Section 338(h)(10) supercharged IPO is only available to an entity that is taxed as a corporation before the IPO, the company does not benefit from tax arbitrage because both the tax liability that generates the step-up and the resulting deductions created by the step-up are recognized by corporations at the same corporate rate of 35 percent.

3. Tax Deferral

In a Section 338(h)(10) supercharged IPO, pre-IPO owners are forced to incur an immediate tax liability on their interests in the historic company when they make the Section 338(h)(10) election in connection with supercharging the IPO.[125] In contrast, in an Up-C (and in a PTP supercharged IPO), pre-IPO owners can choose to defer recognizing gain until they sell their interests.

An example helps illustrate why there is no timing cost to the Up-C structure.[126] Suppose that partners in a partnership

123. For a critique of the fifteen-year amortization period, see Calvin Johnson, *Extend the Tax Life for Acquired Intangibles to 75 Years*, 135 TAX NOTES 1054 (2012).

124. *See* Fleischer & Staudt, *supra* note 1, at 366 ("[O]ur empirical findings show that the financial innovation of the supercharged IPO was engineered to reduce tax costs. It does so by taking advantage of a tax arbitrage between the founders of firms organized as partnerships and selling equity at a 15 percent tax rate, with Public Co. and its investors taking amortization deductions at up to a 35 percent rate.").

125. *See* I.R.C. § 338(h)(10).

126. When the pre-IPO owners receive voting, non-economic stock in the public company, the receipt of those shares may be taxable to the pre-IPO owners. However, unless a pre-IPO owner holds a significant percentage of the voting shares, any gain from the receipt of non-economic shares should be insignificant. *See supra* note 86.

are considering whether to engage in a traditional IPO or a supercharged IPO. Since owners generally only sell shares of a corporation (rather than interests in a partnership) in an IPO, the owners have two options: either pursue a traditional IPO by converting the partnership into a corporation (Traditional Co.) or use an Up-C structure and create a new corporation (Up Co.) that will own interests in the historic partnership.[127] If the partners pursue a traditional IPO, Traditional Co. will issue new shares and then sell those shares in an IPO. Converting the partnership into Traditional Co. is a tax-free reorganization.[128] The pre-IPO owners receive shares in Traditional Co. but defer recognizing any gain until they sell their shares, which they can choose to do in the IPO or at a later date. The issuance of new shares in the IPO dilutes the pre-IPO owners' ownership percentage of Traditional Co., but it infuses cash into Traditional Co. in an amount that is intended to compensate for the dilution. If the partners were to instead pursue an Up-C, the partners would create a new corporation (Up Co.) above the historic partnership and the historic partnership would issue new interests to Up Co., thereby diluting the owners of the historic partnership. Up Co. would then sell shares in an IPO and use the proceeds from the IPO to purchase the newly issued interests from the historic partnership. The cash from the IPO ultimately ends up with the historic partnership, and, like the traditional IPO, the cash paid to the historic partnership compensates the pre-IPO owners for the dilution created by an issuance of new interests.[129] Neither the issuance of new interests in the historic partnership nor the sale to Up Co. generates a tax liability.[130] Although the pre-IPO owners may choose to sell some of their partnership interests to Up Co., they are not required to.[131] In other words, deferral works exactly the same way in a traditional IPO as it does in an Up-C. In both cases

127. *See supra* note 59 and accompanying text.

128. *See* Rev. Rul. 84-111, 1984-2 C.B. 88.

129. *See* GINSBURG ET AL., *supra* note 15, ¶ 1602.10.2 ("Newco-C uses its IPO cash proceeds to purchase newly issued old partnership/LLC common units directly from old partnership/LLC (to the extent old partnership/LLC is to receive the cash for working capital, debt repayment, or expansion) and/or to purchase previously outstanding old partnership/LLC common units from the existing equity owners (to the extent the equity owners are to receive proceeds) . . . .").

130. *See* I.R.C. § 721(a); Willens, *supra* note 19 and accompanying text.

131. Willens, *supra* note 19 and accompanying text.

the historic company issues new interests or shares, diluting those of the pre-IPO owners, and the owners only owe tax to the extent they choose to cash out.[132]

4. Up-C Costs

The lack of a timing difference between a traditional IPO and the Up-C, in conjunction with tax arbitrage, and the fact that pre-IPO owners are able to remain subject only to a single level of tax, shifts the question from why owners of a partnership choose to supercharge an IPO to why they would ever choose *not to* supercharge an IPO when the Up-C structure is available?[133] While the Up-C structure has many benefits, it is not without costs.[134] The costs and benefits vary with each Up-C, which is why supercharging may make sense in some instances but not in others. The costs are mostly administrative in nature because an Up-C requires setting up and maintaining multiple entities, which entails additional accounting and legal expenses.[135] While these expenses vary

132. The pre-IPO owners may also recognize gain when the partnership sells its underlying assets. *See* I.R.C. § 704(c). However, since the pre-IPO owners typically retain control over at least fifty percent of the partnership units (through their voting Class B shares), they usually maintain control over the company's affairs, and thus are in control of which assets are sold and when. *See supra* note 90 and accompanying text.

133. As explained above, the Up-C is not an option if the historic company is organized as a corporation. There are many reasons companies choose to organize as or convert to a corporation prior to the point at which they are ready to go public, including the fact that venture capital funds often refuse to invest in flow-through entities, and flow-through entities are generally more expensive to maintain. In addition, because private equity firms generally have to use a corporate entity to "block" around half of their investors, they generally receive only half of the benefit of owning a flow-through entity, and therefore frequently choose to block the entire investment.

134. *See* Zanki, *supra* note 49 ("The multilayered structure of an Up-C increases compliance costs, requires more sophisticated accounting to track the TRA, and adds complexity to shareholder liquidity matters . . . . While none of these additional obligations is trivial, they are generally not a deterrent if a thorough tax analysis has otherwise concluded that the Up-C structure makes business sense for the company, according to attorneys.").

135. *See supra* section I.C.2 (showing that the Up-C structure requires both a corporation and a partnership). An additional potential cost comes from the I.R.C. § 197 anti-churning rules, which preclude amortization of intangibles if a party acquires an intangible asset from a "related" party. *See* I.R.C. § 197(f)(9). The details of the anti-churning rules are complex and outside the scope of this Article. For an explanation of the anti-churning rules and proposals for reform, see Romina Weiss, *Fifteen Years of Antichurning: It's Time to Make Butter*, 122

somewhat depending on the complexity of the deal, the expenses are more static than the potential benefits. If the company is large enough, it can justify the expense of a two-tier structure, but a smaller company is more likely to decide that the costs outweigh the benefits.[136] However, if a company is organized as a partnership at the time the owners choose to take the company public, in most cases the significant potential benefits of the Up-C structure should outweigh the added costs.

B. *A Response to Professors Fleischer and Staudt*

Professors Fleischer and Staudt, in what is the most comprehensive treatment of supercharged IPOs in the legal literature to date, set out to empirically explain why owners choose to supercharge an IPO.[137] Their empirical study is an important first step at examining supercharged IPOs, and it helped turn scholarly attention to these important but understudied transactions. Although Professors Fleischer and Staudt's study helped lay the groundwork for discussing supercharged IPOs, their work lumps together all three types of supercharged IPOs even though, as this Article has shown, the three types of supercharged IPOs are quite different.[138]

TAX NOTES 227 (2009).

136. *See* Zanki, *supra* note 49 ("[T]he added expenses can weigh more heavily on smaller companies, which already find it harder to go public than larger businesses because small firms have less capacity to absorb the greater costs of becoming a full reporting company with the U.S. Securities and Exchange Commission.").

137. Fleischer & Staudt, *supra* note 1.

138. Professors Fleischer and Staudt explain the mechanics of the 338(h)(10) supercharged IPO, which does not benefit from tax arbitrage because it involves two corporations rather than a partnership and a corporation, and thus does not qualify for preferential capital gains tax rates that allow for tax arbitrage. Fleischer & Staudt, *supra* note 1, at 319–24. They then state that "the deals often involve a partnership and a corporation, rather than two corporations[]" and explain that only the deals involving a partnership and a corporation benefit from tax arbitrage. *See id.* at 322. However, other than noting that difference, they lump together the three types of supercharged IPOs, despite the fact that they are quite different. In addition, Professors Fleischer and Staudt do not explain the mechanics of the partnership structures (the Up-C and PTP structures). The fact that they focus on tax arbitrage, which is only available in the Up-C and PTP supercharged IPOs, while their main example and descriptions involve the Section 338(h)(10) supercharged IPO, makes their empirical findings hard to match with their descriptive and theoretical discussions. This was likely a factor in their misunderstanding of the mechanics of the Up-C and PTP supercharged IPOs.

This section shows that by treating the three types of supercharged IPOs as one, Professors Fleischer and Staudt reached misguided conclusions about their study's central question: why owners choose to supercharge an IPO. This section shows that the reason parties supercharge is to take advantage of the many benefits of the Up-C, of which tax arbitrage is only one. This section then explains why Professors Fleischer and Staudt's table and calculations that purport to prove that parties supercharge an IPO to take advantage of tax arbitrage is factually incorrect because it conflates the different types of supercharged IPOs. A close examination of their calculations and assumptions and, in particular, their Table A1, clearly shows that Professors Fleisher and Staudt based their conclusions on a hybrid supercharged IPO with both a timing cost and tax arbitrage, which, as this Article has shown, does not exist.[139]

1. Why Owners Supercharge

Professors Fleischer and Staudt empirically tested several theories for why owners choose to supercharge, and concluded that "tax arbitrage . . . is the primary motivator for supercharging an IPO."[140] They reached this conclusion for two reasons. First, their empirical study showed that when owners have the opportunity for tax arbitrage, they will supercharge an IPO 44 percent of the time, but when owners do not have the opportunity for tax arbitrage, they will only supercharge an IPO one percent of the time.[141] Second, as discussed in detail in the following section, they incorrectly claimed that

139. As this Article has shown, tax arbitrage is only available in the Up-C and PTP supercharged IPOs, while the timing cost is only an element of the Section 338(h)(10) supercharged IPO. *See supra* sections I.C.1–3.

140. Fleischer & Staudt, *supra* note 1, at 353. *See id.* at 360, 363 ("With respect to the underlying justification for adopting the supercharged deal structure, we found that the primary motivator was the ability to engage in tax arbitrage . . . ." "The tax arbitrage created when founders sell equity at capital gains rates while generating a tax asset that can be amortized at ordinary rates is, according to our study, the key driver of this innovation.").

141. *Id.* at 353 ("44 percent of all the parties capable of engaging in tax arbitrage executed a TRA, while only 1 percent of the parties who had no arbitrage opportunities but goodwill present adopted a TRA."). Professors Fleischer and Staudt include IPOs through February 3, 2014. *See id.* at 342 n.126. It would be interesting and informative to have updated statistics, given how new the Up-C is, though doing so is outside the scope of this Article.

supercharging an IPO results in an immediate tax liability and that tax arbitrage is necessary to make the supercharged IPO cost effective. Although Professors Fleischer and Staudt did not discuss the Up-C, tax arbitrage is only available when the historic company is a partnership. Therefore, another way to state their findings is that when owners have the opportunity to engage in an Up-C (or a supercharged PTP, though those are rarely an option) they will do so 44 percent of the time, but when they have the opportunity to engage in a Section 338(h)(10) IPO they will do so only one percent of the time.[142]

As this Article has established, tax arbitrage is only available in the Up-C and the PTP supercharged IPOs, and is only one of several benefits afforded by those transactions. So although Professors Fleischer and Staudt were on the right track when they examined how tax arbitrage affects a company's decision to supercharge, they were incorrect in claiming that tax arbitrage is *the* reason why pre-IPO owners choose to supercharge an IPO. That claim is incorrect because tax arbitrage is always accompanied by other benefits that Professors Fleischer and Staudt did not mention. In other words, when Professors Fleischer and Staudt's findings showed that owners will supercharge 44 percent of the time they have the opportunity for tax arbitrage, this actually meant that owners will supercharge 44 percent of the time they have the opportunity for tax arbitrage *and* corporate tax avoidance *and* deferral. While tax arbitrage is one benefit of supercharging, Professors Fleischer and Staudt's findings do not prove that it is the primary reason parties supercharge.

To reframe these conclusions in the context of the IPO market, saying that parties choose to supercharge 44 percent of the time they have the opportunity for tax arbitrage, corporate tax avoidance, and deferral is the same as saying that when owners have the opportunity to pursue an Up-C or PTP supercharged IPO, they do so 44 percent of the time. Since the PTP supercharged IPO is rarely available, the reasons owners choose to supercharge are found in the many benefits of the Up-C. Had Professors Fleischer and Staudt analyzed the three types of supercharged IPOs separately and conducted their

142. *Id.* at 351–63 ("Firms that are going public and are organized as partnerships position themselves to take advantage of [tax arbitrage] and, indeed, are vastly more likely to use a supercharged IPO than firms organized as corporations.").

empirical study accordingly, they likely would have realized that their conclusions about tax arbitrage were incomplete and that the many benefits of the Up-C are the real reason to supercharge an IPO.

2. Professors Fleischer and Staudt's Calculations

In conjunction with their findings that owners supercharge at a much higher rate when there is an opportunity for tax arbitrage, Professors Fleischer and Staudt created a table with calculations that purport to confirm that tax arbitrage is the primary reason owners choose to supercharge an IPO.[143] They claim that tax arbitrage is necessary to make a supercharged IPO worth pursuing because of a supposed timing cost as compared to a traditional IPO.[144]

However, their calculations are based on a factually incorrect understanding of the mechanics of supercharged IPOs. They claim that in a supercharged IPO the pre-IPO owners are required to immediately recognize gain, while in a traditional IPO the pre-IPO owners benefit from being able to defer recognizing gain (and that pre-IPO owners will choose to supercharge only when the tax arbitrage benefit is great enough to overcome the costs of giving up deferral).[145] As this Article has shown, tax arbitrage is only available in the Up-C and PTP supercharged IPOs, while the timing cost is only an element of the Section 338(h)(10) supercharged IPO. The two partnership structures, including the Up-C structure, do not require pre-IPO owners to pay taxes any sooner than in a

143. *See id.* at 372 ("This result confirms our empirical finding above.").

144. *See id.* at 370–73 ("If the parties pursue the traditional IPO, no tax costs or benefits arise, but if they pursue a supercharged IPO, Founders Co. will be subject to tax costs, and Public Co. will obtain tax benefits."); *see id.* at 320–21 (A supercharged IPO "is likely to generate substantial taxes on [the public company] and its owners." In a traditional IPO there were "no immediate tax burdens triggered."); *see also id.* at 371 ("If the parties pursue a supercharged IPO, Founders Co. will be viewed as having sold the company to Public Co. for $10 million (the value of the asset) and thus will pay an immediate up-front tax of $1.5 million (a 15% rate) or $3.5 million (a 35 percent rate).").

145. Some practitioners have also confused this issue. *See* Joe Garza, *Supercharged IPOs Draw Attention*, GARZA & HARRIS (Apr. 1, 2013), http://garzaharris.com/supercharged-ipos-draw-attention/ [https://perma.cc/M5ZC-BZWR] (describing a supercharged IPO with tax arbitrage, but also stating that "the 'cost' of creating this asset is that the private company's owners have to pay an immediate tax bill").

traditional IPO.[146] Because Professors Fleischer and Staudt lumped together the three types of supercharged IPOs, they missed the fact that tax arbitrage and timing costs are never both present in any of the three supercharged IPOs (in other words, there is no timing cost when there is tax arbitrage). Therefore, they were incorrect when they claimed that a timing cost "confirms" that tax arbitrage was the primary reason pre-IPO owners choose to supercharge.[147]

FIGURE 2: PROFESSORS FLEISCHER AND STAUDT'S TABLE A1

Table A1: The Costs and Benefits to Owner-Founders and Public Co. of a TRA in Traditional and Supercharged IPOs (Present Value Dollars)

Nature of Costs and Benefits	Traditional IPO	Supercharged IPO	
		Tax Arbitrage	*No Tax Arbitrage*
1. Value of Tax Assets w/o TRA			
To Owner-Founders	$0	$0	$0
To Public Co.	0	3,049,750	3,049,750
2. Value of Tax Assets w/ TRA			
To Owner-Founders	0	2,592,290	2,592,290
To Public Co.	0	457,460	457,460
3. Tax Costs in Deal w/ TRA			
To Owner-Founders	0	(1,888,840)	(4,407,300)
To Public Co.	0	0	0
4. Net Value of Deal w/ TRA			
To Owner-Founders	0	703,450	(1,815,010)
To Public Co.	0	457,460	457,460
5. Division of Surplus (Owner-Founders : Public Co.)		61:39	Net Loss

* Supercharged IPOs with a tax-arbitrage opportunity entail a 15% tax rate on owner-founders and a 35% tax rate on Public Co.; if all the parties are taxed at a 35% tax rate, the parties have no arbitrage opportunity.

This distinction is complicated but imperative to understanding the nature of supercharged IPOs, so it is worth looking more closely at where exactly Professors Fleischer and Staudt went wrong. Professors Fleischer and Staudt's claim

146. *See supra* section II.A.3.
147. *See* Fleischer & Staudt, *supra* note 1, at 372.

that there is a timing cost associated with tax arbitrage is most clearly illustrated numerically in Table A1 of their article, which shows "The Costs and Benefits to Owner-Founders and Public. Co of a [Tax Receivable Agreement] in Traditional and Supercharged IPOs."[148] In this table they have three columns with numbers showing the costs and benefits of (1) traditional IPOs, (2) supercharged IPOs with tax arbitrage, and (3) supercharged IPOs with no tax arbitrage.[149] Their mistake is illustrated most clearly in row three, which shows "Tax Costs in Deal w/ TRA". In that row, the column for the traditional IPO shows that the pre-IPO owners choose to defer selling any of their interests, but the pre-IPO owners in supercharged IPOs both *with and without* tax arbitrage recognize an immediate gain.[150] This is incorrect because only the Section 338(h)(10) supercharged IPO (i.e. a supercharged IPO without tax arbitrage) requires owners to recognize immediate gain.

Furthermore, since pre-IPO owners in both a traditional IPO and a supercharged IPO with tax arbitrage can opt for deferral, and thus only recognize gain when they choose to sell, Table A1 simultaneously assumes two different sets of facts—in the case of the traditional IPO, the pre-IPO owners choose not to sell and in the supercharged IPO with tax arbitrage, the pre-IPO owners choose to sell their entire interest. An apples-to-apples comparison would have to show a scenario where the pre-IPO owners make the same decision to sell or not to sell in both the traditional IPO and supercharged IPO with tax arbitrage. The first would be the scenario in which the pre-IPO owners chose not to sell their interest. In such a case the column for the supercharged IPO *with* tax arbitrage (meaning an Up-C or PTP) would have all zeros, just like the traditional IPO, because the sellers in both cases would incur no tax liability, and therefore no tax assets would be created from the supercharged IPO. In both the traditional IPO and supercharged IPO with tax arbitrage, the pre-IPO owners would incur a tax liability in the future when they sold their

148. *Id.* at 372. Professors Fleischer and Staudt claim that "Table A1 (presented in the Appendix) provides numbers confirming that tax arbitrage opportunities are an essential component to the supercharged IPO." *Id.* at 330.

149. In their table, the costs and benefits in the traditional IPO column are all 0 (see rows 1–3), while the column for supercharged IPOs with tax arbitrage and the column for supercharged IPOs without tax arbitrage both have numbers showing the costs and benefits to pre-IPO owners in an IPO (see rows 1–3).

150. *See supra* Figure 2.

interest. At that point, tax assets would be created for the supercharged IPO, but not for the traditional IPO. The second scenario would be to assume that the pre-IPO owners in both instances disposed of their entire interests. In this case, the column for the supercharged IPO with tax arbitrage would look the same as it does in Professors Fleischer and Staudt's Table A1, but the column for the traditional IPO would have to change to account for the tax cost that the pre-IPO owners would incur from selling their entire interest in the company.

C. Challenging the Up-C

Until now this Article has approached the Up-C in a primarily descriptive manner. This section explores the Up-C with a more critical eye, examining the legal basis for the transaction to show that it seems to conflict with both congressional intent and the regulations that supposedly allow it.

Congress has twice considered eliminating some of the benefits of supercharged IPOs, but has not separately considered the unique benefits that occur in the context of the Up-C, likely because they examined supercharged IPOs prior to the rise of the Up-C. In 2007 and again in 2009, Congress proposed eliminating the tax arbitrage benefit, which, as explained above, is a benefit of both the PTP supercharged IPO and the Up-C.[151] The proposed bills would have taxed the sale of partnership interests, which are generally taxed at capital gains rates, at ordinary income rates if the transaction contained a tax receivable agreement and if the gain was attributable to depreciable or amortizable assets, such as goodwill.[152] This legislation was specifically aimed at the

151. *See supra* note 40 and accompanying text.

152. *Id.* Since the proposed 2007 legislation, Congress has made changes to the tax system that somewhat reduce the tax arbitrage benefits of the supercharged IPO, even though those changes were not directed at these transactions. The decreasing benefit of tax arbitrage somewhat mitigates the cost to the government of the increasing popularity of the supercharged IPO. At the beginning of 2015 the capital gains rate increased from 15 percent to 20 percent, and the Patient Protection and Affordable Care Act added a new 3.8 percent tax on net investment income for taxpayers earning over certain amounts. This means that in 2007, the tax arbitrage benefit in an Up-C was 20 percent—the difference between the 35 percent highest marginal tax rate for corporations and the 15 percent marginal rate for capital gains for the highest earning individuals. Today, the tax arbitrage benefit has decreased somewhat to 11.2 percent—the difference between the 35

Blackstone IPO, which used a PTP supercharged IPO structure.[153]

Because Congress focused only on the PTP supercharged IPO in 2007 and again in 2009, the proposed bills would not have disallowed the benefit that allows pre-IPO owners to continue to hold their interests in partnerships.[154] That Congress did not target this benefit makes sense in the PTP context because Congress specifically allows PTPs to be both publicly traded and avoid corporate-level taxation, provided that they earn certain types of qualifying income.[155] This, however, is a substantial deviation from the general rule of IPOs, which requires owners to hold their shares through an entity taxed as a corporation after the IPO, meaning that the owners are subject to two levels of taxation on their shares. There is no evidence that Congress has ever intended to allow pre-IPO owners of regular corporations that go public to enjoy both the benefits of being publicly traded and of holding their interests in a way that escapes corporate-level taxation. Going public provides a company certain benefits, and Congress generally requires that those benefits come at the expense of the owners being subject to corporate taxation. However, pre-IPO owners in an Up-C get to enjoy all the benefits of going public without paying corporate tax. They do this even though they do not fall within a specific exception for publicly traded entities that are exempt from corporate taxation, like REITs and PTPs. Congress's failure to target this benefit in the 2007 and 2009 proposed legislation does not appear to have been a conscious decision. Rather, Congress did not appear to be paying attention to the Up-C, likely due the fact that, at that time, the Up-C was relatively rare and the media was fixated on Blackstone and other similar, big-name PTP supercharged IPOs. A reconsideration of supercharged IPOs is long overdue, but with a focus on the now dramatically more popular Up-C structure.

There is good reason to question whether the regulations

percent highest marginal tax rate for corporations and the 23.8 percent capital gains rate plus net investment income tax rate for the highest earning individuals. The fact that the Up-C has gained so much popularity despite the decrease in the tax arbitrage benefit indicates that the other benefits of the Up-C are material.

153. *See Taxing Blackstone*, *supra* note 99 and accompanying text.

154. *See supra* section II.A.

155. *See* I.R.C. § 7704(c)–(d).

relied on to justify the Up-C actually support the Up-C structure and its unique tax benefits. Although commentators seem to assume these regulations do allow this structure, the regulations are specific to a particular type of REIT structure that is different from Up-Cs in important ways.[156] The relevant regulations specifically permit a structure whereby a REIT becomes the parent of a partnership, commonly called an UPREIT.[157] This is beneficial from a tax perspective because it allows a partner to contribute appreciated property to the partnership, thereby avoiding immediate taxation, instead of contributing it to the REIT, which would trigger immediate taxation.[158] In return, the partner gets partnership interests that can be converted into shares of the REIT.

The Up-C structure appears to be beyond both the letter and spirit of the UPREIT regulations. It is beyond the letter because the regulations expressly condone using a REIT on top of a partnership but say nothing about the use of a regular corporation on top of a partnership, which, as explained above, is the structure used in the Up-C.

The Up-C structure is also beyond the spirit of the regulations because the purpose of the regulations is to allow partners to avoid immediate taxation on property, not to give pre-IPO owners the benefits of being publicly traded without being subject to corporate taxation.[159] The REIT regulations

156. Hart, *supra* note 31, at 22 ("Despite its structural similarities to the UPREIT, the UP-C is designed to achieve different tax objectives.").

157. Treas. Reg. § 1.701-2(d), Example 4. Some commentators have recently argued that Example 4 causes "mischief" and should be reexamined, even in the REIT context. *See* Monte Jackel, *The Partnership Antiabuse Rule and UPREIT Structures Revisited*, 150 TAX NOTES 113 (2016) ("When stripped down to its essentials, the conclusion in Example 4 is a mystery that defies the general principals of [reg. section 1.701-2(a), (b), and (c)]. It would seem that the conclusion should have gone the other way. . . . I think it is time to reexamine the premises on which the regulation example was based.").

158. I.R.C. §§ 351(e), 357(c).

159. In form, the pre-IPO owners only own an economic interest in the underlying partnership, but in practice they effectively own interests in the public corporation, and the IRS should treat them as actually owning an interest in the public corporation from day one. Courts have generally applied a "facts and circumstances" test to determine ownership and have focused on owners' rights to (1) exchange or dispose of their interests, (2) vote, (3) participate in earnings and profits, and (4) share in assets upon liquidation. Hart, *supra* note 31, at 92–95. In the Up-C, the pre-IPO owners' best argument that the IRS should respect the Up-C form (rather than treating the pre-IPO owners as owning equity in the public corporation from day one), is that there are certain restrictions on the pre-IPO owners' ability to exchange their interests for shares in the public corporation. *See*

are clearly not aimed at allowing partners to avoid corporate taxation. Although REITs are technically corporations that may be publicly traded, they are a special kind of corporation that, for policy reasons relating to the ownership of property, are specifically exempt from corporate taxation if they meet certain income qualifications.[160] This means that owners of REITs receive the benefits of being publicly traded without being subject to corporate taxation, whether or not they engage in an UPREIT structure.[161] The REIT regulations simply do not address whether pre-IPO owners may use the Up-C structure to continue holding shares in a partnership while receiving all of the benefits of being publicly traded, which they would otherwise not be able to do. It seems highly unlikely that Treasury would have intended to hide such an important and costly policy change, which fundamentally alters the nature of IPOs for regular corporations, inside REIT regulations that are not even directly related to the Up-C, but instead must be applied by analogy to the Up-C.[162] A closer examination of the substance of the Up-C transaction makes it clear that relying on the REIT regulations to justify the Up-C seems suspect at

supra note 95 and accompanying text. However, these restrictions are minimal. *Id.* Under the other three prongs, the pre-IPO owners' rights are virtually identical to the public shareholder rights, even if they are held in a slightly different form. *See supra* section I.C.2 (explaining that the pre-IPO owners hold their voting rights and economic rights in different form than the public shareholders, but that in substance, the pre-IPO owners' rights are essentially the same as the public shareholders' rights).

160. Technically, a REIT is able to deduct dividends paid to its shareholders, and because most REITs distribute all their taxable income each year, the dividends-paid deduction eliminates the corporate-level tax on the REIT's income. *See* I.R.C. §§ 856–857.

161. The pre-IPO owners' rights to exchange (or redeem) their partnership interests for economic shares in the public corporation are limited to minimize the risk of triggering the PTP rules. For example, the pre-IPO owners may only be able to exchange their partnership interests for shares in the public corporation a few times per year, or they may be required to give sixty days' notice before any such exchange. However, other than this limitation, the pre-IPO owners generally enjoy the same benefits (and more) as the public investors.

162. If the IRS does challenge these transactions under the partnership anti-abuse regulations, then the government would recoup revenue for companies that have already chosen to use the Up-C structure. However, the prospective effect is less certain. Some companies that had considered going public may choose to remain partnerships and not go public if the Up-C structure is no longer an option. To the extent companies choose to remain private partnerships rather than going public and becoming subject to corporate-level tax, they would pay less in tax (and therefore generate less tax revenue). The net effect is difficult to determine.

best.[163]

Furthermore, pre-IPO owners will often choose to structure their exchange rights in ways that make their interests very similar to directly owning an economic interest in the public corporation from day one. This fact adds to the already strong argument that pre-IPO owners should not be able to avoid corporate tax based on the REIT regulations.[164] There is no good reason why pre-IPO owners, whose rights are virtually identical to public shareholders' rights, should be able to avoid corporate taxation. The IRS has strong grounds to challenge the Up-C by arguing that the pre-IPO owners are actually owners of the public, corporate entity from the time of the IPO, because in substance that is what they are. If the IRS

163. The partnership anti-abuse regulations, which specifically bless the UPREIT structure, state that "the proper reflection of income requirement . . . is treated as satisfied with respect to a transaction that satisfies [these regulations] to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are *clearly contemplated* by that provision." Treas. Reg. § 1.701-2(a)(3) (emphasis added).

164. If the exchange rights are structured as direct exchange rights between the pre-IPO owners and the public company (of either cash or Class A shares, which the pre-IPO owners can then monetize) or as a disguised sale with consideration sourced from the C corporation, then the exchange rights make the pre-IPO owners' interests look like direct interests in the public company, making it more likely that the IRS could treat the pre-IPO owners as owning a direct equity interest in the public company from day one. However, if the pre-IPO owners receive only a right of redemption with consideration sourced from the historic partnership, then they have a somewhat stronger argument that the IRS should not treat them as owning direct interests in the public company from day one. The heightened risk in direct exchanges and disguised sales rights may be preferable because exchange rights structured as either direct exchanges or as disguised sales provide the public company with a step-up under Section 743(b), which steps up the basis of partners' interests in the historic partnership, such that the public company then has a fully stepped-up basis in those interests. In contrast, if the exchange rights are structured as a redemption, so that the exchange of the pre-IPO owners' interests in the historic partnership is instead sourced from the historic partnership (i.e. the pre-IPO owners do not have a direct right against the public company), then the public company gets a step-up under Section 734(b), which provides a step-up to the common bases of the historic partnership's assets. This step-up under Section 734(b) (to the common bases of the assets) provides less of a tax benefit to the public C corporation than the step-up under Section 743(b) (which steps up the exchanged partnership interests) because the step-up under Section 734(b) benefits all the partners, while the step-up under Section 743(b) specifically benefits the public C corporation. *See also* GINSBURG ET AL., *supra* note 15, ¶ 1602.10.2 (explaining that in an Up-C, the public corporation obtains a tax benefit in its share of the partnership's assets under I.R.C. § 743(b) when it purchases interests from the existing equity owners, and under I.R.C. § 704(c) when it purchases newly-issued partnership interests).

challenged the Up-C structure, they could do so under the anti-abuse rules of Treasury Regulation Section 1.701-2. Although the IRS does not frequently challenge transactions under the partnership anti-abuse rules, the Up-C fundamentally weakens the corporate tax system, so it is the type of abuse that warrants the IRS's attention.

Despite the fact that the Up-C is beyond both the letter and spirit of the regulations that supposedly support the transaction, Professors Polsky and Rosenzweig argue that there is "nothing particularly nefarious" about the Up-C.[165] They reason that "one's take on Up-Cs likely depends on one's view of the corporate tax generally."[166] This is only partially true, since whether or not one believes there is a justification for corporate taxation, it is problematic to allow pre-IPO owners in an Up-C to avoid corporate taxation while public shareholders, who own an essentially identical interest, are subject to it. Moreover, whether the Up-C is a partnership abuse transaction is a separate issue from whether corporate taxation is normatively desirable.[167] Even if corporate taxation lacks any normative foundation, this does not make the Up-C any less of an abusive transaction under existing law. Currently pre-IPO owners in Up-Cs do not pay corporate tax despite a lack of statutory or regulatory support for that position, and skepticism about corporate taxation does not justify violating the law.

If owners of a partnership want to be able to use the Up-C structure, they should have to lobby Congress to enact a law that creates a legal basis for the structure. And if Congress or Treasury does create a law or regulation supporting the Up-C, they will have to explicitly consider why it is acceptable to carve out an exception to the long-standing and relatively clear-cut rule that publicly traded entities are subject to corporate taxation. Until then, at a minimum, companies that

165. *See* Polsky & Rosenzweig, *supra* note 11.

166. *Id.*

167. Though there is no general consensus regarding why certain entities should be subject to corporate taxation while others are not, if we start from the premise that some entities will be subject to a second level of tax, the existing public trading boundary is relatively clear cut and has some normative justification because publicly traded entities receive a benefit from accessing the public equity markets. *See, e.g.*, *Taxing Blackstone*, *supra* note 99, at 107; Calvin Johnson, *Taxing GE and Other Masters of the Universe*, 132 TAX NOTES 175 (2011).

use the Up-C structure should disclose in their public filings that the Up-C does not have clear statutory or regulatory support.[168]

CONCLUSION

Supercharged IPOs fundamentally change the nature of IPOs, increasing the value of a company by generating new tax assets. This Article shows that the most popular of the three types of supercharged IPOs, the Up-C, is even more tax advantaged than scholars have realized, calls into question both its legal foundation and normative desirability, and shows that other scholars have misunderstood the Up-C and therefore reached incorrect conclusions regarding the transaction. This Article concludes that the Up-C is not justified by the regulations that supposedly allow it, and that the IRS should therefore challenge the Up-C transaction under the partnership anti-abuse regulations.

168. Until there is law that more plausibly supports the use of the Up-C structure, companies that go public should include a risk factor in their S-1 regarding the lack of statutory or regulatory support for the Up-C so that public investors are aware that the IRS may challenge the legality of the Up-C. In addition, companies that advise clients regarding use of the Up-C structure should explain that the structure does not have explicit statutory or regulatory support. For an example of a "Big Four" accounting firm stating that the Up-C is legal (without providing any explanation of possible risks), see DEWITT, *supra* note 13 ("On the regulatory side, accounting rules and tax laws allow use of the structure.").