

Secondary Transactions: What do GPs Need to Know About Tax?



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Agenda

- **Withholding on ECI under Section 1446(f)**
- **Withholding under FIRPTA**
- **Impacts of Section 754 Elections**
- **Publicly Traded Partnership Concerns**



What is a Secondary?

- **Sale of an existing interest in a fund to a new LP.**
 - The fund remains the same, no transfer to a continuation fund.
- **Can be GP-led or investor-led.**
- **Provides liquidity to investor when the fund is not otherwise at the end of its lifecycle.**



**Have you participated in a secondary
(either on the GP, LP or advisor side)?**

- A. Yes
- B. No
- C. We expect to

Background on Taxation of Non-US Partner's Sale of a Partnership Interest

- **General Rule:** Foreign partners generally are not subject to tax in the US on capital gains.
- **Two Exceptions to the General Rule**
 1. Sales of partnership interests if a sale of the underlying assets would give rise to ECI.
 2. Sales of US real property interests are taxable under FIRPTA.
- **Enforced via withholding.**

Withholding on ECI under Section 1446(f)

Background on Section 1446(f)

- **Tax is imposed to the extent a sale of the underlying assets would give rise to ECI.**
- **Enforced via withholding of 10% of the amount realized unless an exception applies.**
 - Amount realized includes cash paid, debt assumed and reduction in partner's share of liabilities.
- **It's all about the certificates.**



Transferee Notice to Partnership

**Within 10 days of
transfer**

**Include 8288-A
or state amount
realized and withheld**

**Include any
certificates supporting
exemptions/amounts
withheld**

Foreign Transferor Notice to Partnership

**Within 30 days of
transfer**

**Names, addresses
TINs of transferor and
transferees**

Partnership Notice to Transferring Partner

**No later than date
(including extensions)
for K-1s
Must be included on K-1**

**Deemed sale
effectively connected
items (including items
from lower-tier
partnerships)**

**Obligations arise if
transferor provides the
notice described in
prior slide or if
partnership has actual
knowledge**

Partnership Withholding

Applicable to **transfers** after December 31, 2022

From distributions to transferee

100% until satisfied

Rely on certificate from transferee

Unless know or reason to know incorrect/unreliable

May rely on W-9 on hand

Facts on certificate differ from W-9 – deemed unreliable

IRS may notify partnership to withhold

Amount of Withholding

100% until collect 10% amount realized

Amount realized solely under general rule

Cannot rely on the maximum liability

Must also collect interest amount

Withholding ends on the earlier of:

Collect all required amounts

Receive the certification from transferee claiming exemption from withholding

Failure to Withhold

Transferee/partnership liable

- Tax
- Penalties
- Interest

General Rules for All Certifications

Name and address of provider

TIN of transferor if transferor has or is required to have

- No reliance if missing

Signed under penalties of perjury

- Certification applies to all documents
- e.g., withholding certificates and withholding statements

Provided within 30 days

- Exception for certification by transferee to partnership

Electronic submission permissible

- Email, image in email, PDF all ok (unless recipient knows transmitted by someone w/o authorization)

Determination Date

- **Information on certification must be as of the "determination date"**
- **Same date must be used for all purposes w/ respect to transfer**
- **Must state the determination date on the certificate**

What is the Determination Date? 3 Possibilities.

Date of transfer

Any date w/i 60 days
before transfer

Later of: (i) 1st day of
LP tax year of transfer
or (ii) most recent
reevaluation date

Controlling partner
cannot use

Certificate of Non-Foreign Status

- **No withholding**
- **Transferor provides**
- **Must include name, TIN, address**
- **Signed under penalties of perjury**
- **W-9 sufficient**
 - Rely on existing W-9 in possession

No Realized Gain

- **No withholding**
- **Transferor provides to transferee**
 - **Transferee partnership relies on books and records**
- **Must be no gain at all – tax deferred transfers separate**
- **No 751 – May rely on partnership certificate**
- **See general rules for additional contents**

De Minimis ECI Gain

- **No withholding**
- **Partnership provides to transferee**
- **3 alternatives:**
 - (i) Partnership not ETB any time during year of sale
 - (ii) On hypothetical sale of partnership *assets*
 - no gain would be ECI or less than 10% *net* gain would be ECI or
 - no (or less than 10%) distributive share of net ECI gain
- **Partnership transferee**
- **No certificate: Partnership relies on books and records:**
 - (i) for year through date of transfer.
 - (ii) as of determination date.

De Minimis ECI

- **No withholding**
- **Transferor provides to transferee**
- **Partner throughout lookback period**
 - Transferor's prior taxable year and 2 preceding that year
- **De Minimis rule**
 - Less than \$1m ECI for each year of lookback; AND
 - Less than 10% of distributive gross income was ECI in each lookback year
- **ECI reported and tax paid**

Non-Recognition Transfer Certificate

- **Certificate that transferor will not recognize gain**
 - Distinguish from no realized gain.
 - This result of non-recognition (e.g., 351)
- **Not available if only portion of gain not recognized (e.g., boot)**

Treaty Certificate

- **Claim for exemption under treaty made on W-8 BEN or BEN-E**
- **Must be mailed to IRS within 30 days after transfer**
- **Cover letter requires transferor TIN**
- Generally, a TIN is required to claim treaty benefits

Maximum Tax Liability Certificate

- **Transferor provides to transferee**
- **Withhold ECI Gain x regular 1446 withholding rate**
- **May require GP input as to amount of ECI Gain and Character (OI v. CG)**
- **No application to the IRS**

Transferor Certificate of Liabilities

Transferor certificate of liabilities on most recent K-1

Controlling partner can't use

Certify no actual knowledge of events causing more than 25% difference

K-1 for last day of tax year less than 22 months before transfer

Partnership Certificate of Liabilities

Partnership certificate
of liabilities on
determination date

Controlling partner

Certify no actual
knowledge of events
causing more than 25%
difference

Absent transferor or
partnership certificate
and absent actual
knowledge, must
withhold

100%

BUT

- The **partnership** remains liable for amounts under-withheld if the **partnership** knows/reason to know certification incorrect or unreliable

ECI GP Concerns

- **Ensuring sufficient withholding by transferee to avoid secondary withholding.**
- **Determining whether the fund will provide any certifications or input.**





If you're a general partner or advising a GP, are you assisting in providing 1446 certificates?

- A. Yes, we provide any certificate the fund is able to provide.
- B. Yes, we provide assistance with information for the transferor to make a certification.
- C. No, we do not provide assistance.
- D. N/A

Withholding under FIRPTA

FIRPTA Generally

- **Gain recognized by a foreign person on the disposition of a US real property interest (“USRPI”) is taxed as ECI.**
- **Withholding rate is 15% of the gross amount realized.**
 - Amount realized includes cash, the FMV of property transferred, and the amount of any liability assumed by the transferee or to which the property is subject.



FIRPTA Certificates

- **-11T Certificate**
 - **Partnership** provides a certificate that:
 1. 50% or more of the value of the partnership's gross assets does not consist of USRPIs; or
 2. 90% or more of the value of the partnership's gross assets does not consist of USRPIs plus cash or cash equivalents.
 - GPs typically do not offer this certificate.
- **Non-Recognition**
 - Available if eligible for a non-recognition provision (*e.g.*, 351).
 - Not available if only portion of gain not recognized (*e.g.*, boot)



FIRPTA Certificates

- **IRS Certificate of Max Tax Liability**
 - Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of USRPIs*
 - Generally takes about 90 days for IRS to respond
- Compare to max tax liability certificate under 1446
- **Certificate of Non-Foreign Status**
 - Available for qualified foreign pension funds (“QFPFs”).



FIRPTA GP Concerns

- **No secondary withholding liability for the fund.**
- **Most funds do not offer a certificate regarding the fund's classification as a USRPI.**
- **Funds may provide a representation regarding whether they own USRPIs.**



Impacts of Section 754 Election

754 Election Generally

- **An election which allows the fund to “step-up” (or “step down”) the basis of the assets in the fund on the sale of an interest.**
- **Mandatory basis adjustment if there is a substantial built-in loss.**
 - There is a substantial built in loss if:
 1. The partnerships adjusted basis in the partnership property exceeds the FMV of the property by more than \$250k, or
 2. The transferee partner would be allocated a loss of more than \$250k if the partnership assets were sold for cash equal to their FMV immediately after the transfer.



Electing Investment Partnership (EIP)

- **If a partnership elects to be an EIP, then it is not treated as having a substantial built-in loss (i.e., no basis step down on a transfer).**
- **Instead, the transferee partner's distributive share of losses are disallowed except to the extent the loss exceeds the loss recognized by the transferor on the transfer of the partnership interest.**
 - Buyer → recognizes no losses from fund until the losses exceed the loss recognized by the transferor
- **Seller must provide the EIP and the buyer with a statement within 30 days of the transfer that allows the buyer to calculate the disallowed losses.**
 - If the statement is not provided, all losses are disallowed unless the fund provides the information necessary to properly determine disallowed losses.



Secondary Considerations

- Whether the fund makes a 754 election or is an EIP.
- Who pays expenses associated with a 754 election.



Publicly Traded Partnership Analysis



How do you get comfortable that a secondary sale will not cause your partnership to become a publicly traded partnership?

- A. We only permit transfers within the 2% safe harbor.
- B. We rely on the private placement safe harbor.
- C. As a private fund, we are not overly concerned.
- D. Not sure what you mean.

PTPs Treated as Corporations

- **Domestic PTP taxed as a corporation**

- Entity-level taxation – 21%
- Distributions (supported by earnings) subject to 30% (or lower treaty rate) withholding

- **Foreign PTP**

- ECI and US source FDAP (e.g., interest/dividends) taxed at PTP level
- 30% branch profits tax on ECI
- Turns off 892 benefits otherwise available to sovereign wealth funds
- Turns off 897(I) FIRPTA exemption for QFPFs
- Possible violation of LPA/side letter covenants

What is a PTP?

- **Interests traded on an established securities market**

- Includes interdealer quotation system that regularly disseminates firm buy or sell quotations

- **Interests readily tradable on a secondary market or substantial equivalent**

- Taking into account facts and circumstances, partners are readily able to buy, sell or exchange partnership interest in a manner that is comparable economically to trading on an established securities market

- **Primary safe harbors:**

- Block transfers (transferor and related parties transfer more than 2% capital/profits w/i 30 days)

- Private placement (all transfers exempt under '33 Act (other than reg S) and no more than 100 partners)

- No more than 2% capital/profits transferred w/i year

- Carry over basis transfers



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- Steve guides clients in transactional matters involving complex domestic and international tax issues with particular experience in the private equity space.
- Steve handles a broad range of transactions, including asset, stock, cross-border, and domestic acquisitions, recapitalizations and reorganizations. A significant portion of his practice focuses on structuring domestic and international private equity transactions. Steve also is regularly involved in the formation of global private equity funds.
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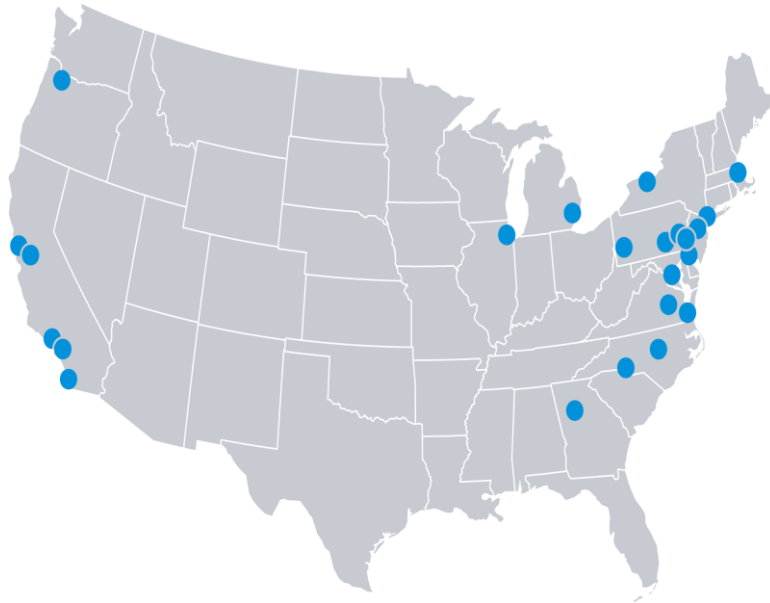


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- Morgan's practice focuses on federal and international income tax, specifically on the private equity arena and pass-throughs.
- Morgan advises clients on federal and international income tax and private equity matters. Her practice includes advising on mergers, acquisitions, reorganizations, dispositions, capital markets, and restructurings. She is also involved in the formation of private equity and hedge funds.
- Morgan is an adjunct tax professor at Temple University Beasley School of Law, Vice-Chair of the Partnership Committee of the Tax Section of the American Bar Association, and treasurer of the Philadelphia Tax Conference.



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