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An Overview of The Up-C Structure in Energy Deals

The UP-C structure — which offers tax benefits to pre-IPO investors and sponsors — likely will expand among energy companies.

In 2013, several energy companies went public using a so-called UP-C structure. In using this structure, the public company (IPOCo) typically owns a substantial equity interest in a subsidiary holding company (Holdings), which owns the operating assets and is a tax passthrough entity (*e.g.,* a limited partnership or limited liability company). The equity interests in Holdings not held by IPOCo are typically owned by the pre-IPO owners, which may consist of individual investors, private equity funds or others. The pre-IPO owners in Holdings have the right to exchange their Holdings equity interests for shares in IPOCo, at which point IPOCo gets a stepped-up tax basis in the Holdings equity interests (which results in tax savings to IPOCo through additional depreciation and amortization). The pre-IPO owners are taxed on any gain recognized as a result of the exchange. The pre-IPO owners and IPOCo may enter into a tax receivable agreement pursuant to which IPOCo would pay the pre-IPO owners a portion (typically 75 to 85 percent) of the tax benefits realized from the basis step-up resulting from the exchanges.

These types of structure are likely to continue gaining popularity and can be used in a variety of industries. The following table provides additional information and compares a conventional public company structure with the UP-C structure:

	Conventional Public Company	**UP-C Structure**
Public Market Transparency / Investor Demand	• Corporate structure is well recognized and accepted by public markets • Variations such as dual class voting and control by parent company should be analyzed on case-by-case basis	• Structure provides same economics and value to public investors as conventional structure • In a variety of scenarios, the structure could result in substantial tax benefits to public shareholders (*e.g.*, asset basis step-up results from company effecting secondary sale via taxable exchange of its Holdings interest for IPOCo stock)

	Conventional Public Company	UP-C Structure
Accounting	• Public company consolidates its operations • All assets and liabilities appear on balance sheet and all income and expenses appear on income statement • No minority interest on income statement or balance sheet	• IPOCo consolidates Holdings since IPOCo is managing member • Consolidation is critical for capital markets and ’40 Act purposes • Holdings interests show up as minority interests on income statement and balance sheet (until accounting rules change), but revenues, earnings before interest and taxes (EBIT), net income before minority interest and earnings per share (EPS) are not affected
Tax Consolidation / Single Level Taxation	• All of public company’s earnings are subject to corporate level tax and any dividends would be subject to second level of tax • No ability to use operating losses from other sources to offset taxable income of public company	• Retains flow-through tax benefits of Holdings structure for owners of Holdings • Holdings owners can use operating losses from operations or other sources to offset taxable income allocations from Holdings
Increased Tax Depreciation / Amortization	• Future secondary sales by partner owners will result in capital gains tax but will not result in any tax basis step-up in public company’s assets	• Future secondary sales (via exchange of Holdings interests for public company stock) will increase tax basis of IPOCo interest in Holdings by amount of gain recognized • This will increase cash flow and EPS due to less IPOCo current taxes
Control	• Vote and value typically linked unless separate class of supermajority stock issued	• Vote and value can be separated through several different options including issuing special non-economic “golden shares” to Holdings owners or via election of a majority of directors of public company or including approval rights on material transactions of Holdings

	Conventional Public Company	UP-C Structure
Gain Upon Formation	• Based on tax basis of Holdings assets • Need to structure formation transaction so no "boot" recognized (*e.g.*, liability assumption)	• Could take advantage of partnership tax rules to allow partners to extract some cash in IPO • Need to avoid "disguised sale" rules upon formation
Subsequent Acquisitions by Public Company	• Can acquire public or private corporations in tax-free mergers using its publicly traded stock as acquisition currency • IPOCo can offer preferred stock (convertible or non-convertible) as tax-free acquisition currency, but dividends on preferred are not tax-deductible	• Can effect tax-free mergers with target corporations by merging target into IPOCo in exchange for IPOCo stock and dropping assets into Holdings • Ability to acquire private companies (S corps and partnerships) using a tax-deductible preferred partnership interest (convertible or non-convertible) as tax-free acquisition currency • Cash acquisitions also feasible using variety of structures
Acquisition / Sale of Public Company	• Would likely be structured as acquisition of stock of public company; could be structured as tax-free reorganization • No tax basis step-up in public company's assets to Buyer	• Taxable acquisition provides Buyer with tax basis step-up in assets to extent of Holdings interests acquired from partners; value of basis step-up could significantly increase purchase price • Could structure as tax-free stock deal through "holding company" (*i.e.*, 351) transaction; however, basis step-up is likely to be much more valuable than tax-deferral to sellers
Rule 144 Secondary Sales	• Generally, can sell under Rule 144 after initial holding period	• Rule 144 may not be available for secondary sales • IPOCo may be required to keep a shelf registration statement available for future secondary sales by owners of Holdings interests who exchange interests for stock of IPOCo (or use demand registration)

	Conventional Public Company	UP-C Structure
Employee Stock Options	• Company can offer ISOs and NQSOs to its employees as well as restricted stock and RSUs	• Because Holdings is not a C corp, it cannot offer ISOs to its employees • IPOCo may offer such ISOs to employees of both IPOCo and partnership • Alternatively, could issue "profits interests" in Holdings which are generally superior to ISOs

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