taxnotes federal

Volume 178, Number 4 ■ January 23, 2023

Where Is the TRA? Extracting Value in an UP-C Without a TRA

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Reprinted from *Tax Notes Federal*, January 23, 2023, p. 547

Where Is the TRA? Extracting Value in an UP-C Without a TRA

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In this article, DeMyer and Brown provide an overview of the umbrella partnership C corporation structure and the mechanics of a tax receivable agreement, and they explain why energy companies valued on yield using that structure in a public offering may be discouraged from entering into one of those agreements.

I. Introduction

The umbrella partnership C corporation (UP-C) structure and tax receivable agreement (TRA) are inseparable to many tax professionals. The UP-C provides a powerful legal entity structure to facilitate a public offering for passthrough entities.[1] A TRA provides a mechanism to ensure the sharing of tax attributes, including tax basis step-up, between sponsors[2] and public investors. In many mergers and acquisitions transactions, tax attribute sharing is a pivotal deal point, and well-advised sellers can use their knowledge of tax attribute creation and usage as a powerful negotiation tool. With that said, how tax attributes are shared (or really the value derived therefrom) differs based on the type of tax attribute, the preferred transaction structure, the profile of the taxpayer intending to use the tax attribute, and the industry of the business at issue.

This article provides a general overview of the UP-C structure as well as mechanics of a TRA and presents reasons why energy companies valued on yield using the UP-C structure in a public offering may be discouraged from entering into a TRA. It gives an overview of the energy industry, focusing on the oil and gas industry's value chain; a brief review of the UP-C structure and TRA mechanics; and a highlight of unique considerations for companies valued on yield when considering a TRA.

II. Overview of the Energy Industry

The energy industry can generally be divided into two parts: (1) power and utilities, and (2) oil and gas.

The power and utilities sector is characterized by the generation, transmission, and distribution of electricity. The generation of electricity can be in the form of traditional power plants that use coal or natural gas as fuel, nuclear power plants, or alternative sources such as renewable energy assets (for example, wind or solar). The generated electricity is then sent to substations through transmission and distribution power lines and ultimately distributed to end users.

The oil and gas sector can best be described through a value chain. This chain starts with companies that identify mineral resources and ends with those that sell the products of those

[1] For further discussion on the UP-C structure, see Phillip W. DeSalvo, "The Staying Power of the UP-C: It's Not Just a Flash in the Pan," *Tax Notes*, Aug. 8, 2016, p. 865; and DeSalvo, "The Evolution of the UP-C," *Tax Notes*, Oct. 22, 2018, p. 439.

[2] In this context, a sponsor represents the historical partner in the passthrough entity that will ultimately be the partnership in the UP-C structure.

resources.[3] These oil and gas companies can generally be divided into six sectors:

- the minerals sector acquires mineral rights for large swaths of property and grants upstream companies the right to extract minerals in return for royalty payments;[4]
- the upstream sector is involved in the exploration and production of oil and natural gas resources;[5]
- the midstream sector handles the transportation and storage of energy and natural resources before they make their way to downstream companies;[6]
- the oil field services sector provides services to companies operating in the oil field (that is, upstream and midstream companies);[7]
- the downstream sector refines the natural resources into distinct petroleum products;[8] and
- the retail sector sells the refined products to customers.[9]

While these six sectors focus on and ultimately derive value from the same or similar resources, the way that value is derived is very divergent. Contrasting the minerals sector with the upstream industries sector provides a clear comparison. Both derive value when natural resources are extracted. However, mineral companies do not hold a working interest in these assets (like upstream operators do). Instead, they are compensated based on a percentage of what is extracted by upstream companies. Even though holders of mineral rights are compensated based on the extraction of resources, they often have little influence regarding drilling schedules. Instead, mineral rights holders have contractual protections to ensure minimum drillings, which provide some long-term predictability in revenue streams. This nuance in operations often affects how companies in the upstream and minerals industries are valued.

This comparison illustrates that value in each energy sector is inherently driven in a different manner. At the risk of oversimplifying the matter, some sectors derive value based on their ability to efficiently generate positive cash flows (for example, the upstream industry), while other sectors generate value by identifying long-term sources of predictable value (for example, minerals and other royalty-based industries). This key difference affects how companies are valued.

At a high level, deal professionals often see three broad categories of valuation methods applied to the energy industry:

- Under the market-based approach/comparable transaction analysis, the fair value of the asset reflects the price at which comparable entities or assets are purchased under similar circumstances. This approach requires that comparable transactions be available and is often found when the acquired asset is widely marketed to third parties.
- The income approach/distributable cash flow analysis is predicated upon the value of the future cash flows that an asset will generate over its remaining useful life. Step one involves projecting the cash flows that the asset is expected to generate. Step two involves converting these cash flows into a present-value equivalent through discounting when the discount rate is a key variable in determining overall value.
- In the cost approach, the fair value of an asset is estimated as a function of the current cost to purchase or replace the asset.

A discussion of the intricacies that determine which valuation approach is applied throughout the energy industry is outside the scope of this article. However, as we hope will become more apparent, the selection of a valuation method can result in a value indication that may drive the decision of whether to monetize tax attributes via a TRA in an UP-C structure.

[3] *See* Silvana Tordo, Brandon S. Tracy, and Noora Arfaa, "National Oil Companies and Value Creation," The World Bank Group Working Paper No. 218, at 7 (July 2011).

[4] *See* Robert A. Swiech et al., *Income Taxation of Natural Resources*, ch. 2.11 ("Fee Mineral Interest") (2014).

[5] Tordo, Tracy, and Arfaa, *supra* note 3, at 7.

[6] *Id.*

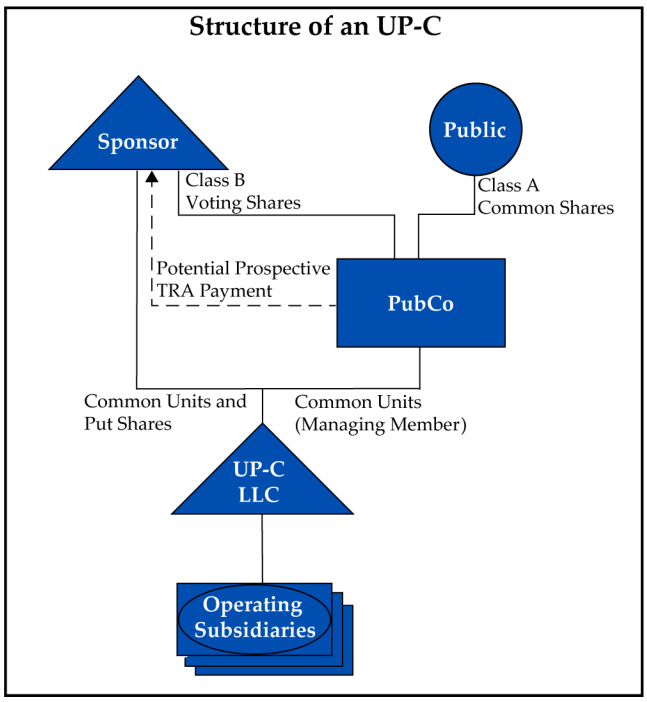
[7] *Id.*; *Income Taxation of Natural Resources*, *supra* note 4, at ch. 10.60 ("Exploration and Development").

[8] Tordo, Tracy, and Arfaa, *supra* note 3, at 7.

[9] *Id.*

III. Overview: UP-C

A. Structure



An UP-C structure allows the historical owners of a flow-through entity (UP-C LLC) to effectuate an initial public offering through a C corporation (PubCo) that holds an interest in UP-C LLC while maintaining the limited liability company's status as a flow-through entity for U.S. federal income tax purposes. In conjunction with the IPO, the public receives class A PubCo stock, which represents all the economic interest in PubCo. Class B PubCo stock is issued to the historical owners,[10] giving them voting power in PubCo consistent with the economic interests that the historical owners have in UP-C LLC.[11] If UP-C LLC makes a section 754 election and the assets of the LLC have a built-in gain, PubCo generally will receive a step-up in the tax basis of the LLC assets under section 743(b) when it acquires UP-C LLC equity from the historical owners.[12] If PubCo enters into a TRA with the historical owners (discussed below), both the public and the historical owners may have the opportunity to benefit from the additional tax shield generated from the section 743(b) step-up.

Historical owners can put their interest to UP-C LLC for shares of PubCo class A common stock or cash.[13] This right is typically set forth in the LLC operating agreement and gives the historical owners a viable path to liquidity through their ability to put their LLC units to the partnership in exchange for cash or publicly traded stock.[14] To effectuate the exchange right, the historical owners must notify the LLC of their intention to put the applicable units to the partnership for cash or PubCo class A common stock.[15] UP-C LLC, at its sole discretion, can transfer PubCo class A common stock or cash to the historical owners.[16] As long as the distributed cash or PubCo class A common stock is contributed by PubCo in connection with the distribution, each exchange provides PubCo with additional tax basis step-up in UP-C LLC's assets, increasing PubCo's tax shield.[17]

In addition to gaining exchange rights and retaining a flow-through structure, historical owners in an UP-C structure also can benefit from tax receivable payments. A TRA is a contract between PubCo and the historical owners requiring PubCo to pay a portion of the cash tax savings it realizes when tax attributes (such as depreciation or amortization from a step-up under section 743(b)) are used by PubCo.[18] Because TRA payments are predicated on PubCo reducing its tax liability, historical owners of

[10] The issuance of class B voting shares in an UP-C structure must be carefully analyzed, and the tax ramifications of this issuance should be considered separately in each UP-C transaction. For example, it may be recommended that the recipients of the class B voting shares contribute cash or property in exchange for the class B shares to ensure that the issuance is not considered a taxable event (*e.g.*, compensation in exchange for services, etc.).

[11] Dean S. Shulman, Sara B. Zablotney, Margaret R.T. Dewar, "Upended: The Impact of Tax Reform on UP-C Structures," 33(1) *Prac. Tax Law.* 33, 34 (2018).

[12] *Id.*; *see* section 707(a)(2)(B). In some transactions, PubCo may not receive a section 743(b) step-up, such as if a section 754 election is not in effect, or if PubCo purchases units in HoldCo from the historical owners directly.

[13] DeSalvo, "The Staying Power of the UP-C," *supra* note 1, at 866-867. The exchange right may also be referred to as a redemption right.

[14] *Id.* at 867.

[15] *Id.*

[16] *Id.*

[17] *Id.* at 937-938 (explaining that the step-up in basis received by PubCo is equal to the amount of gain recognized by the historical owners). This assumes that HoldCo's assets have built-in gain and there is a positive adjustment under section 743(b).

[18] *Id.* The typical rate for a TRA payment to the historical owners is 85 percent, while PubCo retains the remaining 15 percent.

businesses that expect to generate future losses will often not benefit from a TRA.

B. Valuation

The UP-C structure with a TRA provides the historical owners with the most value when the operating entity has specific characteristics. A business that will generate taxable income is desirable. An ideal UP-C candidate will have business assets with a significant amount of built-in gain,[19] allowing the historical owners to maximize cash tax savings upon the sale or exchange of LLC interests.[20] Entities in an "organic growth mode" will often benefit the most because their historical owners deliver not only an initial tax basis step-up at the IPO but also additional step-up upon the occurrence of later sales or exchanges of UP-C LLC units to PubCo.[21]

An UP-C structure likely provides value to both historical owners and PubCo throughout the life cycle of the structure. Most notably, as described earlier, historical owners maintain economic ownership in a flow-through entity and therefore benefit from a single layer of tax.[22] Historical owners also can more readily monetize their interest in UP-C LLC by exercising their put right.[23] Also, the stepped-up tax basis in UP-C LLC assets resulting from the UP-C structure produces value for PubCo through additional amortization or depreciation.[24]

IV. Yield-Based Valuations

Historically, the valuation of companies in the midstream sector, the minerals sector, or other royalty-based industries revolves around the yield investors require relative to the company's distributable cash flow. Distributable cash flow is the amount of cash the entity has readily available to distribute to its investors.[25] As such, the amount of cash distributions anticipated is an important component of the market value of each unit.[26] For example, a midstream or mineral company with a high yield should provide an investor with more value (that is, distributions) relative to the company's trading price (that is, market value) than a midstream or mineral company with a low yield.[27]

Market value is a critical factor in a company's ability to raise additional capital through the issuance of new units to investors or access to debt financing.[28] The valuation of a royalty-based company is often measured by the consistency and predictability of its distributable cash flow. Royalty-based businesses (like mineral companies) generally have long-term arrangements that provide consistent and predictable revenue streams and are considered more stable than upstream and oil field services businesses, which face more exposure to commodity fluctuations and industry risks.[29]

Thus, there is a general expectation for midstream, minerals, or other royalty-focused companies to provide a recurring yield to the public through quarterly cash distributions and to focus on increasing the size of these cash distributions. If a company does not continue to provide consistent or increasing quarterly distributions, its stock value will suffer. As an example, assume a company in the energy sector declares a distribution of $0.50 per share in a given quarter. If the general sentiment is that this company is expected to provide a 10 percent yield, the likely trading price of that stock will be $20 per share, which is based on a $2 annual distribution divided by the 10 percent yield expectation ($2/0.1 = $20). If, however, that company cuts its distribution to $0.40 per share in the next quarter and the public still expects a 10 percent yield, the trading price of that stock

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] DeSalvo, "The Evolution of the UP-C," *supra* note 1, at 440.

[23] DeSalvo, "The Staying Power of the UP-C," *supra* note 1, at 867.

[24] *Id.*

[25] VettaFi, MLP 201, Energy Infrastructure University (Dec. 21, 2022).

[26] *See* Deborah Fields, Holly Belanger, and Eric Lee, "Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part II — Property Acquisitions)," *TAXES: The Tax Magazine* (Feb. 2010).

[27] Elizabeth Arnason and Alexandra Cagan, "Master Limited Partnerships: Implications for US Energy Infrastructure," at 10 (Apr. 27, 2018) (master of environment management degree project in the Nicholas School of the Environment of Duke University).

[28] *Id.* at 10.

[29] *Id.* at 11.

would be expected to fall to $16 per share based on a new $1.60 annual distribution divided by the 10 percent yield ($1.60/0.1 = $16).

Also, while making $2 per share in cash distributions yearly may satisfy the public's demand for a 10 percent yield, not all distributions are the same. When the public company structure considered is a master limited partnership structure, the public directly owns partnership interests. In this master limited partnership structure, public equity holders are likely to recognize income through the underlying flow-through operations of the company. If the public company is in an UP-C structure, the public investors may indirectly be affected by tax attributes like earnings and profits at PubCo, and some portion of the cash distributions may be subject to tax as a dividend. As a result, in an UP-C structure that pays cash distributions to its shareholders, the public takes into account how much tax will be paid regarding that cash distribution when deciding to invest in the public equity.

A. Tax Shield

Given the importance of cash flows on valuation in these types of companies, it is not hard to see the effect that cash taxes can play on the valuations of yield-driven companies. To enable investors to simplify and understand the tax effect on cash flows (and thus value), the concept of "tax shield" is used. It is important to understand this term, as well as the nature of a company tax shield versus an investor tax shield.

The first type of tax shield is a company tax shield. A company's tax shield represents the use of tax attributes to reduce the amount of company taxable income (and therefore cash tax liability) when compared with a non-income tax metric — for example, pretax distributable cash flows; earnings before interest, taxes, depreciation, and amortization; or generally accepted accounting principles net income before taxes.

The next type of tax shield is an investor tax shield, which depends on the tax attributes of the company. Determining the investor tax shield enables public investors to understand how much of a distribution actually ends up in the public's pocket after paying their own income taxes. An investor tax shield represents tax attributes used to reduce the investor's taxable income compared with cash received. For instance, using the previous example, if the public investors pay no tax concerning the $2 per share in annual distributions received, we could say that there is a 100 percent investor tax shield (that is, tax attributes have shielded the investor from any income tax obligation). We would also say that the public received an after-tax yield of 10 percent. To the extent the public has to pay tax on income recognized as a result of the investment, it will affect that after-tax yield, which in turn may affect the yield demanded by the public. If the distributed cash was $2 per share, but the public had taxable dividend income of $0.50 per share, the after-tax distribution would be less than $2 per share. In this case, the tax shield reported to the public is 75 percent (that is, tax attributes from the company shielded the investor from a tax liability up to 75 percent of cash received, while the other 25 percent of cash received is required to fund a tax liability).

The most efficient structure is one that maximizes the current receipt of cash by the public compared with the public's current income tax burden. As this delta increases, the tax shield increases. A higher tax shield represents a lower tax drag on distributable earnings, which generally translates into an increased share price.

B. TRA Effect on Tax Shield

As discussed, the public often values companies in the midstream, minerals, or other royalty-based industries based on the yield offered. The more cash in the investor's hands (as a result of quarterly distributions), the higher valuation these companies generally receive. For these types of industries, the tax structure should be designed to maximize a tax shield, and the best way to accomplish that is often to increase deductions to the taxpayer (both the company and the public investor).

In general, the largest deductions are available through depreciation, depletion, and amortization. Thus, the most effective tool to mitigate the company's (and ultimately the investor's) tax burden is through stepped-up tax basis in depreciable, depletable, or amortizable assets. As discussed, the UP-C structures deliver this step-up to the public company (and therefore

indirectly to the public investors) and thus provide additional deductions, which further increase the after-tax yield to the taxpayer, thereby increasing the value of the company. In an UP-C, this step-up is mainly focused on minimizing or eliminating the cash tax burden of PubCo to ensure as little cash tax leakage as possible (and enhance distributions). In addition to reducing cash tax leakage at PubCo and increasing the company tax shield, depreciation, depletion, and amortization can reduce E&P at the PubCo level. The reduced E&P may result in an increased tax shield at the investor level, as a smaller percentage of cash distributions sent to the public shareholders would be considered dividend income.

An additional drag on cash flow in the UP-C structure, and thus valuation (if value is determined solely based on cash yield), is the payment of TRA obligations. As discussed earlier, when a TRA is entered into between PubCo and the historical owners, PubCo is required to pay the historical owners a portion of the cash tax savings it realizes when specified tax attributes are used by PubCo.[30]

To illustrate this valuation drag, the following example highlights how the annual cash flow effect of TRA payments could affect IPO value for a dividend-paying public company that is valued based on cash yield. Table 1 displays some key tax assumptions and calculations that drive both tax shield and TRA payments, which affects after-tax distributable cash flow and ultimately the company's valuation.

Table 1. TRA Valuation Illustration (dollars in millions)

	Inputs	
	With TRA	**Without TRA**
Asset value	$1,276.7	$1,438.8
Tax basis	—	—
Section 743(b) adjustments (20-year asset)[a]	$1,276.7	$1,438.8

Table 1. TRA Valuation Illustration (dollars in millions) *(Continued)*

	Inputs	
	With TRA	**Without TRA**
Year 1 amortization of section 743(b) (straight line)	**($63.8)**	**($71.9)**
Estimated income tax rate[b]	21%	21%
Estimated tax savings for section 743(b)	($13.4)	($15.1)
TRA rate	85%	0%
Year 1 TRA payment (made in Year 2)	($11.4)	—
Year 10 amortization of section 743(b) (straight line)	**($63.8)**	**($71.9)**
Estimated income tax rate[b]	21%	21%
Estimated tax savings for section 743(b) (step-up)	($13.4)	($15.1)
Estimated tax savings for section 743(b) (iterative)	($2.2)	—
Estimated tax savings for section 743(b) (total)	($15.6)	($15.1)
TRA rate	85%	0%
Year 10 TRA payment (made in Year 11)	**($13.2)**	**—**

[a]Assumes that all section 743(b) adjustments concerned 20-year assets that amortize under a straight-line method.

[b]Assumes no state income tax for simplicity.

In Table 2, most of the benefit of the UP-C structure is sent out of the public company to the historical owners in the form of the TRA payment (that is, the $13 million cash tax benefit at the company versus the $11 million TRA payment to the historical owners).[31] If the valuation of the company is purely based on distributable cash flow, a TRA payment obligation has the potential to reduce the public market valuation by roughly $162 million ($1.439 billion less $1.277 billion). Assuming zero tax basis in the partnership's assets, the present value of the TRA payment

[30]Those tax attributes may include additional depreciation, amortization, or depletion generated by a section 743(b) adjustment.

[31]The increased cash tax benefit of the step-up in the "Without TRA" scenario is driven by an increased implied value.

stream at a 10 percent discount rate of $109 million doesn't overcome this $162 million value difference.

Table 2. Comparative Values With and Without TRA (Year 1) (dollars in millions)

	Illustration Year 1	
Targeted yield	8%	
TRA discount rate	10%	
Average tax life of assets	20 years	
	With TRA	**Without TRA**
Distributable cash flow before tax benefits	$100	$100
Cash tax benefit of step-up	$13.5	$15.1
After-tax distributable cash flow	$113.5	$115.1
Less: TRA payment	($11.4)	—
Total distributable cash flow	$102.1	$115.1
Target yield	8%	8%
Implied value	$1,276.7	$1,438.8
Plus: Discounted value of TRA payments	$109.1	—
Total value	**$1,385.8**	**$1,438.8**

While Table 2 focuses on the first year a TRA payment is due, additional tax basis is created as payments are made on the TRA, because of the installment sale rules.[32] Therefore, the difference between a value with a TRA and without a TRA is expected to decrease over time as the additional deductions created by payments on a TRA result in cash tax savings, as shown later.

In Table 3, we look at the same TRA but at year 10. For clarity, Table 3 assumes that payments have been made on this TRA, which results in additional deductions. As the company has more deductions, it ultimately has less of a cash tax burden. Consequently, the company's cash available to distribute (or to make TRA payments) is greater in the "with a TRA" than "without a TRA" scenario. With that said, once the company's TRA obligation is factored in, the ultimate cash available for distribution is less in the "with a TRA" than "without a TRA" scenario.

Looking at year 10, if the valuation of the company is purely based on distributable cash flow, a TRA payment obligation has the potential to reduce the public market valuation by roughly $160 million ($1.439 billion less $1.279 billion). Assuming zero tax basis in the partnership's assets, the present value of the TRA payment stream at a 10 percent discount rate of $109 million[33] doesn't overcome this $160 million value difference.

Table 3. Comparative Values With and Without TRA (Year 10) (dollars in millions)

	Illustration Year 10	
Targeted yield	8%	
TRA discount rate	10%	
Average tax life of assets	20 years	
	With TRA	**Without TRA**
Distributable cash flow before tax benefits	$100	$100
Cash tax benefit of step-up	$15.6	$15.1
After-tax distributable cash flow	$115.6	$115.1
Less: TRA payment	($13.2)	—
Total distributable cash flow	$102.4	$115.1
Target yield	8%	8%
Implied value	$1,279.2	$1,438.8
Plus: Discounted value of TRA payments	$109.1	—
Total value	$1,388.3	$1438.8

[32] In general, the TRA provides for payments to be made to a selling partner in a year after the year of the sale. Thus, the transaction is often viewed as an installment sale with a contingent purchase price. The purchase price is contingent on the company's ability to generate taxable income and realize the benefits of the deductions created on the sale.

[33] For purposes of the year 10 illustration, the total discounted value of the TRA has been included. In reality, the remaining value of the TRA at year 10 is expected to be materially less than the $109 million.

Some additional items to observe include:

- Table 3 assumes zero existing tax basis. This increases the TRA value given TRAs are generally paid on tax step-up and not existing tax basis. However, the tax shield without a TRA would stay roughly constant regardless of whether it is delivered by existing tax basis or tax step-up.
- Table 3 shows a higher cash tax benefit of step-up in the scenario without a TRA because the step-up is driven by value. If the stock price of the company is increased because there is no TRA, then presumably there would be an increased step-up and tax benefit upon future taxable exchanges of LLC units.
- The discount rate to apply to TRA payment streams is very subjective. History has shown TRA obligations being settled anywhere from 35 cents on the dollar to full price. Given the subordinate and contingent nature of TRA payments, a 10 percent discount rate may provide more value in the TRA than the holders of the TRA are likely to receive.
- Table 3 is more akin to mineral businesses, with the 20-year tax life of the assets. For midstream businesses, the recovery rate is generally faster. Whether that exacerbates the difference in value will depend on other factors of the company, including taxable income outside the tax basis step-up to which the TRA is related.

In all cases, energy companies considering an UP-C structure should undertake a detailed analysis with their tax advisers and their financial advisers to best estimate the effect a TRA may have on their public valuation.

V. Conclusion

The use of the UP-C structure in capital markets has been cemented as a powerful tool for sponsors as well as the public. TRAs also allow historical owners to share in tax benefits delivered to PubCo at the cost of reducing PubCo's distributable proceeds. Structuring considerations, such as those presented in this article, are not a one-size-fits-all solution. Most companies, whether already public or considering going public, are not valued based on the amount of cash distributed to their owners quarterly; thus, an UP-C structure may be extremely valuable to all stakeholders and at the same time have little to no effect on public company value. A company in the midstream sector, the minerals sector, or any other royalty-based industry that is valued on yield and contemplating a public offering would be well advised to consider all possible alternative structuring solutions. If the UP-C is the preferred capital markets structure, the potential benefit of a TRA should be weighed against the potential increased value of PubCo when no TRA is in place.[34] ■

[34]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.