Moving away from the C-Corporation: Understanding REITs, MLPs, PTPs and BDCs

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Agenda

• Overview
• Up-Cs
• REIT Conversions
• BDCs
• Optimized MLPs
• Kinder Morgan Exception
• Tax Reform?
Overview: Primer on Tax Pass-Thrus

• Corporations subject to 35% federal income tax; shareholders subject to tax on dividends received at 39.6% maximum rate (20% for “qualified dividends”)

• The U.S. Internal Revenue Code creates various pass-thru entities:
  • Partnerships (general partnerships, limited partnerships or limited liability companies under state law) that are not publicly traded
  • Publicly traded partnerships that engage in certain activities such as oil and gas production
  • Real estate investment trusts (“REIT”s)—corporations for tax purposes that hold mostly real estate assets like real estate or mortgages and earn mostly passive income
  • Regulated investment companies (“RIC”s)—corporations for tax purposes that hold securities and earn mostly passive income
Common Theme

- Taxpayers will gravitate over time to structures that optimize the different entity taxation regimes

- They will use tax pass-thrus to the extent possible, with only those activities that must be in corporate solution in corporations

- At a certain size, certain pass-thrus (e.g., MLPs) may revert back to taxable corporation status (Kinder Morgan Exception)
Up-C
The Up-C structure has become increasingly common for IPOs of companies that have historically operated as partnerships.

The Up-C structure derives its name from the UPREIT structure. Essentially, a newly formed corporation ("PubCo") will be the entity that undertakes the IPO. PubCo will sit above an existing limited liability company (the "LLC").
• PubCo will be a holding company and will have as its subsidiary the LLC. The principal assets/operating business will continue to be at (or below) the LLC level

• PubCo will receive the IPO proceeds and downstream the proceeds to the LLC
Typical Pre-IPO Structure - Corporation

Disadvantages

- Income from operating subsidiaries subject to entity-level tax when earned by the corporation
- Historic partners (and other shareholders) subject to tax when they receive dividends
Typical Pre-IPO Structure - Partnership

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

**Disadvantage**
- Listing partnership when going public may result in the partnership being taxed as a corporation
Up-C Structure: Immediately After Formation of C-Corp

Company incorporated in Delaware with two classes of common stock, Class A and Class B. Class A is offered in the IPO and Class B is held by the Historic Partners and provides no economic rights, only voting rights.
Up-C Structure: Immediately following IPO

Public Shareholders* (Class A Holders)
- 100% economic interest
- Minority voting interest

Cash

Historic Partners
- Voting interest
- 100% economic interest

PubCo (Delaware C-Corp)

LLC

* Public shareholders purchase their shares for cash in the IPO
Up-C Structure: Final Structure

Class A Holders
- 100% economic interest
- 40% voting interest

PubCo (Delaware C-Corp)

Historic Partners
- 60% voting interest
- 60% economic interest

LLC
- LLC interests convertible into shares of Class A common stock
- 40% economic interest
- Sole managing member

- PubCo uses the proceeds received in the IPO to purchase LLC interests
- LLC redeems partnership interests from the Historic Partners (treated for tax purposes as a “disguised sale” or direct purchase of partnership interests by PubCo from the Historic Partners)

(percentages are included only for illustrative purposes)
Why an Up-C structure?

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

• Through the Up-C structure, the pass-through structure remains in place and PubCo pays the pre-IPO equity holders (LLC members) for the value of PubCo’s tax attributes as those tax attributes are used after the IPO. This creates a market dynamic that permits value to be extracted from PubCo after the IPO, without decreasing the value of PubCo in the offering.
Why an Up-C structure (cont.)?

- To effectuate the Up-C structure, PubCo will enter into various arrangements with the LLC and its members. These include an LLC operating agreement and Tax Receivable Agreement ("TRA"). Generally, TRAs do not appear to impact the valuation of a corporation in its IPO.
Why an Up-C structure (cont.)?

- Public stockholders often do not assign full value to the tax attributes of a corporation. Similarly, public stockholders apparently do not discount the value of a corporation to account fully for future payments to be made under a TRA. Through the TRA, the IPO corporation pays for a valuable tax attribute (for example, a basis step-up)
**Tax Receivable Agreements**

**PubCo (Delaware C-Corp)**

- 40% economic interest
- Sole managing member

**Historic Partners**

- 60% economic interest

**LLC**

- LLC interests convertible into shares of Class A common stock

(Percentages are included only for illustrative purposes)
Benefits of the Tax Receivable Agreement

• Because the historic partners sell partnership interests to PubCo (rather than stock, as in a traditional IPO structure), PubCo receives a “step-up” in the tax basis of its assets

• This tax basis step-up is allocated to PubCo’s share of the historic partnership’s assets, and in many cases the step-up is primarily allocable to intangible assets that are amortizable on a straight-line basis over 15 years (so-called “Section 197” intangibles)

• Through a TRA the historic partners effectively capture the majority of the value associated with the PubCo’s tax basis step-up
Benefits of the Tax Receivable Agreement (cont.)

- Under the terms of the TRA, PubCo is obligated to pay the historic partners in cash an amount equal to PubCo’s tax savings generated by the tax basis step-up (typically 85% of such savings)

- Payments under the TRA are effectively treated as additional purchase price paid by PubCo for its interest in the historic partnership
Benefits of the Tax Receivable Agreement (cont.)

Illustration of Potential TRA Economics

- Amount of PubCo Tax Basis Step-Up* $300 million
- Amortization Period 15 years
- Annual Amortization $20 million
- PubCo Tax Rate (Federal & State) 40%
- PubCo Annual Savings $8 million
- TRA Payout Ratio 85%
- Annual Payment to Historic Partners** $6.8 million
- Total Payments to Historic Partners $102 million

*Any future exchanges of partnership units for Class A shares of PubCo also may give rise to additional tax basis step-up for PubCo (thereby increasing the amounts payable under the TRA over time)

**Payments under the TRA also give rise to additional tax basis step-up for PubCo (thereby increasing the amounts payable under the TRA over time)
Additional Considerations Related to Up-C Structure

• The Up-C structure maintains continuing pass-through treatment (single level taxation) for the historic partners with respect to their proportionate share of net income realized by the partnership.

• The historic partners obtain liquidity through the right to exchange partnership units for Class A shares of PubCo.

• The Up-C structure provides a range of options for making strategic acquisitions and compensating employees (e.g., PubCo stock, PubCo options, and partnership units).
Additional Considerations Related to Up-C Structure (cont.)

• PubCo becomes the managing member of the historic partnership and the historic partners retain voting control through Class B PubCo shares.

• PubCo consolidates the historic partnership for financial statement purposes.
Miscellaneous Issues Related to Up-C Structure

- “Anti-churning rules” under Section 197 of the Internal Revenue Code
- Tax distributions to PubCo and historic partners
- Continuing administration of TRA and determination of annual payments to be made by PubCo to historic partners (reviewed and approved by PubCo audit committee in conjunction with outside advisors)
- Investment Company Act (“40 Act”) status of PubCo
REIT Conversions
REIT Conversions

- Penn National Gaming
- CBS Outdoor
• Goal: separate the real estate from the operating assets and allow real estate to trade separately, achieving a higher valuation multiple for those assets.
Related Party Rents

- Rent paid to a REIT is not “qualifying” if REIT owns 10% or more of tenant

- Attribution rules: if a shareholder owns 10% (or more) of both REIT and tenant then REIT considered to own 10% (or more) of tenant
Carlino Family

Exchange PENN Shares (to bring Family below 10%)

Public

REIT Shares

PENN

REIT
Penn National Gaming (cont.)

Public/Family

100%

Tax Free Spin-off

PENN

Gaming and Leisure Properties, Inc. (“GLPI”) REIT

Operating Assets
Penn National Gaming (cont.)

- Distribution of GLPI stock is tax free
- Restrictions on PENN and GLPI stock sales post spin-off
- IRS private letter ruling confirms tax treatment
CBS Outdoor

CBS Corporation

CBS Outdoor Americas Inc. REIT

1. 17% IPO

2. 83% Tax Free Split-off
CBS Outdoor (cont.)

Public
(former CBS shareholders that have elected to take REIT shares and give up their CBS shares)

IPO shares

CBS

Lease
Rent

CBS Outdoor Americas Inc.
REIT

Real Estate (outdoor ad displays)
BDCs
BDCs

• Business development companies register with the SEC under the Investment Company Act of 1940
• BDCs can either be partnerships for tax purposes or “regulated investment companies” under Subchapter M of the Code
• RIC provisions in IRC §851-§855 are like REIT provisions: they permit a RIC to pay dividends to shareholders that the RIC deducts in computing taxable income
• RIC requirements include income tests (income from passive sources like dividends and interest) and asset tests (assets must be a diversified pool of securities)
• A publicly traded partnership that is registered with the SEC under the ‘40 Act must elect RIC status, i.e., it cannot be a PTP taxed as a partnership
Optimized MLPs
In 1987 Congress passed IRC section 7704 which treats a “publicly traded partnership” as a corporation for federal income tax purposes. The exceptions to the rule were substantial, however. A partnership with 90% or more qualifying income for the taxable year was excepted and, therefore, treated as a corporation. Qualifying income includes the normal types of passive income including interest, dividends, rents, etc. However, income from natural resources was also included.
MLP Basics (cont.)

• Broad definition of natural resource income: “income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of any fuel described in subsection (b), (c), (d), or (e) of section 6426, or any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as defined in section 40A(d)(1).”
## MLP Basics (cont.)

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<thead>
<tr>
<th>Issuer</th>
<th>Business Description</th>
<th>Offer Date</th>
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<tbody>
<tr>
<td>Antero Midstream Partners LP</td>
<td>Owns, operates and develops midstream gathering, compression and pipeline assets</td>
<td>11/10/2014</td>
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<tr>
<td>Shell Midstream Partners, L.P.</td>
<td>Owns and operates crude oil and refined product pipelines</td>
<td>10/29/2014</td>
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<tr>
<td>Dominion Midstream Partners, LP</td>
<td>Owns, operates and develops natural gas infrastructure assets</td>
<td>10/15/2014</td>
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<tr>
<td>USD Partners LP</td>
<td>Owns a crude oil rail terminal</td>
<td>10/8/2014</td>
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<tr>
<td>JP Energy Partners LP</td>
<td>Owns, operates and develops midstream energy assets</td>
<td>10/2/2014</td>
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Optimized MLPs

- Public (Tax Exempts/non-U.S.)
- C Corp (“blocker”)
- Public (U.S.)

MLP
Hiatus in MLP Rulings – March 2014

• Why?

• When will it end?
Kinder Morgan Exception
Kinder Morgan Exception

- Kinder Morgan, Inc. ("KMI") is the general partner of two large publicly traded partnerships: Kinder Morgan Energy Partners LP and El Paso Pipeline Partners LP; it also owns the voting interests in another publicly traded entity treated as a corporation for tax purposes: Kinder Morgan Management LLC
- On August 10, 2014 Kinder Morgan announced plans to purchase the outstanding interests in these three entities.
- Going forward, KMI, a C corporation for tax purposes, will operate all these businesses with a total enterprise value of $140 billion
- CEO Richard D. Kinder: “This transaction dramatically simplifies the Kinder Morgan story by transitioning from four separately traded equity securities today to one security going forward…”
Takeaways

• Continued expansion of UP-C structure and C Corp/MLP structures
• Real estate intensive businesses will continue to attempt to unlock value through REIT conversions and spin-offs
• There may be a natural limit on the size of a pass-through (or maybe not...)
Tax Reform?
Tax Reform?

• Beginning in 2013 Rep. Dave Camp (R-MI) released “discussion drafts” of draft tax reform legislation
• No legislation has been introduced
• No hearings have been held on the discussion drafts
• Rep. Camp is retiring this year
• Impact of recent elections?
Tax Reform?

• Pass-Thru and Certain Other Entities
  • Publicly traded partnership exception restricted to mining and natural resources partnerships
  • Prevention of tax-free spinoffs involving REITs
  • Certain short-life property not treated as real property for purposes of REIT provisions
  • Repeal of special rules for timber held by REITs
  • Non-REIT earnings and profits required to be distributed by REIT in cash
Tax Reform?

- Pass-Thru and Certain Other Entities
  - Debt instruments of publicly offered REITs and mortgages treated as real estate assets
  - Reduction in percentage limitation (to 20% from 25%) on assets of REIT which may be taxable REIT subsidiaries
  - Recognition of net built-in gain on assets when a C corporation converts to a REIT or RIC, or when a REIT or RIC acquires assets from a C corporation in a carryover basis transaction
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