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Tax Opportunities – Tax Planning in a Post-Brexit World

Although the long-term impact of Britain's exiting the EU cannot be known, the prudent course of action remains one of steadiness over the coming weeks and months as the ramifications of Brexit begin to unfold.

That said, it is understandably difficult to ignore significant volatility in the financial markets, whether from the British decision to exit the EU or from other causes, and taxpayers often ask: *Is there anything that can or should be done today?*

Sometimes, the answer is yes. Volatility and what an investor determines to be temporarily depressed asset values may present a prime opportunity for beneficial tax planning. In the June issue of For the Record, the article Tax Planning Opportunities During a Market Decline identifies certainly planning ideas for turbulent markets. In this article, the focus will be on some transactions that harness economic volatility while still limiting downside exposure should there be further decline.

When the value of an asset suddenly drops due to what the investor believes are exogenous circumstances, rather than fundamental factors inherent in the asset itself there can be an opportunity to reap significant transfer tax savings. Simply stated, one can transfer more of an asset when its value is low than when it is high for the same gift cost. While there is risk of further loss in value after the transfer, if the overall plan is for the donee individual or trust to hold the asset long-term, the greater the chance the asset's future value will exceed, possibly significantly, its transfer value.

Another possibility is to simply make a cash gift, thereby allowing the donee individual or trust to purchase assets at a lower value. This type of transfer allows for the targeting of a specific asset if it is believed that it has been particularly impacted by current financial conditions and therefore has greater buy-low potential. In addition, transferring cash can avoid the dual-basis trap that can occur when transferring a depreciated asset.

The dual-basis rules look to prevent a taxpayer from transferring a tax loss to another. If depreciated property is gifted, its basis becomes fair market value if that asset is sold when the value is less than the transferor's original basis. If a taxpayer wants to gift a specific depreciated asset, then it should be done through a grantor trust. Because the grantor trust rules impute income tax ownership of an asset back to the grantor, this dual-basis rule wouldn't apply and the loss would be preserved if it were ultimately decided to sell the asset at the lower value.

Another transaction that can be particularly powerful in an economic climate where asset values are temporarily depressed is a grantor retained annuity trust (GRAT). Because a GRAT is designed to leverage low values and transfer future appreciation with little to no gift tax impact and therefore no depreciation risk, it can be an ideal transfer vehicle under such conditions. As discussed in the June issue, in this transaction an asset is transferred irrevocably to a trust that pays an annuity back to the grantor for a term of years. At the end of the trust term, any remainder interest goes to the trust beneficiaries. Because the present interest value of the annuity is equal to 100% of the asset value plus the Sec. 7520 interest rate (1.8% in June and July), at transfer the remainder interest is valued at close to zero and therefore there is little to no gift tax ramifications. If the asset appreciates at a rate exceeding that 1.8% interest rate and the grantor outlives the trust term, that appreciation is transferred to beneficiaries free of any gift tax.

In addition, most economic analysis indicates that short-term GRATs (most practitioners believe the shortest permissible term is two years) holding volatile assets tend to perform the best. Part of the reasoning behind this analysis is that because the annuity payments are fixed based on the asset value at the time of transfer, sudden value spikes after transfer can increase the GRAT's effectiveness. If an asset value is depressed due to outside factors, there may be greater potential for that value spike. The key in maximizing GRAT efficiency is the ability to harness asset volatility and catch the asset at these value high-points. One way to achieve this result is through what is known as a GRAT freeze.

In a GRAT freeze, if it is believed that an asset has reached a value high-point, a taxpayer would substitute in an asset with a relatively fixed value (such as a bond) in exchange for the more volatile asset. By doing so the GRAT value is now frozen at this high-point thereby guaranteeing its success. The taxpayer would then be free to re-GRAT that asset and capture additional growth, if any.

Finally, since there is little or no gift-tax cost with respect to GRATs, taxpayers can set up as many as they want and fund them with as much as they want. If an asset continues to decline in value so that the total annuity payments exceed the trust value, the worst that happens is the GRAT busts, and 100% of the asset is returned to the grantor. Because there is significant potential upside with little to no downside, GRATs can be an extremely attractive option

under the right circumstances, which might be now.

In the wake of the Brexit vote, the only thing clear is uncertainty. Although this uncertainly and its impact on markets has understandably made taxpayers nervous, it has also created potential tax planning opportunities that can result in significant savings. Now is a good time to discuss these and other opportunities with one's tax and financial advisors.

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The Rise of the Up-C and TRA in IPOs

At first reading, it may sound complicated and perhaps a little ominous.

However, while it is likely complicated, recent trends in going public can enhance the value for both the new public shareholders and the legacy business owners alike.

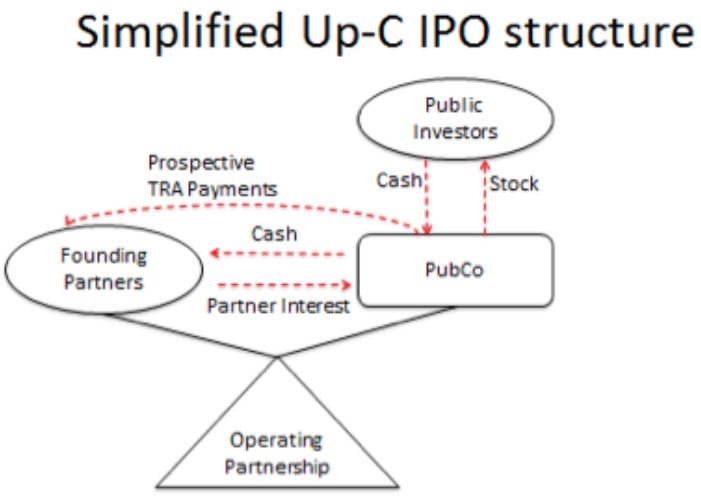
Up-C structure

The Up-C structure derives its name from the UpREIT transaction that became popular in the late 90's. With limited exceptions, a business desiring to become a public company must be taxed as C corporation (C Corp). As a result, many businesses that have historically been taxed as a partnership convert to a C Corp prior to executing the initial public offering (IPO). This conversion can be accomplished in a variety of tax free transactions. However, the very nature of a tax free transaction causes the C Corp to have carryover tax basis in the business assets. Therefore, conversion from partnership to C Corp causes the built-in gain of the assets of the business to go from a single level

of taxation to a double level of taxation (taxed at C Corp level and upon distribution at the shareholder level).

In the Up-C transaction, a new C Corp is formed as the vehicle to raise capital from the public market. The C Corp uses the IPO funds to purchase a portion or all of the legacy partners' interests in the partnership. Provided that the partnership has made the IRC Sec. 754 election, the C Corp will receive a step-up in tax basis of the partnership assets pursuant to IRC Sec. 743(b). Often the most significant asset that is stepped-up is the business goodwill. For tax purposes, goodwill is an IRC Sec. 197 asset that is amortized over a 15-year period. Therefore, if the goodwill step-up is $150 million, the C Corp will be able to shield $10 million of income from taxation each year for the next 15 years.

While this tax shield will provide for additional cash flow from earnings, the public markets have traditionally not given credit for this attribute in valuing the stock price. In part, this may be caused by traditionally valuing businesses based on pretax income. Additionally, shareholders have not typically identified the value of the reduction in earnings and profits caused by the tax amortization of the stepped up assets. Based on the above example, if the C Corp generated $10 million of income that was 100% offset by the amortization, the C Corp's earnings and profits would be zero. Therefore, if the C Corp distributed out to its shareholders the $10 million cash generated by the operations, it would be a return of capital rather than a dividend subject to tax at the shareholder level. Effectively, the Up-C structure causes the built-in gains of the business to only be subject to one level of taxation, in contrast to when the partnership merely converts to C Corp as discussed above.



TRA - Tax Receivable Agreement

The tax receivable agreement (TRA) is a contract between the legacy partners who sold their partnership interests and the new public C Corp that acquired the interest to share the value of the tax benefits that arose from the step-up on the sale of the partnership interests. Typically, the legacy partners will receive 85% of the tax savings from the step-up and the C Corp will retain 15% of the value. A TRA liability is recorded by the C Corp for the 85% of tax savings that are payable to the legacy partners.

Interestingly, as the public shareholders typically don't account for the value of the tax shield from the step-up, they similarly appear to disregard the TRA liability when valuing the stock of the C Corp.

Step-up on Steroids

As mentioned, the C Corp records a TRA liability for the future payments required pursuant to the TRA. This liability is payable to the legacy partners as the C Corp receives the benefits from the actual tax savings from the step-up. As a result, the C Corp performs a with and without step-up calculation of its income tax return to determine the TRA liability currently payable to the legacy partners. As the TRA is a component of the original purchase of the legacy partners' partnership interest, this payment constitutes additional purchase price of the partnership interest. When this payment is made an additional step-up occurs. Effectively, there is a step-up on the step-up payments. The additional step-up is amortized over the remaining number of years from the original purchase transaction. For example, if a TRA payment related to goodwill is made one year after the original transaction, then the period of amortization for the additional step-up is 14 years.

Complications

There are numerous disclosure requirements needed in the S-1 filed prior to an IPO. Pro Forma statements are needed to identify the impact of the transaction as if this structure had been in place from the beginning of the period being presented in the S-1. An estimate of the maximum TRA liability, maximum and minimum annual TRA payments, and the present value payment of any termination of the TRA is required to be disclosed. The TRA typically provides for a termination payment to the legacy partners if there is a change in control of the C Corp that requires an estimate of all the future TRA payments at present value for the period reported in the S-1.

Traditionally, the legacy partners receive super voting shares in the new public C Corp and, therefore, retain control of both the legacy business and the C Corp. As a result, the transaction for accounting purposes is not recorded using the purchase accounting rules and no step-up occurs for book purposes. This inherent difference between the book asset basis and the tax asset basis creates a significantly deferred tax asset. An evaluation of the future income is required to determine if there will be sufficient income to utilize this deferred tax asset. This analysis may determine that a valuation allowance is required against the deferred tax asset.

While the most significant asset that is stepped-up is often goodwill, a valuation of all of the business assets is necessary to determine the step-up on an asset-by-asset basis. If other assets are stepped-up, it is necessary to evaluate when this additional basis would be realized for tax purposes.

The above discussion was predicated on a single sale of the legacy partners' interests. However, the C Corp could have multiple rounds of funding and purchases of partnership interests. Additionally, many transactions allow for future exchanges of the legacy partners' interests for stock of the C Corp. Each of these subsequent sales or exchanges would result in new tranches of step-ups that have to be layered into the calculation to determine which tranch's step-up is producing the tax savings and therefore entitled to the TRA payment.

Conclusion

Despite the complexity and onerous reporting requirements, the value generated for both the legacy partners and public shareholders can be so significant that more and more businesses are pursuing this IPO strategy. However, to take full advantage of these benefits it is critical that the S-1 process, the post IPO TRA accounting, and early termination calculations take these additional complications into account.

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Tax and Financial Planning Considerations With Master Limited Partnerships

Publicly traded master limited partnerships (MLPs) have long been an option for investors seeking ways to enhance yield while minimizing their tax burden.

However, due to recent and significant fluctuation of oil and gas prices, there is greater risk associated with MLPs then there has been in the past. Along with this volatility of their MLP holdings, some MLP investors may now also be in for an unpleasant tax bill as well.

Master Limited Partnership Overview

A publicly traded oil & gas MLP is an asset that meets specific standards with regards to the source of its income and certain distribution requirements. Since an MLP is a partnership for tax purposes, an investor is considered a partner and receives partnership units rather than stock. This structure permits the MLPs to avoid taxation as tax

attributes flow directly to each partner (investor). Other forms of publicly traded securities are typically structured as corporations, which carry with them the burden of double-taxation.

MLPs can be attractive to investors since they often provide high distributions on a frequent basis. MLPs are appealing from a tax standpoint because these distributions are typically a return of capital and avoid taxation. However, this return of capital also has the effect of reducing the investor's basis, which plays a critical factor in determining gain or loss upon ultimate disposition of the investment. One of the reasons MLPs offer distributions without immediate tax consequence is because positive cash flow from operations, which would otherwise be taxable income, is often offset by depreciation and drilling deductions. Additionally, the MLP could sell the drilling well or pipeline, potentially resulting in long-term gain. As a result, investors enjoy initial tax-free return of capital rather than recognizing ordinary income while later recognizing gains at the more favorable capital-gain tax rate.

Current Issues

From both a tax and financial perspective the MLP appeal is evident when oil & gas prices have risen. However, due to uncertainty in the energy sector, some MLPs may now pose troubling tax consequences that investors may not have anticipated. Many energy sector MLPs have structures that contain significant debt in order for them to meet their capital needs. This structure supports high output and cash distributions to remain competitive within the industry. With recent declines in oil prices through 2015 and into early 2016, some MLPs have had trouble paying off maturing debt or interest payments. As a result, some MLPs have refinanced this debt or have sold underlying assets to make payments.

Debt refinancing by the MLP that results in debt forgiveness creates cancellation of debt income. Additionally, any sales of business assets may be considered section 1231 assets and yield either current capital gains or potentially suspended ordinary losses. As MLP investors are partners in these investments, unfavorable tax attributes, like ordinary income or gain, flow through regardless of whether any actual distributions occurred. The very benefit of MLPs being structured as partnerships may now leave some investors with an unexpected tax bill. Mutual fund investors experienced a similar situation fifteen years ago when the dot-com bubble burst and the funds sold off assets. Subsequent distributions of capital gains from these sales created a tax burden for investors - even though their holdings decreased in value.

Future Issues

Given the current market issues with MLPs, investors may feel compelled to sell off their interests. However, this option should be considered carefully before pursuing. Remember all of the depreciation and drilling deductions that offset the MLP's income thus allowing tax-free distributions? IRS requires that these benefits be recaptured as ordinary income upon sale of MLP units. In a simplistic example, if an MLP holder bought units at $10 and received $2 of distributions as return of capital because of depreciation deductions, basis is lowered to $8. If the MLP is sold at $5, only $3 would be capital loss ($8-$5) and $2 of depreciation could be recaptured as ordinary income. Far from an ideal scenario is to take a loss and still have ordinary income tax to pay on the transaction. This example is a stark reminder that MLPs should be viewed as a tax deferral investment, rather than avoiding ordinary income altogether.

All hope is not lost however. If an MLP had generated passive tax losses over time, it is likely that those losses have been suspended. Upon the entire disposition of the MLP interest, these ordinary losses can be released for tax purposes to offset other income, including any ordinary income recapture. It is important that these tax ramifications be considered along with the financial implications when looking to dispose of MPL interests.

The once clear benefits of being a partner in an MLP may now prove to be detriments for many investors come tax time. Solvent MLPs that rely less on debt in their capital structure are less likely to produce debt forgiveness income or unanticipated capital gains passing to partners, while less financially secure MLPs can produce these negative tax consequences. As a result, navigating the intertwined tax and investment considerations of MLPs for an individual investor can be a complicated endeavor and a proper analysis of an investor's MLP holdings may be worthwhile.

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Getting Ahead of the New Documentation Requirements of Proposed Sec. 385 Regulations

On April 4, 2016, the U.S. Treasury Department proposed new regulations aimed at stopping corporate inversions and eliminating the earnings stripping transactions that typically occur following an inversion.

The primary targets in these regulations were large profitable U.S. corporations that were undergoing inversion transactions in order to move their corporate addresses offshore to a lower tax rate jurisdiction and, as a result, lower their tax bill. The impact of the regulations was felt almost instantly as on April 6, 2016, only two days after their release, Pfizer and Allergan called off a $160B inversion transaction, which would have been the largest such transaction ever.

While media attention has focused on the inversion aspects of the regulations, the proposed regulations issued under Sec. 385 of the Internal Revenue Code have much broader reaching consequences than simply deterring

future inversion transactions. As currently written, the proposed Sec. 385 regulations could be applicable to any group structure with related party debt, including domestic groups. Groups subject to the proposed regulations may find the results unpalatable.

Depending on the relationship and the aggregate amount of debt outstanding between related-party members, the proposed Sec. 385 regulations require that taxpayers maintain certain contemporaneous documentation, and empowers the IRS with the ability to either completely recharacterize a debt instrument to equity or bifurcate the debt instrument and treat a portion as debt and a portion as equity.

The proposed documentation requirements are the direct result of the changing environment in which related-party debt is used by corporations and other group structures. U.S. Treasury Department acknowledged in the preamble of the proposed regulations that the size, activities, and financial complexity of corporations and their group structures have grown exponentially over time. The proposed regulations look to fill a gap in guidance by prescribing the information and documentation necessary to support the characterization of a purported debt instrument as indebtedness in the related-party context.

Required Documentation:

U.S. Treasury Department identified four key characteristics that must be in place in order for related-party debt instruments to be respected as debt for federal tax purposes. These characteristics are:

- A legally binding obligation to pay (documentation must be prepared within 30 days from date of issuance of qualified debt instrument);
- Creditor's rights to enforce the obligation (documentation must be prepared within 30 days from date of issuance of qualified debt instrument);
- A reasonable expectation of repayment at the time the interest is created (documentation must be prepared within 30 days from date of issuance of qualified debt instrument); and
- An ongoing relationship during the life of the interest consistent with arms-length relationships between unrelated debtors and creditors (documentation must be prepared within 120 days from date of payment of interest/principal or 120 days from an event of default).

Groups Subject to Documentation Requirements:

- If the stock of any member of the expanded group is publicly traded; or
- Total assets of the expanded group exceed $100 million on any applicable financial statement; or
- Annual total revenue of the expanded group exceeds $50 million on any applicable financial statement.

Effective Date:

The new documentation requirements are generally applicable to debt instruments issued between members of an expanded group on or after the date the regulations are finalized. Signaling its intent to move swiftly, the U.S. Treasury Department set a July 7, 2016 deadline for comments and offered Labor Day 2016 as a potential date for finalization.

Opportunity:

Importantly, the proposed Sec. 385 regulations clearly state that: (i) related-party debt obligations may be treated partially as equity and partially as debt; and (ii) that any recharacterizations of debt will be made on the basis of

timely prepared documentation. Accordingly, these proposed regulations indicate that Treasury will perform an analysis of the borrower's financial status and on that basis determine the extent of debt it respects, which in turn depends on the extent of reasonably likely debt repayments.

In anticipation of this review process, taxpayers should consider undertaking a creditworthiness analysis of all related-party debt obligations, not just those debt obligations currently covered by the proposed regulations, and document their findings. This level of analysis and contemporaneous documentation will benefit taxpayers by:

1. Creating uniform internal controls and processes for analyzing, reporting and documenting related-party debt obligations;
2. Maintaining documentation for non-covered related-party debt obligations that become covered by the proposed regulations in the future (e.g. taxpayer goes public or there is an increase in taxpayer revenue);
3. Establishing detailed support for any positions challenged under IRS examination; and
4. Providing timely support for any due diligence proceedings as part of future acquisition or sales transactions.

Such an analysis should assess the solvency of the borrower and determine the extent to which its debt obligation is reasonably likely to be repaid. For example, projections should be made of the borrower's future free cash flows over the term of the debt period. Then, because it is customary for lenders to divide total outstanding debt by the future free cash flows, the resulting ratio may be compared against industry practices to gauge the reasonableness of the borrower's debt obligation. Other types of financial analyses may be performed as well, but the point here is simply that by proactively preparing a solvency analysis taxpayers will not only help meet their new documentation requirement under proposed Sec. 385 regulations, but they may also be able to pre-empt significant IRS challenges to their position given that such challenges will be based on the documentation provided by the taxpayer.

In Summary

Although the proposed regulations do not change pre-existing requirements for establishing a true debtor-creditor relationship, they do require documentation that must be prepared timely with respect to the introduction of the debt instrument and made available upon IRS request. Many taxpayers may find that this level of detail in documenting related-party debt troubling. However, by proactively assessing and documenting the reasonableness of related-party debt instruments, taxpayers may be able to safeguard such positions against the new level of scrutiny and mitigate the risks of a potential tax adjustment. Regardless, the new documentation requirements under proposed Sec. 385 regulations leave no doubt that proactive analysis, documentation (and possibly, adjustments) must be made.

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