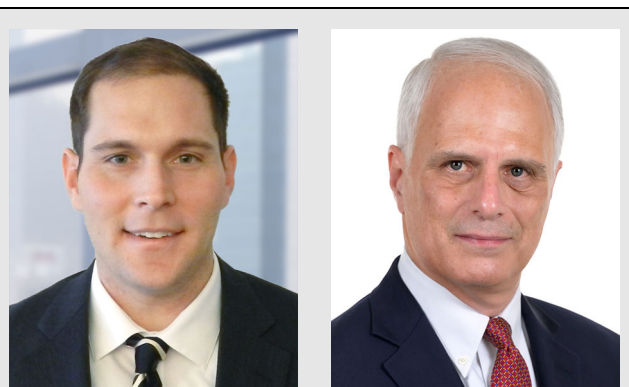


Common Corporate Tax Issues in Up-C Structures

by Stephen M. Marencik and Erik H. Corwin



Stephen M. Marencik

Erik H. Corwin

Stephen M. Marencik is a managing director in WilliamsMarston's specialty tax practice, and Erik H. Corwin is a principal in BDO USA's Washington National Tax practice. They thank Mark Hoffenberg and Kevin Ainsworth for helpful comments on earlier drafts of this article.

In this article, the first installment of a three-part series, Marencik and Corwin review the structuring of initial public offerings of umbrella partnership C corporations and examine corporate tax considerations in the issuance of noneconomic voting shares to founding partners.

Any errors or omissions are the authors' own.

Copyright 2026 Stephen M. Marencik and Erik H. Corwin.
All rights reserved.

Umbrella partnership C corporation (Up-C) structures have historically been an efficient way to facilitate an initial public offering of a business originally operated as a partnership for U.S.

federal income tax purposes.¹ When a direct conversion of the partnership to a corporation is undesirable — for instance, because the founding partners prefer to retain all or a portion of their investment in passthrough form — the Up-C structure can be a tax-efficient way to bring a target partnership public.

This article is the first in a three-part series examining certain corporate tax issues that can arise in the context of an Up-C IPO. In addition to identifying the issues, the series suggests structural solutions that may reduce or eliminate technical risks. This first installment provides a basic overview of the Up-C IPO structure² and discusses corporate tax considerations arising from the issuance of noneconomic voting shares to the founding partners in an Up-C IPO. The second installment will focus on certain transferor-related issues that the parties to an Up-C IPO may face when attempting to achieve tax deferral under section 351. The final installment will examine investment company considerations relevant to tax deferral under section 351 and the reorganization provisions under section 368.

Finally, while the issues discussed in this series are framed in the context of Up-C IPOs, many are relevant beyond that structure, so the discussion may have wider applicability.

I. Up-C IPO Structure: Background

In a typical Up-C IPO, a new public company (PubCo) is formed to acquire partnership interests

¹ See Phillip W. DeSalvo, "The Return of the SPAC," *Tax Notes Federal*, Jan. 18, 2021, p. 409 (discussing, in the context of the special purpose acquisition company boom, how the parties to the "go public" transaction often weigh the benefits of converting the partnership to a corporation against the benefits of retaining the target's classification as a partnership).

² This discussion is limited and intended only to introduce the Up-C IPO structure for purposes of framing the corporate tax issues discussed in Section II of this article and in subsequent installments.

in a target operating partnership. PubCo can acquire those partnership interests from historical partners of the target partnership, from the target partnership itself, or through some combination of the two. If the target partnership makes an election under section 754, the acquisition of partnership interests by PubCo from historical owners in taxable exchanges — and any future taxable exchanges — can result in a special tax basis adjustment in the assets of the target partnership, which can generate a tax shield for PubCo through increased depreciation and amortization deductions going forward. As PubCo deducts this incremental depreciation and amortization, it will generally compensate the selling owners for a portion of the resulting tax benefits under the terms of a tax receivable agreement.³

In some cases, corporate owners of the target partnership with valuable tax attributes, such as net operating losses or tax credit carryforwards, may also be acquired by PubCo. These corporations are often blocker corporations that were initially formed by non-U.S. or tax-exempt investors in connection with an earlier private financing. If the target partnership generated losses or tax credits in prior years that were allocated to but not used by the blocker corporation, those losses and credits may reside as carryforwards at the blocker corporation. If properly structured, the acquisition of these corporate affiliates will allow PubCo to inherit these NOL and tax credit carryforwards.⁴ Under the tax receivable agreement, PubCo will compensate the shareholders of the blocker corporation for the value of the resulting tax benefits.

³The tax receivable agreement is entered into at the time of the “go public” transaction. Market practice is often to compensate the historical owners of the target partnership in an amount equal to 85 percent of the actual cash tax savings realized by the corporation using the resulting tax attributes. Many articles have been written on tax receivable agreements, including the different formats they take. See Deborah L. Paul and Michael Sabbah, “Understanding Tax Receivable Agreements,” *Prac. L.J.: Transactions & Bus.* 74 (June 2013); Christopher B. Grady, “Finding the Pearl in the Oyster: Supercharging IPOs Through Tax Receivable Agreements,” 111 *Nw. U. L. Rev.* 483 (2017). Tax receivable agreements are generally beyond the scope of this series, which focuses on other corporate tax matters that arise in the context of an Up-C IPO. Up-C structures can also raise challenging financial accounting issues. Those issues are also beyond the scope of this series.

⁴See, e.g., section 381. Those attributes in the hands of the acquiring public company may be subject to limitations under sections 382 or 383.

The Up-C IPO structure can also achieve tax deferral for the historical owners of the target partnership and shareholders of the blocker corporations, including those that want to roll over their interests into publicly traded PubCo shares. A target partnership in an Up-C typically includes historical owners with different investment profiles. One group of owners is typically made up of founding or other principal owners that want to retain passthrough taxation and control over business operations (referred to here as nonrollover owners). Other owners may want to obtain a direct, liquid interest in the new public company that can be freely exchanged on the open market (referred to here as rollover owners). These owners may include more passive investors (including investors sensitive to unrelated business taxable income or effectively connected income that have historically invested in the target partnership through blocker corporations) or service providers who have received partnership interests in the target partnership as incentive compensation.

For nonrollover owners, tax deferral and passthrough taxation can be achieved by retaining a direct interest in the target partnership. To enable the nonrollover owners to monetize their target partnership interests in the future, the nonrollover owners receive an exchange right that entitles each owner to put or sell their partnership interests to PubCo for new publicly traded shares of PubCo common stock (class A stock) on a one-to-one basis or for a cash equivalent.⁵ A class of noneconomic, voting shares of PubCo stock (class B stock) is also issued to the nonrollover owners to provide them with ongoing control over the target partnership business through PubCo. The class B stock may carry super-voting rights relative to the class A stock held by public investors to facilitate the exercise of control by the nonrollover owners. When nonrollover owners exercise their right to exchange partnership interests for cash or class A stock, a proportionate amount of their class B

⁵Alternatively, the exchange right may be structured as a redemption right issued by and with the target partnership. Under the redemption right structure, the partners put their partnership interests to the operating partnership in exchange for either cash or stock of PubCo. See Gladriel Shobe, “Supercharged IPOs and the Up-C,” 88 *Colo. L. Rev.* 913 (2017) (discussing various approaches to structuring the exchange right).

stock is included as part of the exchange, typically on a one-to-one basis with the partnership interest transferred/class A stock received.

The rollover owners can achieve tax deferral and obtain a more liquid stock investment by transferring their target partnership interests to PubCo in exchange for PubCo stock, provided the exchange is either a nonrecognition transaction under section 351 or part of a reorganization under section 368.

Figure 1 depicts illustrative steps of a simplified Up-C IPO.

An operating partnership (Target Partnership) is owned in varying proportions by a collection of investors that includes rollover owners that would prefer to hold their interests in Target Partnership's business indirectly by owning stock in PubCo and nonrollover owners that want to retain a direct interest in Target Partnership and control over the business. To accomplish the Up-C IPO, the following transactions occur:

- Step 1: PubCo is organized and authorized to issue (1) class A stock, which will be common stock with typical economic entitlements (that is, entitlements to dividends and proceeds on liquidation) and voting rights (usually one vote per share); and (2) class B stock, which will have no economic entitlement to dividends or liquidation proceeds but does have voting rights and, in some cases, super-voting rights (that is, more than one vote per share) to facilitate the ability of nonrollover owners to retain control over the business.
- Step 2: The rollover owners transfer their interests in Target Partnership to PubCo in exchange for PubCo class A stock.
- Step 3: PubCo issues class B stock to the nonrollover owners for no consideration. Exchange rights (not depicted) are also issued to the nonrollover owners. The exchange rights entitle the nonrollover owners to directly transfer their Target Partnership interests to PubCo (or Target Partnership) for PubCo class A stock or cash.⁶

⁶ If the nonrollover owners exercise their exchange rights, a corresponding number of shares of PubCo class B stock are canceled.

- Step 4: PubCo issues shares of class A stock to the public in an IPO.
- Step 5: The cash PubCo receives in the IPO is contributed by PubCo to Target Partnership in exchange for partnership interests so that it can be used in Target Partnership's business operations or used by PubCo to purchase interests in Target Partnership from the preexisting owners. Unless otherwise stated, assume that all net cash proceeds from the IPO are used to purchase interests in Target Partnership.
- Step 6: PubCo is designated the managing member of Target Partnership (not depicted).
- Step 7: PubCo enters into a tax receivable agreement with Target Partnership and the nonrollover owners whereby those owners obtain the right to receive cash payments from PubCo equal to 85 percent of the future cash tax benefits recognized by PubCo as a result of the tax attributes covered by the tax receivable agreement (not depicted).⁷

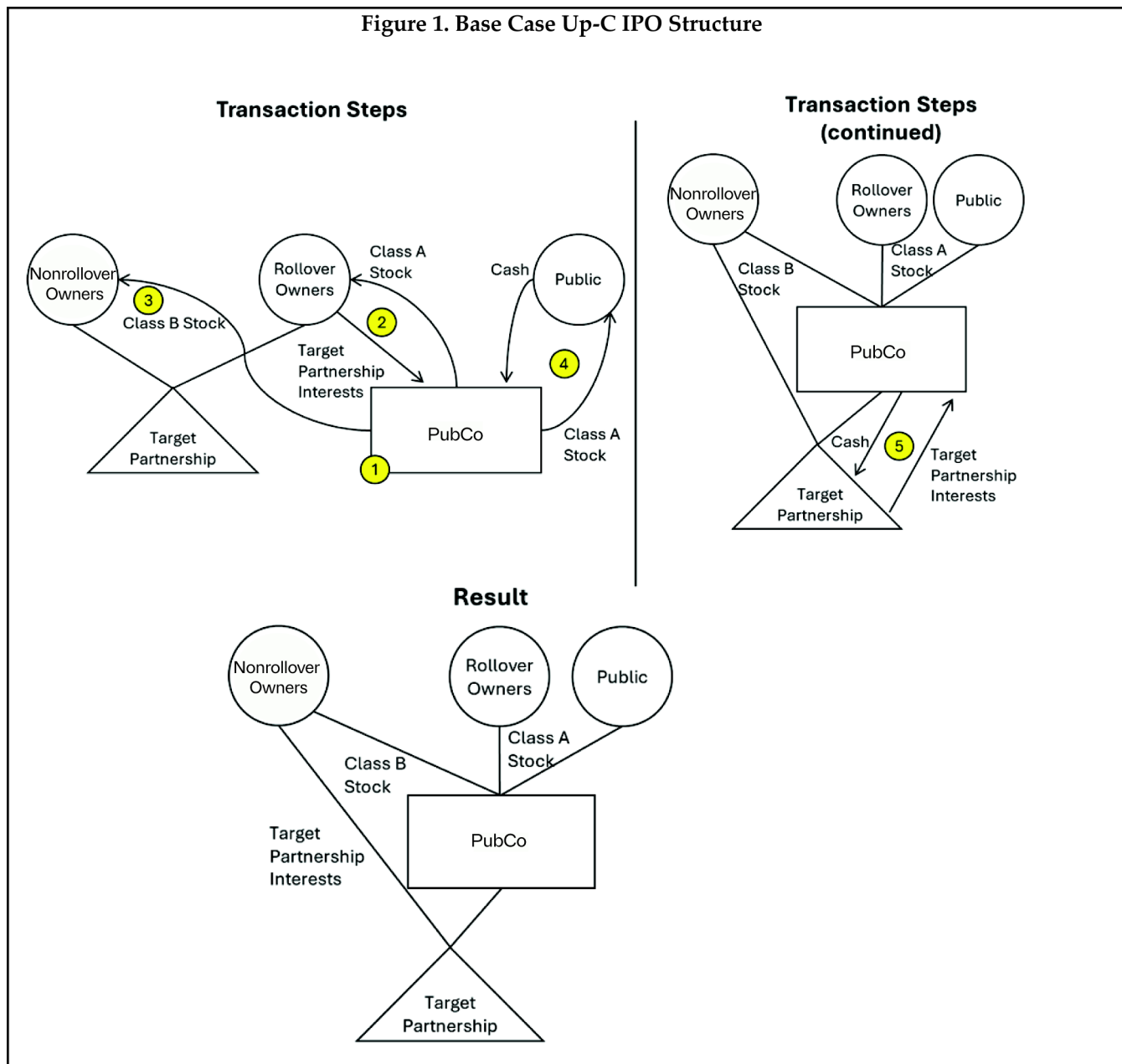
In the transaction steps above, step 2 is intended to qualify as a transaction under section 351 so that the rollover owners do not recognize gain or loss on the transfer of their Target Partnership interests to PubCo in step 2. But only with appropriate structuring can the parties to the transaction be confident that the exchange qualifies under section 351.

II. Issues Related to the Class B Stock

To conclude that the steps in Figure 1 qualify under section 351, one must determine whether the PubCo class B stock is stock for federal income tax purposes. If it is stock, one must then determine whether the stock is held by a

⁷ Variations on this illustrative ordering are possible. The IPO pricing, allocation of shares, and beginning of trading of PubCo may occur before steps 2 and 3, with steps 2 and 3 occurring between the IPO date and the closing of the IPO. The designation of PubCo as managing member of Target Partnership may occur earlier than step 6 and the issuance of tax receivable agreement rights may occur earlier than step 7. Except when indicated, these variations in step ordering should not affect the analysis.

Figure 1. Base Case Up-C IPO Structure



transferor of property for purposes of the “control immediately after” requirement in section 351.⁸

⁸ If it is stock, the class B stock is likely not nonqualified preferred stock within the meaning of section 351(g)(2). Although the class B stock arguably has some elements of nonqualified preferred stock (*i.e.*, it is arguably redeemable at the option of the holder on exercise of the exchange right and is limited as to dividends and does not participate in corporate growth to any significant extent), the class B stock is not preferred as to economic entitlements. Therefore, the class B stock likely does not constitute preferred stock within the meaning of section 351(g)(3)(A) and thus does not constitute nonqualified preferred stock within the meaning of section 351(g)(2).

A. Section 368(c) Control Requirement

Section 351 requires the transferors of property to a transferee corporation to be in control of the transferee corporation immediately after the exchange (the section 368(c) control requirement). Section 368(c) defines control as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the

total number of shares of each class of nonvoting stock in the transferee corporation.⁹

Control is generally tested immediately after the last step that is part of the overall plan in accordance with step transaction doctrine principles. For example, if multiple transfers are part of a single overall plan, the section 368(c) control requirement is tested after the completion of all the transfers that are part of the plan.¹⁰

Authorities indicate that the section 368(c) control requirement is not satisfied if, under a binding commitment entered into before the transfer or potentially otherwise as an integral and interdependent part of the plan, a transferor disposes of a quantum of the transferee corporation's stock to nontransferors that causes the section 368(c) control requirement to not be satisfied.¹¹ Section 351(c) provides an exception to this general rule and establishes that a subsequent distribution of transferee corporation stock by a corporate transferor to its shareholders is not taken into account.¹²

B. Is Class B Stock 'Stock' for Purposes of the Section 368(c) Control Requirement?

To conclude the section 368(c) control requirement is satisfied in an Up-C IPO, one must first determine what stock constitutes stock for federal income tax purposes.

The courts and the IRS have observed that beneficial ownership of stock can involve three important rights: (1) the right to vote and thereby exercise control; (2) the right to participate in current earnings and accumulated surplus; and

(3) the right to share in net assets on liquidation. These enumerated rights are often referred to as the *Himmel* rights.¹³

It is unclear whether the class B stock in Figure 1 should be considered stock for federal income tax purposes. The class B stock is not intended to have any meaningful economic rights and therefore may not contain the second and third *Himmel* rights — namely, the rights to participate in current earnings and accumulated surplus and to share in net assets on liquidation. If the class B stock is not stock for federal income tax purposes, it has no relevance to the section 368(c) control requirement and can be disregarded. In that event, the section 368(c) control requirement would only look to the class A stock received by the rollover owners and the members of the public who acquire class A stock in the IPO. The rollover owners would thus be entitled to section 351(a) protection because, together with the public investors who are also transferors of property (that is, cash) to PubCo, they would own 100 percent of PubCo's voting stock, which would be the only class of PubCo stock outstanding¹⁴ immediately after the transaction. In this case, tax deferral for the rollover owners would be achieved.¹⁵

However, it is not at all clear that the class B stock can be so easily disregarded as stock for federal income tax purposes. First, the class B stock is stock for state law purposes, and the holders of the class B stock are entitled to shareholder rights and protections for legal purposes.

⁹ Section 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

¹⁰ *Portland Oil Co. v. Commissioner*, 109 F.2d 479 (1st Cir. 1940), cert. denied, 310 U.S. 650 (1940).

¹¹ See, e.g., *Hazeltine Corp. v. Commissioner*, 89 F.2d 513 (3d Cir. 1937); Rev. Rul. 70-140, 1970-1 C.B. 73; see generally Boris Bittker and James Eustice, *Federal Income Taxation of Corporations and Shareholders* para. 3.09[2] (2026) (discussing the scope of the step transaction doctrine as it applies to the section 351 control immediately after requirement).

¹² Section 351(c)(1). Another exception relevant here is for qualified underwritings of stock that treat a person acquiring stock from underwriters for cash as the transferor of the cash to PubCo for purposes of section 351 if the underwriter is an agent of PubCo or its ownership of PubCo stock is transitory, which would be the case here. Reg. section 1.351-1(a)(3).

¹³ See *Himmel v. Commissioner*, 338 F.2d 815, 817 (2d Cir. 1964); Rev. Rul. 75-502, 1975-2 C.B. 111.

¹⁴ If the class A stock is nonvoting stock, other section 368(c) questions would arise because no transferors would own voting stock for federal income tax purposes. The authors have not seen this scenario in practice.

¹⁵ In that case, section 1032(a) would presumably not apply to the class B stock because it would constitute a nonstock property right, although this may not matter to the extent that no money or property is received for the class B stock.

Second, state law stock is typically assigned a nominal or de minimis par value, which may technically entitle the holder to some consideration upon liquidation.¹⁶ A generalist court might be inclined to view even a nominal or de minimis par value as an economic entitlement in its assessment of the class B stock, especially when coupled with its denomination as stock and shareholder voting rights.

Moreover, although the class B stock itself does not have express legal economic entitlements, consideration of all the facts and circumstances could support the view that in substance the class B stock does carry an ability to participate in corporate growth. As an initial matter, the class B stock may derive value from the one *Himmel* right it has — its voting rights — particularly if those voting rights enable a single owner or a coordinated group of owners to exercise control over PubCo and, by extension, the Target Partnership business.

Guidance issued by the IRS and other precedent indicate that voting rights do have value.¹⁷ At least one subchapter C revenue ruling (Rev. Rul. 75-93, 1975-1 C.B. 101) recognizes there

is additional value attributable to a block of stock that effectively controls the company.¹⁸ Additionally, courts have regularly considered and applied control premiums and minority discounts for purposes of valuing a decedent's estate for estate tax purposes.¹⁹ Several Tax Court cases have also applied discounts of around 5 percent (but in some cases higher) to nonvoting stock in estate tax cases,²⁰ suggesting that voting stock entails a premium under some circumstances.

These authorities are admittedly an imperfect comparison to the class B stock because they do not consider stock that is otherwise noneconomic by its terms. Still, the proposition that there is value associated with the ability to exercise

¹⁶ The par value of the class B stock could be removed entirely to enhance the argument that the class B stock is not stock for federal income tax purposes. There may, however, be corporate law constraints on issuing stock with no par value, and it is unclear whether doing so would conclusively eliminate the risk of stock treatment. Alternatively, a taxpayer could attempt to ensure that the class B stock is stock for federal income tax purposes by adding economic rights to the class B stock, such as a limited liquidation preference payable on liquidation or redemption, and then ensuring the stock is adequately paid for by the nonrollover owners. While that approach could help take the issue of section 351 qualification off the table, it is likely to be viewed as "nonmarket" for an Up-C structure and hence not an option from a practical perspective.

¹⁷ See Rev. Rul. 83-120, 1983-2 C.B. 170 (Stating that "a factor to be considered in determining the value of the common stock is whether the preferred stock also has voting rights. Voting rights of the preferred stock, especially if the preferred stock has voting control, could under certain circumstances increase the value of the preferred stock and reduce the value of the common stock. This factor may be reduced in significance where the rights of common stockholders as a class are protected under state law from actions by another class of shareholders."). See also *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977).

¹⁸ In Rev. Rul. 75-93, X corporation had outstanding 700x shares of \$2 par value publicly traded class A common stock and 2,100x shares of \$0.20 par value class B common stock. Each class of common stock carried one vote per share. The entitlement of each class B share to dividends and liquidation proceeds was one-tenth of the entitlement of a class A share. All the class B stock was owned by the company's management, who, as a group, controlled 75 percent of the voting power. In a recapitalization, the 2,100x class B common shares were exchanged for 300x shares of newly issued class A common stock (rather than 210x shares, which is what would have been received based on economics only). The ruling states: "Since it had more voting power as a class . . . the class B common stock was more valuable than the class A common stock." The effect of the recapitalization was that the class B shareholders went from having 75 percent of the vote and 23.07 percent of the economics to having 30 percent of each, resulting in an increase in the former class B shareholders' interests in the assets and E&P of X corporation.

¹⁹ See, e.g., *Estate of Bright v. United States*, 619 F.2d 407 (5th Cir. 1980) (stating "the courts have frequently recognized that the per share value of a block of stock that controls a corporation may be greater than the per share value of a block of stock that does not control that corporation"); *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148.

²⁰ *Barnes v. Commissioner*, T.C. Memo. 1998-413 (3.7 percent); *Kosman v. Commissioner*, T.C. Memo. 1996-112 (4 percent); *Estate of Joyce C. Hall v. Commissioner*, 92 T.C. 312 (1989) (5.2 percent); *Estate of Clara S. Roeder Winkler*, T.C. Memo. 1989-231 (9.1 percent); *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981) (3 percent); *Wallace v. United States*, 566 F. Supp. 904 (D. Mass. 1981) (4.8 percent); *Estate of Alvin Thalheimer v. Commissioner*, T.C. Memo. 1977-3 (4.4 percent); *Estate of Alvin Thalheimer v. Commissioner*, T.C. Memo. 1974-203 (5.4 percent); *Jacob S. Kamborian v. Commissioner*, 56 T.C. 847 (1971) (3.9 percent).

control over the assets and business of a public company seems intuitively reasonable,²¹ including in the context of an Up-C structure.²² It is, however, at best unclear whether the mere existence of that value, if it does exist, affects the analysis of whether the class B stock should be treated as stock for purposes of section 351.

Potentially more significantly, the class B stock is inherently tied to an ability to participate in PubCo's ordinary equity. In particular, any exercise of exchange rights by nonrollover owners to receive class A stock or cash in an amount determined by the value of the class A stock will necessarily involve a redemption of a proportionate amount of class B stock. Thus, one might view a portion of any value received as attributable to the class B stock redeemed. Put differently, the nature of exchanges made under the exchange right could indicate that the class B stock in substance has economic entitlements that are not reflected in the formal terms of the legal exchange, which state that all of the value is provided in consideration for Target Partnership interests, and the class B stock is simply canceled for no consideration. The idea that the class B stock is properly allocated a portion of the value on an exchange suggests that the class B stock actually may participate in corporate growth from the date of issuance, arguably bolstering the position the class B stock is stock for federal income tax purposes.

²¹ See Aaron M. Stumpf and Andrew L. Cline, "Price Differentials Between Voting and Nonvoting Stock," Stout (last accessed July 16, 2026). The authors note that the valuation of the voting premium depends on all facts and circumstances, with the key factor being the ability to influence greater shareholder returns through governance. For example, a premium might be associated with voting rights if there is a concentration of voting ownership resulting in unilateral or majority control or the presence of a swing vote that would allow the controlling owners "to change the status quo to generate higher cash flows." If voting ownership is widely dispersed, the ability to influence a decision could be virtually nonexistent, in which case value attributable to voting power may be de minimis. Further, voting shares in a poorly managed company might trade at a premium due to a perceived ability to generate greater economic returns through better management. But as a general matter, the authors note that empirical studies suggest that voting economic stock trades at a premium of 3 percent to 5 percent compared with nonvoting stock with the same economics.

²² See Shobe, *supra* note 5, at 935 (positing that "small blocks of Class B [stock] hold little value, so pre-IPO owners who own a smaller interest in the entities (and who receive a smaller block of Class B [stock]) would be unlikely to trigger much taxable income upon receipt of the Class B [stock]. . . . 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 [stock]) may be taxed upon receipt of the Class B [stock].").

Finally, and importantly, the section 368(c) definition of control, which is the touchstone for section 351 qualification, is inherently focused on voting power. The first prong of the section 368(c) control requirement test looks to whether property transferors own 80 percent of the voting stock, rather than the value, of the transferee corporation. Given this focus on voting power, it might be difficult for a generalist court to simply disregard a class of state law stock that possesses more than 20 percent of the voting power and which may even provide control over the transferee corporation. Put differently, at least in the context of a purported section 351 transaction, a court could conclude that a circumstance in which property transferors receive stock with only minority voting rights is simply inconsistent with the intent and policy of section 351.

In light of the above, it makes sense for tax advisers and taxpayers not to ignore the class B stock but rather to consider the potential consequences if the class B stock were considered stock for purposes of the section 368(c) control requirement. Most obviously, if the class B stock is properly treated as stock for purposes of sections 351 and 368(c), and it possesses more than 20 percent of the voting rights in PubCo, then the transfers by the rollover owners would not qualify for tax-deferred treatment under section 351 if the nonrollover owners are not considered property transferors for purposes of section 351 (a question addressed in the following section). The remainder of this section assumes the class B stock constitutes stock for federal income tax purposes and discusses structuring alternatives that can be implemented to defuse issues associated with the class B stock.

C. Transfer of Property and Potential Structural Solutions

The next threshold question is who are the property transferors for purposes of determining whether those transferors have section 368(c) control of PubCo following the Up-C IPO? The rollover owners and the public clearly qualify as transferors of property — the rollover owners transfer their Target Partnership interests to PubCo, and the public investors transfer cash, each in exchange for class A stock. But what about the nonrollover owners?

In step 3 of Figure 1, PubCo issues the class B stock to the nonrollover owners for no consideration. It is unclear why the nonrollover owners are receiving the class B stock, but assuming that the class B stock is properly treated as stock for purposes of the sections 351 and 368(c) analysis and carries more than 20 percent of the voting rights in PubCo, the nonrollover owners would have to be considered as transferring property in exchange for their class B stock for the transaction to qualify under section 351. The absence of any identifiable consideration given by the nonrollover owners for their class B stock presents a significant and potentially insurmountable challenge in this regard.

The code does not define the term “property,” but cases have interpreted the term broadly to encompass any tangible or intangible property that can be transferred.²³ Property does not include services, indebtedness of the transferee unless the debt is evidenced by a security, or interest on indebtedness of the transferee corporation that accrued on or after the beginning of the transferor’s holding period of the debt.²⁴

A taxpayer intending section 351 treatment might argue that if the class B stock is stock because it has value attributable to the voting rights inherent in the stock, then it is because voting and control rights over Target Partnership have effectively been transferred by the nonrollover owners to PubCo. For example, if in step 6 the partnership agreement for Target Partnership is amended to irrevocably designate PubCo as Target Partnership’s managing member,

whereas formerly the managing member was appointed by Target Partnership’s partners, it can be asserted that the rollover owners have in substance transferred their governance and voting rights regarding the management of Target Partnership to PubCo and that this transfer is for the issuance of class B stock to them.²⁵

It is notable in this connection that certain courts have interpreted the term “property” broadly²⁶ and said that property “encompasses whatever can be transferred.”²⁷ For example, in *Stafford*, the Eleventh Circuit held that a nonbinding letter of intent constituted property for purposes of section 721.²⁸

Other courts have adopted an arguably more restrictive view of property, particularly when the value of the thing or item transferred was not evident. This view has been applied with respect to transfers to both partnerships²⁹ and corporations.³⁰ Potentially more significantly, a court might not view a deemed transfer of inchoate control rights as sufficient to constitute a

²⁵ See *Shobe*, *supra* note 5, at 935 (“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 . . . for equivalent voting rights in the historic partnership in the form of the new Class B shares of the C corporation.”). A taxpayer intending section 351 treatment might alternatively argue that the nonrollover owners actually contributed a vertical slice of their partnership interests (rather than the voting power itself) based on the notion that their pre-Up-C IPO partnership interests were, in the aggregate, more valuable than their post-Up-C IPO partnership interests, which are effectively nonvoting.

²⁶ See *E.I. DuPont de Nemours*, 471 F.2d 1211 (stating that “unless there is some special reason intrinsic to the particular provision (as there is with respect to capital assets), the general word ‘property’ has a broad reach in tax law”).

²⁷ *Hempt Brothers*, 354 F. Supp. at 1175.

²⁸ *United States v. Stafford*, 727 F.2d 1043 (11th Cir. 1984).

²⁹ In *Santa Monica Pictures v. Commissioner*, T.C. Memo. 2005-104, worthless debts were transferred to a partnership in an exchange to which the parties intended section 721 to apply. The Tax Court concluded that a contribution of worthless debt was not a “contribution of property.” See also *Haytun v. Commissioner*, T.C. Memo. 1972-127.

³⁰ In *Seaboard Commercial Corp. v. Commissioner*, 28 T.C. 1034 (1957), the court held under the predecessor to section 351 that a transfer by a corporation of the stock of its worthless subsidiary to another subsidiary was not a contribution of property to capital or as paid-in surplus. The court reasoned: “If in fact the stock was wholly worthless prior to [the year of the transfer] and was wholly worthless when transferred . . . it would be a perversion of the statutory language to consider it as coming within the phrase ‘contribution to capital,’ still less as ‘paid-in surplus.’ A contribution of zero would not really be a contribution, nor could a payment of nothing constitute part of a paid-in surplus or, for that matter, of any kind of surplus.” *Id.* at 1054. Even under this view, a taxpayer could argue that property is anything of value and that the effective transfer of control rights does constitute a transfer of valuable property. See *supra* note 21 and accompanying text, observing that the value of the voting rights may depend on the quantum of voting power held by a particular nonrollover owner.

²³ *E.I. du Pont de Nemours & Co. v. United States*, 471 F.2d 1211 (Ct. Cl. 1973). For example, property includes money (*Halliburton v. Commissioner*, 78 F.2d 265 (9th Cir. 1935)), accounts receivable (*Hempt Brothers Inc. v. United States*, 354 F. Supp. 1172 (M.D. Pa. 1973)), *aff’d*, 490 F.2d 1172 (3d Cir. 1974), *cert. denied*, 419 U.S. 826 (1974)), stock and securities of another corporation (Rev. Rul. 74-502, 1974-2 C.B. 116); *W. & K. Holding Corp. v. Commissioner*, 38 B.T.A. 830 (1938)), installment obligations (*Portland Oil Co.*, 109 F.2d 479), and partnership interests (Rev. Rul. 81-38, 1981-1 C.B. 386). See generally Bittker and Eustice, *supra* n.11, para. 3.02.

²⁴ Section 351(d). The IRS also takes the position that a transaction in which the transferor retains ownership of the property and merely grants the corporation a nonexclusive right to use property may be treated as a leasing or licensing arrangement rather than a transfer of property. See Rev. Proc. 83-59, 1983-2 C.B. 575; cf. *E.I. Du Pont de Nemours*, 471 F.2d 1211.

transfer of property because there is no visible thing being transferred by the nonrollover owners.³¹ In other words, a court might not be prepared to accept such a conceptual or substance-based analysis and might instead look for an actual transfer of a cognizable state law property right.

The inchoate nature of a transfer of a deemed control right also leaves a taxpayer susceptible to other explanations for the nonrollover owner's receipt of the class B stock. For example, are the nonrollover owners receiving the stock as compensation or as an incentive payment for arranging and engaging in the deal? Other possible characterizations may exist.

Other arguments in favor of treating nonrollover owners as property transferors arise in transaction variants in which the nonrollover owners sell a portion of their Target Partnership interests to PubCo for cash in connection with the IPO and also receive class B stock for no separate consideration. Assuming the class B stock is stock, then there is an argument that economically, a portion of the class B stock is received by the nonrollover owners for their transfer of partnership interests to PubCo.

In Rev. Rul. 68-55, 1968-1 C.B. 140, the IRS determined that for purposes of determining the amount of gain recognized in a section 351 transaction involving receipt of boot as well as transferee corporation stock, the fair market value of each category of consideration received must be separately allocated to the transferred assets in proportion to the relative FMVs of the transferred assets — effectively, a pro rata allocation of stock and boot to each asset transferred.³² Arguably, a similar approach could be applied to argue that the cash and class B stock should be allocated pro rata by value to the partnership interests received by PubCo. If that is the case, then the nonrollover

owners would appear to qualify as having transferred property in exchange for stock for purposes of section 351, and their class B stock would count favorably for purposes of the section 368(c) control requirement.

It is unclear, however, whether this analysis would prevail to confer transferor status on the nonrollover owners. Although Rev. Rul. 68-55 embraced a pro rata economic approach in the context of section 351, it did not present section 351 qualification issues. It is also unclear whether the ruling would apply with the same force for purposes of determining transferor status. Notably, Rev. Rul. 68-55 was premised on there being a clear value-for-value exchange. It may not apply if the value of tangible property (cash and class B stock) received by the nonrollover owners exceeds the value of the partnership interests transferred to PubCo. Moreover, if the form of the transaction is such that only cash is exchanged for the partnership interests, and if there are other transaction participants that receive cash or PubCo stock with the same value for their partnership interests without receiving class B stock, a court might treat the issuance of the class B stock as separate from the exchange of cash for partnership interests.

Given that taxpayers are often bound by their chosen form, those engaging in an Up-C IPO would be well advised to contribute clearly identifiable property in exchange for the class B stock. This gives taxpayers attempting to solidify their status as transferors something to point to that is being legally conveyed to the transferee corporation. The following sections analyze potential options for those property transfers and the considerations that they raise.

D. Transfers of Cash

One alternative would be for the nonrollover owners to pay cash in exchange for their class B stock. Consider the following variant on the base case.

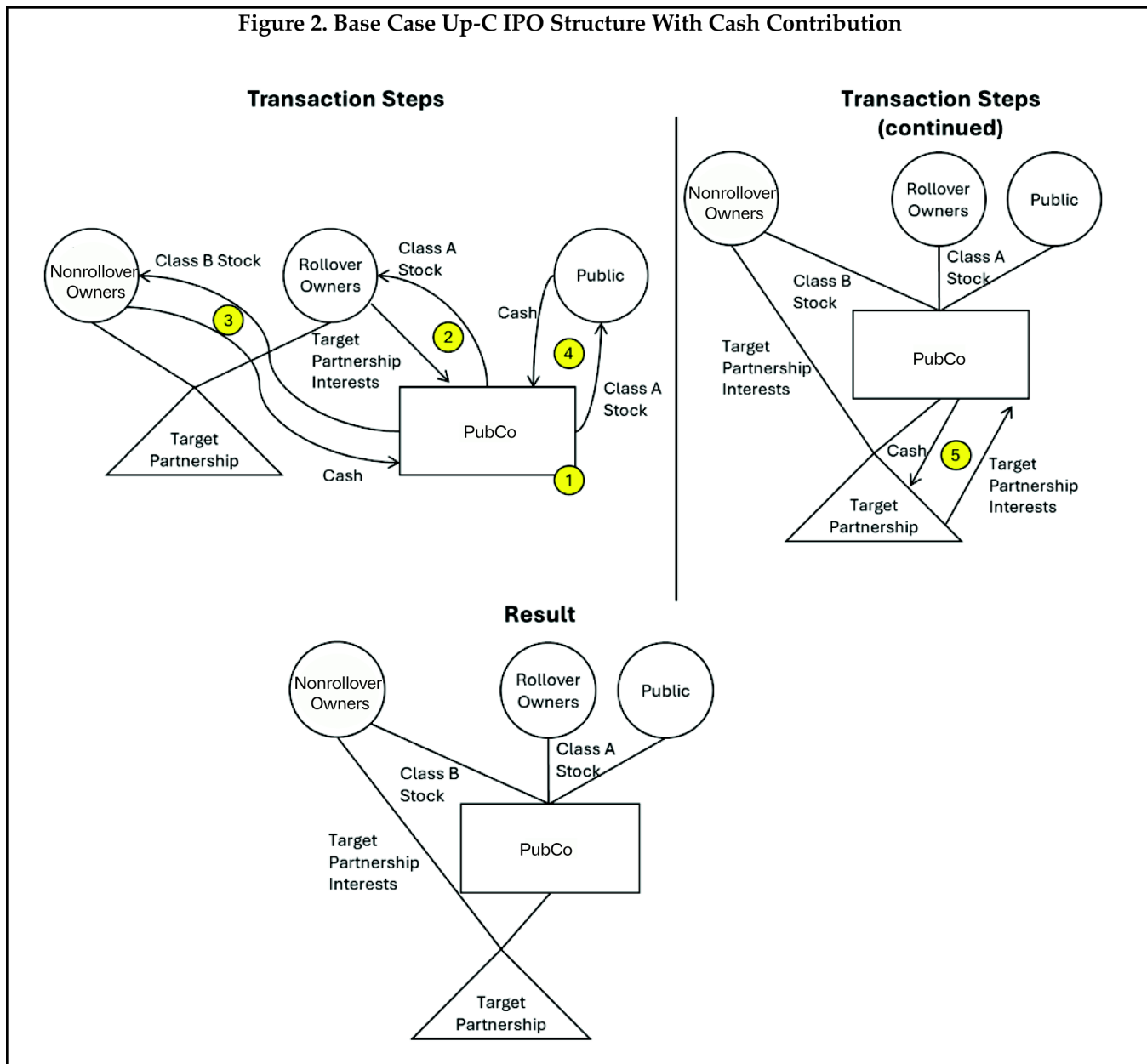
For Figure 2, assume same facts as in Figure 1, except that step 3 is modified as follows: The nonrollover owners transfer cash to PubCo in exchange for class B stock of PubCo.

From a tax perspective, a transfer of cash in exchange for the class B stock may be an improvement on the base case transaction

³¹ In a recent Tax Court case, the court expressed concern with a section 351 exchange because the “stock that [the transferee corporation] ended up with ([target corporation] common stock) was not the type of stock held by those [target corporation] shareholders who participated in the merger.” *Complex Media Inc. v. Commissioner*, T.C. Memo. 2021-14. The Tax Court’s dicta suggests a very literal reading of the “transfer of property” requirement under section 351, and its focus on the legal form of the property transferred versus the legal form of the property received suggests that the court may be inclined to reject a formless transfer of economics.

³² See also Rev. Rul. 85-164, 1985-2 C.B. 117.

Figure 2. Base Case Up-C IPO Structure With Cash Contribution



because it involves a transfer of something that is obviously property into the transaction to solidify transferor status for the nonrollover owners. The cash transfer does, however, raise different questions concerning the value of the class B stock and how much cash is required. These questions are considered below. The cash contribution alternative might also encounter headwinds from a business perspective because nonrollover owners could be reluctant to come out of pocket to fund cash purchases of class B stock.

Value-for-value exchange issues and the accommodation transferor rule. In considering a

possible exchange of cash for class B stock, questions arise. For starters, how much cash should be paid for the class B stock given its absence of economic rights? What if the amount of cash contributed does not equate to the value of the class B stock received, so that the contribution is not a value-for-value exchange? Is the quantum of cash sufficient and bona fide — that is, if the class B stock is assigned a very small value, could a de minimis amount of cash or property be disregarded or treated as insufficient to confer transferor status on the nonrollover owners? The

regulations under section 351 shed some light on these questions.

Taxpayers considering contributions of cash in exchange for class B stock should take measures to properly value the class B stock. The absence of express economic entitlements to the class B stock may make this a challenging valuation exercise, and one that may depend on the particular facts and circumstances. For example, a block of class B stock received by a single nonrollover owner that confers control over PubCo might be valued differently from class B stock received by a nonrollover owner that will have only minority voting rights.

If the class B stock is underpaid or overpaid for, the exchange could have collateral tax consequences for the co-transferors. The regulations under section 351 indicate that when property is transferred to a corporation and the stock received by a transferor is disproportionate to the value of the contributed property, the entire transaction will be given tax effect in accordance with its true nature.³³ In that case, the transaction may be treated as if a proportionate amount of transferee corporation stock had first been received by each transferor and then any disproportionate amounts are used to make gifts, pay compensation, or satisfy obligations between the transferors.³⁴ In effect, the regulations indicate that a section 351 contribution ought to entail a series of value-for-value exchanges or otherwise be subject to gap-filling to explain any disproportionality.³⁵

To illustrate, in Example 1 of reg. section 1.351-1(b)(2), a father (A) and son (B) organize a corporation with 100 shares of common stock to which A transfers property worth \$8,000 in exchange for 20 shares of stock, and B transfers property worth \$2,000 in exchange for 80 shares of stock. Example 1 concludes that no gain or loss will be recognized under section 351. It then

indicates that the disproportionality in the amount of stock received ought to be explained as an “over-the-top” exchange between A and B (for example, classified as a gift, as compensation, or otherwise, as the case may be).

In practice, there is likely to be a commercial desire to limit the amount of new cash the nonrollover owners must inject into PubCo for class B stock with no overt economic entitlements. That desire, and the possibility that the class B stock could be undervalued, may at first glance appear to raise technical concerns under the so-called accommodation transferor rule. However, those concerns are for the most part unfounded. Under the accommodation transferor rule, “stock will not be treated as issued for property if it is issued for property which is of relatively small value *in comparison to the value of the stock already owned (or to be received for services)* by the person who transferred such property and the primary purpose of the transfer is to qualify under [section 351] the exchanges of property by other persons transferring property” (emphasis added).³⁶ While contributions of de minimis value can fall within the crosshairs of the accommodation transferor rule, that rule is directed at de minimis contributions by existing shareholders that are intended to qualify other noncontrolling transferors’ investments as tax free. There is one limited exception to the existing shareholder construct, which is that the accommodation transferor rule can apply to a new shareholder that is receiving the bulk of their shares as compensation for services.³⁷

In Rev. Proc. 76-22, 1976-1 C.B. 562, the IRS established as the guideline for purposes of issuing private letter rulings that a transfer of property will not be considered to be of relatively

³⁶ Reg. section 1.351-1(a)(1)(iii).

³⁷ Example 1 of reg. section 1.351-1(b)(2) is consistent with a limited application of the accommodation transferee rule. As indicated above, Example 1 concludes that no gain or loss will be recognized under section 351. In doing so, Example 1 concludes that each of A and B should be respected as transferors of property with no mention of the accommodation transferor rule and no assessment of the bona fides of B’s property contribution. This may also imply that the accommodation transferor rule cannot apply to the formation of a new corporation unless the service provider component of the accommodation transferor rule is applicable. *But see* Rev. Rul. 79-194, 1979-1 C.B. 145 (Situation 2), discussed *infra*, suggesting that transferor status could be disavowed on other similar grounds based on the substantiality of the value of the property contributed to the corporation relative to the overall amount of stock received in the transaction.

³³ Reg. section 1.351-1(b)(1).

³⁴ *Id.*

³⁵ The predecessor of section 351 (section 112(b)(5) of the 1939 code) contained a requirement that stock or securities be received by each transferor substantially in proportion to the interest of each transferor before the transfer. This requirement was eliminated in the 1954 code. See S. Rep. No. 1622, 83rd Cong., 2nd Sess. 264 (1954). See GCM 3740 (Feb. 9, 1978) (discussing the statutory change and the reason it was made).

small value for purposes of the accommodation transferor rule if the FMV of the property transferred is at least 10 percent of the FMV of the stock and securities already owned (or to be received for services) by the transferor.³⁸ This ruling guideline has been viewed as, in effect, a safe harbor for applying the accommodation transferor rule. The IRS has noted that the 10 percent standard can sometimes cause a transfer of significant value to be treated as relatively small and has acknowledged that it is “not a fixed principle of law that must be applied rigidly in all cases in ignorance of the relevant facts and circumstances.”³⁹

The IRS has also published guidance independent of the accommodation transferor rule illustrating issues that can arise in connection with contributions of limited value. For example, in Situation 1 of Rev. Rul. 79-194, 1979-1 C.B. 145, the section 368(c) control requirement was satisfied when a transferor of property received 80 percent of the stock of a corporation and then sold 31 percent of the stock received to the other 20 percent transferor. Conversely, in Situation 2 of Rev. Rul. 79-194, the section 368(c) control requirement was not satisfied when a transferor of property received 99 percent of the stock of a corporation and then sold 49 percent of his stock to the 1 percent transferor. The IRS said that because the amount of stock issued directly to the 1 percent investor for property was of relatively small value in comparison to the value of all the stock received by the investor in the transaction, the stock received by the investor was not considered in determining whether the transaction qualified under section 351(a). Thus, for purposes of determining control under section 351, the 1 percent investor was not a bona fide

transferor for purposes of section 351, and the stock that was acquired from the 99 percent transferor was not stock held by a transferor “immediately after the exchange.”⁴⁰

In GCM 37409, the IRS reached a different conclusion when a corporation initially received 94 percent of a newly formed corporation’s stock and then sold 45 percent of the stock to a group of investors that initially received for a property transfer only 6 percent of the new corporation’s stock. The IRS concluded that the transaction qualified for section 351 treatment, indicating that at least in that context, the initial receipt of a 6 percent stock interest was bona fide.⁴¹

Most recently, in FSA 200133006, which directly applied the accommodation transferor rule, the IRS indicated that a taxpayer’s receipt of transferee stock worth less than 2.5 percent of the transferee stock already owned by the taxpayer was “certainly a relatively small value” and that taxpayer’s preexisting stock ownership of the transferee corporation should not count for purposes of determining whether the section 368(c) control requirement was satisfied.⁴²

While the traditional formulation of the accommodation transferor rule — comparing the amount transferred with the amount of stock already owned by a purported accommodation transferor — should not apply to an Up-C IPO, the accommodation transferor rule could be in play if the amount paid for the class B stock is relatively small compared with the amount of the class B stock received as compensation for the nonrollover owners’ services. If the class B stock has value over and above the amount paid for it, depending on the circumstances, it is possible that a compensation-for-services rationale could be invoked to explain the difference, particularly if the nonrollover owner is a founder or key employee, or possibly if the excess value could be

³⁸ The 10 percent standard in Rev. Proc. 76-22 was later incorporated into and superseded by Rev. Proc. 77-37, 1977-2 C.B. 568, section 3.07.

³⁹ GCM 36534 (Dec. 23, 1975) (Explaining that: “Of course, the ‘less than 10 percent’ rule of the proposed procedure may cause property of substantial value to be treated for advance ruling purposes as ‘property which is of relatively small value.’ For example, under this rule, property worth \$99,000 transferred by a shareholder who already owns stock worth \$1,000,000 will be treated as such property where the primary purpose of the transfer is to qualify under section 351 the exchanges of others. This result, in our opinion, is proper, notwithstanding the value of the property, since ‘relatively small value,’ as outlined above, connotes comparative rather than absolute value. Moreover, the 10 percent rule is merely an advanced ruling guideline and not a fixed principle of law that must be applied rigidly in all cases in ignorance of the relevant facts and circumstances.”).

⁴⁰ See also GCM 37113 (May 10, 1977).

⁴¹ GCM 37409 (Feb. 9, 1978).

⁴² FSA 200133006. In this field service advice, the IRS also placed weight on the taxpayer’s reason for its contribution, concluding that the transfer appeared to be intended to cause the transfers to qualify under section 351.

construed as a fee for putting together the deal.⁴³ Thus, it makes sense for the affected parties to properly identify the value of the class B stock to eliminate risk that it is underpaid for, with the remainder being otherwise treated as received as compensation.

If the value of the class B stock is in fact quite small because of its lack of economic rights, there could be concern regarding whether a contribution of a small amount that pales by comparison to the contribution of the rollover owners is sufficient to respect the nonrollover owners as transferors for section 351 purposes. We do not believe, however, that the amount of cash or property contributed needs to exceed a specific dollar threshold and thus see no incentive to overpay for the class B stock. Rather, as long as the amount of cash or property contributed equates to the FMV of the class B stock received, even the contribution of a small amount should be sufficient so long as the overall exchange is value-for-value. This is particularly so because issuance of the class B stock is commercially motivated — it is not undertaken for tax purposes. As a technical matter, taxpayers should also take comfort from the specific gap-filling rules in reg. section 1.351-1(b)(1) and Example 1 of reg. section 1.351-1(b)(2) that essentially look to whether there is a value-for-value exchange. Thus, it would seem inappropriate for the IRS to take issue with a value-for-value contribution because it did not exceed a particular dollar or relative value threshold.⁴⁴

All that said, nonrollover owners may be reluctant to come out of pocket to exchange cash for class B stock that is viewed as noneconomic on its face. Therefore, the cash contribution alternative described in Figure 2 may be commercially unattractive. Even if commercially available, there is some level of concern that a

nominal or token contribution would invite questions from the IRS and put pressure on any third-party valuation obtained.

In *Kamborian*,⁴⁵ the First Circuit, affirming the Tax Court, held that a purchase of a small number of shares from a transferee corporation in connection with a purported section 351 transaction was insufficient to qualify the purchaser as a section 351 transferor. The court characterized the acquisition as a “token purchase” that “could have no impact on [the transferee corporation’s] ability to conduct its business.” The court’s holding ultimately turned on its conclusion that the token purchase was properly treated as separate and not part of the same plan as the taxpayer’s property transfer to the transferee corporation. As a result, the section 368(c) control requirement was not satisfied. While it seems unlikely that the holding in *Kamborian* would be applied to a business-motivated issuance of class B stock in the context of an Up-C IPO, it remains something to be considered.

Finally, the injection of incremental cash might be viewed as causing an uneconomic result if a court were to view the nonrollover owner’s relinquishment of effective management over Target Partnership as a deemed property transfer. In that case, relinquishment of effective management might equate the value of the class B stock, in which case any incremental cash would constitute an excess outlay by the nonrollover owners. Consistent with reg. section 1.351-1(b)(1), the issuance of stock disproportionate to the value contributed by the nonrollover owners would have to be evaluated in accordance with its true nature, although we do not believe that it could fairly be invoked to disqualify the nonrollover owners as transferors of property.

E. Partnership Recapitalization

An alternative approach to effecting an actual transfer of property for class B stock that does not involve an outlay of cash by the nonrollover owners is to cause Target Partnership to recapitalize its preexisting partnership interests before the Up-C IPO into class A interests that

⁴³ Even if the contribution by the nonrollover owners were found to be relatively small by comparison to the class B stock they received as compensation, for the accommodation transferor rule to apply, it would still have to be established that the primary purpose of the nonrollover owner transfer is to qualify the exchanges of property by the rollover owners under section 351.

⁴⁴ Similarly, it would seem difficult for the IRS to contend that a member of the public that buys, e.g., a single share of PubCo in the IPO at the IPO price is somehow not included in the transferor group merely because of the small amount invested (or for the IRS to administer any such view).

⁴⁵ *Kamborian v. Commissioner*, 469 F.2d 219 (1st Cir. 1972).

carry economic interests in Target Partnership and a class of voting-only class B interests.⁴⁶ The nonrollover owners could then transfer their class B interests to PubCo in exchange for the class B stock while retaining their class A interests. The voting-only class B interests would be a discrete state law property right that could be contractually conveyed. Moreover, to the extent the class B interests have governance rights in Target Partnership comparable to the governance rights conferred by the class B stock in PubCo, it may be easier for the transaction to be viewed as a value-for-value exchange. This alternative is more fully explored below.

For Figure 3, assume the same facts as in Figure 1, except that step 0 is added to the transaction, and steps 2, 3, 5, and 6 are modified to reflect the partnership recapitalization:

- Step 0: Target Partnership recapitalizes its existing partnership interests⁴⁷ by dividing them into (1) class A units that have the economic entitlements of the former partnership interests, and (2) class B units that have no economic entitlements but possess the voting rights of those former partnership interests.
- Step 1: PubCo is organized and is authorized to issue (1) class A stock, which will be common stock with typical economic entitlements (that is, entitlements to dividends and proceeds on liquidation) and voting rights (usually one vote per share); and (2) class B stock, which will have no economic entitlement to dividends or liquidation proceeds but does have voting rights and, in some cases, super-voting rights (that is, more than one vote per share) to facilitate the ability of nonrollover owners to retain control over the business.
- Step 2: The rollover owners transfer their class A units and class B units in Target

Partnership to PubCo in exchange for PubCo class A stock.

- Step 3: The nonrollover owners transfer their class B units in Target Partnership to PubCo in exchange for PubCo class B stock.
- Step 4: PubCo issues shares of class A stock to the public in an IPO.
- Step 5: PubCo contributes the cash it receives in the IPO to Target Partnership in exchange for class A units in Target Partnership.
- Step 6: PubCo exercises the voting rights of the class B units in Target Partnership to vote itself the managing member of Target Partnership (not depicted).
- Step 7: PubCo enters into a tax receivable agreement with Target Partnership and the nonrollover owners whereby those owners obtain the right to receive cash payments from PubCo equal to 85 percent of the future cash tax benefits recognized by PubCo as a result of the tax attributes covered by the tax receivable agreement (not depicted).

While this approach seems relatively straightforward on its face, there are several complex questions to consider in implementing it.

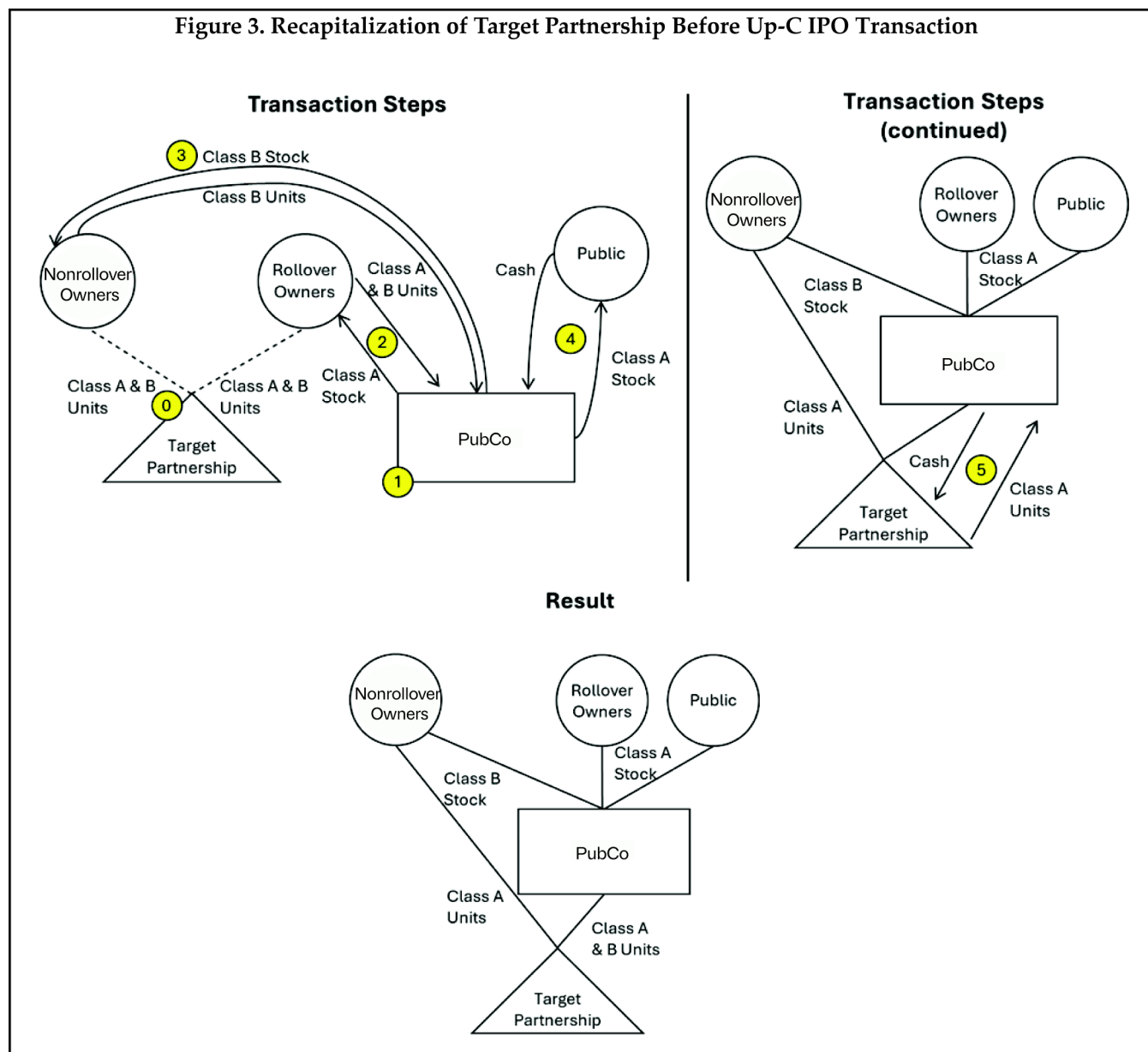
First, for the approach to be respected, it seems important that the class B units and the voting rights they possess not be transitory or deprived of substance by other aspects of the transaction.⁴⁸ Thus, following their transfer to PubCo, the class B units should remain in existence and should not be canceled, recapitalized, or otherwise made a functional nullity (that is, by having exercise of the voting rights be irrelevant or unnecessary to the

⁴⁶The Target Partnership interests will presumably have to be recapitalized in any event to be able to achieve the desired one-to-one correspondence between partnership units and class A stock in PubCo and potentially also to provide put rights enabling nonrollover owners to exchange their retained Target Partnership interests for cash or PubCo stock.

⁴⁷For simplicity, a single class of preexisting partnership interests is assumed.

⁴⁸In our view, the partnership recapitalization is an improvement over the purely substance-based argument that relinquishment of effective control of Target Partnership constitutes a deemed property transfer because in the partnership recapitalization alternative a tangible property right is legally conveyed. If the class B units are immediately unwound, then the partnership recapitalization alternative would arguably return the transaction to the base case.

Figure 3. Recapitalization of Target Partnership Before Up-C IPO Transaction



governance and management of Target Partnership).⁴⁹ Instead, PubCo should affirmatively exercise the voting rights associated

⁴⁹ See Rev. Proc. 2016-40, 2016-32 IRB 228 (allowing a controlled corporation to engage in a recapitalization to enable its post-recapitalization controlling corporate owner, *i.e.*, the distributing corporation, to satisfy the control and distribution-of-control requirements under section 355, provided that no action is taken to unwind the post-recapitalization structure and providing a safe harbor if no action is taken at any time before 24 months after the distribution). See also Rev. Rul. 69-407, 1969-2 C.B. 50 (allowing the predistribution acquisition of control through a recapitalization if it resulted in a permanent realignment of voting control); Rev. Rul. 56-117, 1956-1 C.B. 180 (providing facts suggesting the same); cf. Rev. Rul. 63-260, 1963-2 C.B. 147 (ruling that a predistribution acquisition of control by the distributing corporation is not respected for purposes of section 355(a)(1)(A) if it is transitory or illusory).

with the class B units to elect itself the managing member of Target Partnership.⁵⁰ Moreover, the voting rights associated with the class B units should not be unique to PubCo but instead should run with the units irrespective of the holder, even though the expectation is that the class B units would never be held by any person or entity other than PubCo. There should also be normal voting rights associated with the class B units that entitle

⁵⁰ Often in connection with an Up-C IPO, PubCo is automatically and permanently designated the managing member of Target Partnership under the terms of the amended Target Partnership agreement. That automatic designation of the managing member detracts from the substance of the class B units.

the holder to participate in future votes, remove and replace the managing member, and vote on amendments to the partnership agreement. All these measures are intended to support the view that the class B units have meaningful state law rights that the nonrollover owners actually transfer to PubCo.

Second, the recapitalization approach seems most clearly workable when the recapitalization into class A and class B units represents a natural division of the economic rights and voting rights inherent in the preexisting partnership interests, and the resulting class B unit voting rights in Target Partnership in turn correspond to the voting rights of the class B stock in PubCo. Even in those cases, there might be reasons to question whether the exchange of class B units for class B stock is technically value-for-value. Intuitively, it seems that ought to be the case. Perhaps, however, there are other factors that could affect the value of the respective instruments. For example, are voting rights in a publicly traded company that apply to the election of the board of directors inherently more or less valuable than voting rights in a private entity? On balance, when there is a natural correspondence of the voting rights historically held by the nonrollover owners to the voting rights inherent in the class B stock, courts may not be inclined to treat a class B unit for class B stock exchange as other than value-for-value. Each case should, however, be evaluated on its particular facts.

The recapitalization approach may, however, become more difficult when PubCo's intended governance structure reflects differences from or changes to the Target Partnership voting arrangements. For example, if the nonrollover owners were to receive class B stock that has super-voting rights not present in their preexisting partnership interests to ensure their control over PubCo going forward, that could cause one to question (1) whether the partnership recapitalization is a value-for-value exchange to the extent those incremental rights are included in the class B units, and (2) whether the class B unit for class B stock exchange is value-for-value — and, in either case, to consider the tax consequences that apply if the exchange is not value-for-value.

More broadly, differences in the overall governance structure similar to those described above could exacerbate concerns about a transitory issuance of class B units to the nonrollover owners (and exchange of those units for class B stock) not being respected. The recapitalization approach is founded in the concept that the owners of the class B units have historically been entitled to and exercised the voting rights reflected by the new class B units as a result of their ownership of their preexisting interests in Target Partnership. By engaging in the recapitalization, they are merely crystallizing those rights into a separate instrument that constitutes property for section 351 purposes and are transferring those rights for comparable voting rights in PubCo as reflected in the class B stock.

There is an inherent logic in that analysis that seems generally persuasive, but it could become more challenging if the natural correspondence between historical rights and the class B stock rights diverges. If the nonrollover owners receive rights via the class B stock that do not correspond to rights they historically possessed, it might be more difficult to see those rights as received in respect of the transfer of the class B units that the nonrollover owners hold only briefly, and they may be more readily viewed as received for something else, such as services, etc. That said, in many cases the nonrollover owners might historically have had complete effective control over Target Partnership, and thus this divergence does not arise.

Finally, there is some downside risk to the recapitalization approach if the class B stock is treated as a contractual right, rather than as stock for federal income tax purposes. In that case, the class B unit for class B stock exchange would, from PubCo's perspective, be an exchange to which section 1032 would not apply. That would result in gain to PubCo.⁵¹ The nonrollover owners would also recognize taxable gain under section 1001 on the transfer of the class B units measured

⁵¹This same risk would be present in the cash purchase alternative if the class B stock were not treated as stock.

by the FMV of the class B stock received over the nonrollover owners' basis in the class B units.⁵² If it can be reliably concluded that the class B units and class B stock have limited value, then the potential gain to each transacting party would not be significant.

F. Other Alternatives

Variations and enhancements regarding the transfer of cash and partnership recapitalization alternatives exist. As noted above, a taxpayer could attempt to ensure that the class B stock is stock for federal income tax purposes by adding certain economic entitlements to the class B stock.

Moreover, either as a belts-and-suspenders supplement to the partnership recapitalization approach or as a stand-alone alternative, the nonrollover owners could contribute a portion of their Target Partnership interests (or class A units if preceded by a partnership recapitalization) for class A stock. In theory, the transfer of the Target Partnership interests for class A stock ought to be a value-for-value exchange that does not require a cash outlay by the nonrollover owners. Moreover, the nonrollover owners would be transferring a valuable property right in exchange for publicly traded stock having discernible value. That exchange should establish the nonrollover owners as bona fide transferors for purposes of section 351 because the Target Partnership interests (or class A units in the event of a preceding recapitalization) are clearly property, and the class A stock is clearly stock. Once the

nonrollover owners are treated as transferors, which derives from their transfer of the Target Partnership interests (or class A units), any class B stock they hold (if stock) should count favorably in the section 368(c) calculus. Although there would be no cash outlay under this alternative, the nonrollover owners would lose the benefits of participating in the tax receivable agreement to the extent of the contributed Target Partnership interests (or class A units). Also, to help ensure the exchange is respected, the nonrollover owners would want to be sure the value of the Target Partnership interests or class A units contributed is meaningful, including when compared with the class B stock received.⁵³

III. Conclusion

The amount of technical risk involved in an Up-C IPO fact pattern and associated with any particular structuring alternative is highly dependent on a taxpayer's particular facts and implementation. Before adopting an alternative, each approach must be weighed against the relevant commercial objectives and corporate law limitations to determine what is most practical and suitable for the specific transaction under consideration.

The second installment of this series will discuss other transferor-related issues that the parties to an Up-C IPO might face when attempting to structure the transaction to achieve tax deferral under section 351. ■

⁵² In other scenarios, nonrollover owners have risk of income recognition to the extent that they receive class B stock for "nothing" or in exchange for a payment of cash that is less than its value. See Shobe, *supra* note 5, at 935.

⁵³ At a minimum, the value of the Target Partnership interests transferred/class A stock received should be at least equal to 10 percent of the value of the class B stock received in case the class B stock was treated as received for services, raising accommodation transferor concerns. See discussion in Section II.D, *supra*, regarding the accommodation transferor rule.