

Private equity continuation fund transaction considerations

Hold and roll, or sell
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Recent history has seen a significant increase in the number of continuation fund transactions in the private equity marketplace. In a continuation fund transaction, a new investor or group of investors acquires an interest in an existing fund asset or assets (referred to herein as the “target” asset or assets) through an entity controlled by the existing fund sponsor. Generally, in connection with a continuation fund transaction, existing investors are given the choice of either monetizing their economic interests in the target asset or “rolling” those interests over into the new fund entity. Often utilized where the existing private equity fund is approaching the end of its economic life, a continuation fund transaction allows the fund sponsor to offer

existing investors liquidity while permitting the fund sponsor (and certain limited partners) to retain an economic stake in an asset that the fund sponsor believes to have significant future upside. While not new, continuation funds have proven to be particularly popular during the COVID-19 pandemic, where some investors have experienced a need for liquidity. Moreover, certain fund sponsors have started to build the flexibility to utilize continuation funds into their fund formation documents, including their partnership agreements and offering memoranda.



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Bespoke investments may present unique tax considerations

Due in part to a lack of uniformity in private equity funds, there is no “one size fits all” approach to a continuation fund transaction. However, certain generally applicable observations can be made. First, the new investor or investor group typically will want to invest through a new entity rather than the existing fund entity. This is primarily in order to avoid inheriting potential liabilities for which the existing fund entity may be on the hook and to simplify mechanics of the various agreements.* Second, market demand has shown, the new investor group also generally wants the continuation fund transaction to be effected in a manner such that the new fund entity is not treated as a continuation of the existing fund entity for federal income tax purposes under the partnership continuation rules of I.R.C. Section 708.¹ This is so that the new investor group can invest in a new entity from a U.S. federal income tax perspective, including with respect to potential liabilities under the partnership audit rules.² Third, where existing investors are given the choice of monetizing or “rolling” their interests in the target asset, the tax advisors representing the fund and existing investors should carefully consider the manner in

which the continuation fund transaction is effectuated. Care is often needed so that, to the extent possible, taxable income attributable to those partners exiting the portfolio investment and receiving cash is appropriately borne by such partners, as opposed to the partners who elect to “roll” and continue to hold the investment via the continuation fund.³

Partnership continuation fund transactions frequently are quite complex and involve a lengthy series of steps. Often, the target asset or assets need to be separated from other existing fund assets. Similarly, partnership continuation fund transactions also frequently involve taking assets that historically have been owned by different entities and combining them together for the new investor group. These types of transactions may implicate a number of complex tax rules applicable to partnerships, including the so-called anti-mixing bowl rule, disguised sale rules, rules relating to partnership mergers and divisions, Section 754 elections, investment partnership rules,⁴ and marketable securities rules.⁵ In addition, where all or part of an investment asset is distributed out from a fund as part of a continuation fund transaction, part of the tax basis in the asset attributable

¹ Phillip Gall, Nothing from Something: Partnership Continuations under Code Sec. 708(a), 95 Taxes 167 (March, 2017), page 187. Available at: <https://heinonline.org/HOL/LandingPage?handle=hein.journals/taxtm95&div=36&id=&page=>.

² Section 708(b)(1); see also Section 6241 and Treas. Reg. § 301.6241-3. Where the new entity is treated as a continuation of the old entity under Section 708(a), the partnership may elect to make a “push-out election” under Section 6226, subject to satisfying certain requirements, which would make the historic partners (rather than the partnership) liable for their share of historic tax, penalties, etc.

³ For example, consider the so-called partnership “merger buy-out” rule. Treas. Reg. § 1.708-1(c)(4).

⁴ Section 721(b).

⁵ Section 731(c).

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to past capital contributions by the existing investors may be apportioned to the share of the property that is distributed to the general partner with respect to its carried interest. This can have anomalous results on the amount of gain recognized by the partners if interests in the property (or in a successor property) are subsequently disposed of in a taxable transaction. Because of the multitude of different issues raised, continuation fund transactions will need to be carefully reviewed or analyzed from a tax perspective for the investors and the general partner.

Another important consideration is the holding period of fund assets and fund partnership interests. Existing equity holders who roll their interests – which will generally include the fund sponsor – typically do not want to restart the holding period they have in their partnership interests or the holding period of the target asset itself. Achieving a “tacked” holding period is of particular importance to fund sponsors, who are generally subject to the special “greater than three year” holding period under Section 1061 in order to qualify for long-term capital gains treatment.

The presence of foreign investors also raises certain issues. For example, any actual or deemed sales of partnership interests by foreign partners may create a withholding obligation for the buyer or the partnership itself under I.R.C. Section 1446(f).

The presence of corporations in the fund’s ownership may add additional complications. Where corporate stock is transferred to a related party either for cash or subject to a liability, Section 304 may be implicated. Determining whether parties are related for this purpose, particularly when partnerships own corporate stock, is complex. Thus, understanding the ownership of the partnerships involved is critical. Often times, however, investors don’t want the partnerships to disclose this information, adding even more complexity to the analysis. And if foreign investors own their interests through corporate entities, tax advisers may need to consider whether a withholding tax could be due if Section 304 applies. Likewise, if there are foreign corporations involved, funds need to consider international tax implications, such as Section 367, local country indirect transfer rules, and the US passive foreign investment company rules.

How Ernst & Young LLP can help

Careful analysis is needed so that tax gain is allocated to the exiting partners (but not the roll partners) and holding periods are tacked to manage recharacterization of long-term capital gain into short-term capital gain on exit. Our Passthrough Transactions Group, International Tax and Transaction Services and Private Equity Tax teams can advise you with respect to your continuation fund transaction prior to your successful launch and through exit, including helping you satisfy ongoing tax compliance and information reporting requirements.



Not your typical PE fund compliance

After the continuation fund transaction, tax compliance for the new fund entity is likely to be significantly more complex than tax compliance was for the historic fund entity prior to the continuation fund transaction. Continuation fund transactions often involve actual or deemed contributions of property, which may give rise to built-in gain or loss layers that will need to be tracked going forward under Section 704(c). In addition, the economics of the new fund entity may be complex in that the

fund sponsor may strike different economic deals with the new investor group vs. rolling investors from the old fund entity, including with respect to the calculation of the fund sponsor's carried interest. Where carried interest or other aspects of the economic deal between sponsor and investors are determined differently for different investor groups, that can significantly complicate tax allocations at the fund level.

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