



**23RD ANNUAL  
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**Private Equity Alternative  
Liquidity: Secondary  
Transactions, GP-Led, etc.**

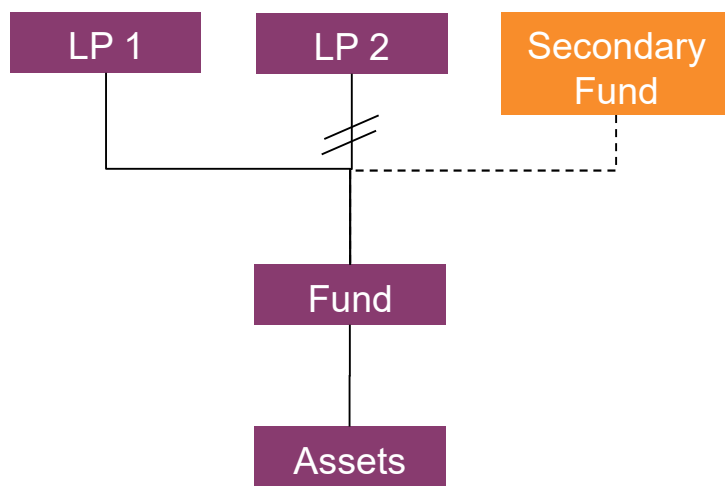


# The Panel

- **Co-Chairs**
- Mike Carew, Kirkland & Ellis LLP, Chicago, IL
- Thierry Lesage, Arendt & Medernach, Luxembourg
- **Speakers**
- Morgan L. Klinzing, Troutman Pepper, Philadelphia, PA
- Marcel Meier, Oberson Abels SA, Geneva
- Bodo Bender, White & Case LLP, Frankfurt am Main
- Ceinwen Rees, Macfarlanes LLP, London
- Jeroen Smits, Stibbe N.V., Amsterdam

# Private Equity Alternative Liquidity: Secondary Transactions, GP-Led, etc.

## LP secondary transaction



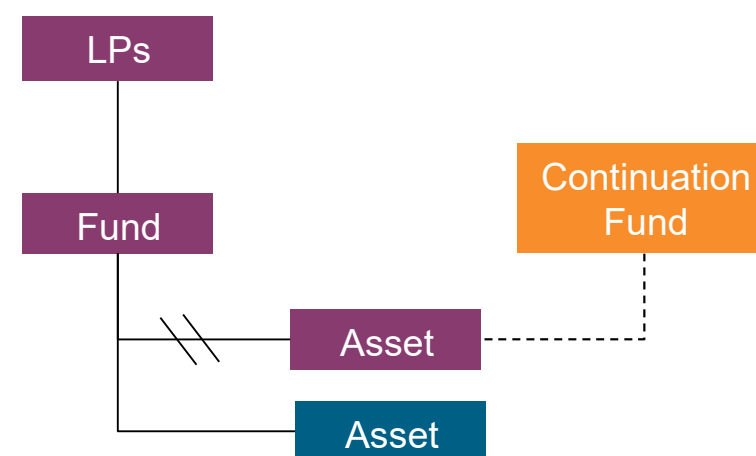
- Limited partner sells interests in funds to other investors
- Purchasing investors (replacement LPs) assume original investors' obligations

## Direct secondary transaction



- Investor sells directly-owned interests in private companies

## GP-led secondary transaction

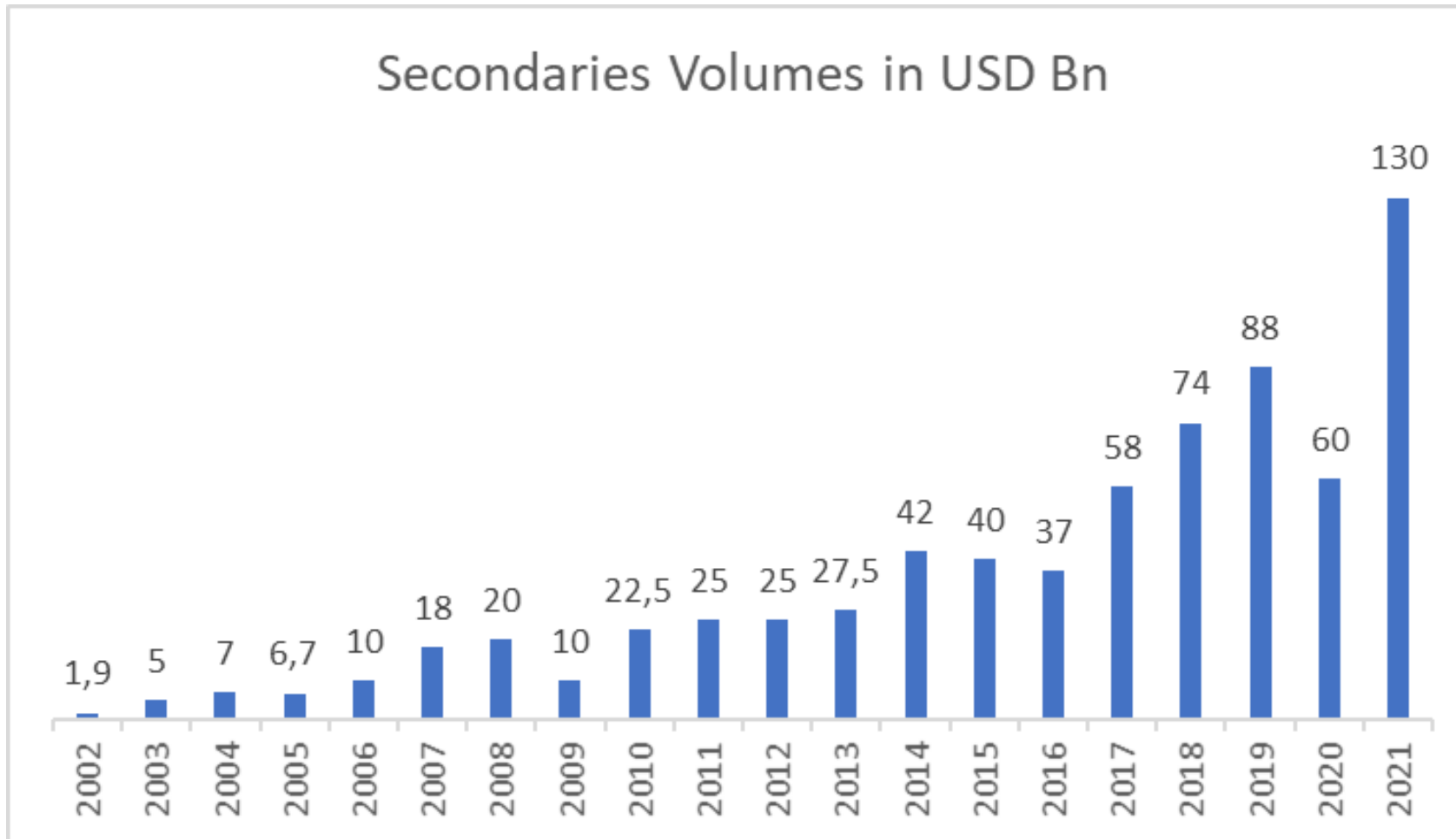


- Fund's GP sells an asset from a Fund it manages to a « Continuation Fund ».
- Continuation Fund managed by the same GP
- Pricing & terms negotiated by and among the lead secondary buyers and the Fund's GP on behalf of the existing Fund

# What is a Continuation Fund?

- A “continuation fund” (“**CF**”) is a newly formed vehicle to acquire an investment (or several investments) from an original fund
- PE funds may use CF strategy to:
  - Provide **liquidity** for Selling Partners
  - Allow **tax deferral** for Rolling Partners
  - **Crystallize** carry for GP
- **Major parties**
  - New Investors
  - Rolling Partners
  - Selling Partners
  - Reinvesting Partners

# Private Equity Alternative Liquidity: Secondary Transactions, GP-Led, etc.



Source: Jefferies as of January 2021

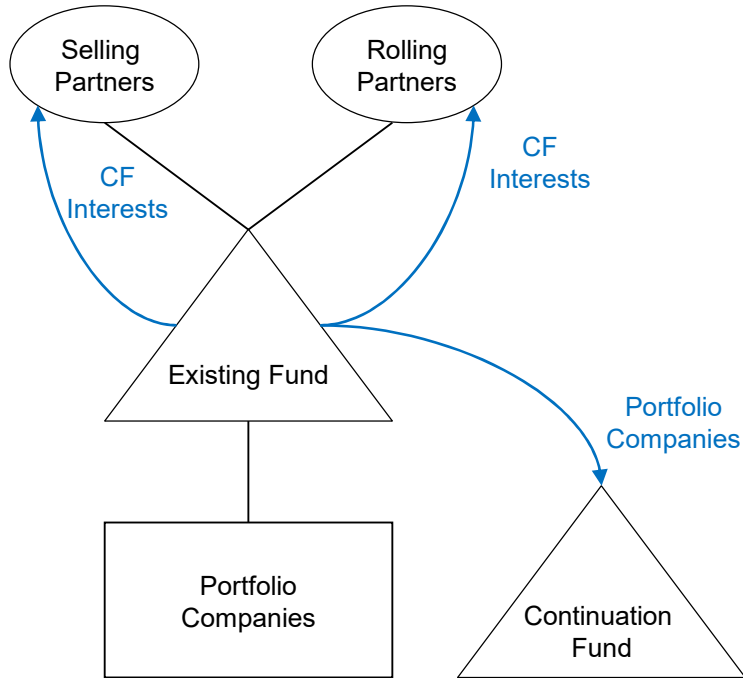
# Private Equity Alternative Liquidity: Secondary Transactions, GP-Led, etc.

## General considerations

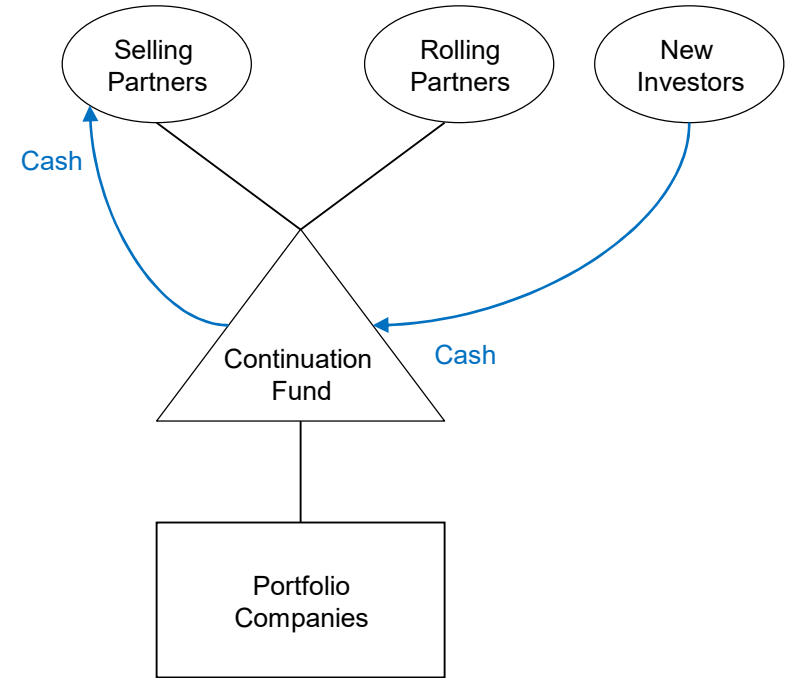
- Pricing and valuation – crucial role of advisors
- Liquidity in the secondary market is not guaranteed
- Carried interest not held to maturity– financing solutions
- Increased regulatory compliance required for financial institutions (in terms of capital amount allocated to each asset class) leading to new LPs entering the market (family offices, etc.)
- Conflicts of interest between GPs and LPs

# Continuation Fund Transaction Structure #1

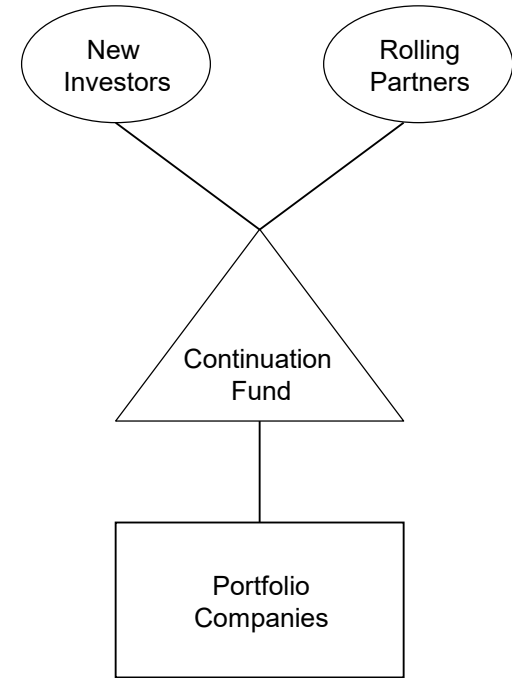
## Disguised Sale + Tax Deferred Rollover



- Existing Fund contributes assets to Continuation Fund and distributes CF interests to its partners
- Treatment of Existing Fund GP (and its members) to be assessed for each transaction



- New Investors contribute cash to CF and such cash is used to redeem Existing Fund partners that have elected to sell
- “Disguised sale” of CF interests by Selling Partners to New Investors for US tax purposes

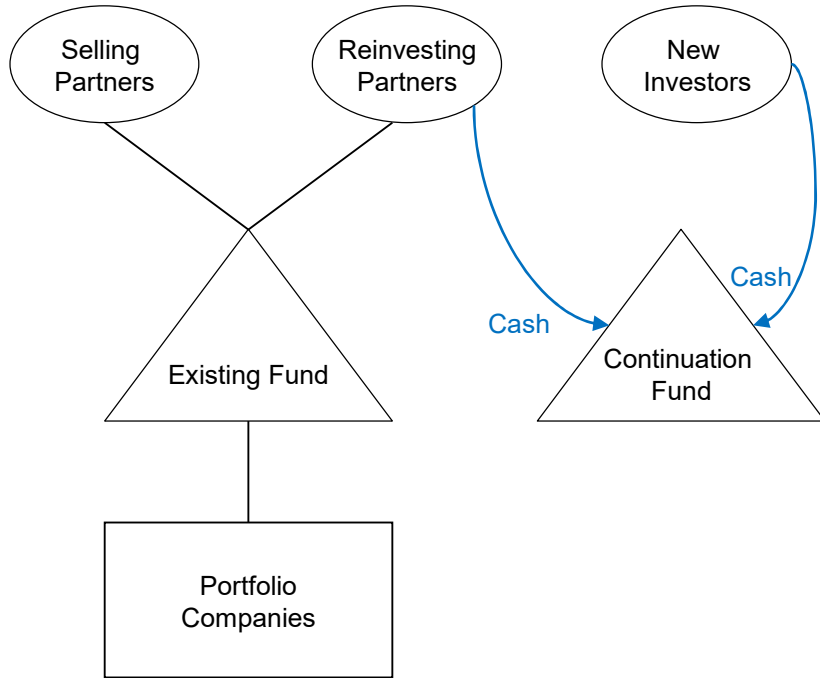


- Sellers (including Existing Fund GP if applicable) have been cashed out
- Existing Fund partners electing to “roll” retain their CF interests going forward and roll on a tax-deferred basis

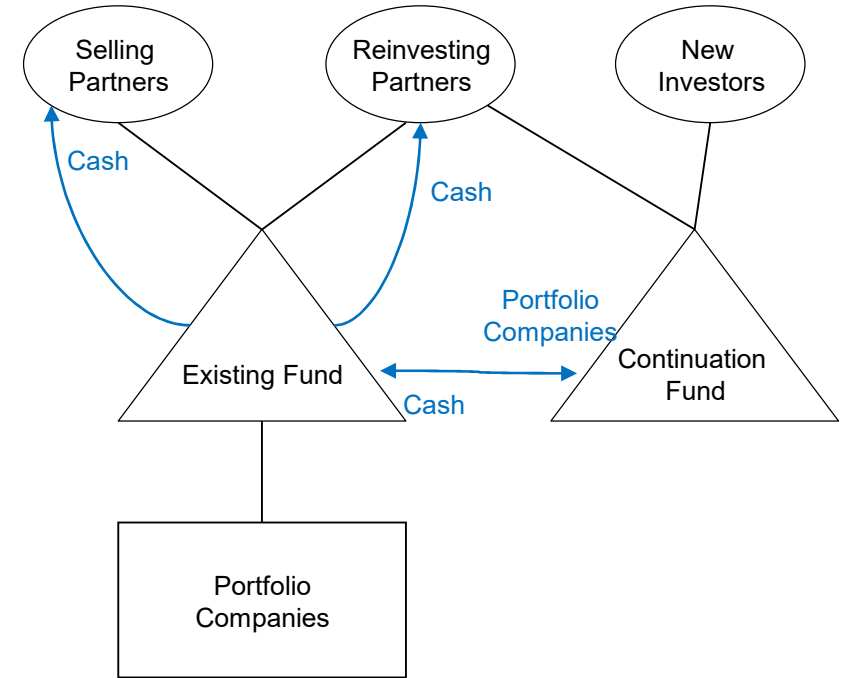


# Continuation Fund Transaction Structure #2

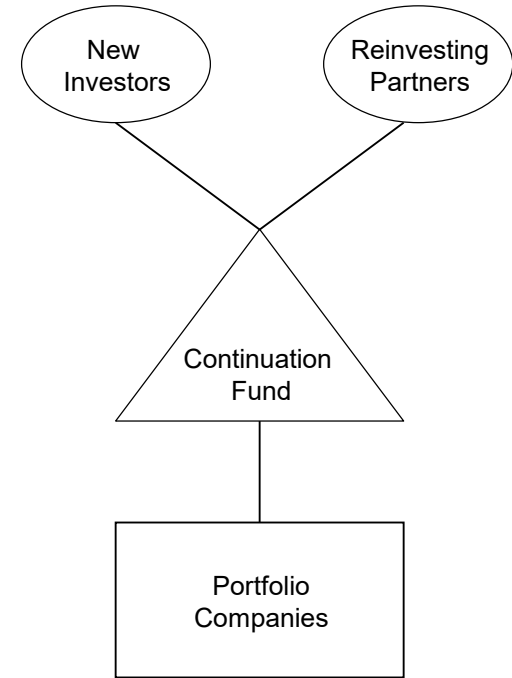
## Fully Taxable Sale with After-Tax Reinvestment



- New Investors and Existing Fund partners electing to “reinvest” contribute cash to the CF for CF Interests
- Treatment of Existing Fund GP (and its members) to be assessed for each transaction



- CF uses such cash to purchase included assets directly from Existing Fund
- Existing Fund distributes such cash to all of its partners
- Fully taxable sale for all Existing Fund partners for US tax purposes



- Sellers (including Existing Fund GP if applicable) have been cashed out
- Existing Fund partners electing to “reinvest” do so on an after-tax basis (i.e., no tax deferred rollover)



# US Tax Considerations

- Whether the Continuation Fund is a “continuation” of the Existing Fund under Code §708
- Structure #1 (tax deferred roll):
  - Treatment of transaction as partnership division
    - Which partnership is the continuation? Form of division—assets up vs. assets over
  - US tax deferral on contribution of assets to CF—application of Code §721(b)
    - Is Continuation Fund an “investment company” immediately after?
- Structure #2 (fully taxable sale):
  - Potential recast as a partnership division?
  - Round-tripping of Reinvesting Partner cash
  - Loss recognition—Code §267

# US Tax Considerations

- FIRPTA and Code §1446(f) (“ECI”) withholding
  - If CF holds ECI or FIRPTA assets, non-US Selling or Reinvesting Partners subject to US withholding on sale proceeds
  - Secondary withholding obligation for ECI withholding also imposed on the Continuation Fund effective Jan. 1, 2023 (if buyer fails to withhold)
  - Certificates can be used to eliminate withholding
    - US sellers can provide IRS Form W-9
    - Non-US sellers can provide no/de-minimis ECI certificates (depending on the facts)
    - Continuation Fund can provide non-FIRPTA / non-ECI certificates (depending on the facts)
  - Evaluate which certificates can be provided or if withholding will apply and include relevant language in transaction agreement

# US Tax Considerations

- Basis step-up
  - Code §754 election and ensuring elections are pushed down to relevant subsidiaries
  - CF often agrees to make a Code §754 election at the CF level and at controlled flow-through entities owned by the CF
- Pre-closing US tax audits
  - CF often agrees to make a Code §6226 “push-out” election for tax audits relating to pre-closing tax periods
  - Relevant if CF is a “continuation” or if it owns underlying flow-through subsidiaries (e.g., holding companies)

# US Tax Considerations

- Existing Fund GP's carried interest
  - Often “crystallized” and then can be sold for cash (alongside Selling LPs) or rolled into CF (alongside Rolling LPs)
  - Application of Code §1061
    - Requires 3-year holding period for long-term capital gain treatment
- Continuation Fund GP's new carried interest
  - Taken on profits above transaction value—\$0 liquidation value at grant
    - Code §83(b) elections for Continuation Fund GP members
  - In Structure #1, Continuation Fund typically “tacks” existing holding period in portfolio companies
    - If 3+ years, new carry can get long-term capital gain on future sale by CF

# UK Tax Considerations

- Asset level transaction – entity level tax
  - Consider non-resident CGT (if hold UK real estate)
  - Change in ownership, impact on group losses
  - Not really tax but...is MIP triggered
    - If yes, will tax-free rollover be available for management?
- Asset level transaction – “buyside” tax issues
  - Application of unallowable purpose rule for 3<sup>rd</sup> party/shareholder debt
    - Blackrock case casts doubt, CT context is more difficult, especially if rolling LP numbers are high

# UK Tax Considerations

- Asset level transaction – investor tax issues
  - If partnership to partnership
    - For capital assets can achieve tax free rollover (or not...)
    - For debt securities less clear, need to deal with accrued interest
- Fund level transaction
  - Usual secondaries tax issues apply, for UK worry about stamp duty (although easy to fix)
  - UK NRCGT may apply for real estate heavy structures

# UK Tax Considerations

- Tax issues for UK carry holders
  - Usual rules for distributions
  - What about rollover?
    - Asset level - difficult to achieve tax deferral
    - Fund level – may be able to rollover tax free
  - New carry
    - Is it in the UK's carried interest regime?
    - Income based carried interest – re-set clock on average holding period
    - Valuation issues
      - Does the “MoU” apply?
      - Single asset CF – likely high value for carry



# Swiss Tax Considerations

- Collective investment scheme
  - Private Equity Funds (closed-ended funds) usually established outside CH
  - Swiss limited partnership for collective investment
    - Introduction in 2007 but very limited success in practice (use in particular for Swiss real estate projects)
  - If EF and CF are US limited partnerships, they are fiscally transparent
  - Swiss resident portfolio companies
    - Fiscally transparent foreign partnerships are generally not entitled to claim benefits under DTCs concluded by Switzerland
    - Intergovernmental agreements with some states under which certain collective investment schemes can claim a full or partial refund of the Swiss federal withholding tax (35%) on behalf of investors

# Swiss Tax Considerations

- US resident limited partners
  - For the purposes of the Swiss/US DTC,
    - the expression "*a resident of a Contracting State*" includes: a partnership, estate or trust, to the extent that the income of the partnership, estate or trust is *taxed in this State as income of residents of this State*, either on the partnership, estate or trust itself or on the participants or beneficiaries (see art. 4 para. 1 letter d DTC)
    - Is this article applicable to a US private equity fund (collective investment scheme) in the form of a fiscally transparent US limited partnership ?
  - Based on articles 4 in conjunction with 10 para. 2 letter a or b Swiss/US DTC, US resident partners would generally be entitled to claim a Swiss federal withholding tax refund of 30% (corporate investors  $\geq 10\%$ ) or 20% (corporate investors  $< 10\%$ ; individuals) which results in a residual tax rate of 5% or 15%

# Swiss Tax Considerations

- Swiss portfolio companies
  - Use of foreign based or Swiss based acquisition companies to purchase Swiss portfolio companies
    - Issue of treaty shopping in international tax law (DTC or art. 26 VCLT); and
    - Anti-abuse rules under domestic tax law and practice of SFTA regarding international holding structures
  - Main analysis of SFTA
    - Improvement of federal withholding tax refund position ?
    - Lack of substance (B/S, holding function, qualified staff and premises) *at the time of the transaction* ?
    - Intention to save taxes ?

# Swiss Tax Considerations

## ■ Structure #1

- EF contributes assets to CF – extended international transposition ?
  - The SFTA assesses cases where the federal withholding tax base is transferred into the tax-free area (i.e., share capital, capital contribution reserves and loans)
  - For instance, the SFTA would deny, based on the concept of the extended international transposition (tax avoidance), the federal withholding tax refund or the application of the reporting procedure in the event of distributions of Swiss based portfolio companies, to the extent that a newly established *Swiss acquisition company* is able to distribute reserves without federal withholding tax deduction to investors that are not entitled to a (full) refund
  - Avoidance of extended international transposition if the total amount of share capital, capital contribution reserves and shareholder loans of the *Swiss acquisition company* does not exceed the total amount of share capital, capital contribution reserves and shareholder loans of the Swiss portfolio company

# Swiss Tax Considerations

## ■ Structure #2

- CF purchases assets directly from EF – old reserves practice
  - If a *foreign acquisition (or holding) company* of EF that is not entitled to a refund of federal withholding tax sells its Swiss portfolio company to a foreign acquisition (or holding) company of CF that is entitled to such a refund, the so-called old reserves practice of the SFTA is very likely applicable
- ⇒ The buyer is denied a refund of the federal withholding tax (35%) on funds which are not required for the business operations of the Swiss portfolio company and available for distribution under Swiss commercial law (so-called old reserves) *at the time of sale*
- It is advisable for the buyer to define the relevant amount of old reserves with the SFTA (tax ruling) before the purchase or restructuring

# Swiss Tax Considerations

## ■ Structure #2

- CF purchases assets directly from EF – “liquidation by proxy” ?
  - If a *foreign acquisition (or holding) company* of EF that is not entitled to a refund of federal withholding tax sells its Swiss portfolio company to a foreign acquisition (or holding) company of CF that is entitled to such a refund, the SFTA may deny a refund of the federal withholding tax (35%), computed on the purchase price (i.e., including hidden reserves and goodwill) less (i) share capital and (ii) capital contribution reserves of the Swiss portfolio company
  - Condition: intention of the buyer *at the time of the transaction* (as opposed to business or legal developments after the transaction) to liquidate the acquisition company owning the Swiss portfolio company

# German Tax Considerations

- Initial question: German tax treatment of the Funds
  - Usually only asset administering partnership (fully disregarded for German tax purposes, investors hold shares in portfolio companies)
  - Commercial partnership
- For partnerships established under non-German law mainly relevant in case of permanent establishment in Germany
- GP-led secondaries often structured as exit and reinvestment
  - Reinvestment on an after-tax basis
  - many investors tax exempt or privileged in any case
  - Certain investors may incur tax leakage (usually on timing effect assuming no subsequent reduction in value)



# German Tax Considerations

- Roll-over structure more complex, but can be favorable for individuals in particular
  - Should only be available for asset administering partnerships
  - Due to tax transparency rolling investors may keep their tax basis also under the Continuation Fund
  - Likely not available to the extent of different (indirect) participation through Continuation Fund in a portfolio company
  - There may be a reduction of interest in portfolio company (and therefore taxable event) of rolling investor even if exchange against higher or new participation in another portfolio company should be treated as sale

# Dutch Tax Considerations

- GP-led secondaries typically structured as exit and reinvestment
  - Distribution of Continuation Fund Interests generally not feasible due to constraints arising from specific Dutch tax (transparency) constraints
  - Secondaries may also be structured through an LP Tender Offer instead of an asset sale, but typically not preferable due to tax (transparency) constraints
- The sale of assets to the Continuation Fund, is recognised as a disposal at the level of the Existing Fund (if structured as a Coop) or at the level of the investment holding company
- However, disposal proceeds are fully exempt from Dutch CIT under the Dutch participation exemption
- Roll-over may be implemented through a distribution by the Existing Fund of a note to reinvesting partners which is subsequently contributed into the Continuation Fund

# Dutch Tax Considerations

- Due to the Existing Fund being opaque or the use of an investment holding company, the investors would typically not be considered to hold an interest in the underlying assets
- Investors receive a distribution from the Existing Fund:
  - Cash in case of selling partners
  - Note/cash in case of reinvesting partners
- Whether a carry-over of the tax basis to the Continuation Fund is available, will depend on the jurisdiction in which the reinvesting partner is located, however, complicated by distribution character of roll-over
- Reinvesting partners that are subject to Dutch CIT would typically not be eligible for a roll-over of the tax basis, but any (deemed) gains are generally CIT exempt under the Dutch participation exemption

# Dutch Tax Considerations

- Structure of the Continuation Fund chosen in conjunction with the corner stone investors, but recent and announced developments are to be taken into account:
  - Dutch ruling policy prohibits the DTA to issue a ruling if a low tax jurisdiction (LTJ) is involved, so if new investors are in a LTJ it may not be possible to obtain a ruling
  - Reverse hybrid mismatch rules (ATAD2) may cause a CV to become subject to Dutch CIT and DWT, but AIF exemption may be available
  - As of 2024 distributions to LPs in a LTJ may become subject to a CWHT, but question pending whether LPs are considered a ‘cooperating group’
- Trend from CV-Coop structures to Coop only structures
- Carried interest for the Continuation Fund is a point of attention

**Questions?**