KPMG

# Executive View

## Unlocking value beyond a traditional IPO

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Private business owners are increasingly using an Up-C structure as a flexible and value-creating strategy to execute an IPO.

### What is an Up-C structure?

An umbrella partnership C corporation (Up-C) structure enables owners of a flow-through entity (such as a limited partnership or limited liability company) to conduct an initial public offering (IPO) via a newly formed C corporation, which ultimately holds only an equity interest in the flow-through entity.

The C corporation conducts an IPO, and the proceeds are either transferred to the flow-through entity in exchange for ownership interests or used to acquire some of the owners' interests in the flow-through entity.

Based on the terms of the IPO, the owners may be able to immediately monetize a portion of their individual partnership interests, while retaining some of their economic interests in the partnership and maintaining voting control of the C corporation through a separate class of shares.

The flow-through nature of the entity allows the C corporation to receive a step-up in its share of the partnership assets' tax bases, which creates future cash-tax savings. The owners typically retain 85 percent of these savings through a tax receivable agreement (TRA), with 15 percent benefiting the new public investors, which creates value for both parties. By retaining economic interests in the pass-through entity, the owners also retain the benefits of single-level taxation.

Typically, an Up-C structure includes a redemption right to provide an additional path to liquidity that owners of private companies usually don't have. Subject to certain lock-up periods, the redemption right gives owners the ability to periodically redeem or exchange their interests in the flow-through entity for cash or shares in the public company, which can be sold on the secondary market.

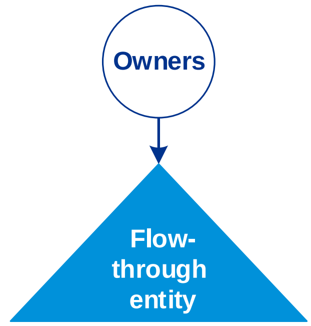
To realize the most value from the Up-C structure, a business should currently operate as a flow-through entity for US federal income tax purposes and should expect to generate taxable income on a prospective basis.

### What should companies consider before using an Up-C?

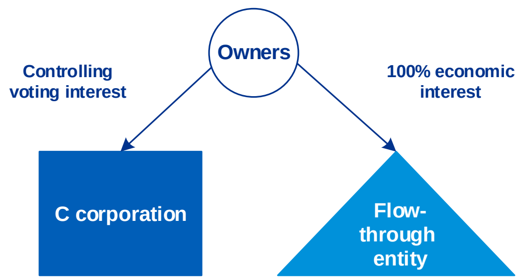
- What are the financial reporting effects on the C corporation including:
  - Should the C corporation apply acquisition accounting when it acquires interests in the flow-through entity?
  - How should the C corporation present the TRA in its financial statements?
- What are the SEC filing requirements?

## Creating an Up-C structure

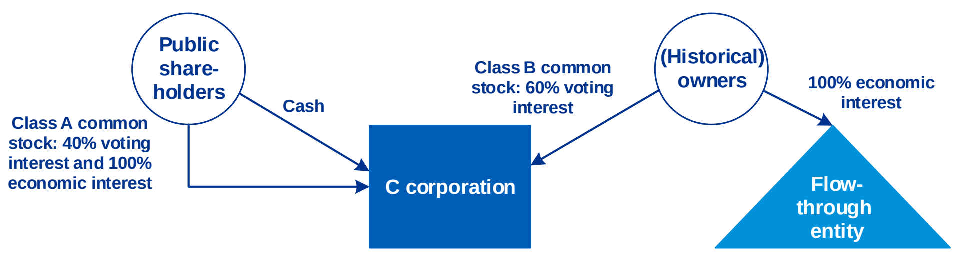
Before the Up-C structure is created, this is the typical structure.




**Step 1.** The owners form a C corporation and recapitalize the flow-through entity using a single class of units in the flow-through entity that can be, at a later date, exchanged into shares of the newly formed C corporation or redeemed for cash. The C corporation may issue a separate class of shares (Class B shares) to the owners that entitle them to proportionally higher voting rights than the Class A holders.

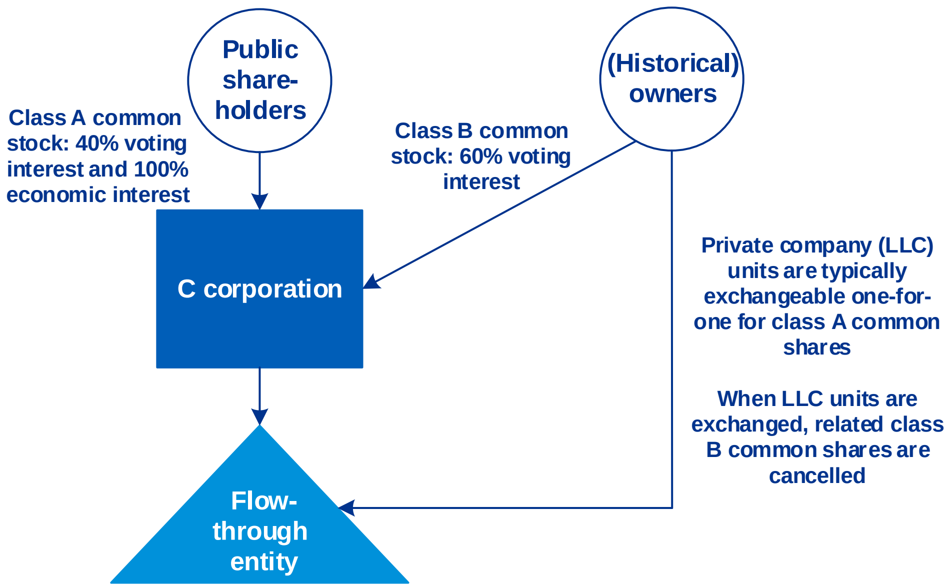



**Step 2.** The C corporation conducts an IPO by issuing Class A shares.



**Step 3.** The C corporation uses the proceeds received from the IPO to acquire a controlling interest in the existing flow-through entity – e.g. LLC units with managing member rights in the flow-through entity. When an owner redeems or exchanges its interests in the flow-through entity, which carry economic rights, it simultaneously forfeits a proportionate amount of its Class B shares.

The resulting structure looks like this.




## Tax receivable agreement

To share the cash-tax savings with the owners, most Up-C structures include a TRA. The TRA typically requires the C corporation to pay the owners a percentage of the incremental cash-tax savings attributed to certain tax attributes delivered by the owners to the C corporation as part of the IPO transaction.

The tax attributes are the tax-basis step-up generated by the C corporation's purchase of its interest in the flow-through entity and net operating losses delivered as part of a pre-IPO transaction.

In most Up-C structures, the owners are entitled to 85 percent of the incremental cash-tax savings, while the C corporation retains 15 percent, although each structure may differ. Each time the owners redeem or exchange their interests in the flow-through entity, the tax-basis of the C corporation's share of partnership assets may increase, which may provide more cash-tax savings in future periods.

## C corporation's accounting

The combination of the C corporation and the flow-through entity generally lacks substance and is not treated as a business combination. Rather, the combination is treated as a recapitalization, and the C corporation's financial statements, including its presentation of earnings per share, show the historical results of the pass-through entity with the new equity structure.

The flow-through entity typically does not record income tax expense, nor does it record deferred tax assets and liabilities. When the C corporation initially consolidates the flow-through entity, it records related deferred taxes in its consolidated financial statements.

Going forward, the C corporation will recognize income tax expense or benefit for the operations of the flow-through entity. The calculation of deferred taxes in connection with an Up-C transaction requires the involvement of tax specialists and can take considerable time to perform and audit.

The C corporation generally presents the owners' retained equity interests in the flow-through entity as noncontrolling interests; however, all features of the interests should be considered. In some cases, relevant SEC guidance may require presentation in temporary or mezzanine equity.

### Presentation of the tax receivable agreement

- The TRA requires the C corporation to distribute cash to the owners; therefore, it should be presented as a liability and a reduction of equity, similar to a declared dividend.
- Generally, the liability is initially measured at the undiscounted amount presumed payable to the owners based on the recognized net deferred tax asset.
- Subsequent changes in the measurement of the TRA liability are recognized in profit or loss outside of income tax expense because the liability is not a transaction with a taxing authority.
- The tax basis of each of the C corporation's assets and liabilities may change as owners redeem or exchange their shares, which will complicate the accounting for income taxes.

## SEC requirements

If the operations of the pass-through entity belonged to a larger organization before the Up-C transaction, the SEC may require the C corporation to prepare carve-out or pro forma financial statements of the pass-through entity for its IPO and ongoing financial reporting filings. To prepare these financial statements, companies need to consider the allocation of assets, liabilities and expenses that may be accounted for at a materiality level that is different from the consolidated group.

An Up-C is a distinct transaction from a regulatory perspective. The C corporation should consider the SEC filing requirements such as an initial registration statement filed on Form S-1.


### Contributing authors

Alex Cadet; Phillip DeSalvo; David Elsbree Jr.; Dan Langlois; Greg MacDonald; Michael Nesta