CONTINUATION FUNDS: TAX ISSUES

Daniel A. Zygielbaum and Jennifer A. Fitzgerald

Continuation funds are an increasingly popular tool with a variety of uses for investment fund sponsors. This article discusses the most common issues tax practitioners encounter when advising on continuation fund transactions.

INTRODUCTION

Exit plan, refinancing strategy, buy-out mechanism. Continuation funds are an increasingly popular tool with a variety of uses for investment fund sponsors. In this article, we identify the most common issues tax practitioners encounter when advising on continuation fund transactions.

In a typical continuation fund transaction, a new investment vehicle (the continuation fund) uses capital from new investors to acquire one or more assets from an existing fund that is managed by the same sponsor. The continuation fund is usually formed specifically for the purpose of making this acquisition. Limited partners in the existing fund are normally offered the option either to be cashed out or to retain their interests in the underlying assets through an investment in the continuation fund. However, as we will see, each continuation fund transaction is unique.

BACKGROUND

Initially, sponsors mostly used continuation funds to allow a fund nearing the end of its life to exit investments for which there were few other sale opportunities (often because those investments were distressed). The primary new investors in these initial continuation funds were secondaries buyers, and the market developed as an offshoot of the secondaries market. Now, however, continuation fund transactions have greatly expanded. In addition to serving as a means to exit investments at the end of an existing fund's life, sponsors use continuation fund transactions to access additional capital, reset management incentive plans, buy out co-investors, provide liquidity to existing investors, or crystalize carry, among other reasons. And these transactions are getting the attention of investors beyond the typical participants in secondaries transactions (and often for much bigger checks).

Continuation funds have become so popular that in 2023 they made up approximately 78% of GP-led secondaries, accounting for more than $37 billion in deal volume.[1] Strong exits from the initial wave of continuation funds may encourage continued deal flow.

New investors in continuation funds often get access to assets with a proven track record and a shorter time to exit than a typical fund investment. For existing investors, a continuation fund transaction provides an opportunity to cash out of investments or, if they remain invested, to potentially increase their investment and move into a vehicle where the sponsor's interest is more aligned with theirs.

The particular reasons for carrying out a continuation fund transaction influence the structure of the transaction and of the continuation fund vehicle(s). Below we summarize the main types of continuation fund transactions and some of their most common features.

Types of Continuation Fund Transactions.

The following are four types of continuation fund transactions:

- *Full Fund Restructuring.* The continuation fund acquires all or substantially all of the existing fund's assets.
- *Multiple Asset Acquisition.* The continuation fund acquires multiple, but not all, assets from the existing fund.
- *Single Asset Acquisition.* The continuation fund acquires a single asset from the existing fund.
- *Strip Sale.* The continuation fund acquires a specified percentage of one or more assets from the existing fund but does not acquire the existing fund's entire interest in any asset.[2]

A continuation fund may also acquire assets from more than one existing fund, including through a combination of acquisition types described above.

Typical Features of Continuation Funds.

Lead Investor's Role. The lead investor typically will be the largest new investor in the continuation fund and, depending on deal size and valuation, may be the only new investor. They may win this position through a bidding process. If there are multiple new investors, they may work together as a consortium.

Lead investors negotiate both the terms of the transfer of assets from the existing fund to the continuation fund (in the role of "buyer" against the sponsor in the role of "seller") and the terms of the continuation fund itself (in the role of limited partner against the sponsor in the role of general partner).

Valuation or "Lockbox." The price paid for the assets being acquired by the continuation fund normally is set based on a specific reference date value, often the selling fund's recently reported, quarter-end net asset value. Instead of working capital adjustments, which would require complex purchase price adjustments, typically this "lockbox" price is increased for any contributions and decreased for any distributions between the valuation date and the closing.

Diligence. Because the fund sponsor usually rolls both its capital interest

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and its carried interest in the transferred assets into the continuation fund, new investors can rely on alignment with the fund sponsor to some extent. As a result, continuation fund transactions may involve less due diligence of the underlying assets than a typical private M&A transaction. However, in recent years the market for continuation fund transactions has moved closer to an M&A model where the new investors do more diligence, including tax diligence, on the assets being transferred.

Limited Indemnity; RWI. Much like a public M&A deal, often there is a limited indemnity, with only fundamental representations and certain "excluded obligations" covered. But as with due diligence, the market is moving toward more fulsome representations. As a result, representations and warranties insurance ("RWI") is increasingly favored in continuation fund transactions. In some cases, the policies benefit only new investors; in other cases, policies also protect the continuation fund as a whole, including, indirectly, the rolling investors.

PRACTICAL ECONOMIC CONSIDERATIONS

Although each continuation fund transaction is unique, there are recurring economic considerations that must be addressed in most transactions, some of which we highlight below.

Existing Investors' Options.

In a standard transaction, investors in the existing fund are given the option to either cash out their interests in the assets being transferred (the "sale option") or remain invested (the "roll option"), although in some cases existing investors are forced to take the sale option.

If the sponsor offers existing investors a roll option, it must determine on what terms the existing investors will retain their indirect investment in the transferred assets. The sponsor could give existing investors the option to invest in the continuation fund on the same economic terms (*i.e.*, fees and carried interest) as new investors. Alternatively, existing investors could be given the option to retain their indirect investment on a "status quo" basis that replicates, as closely as possible, the economics of their investment in the existing fund. The sponsor may offer both options or a combination of the two, or something in between.

The sponsor must also decide whether existing investors will roll into the same continuation fund vehicle as new investors or will instead have their own separate vehicle. Existing investors that roll on the same economic terms as the new investors typically roll into the same continuation fund vehicle; existing investors that roll on different economic terms (e.g., the status quo roll), typically roll into a separate vehicle.

> In a typical continuation fund transaction, a new investment vehicle (the continuation fund) uses capital from new investors to acquire one or more assets from an existing fund that is managed by the same sponsor.

Perhaps most relevant to the tax advisors on a continuation fund transaction is whether the roll option is intended to be tax-free. In most cases, the sponsor will offer a tax-free roll option because it benefits both existing investors and the sponsor, who usually is also rolling its investment into the continuation fund. This tax-free roll is usually what creates the most structuring complexity in continuation fund transactions.

Additional complexity can arise if the existing fund, or the continuation fund, or both, owns assets through "blocker" corporations (or "blockers").[3] Existing blocked investors usually would prefer that the existing fund transfer its existing blockers, rather than the assets those blockers own, to the continuation fund. A sale of blockers ordinarily will be tax free for existing blocked investors, whereas a sale of assets by the blockers ordinarily would be taxable.[4] And, for existing blocked investors that choose the roll option, it may not be possible to do a tax-free roll without transferring the existing blockers to the continuation fund.

However, new investors in the continuation fund may or may not want the continuation fund to invest through blockers, depending on their tax status. And, even if new investors do want blockers, they typically would prefer that the continuation fund form new blockers to acquire the underlying assets directly so that the new blockers can get a step up in basis in the acquired assets (assuming the existing blockers have unrealized built-in gain in the assets).

Illustrative Steps.

The charts in Exhibit 1 illustrate a simplified continuation fund transaction that provides a sale option and a tax-free roll option for existing investors. Although many continuation fund transactions follow this general format, each transaction will be slightly different because of the intrinsic features of that deal, including those factors described above.

PRACTICAL TAX CONSIDERATIONS

Tax Treatment of the Transaction.

The following discussion explains the typical tax treatment of a continuation fund transaction structured in substantially the same form as the transaction depicted in the charts in Exhibit 1.[5]

Partnership Division Rules. Continuation fund transactions often implicate the partnership division rules under Section 708 and Treas. Reg. 1.708-1(d). When an existing fund that is a partnership for U.S. federal income tax purposes transfers some or all of its assets to one or more new partnerships (the continuation fund(s)), the partnership division rules dictate the steps by which assets and/or partnership interests are deemed to be transferred for tax purposes, as well as which entity or entities are treated as continuations of the existing fund.[6] These deemed steps and results impact the tax consequences of the transaction.

Specifically, a partnership division can take one of two forms: (1) the "assets over" form, whereby the "divided partnership" is treated as contributing its assets to one or more "recipient partnerships" in exchange for interests in those recipient partnerships and immediately thereafter distributing those

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recipient partnership interests to the divided partnership's partners in partial or complete liquidation of the partners' interests in the divided partnership;[7] or (2) the "assets up" form, whereby the divided partnership distributes certain assets to its partners who then immediately contribute those assets to one or more recipient partnerships in exchange for interests in the recipient partnerships.[8] The "assets up" form only applies if assets are actually transferred as described above.[9] Because transferring the existing fund's underlying assets directly to investors and having those investors contribute the assets to the continuation fund is not practicable, most continuation fund transactions do not follow the "assets up" form and thus are treated as "assets over" divisions.

Note that the description above of an "assets over" division is deceptively simple, because it is not always immediately apparent which partnership (*i.e.*, the existing fund or a continuation fund) is treated as the "divided" partnership and which is treated as the "recipient" partnership(s). Nor is it always obvious which, if any, of the surviving partnerships is treated as a continuation of the existing fund.[10]

Each resulting partnership (*i.e.*, the existing fund and each continuation fund) whose partners after the transaction held more than 50% of the capital and profits of the existing fund before the transaction is treated as a continuation of the existing fund.[11] Each resulting partnership whose partners after the transaction held 50% or less of the capital and profits of the existing fund before the transaction is treated as a new partnership.[12] Therefore, provided the existing fund remains in existence and retains its partners who held more than 50% of its capital and profits interests (which is typical), the existing fund will be treated as a continuation of itself. A continuation fund will be treated as a continuation of the existing fund only if a majority of the existing fund partners (by capital and profits interests in the existing fund) elect to roll. More often than not, continuation funds are not treated as continuations of the existing fund because a majority of investors in the existing fund do not elect to roll into the continuation fund(s). But that is not always the case.

If only the existing fund is a continuation of itself, then the existing fund is treated as the "divided" partnership that contributes assets to the "recipient" partnership(s) (the continuation fund(s)),[13] and then distributes continuation fund interests to its partners in partial or complete liquidation of their partnership interests.[14] These steps should be treated as a contribution of assets by the existing fund to the continuation fund in exchange for partnership interests in the continuation fund under Section 721 followed by a distribution or distributions by the existing fund of its partnership interests in the continuation fund to the existing fund's investors under Section 731, respectively.[15]

Continuation fund transactions often implicate the partnership division rules under Section 708 and Treas. Reg. 1.708-1(d).

Practitioners must take care to confirm that each of these steps is tax-free. For example, the deemed contribution to a continuation fund under Section 721 will be taxable if the continuation fund would be treated as an investment company (within the meaning of Section 351) if it were a corporation.[16] And the deemed distribution by the existing fund of interests in a continuation fund could be taxable if the continuation fund holds marketable securities.[17]

If the existing fund is not a continuation of itself and only one of the continuation funds is a continuation of the existing fund, then that continuation fund will be treated as the "divided" partnership.[18] If the existing fund is not a continuation of itself and more than one continuation fund is a continuation of the existing fund, then the continuation fund with the assets having the greatest fair market value (net of liabilities) will be treated as the "divided" partnership.[19] If no resulting partnership is a continuation of the existing partnership, the existing partnership is treated as the "divided" partnership and is treated as liquidating by distributing interests in the continuation fund(s) to its partners.[20]

In each case, the deemed Section 721 contribution and Section 731 distributions must be examined to ensure they are not taxable transactions.

In addition to impacting the deemed transaction steps, whether a continuation fund is treated as a continuation of the existing fund also has ongoing consequences for the continuation fund and its partners.

If a continuation fund is treated as a continuation of the existing fund, then all of the existing fund's U.S. federal tax elections will remain in effect for the continuation fund (e.g., a Section 754 election).[21] In addition, the continuation fund could be subject to an audit (and associated imputed underpayment) in respect of pre-closing tax periods for the existing fund.[22] The assets held by the continuation fund are not treated as having moved to a new partnership, and thus, the continuation fund retains the existing fund's holding period and basis in the assets.[23]

If the continuation fund is not a continuation of the existing fund, the continuation fund should still retain the existing fund's holding period and basis in the assets, but only if the deemed contributions and distributions described above are tax-free under Sections 721 and 731.[24]

A rolling investor in a tax-free continuation fund transaction whose interest in the existing fund is being completely liquidated can expect to take their partnership interest in the continuation fund with a basis equal to the investor's adjusted basis in their existing fund partnership interest.[25] A liquidated rolling investor should also take a tacked holding period in their partnership interest in the continuation fund, although they may take a split holding period based on the existing fund's different holding periods for different assets.[26] Where a rolling investor also maintains their partnership interest in the existing fund, they take the partnership interest in the continuation fund with a carryover basis, up to the amount of their outside

basis in their existing fund partnership interest.[27] As discussed further below, in the case of the sponsor's partnership interest in the continuation fund attributable to its carried interest in the existing fund, the holding period and basis need to be considered in light of the three-year holding requirement of Section 1061.

Disguised sale of partnership interests. As described in the illustrative charts in Exhibit 1, typically the final steps in a continuation fund transaction are a contribution of cash by the new investors to the continuation fund in exchange for continuation fund interests, followed by a distribution of that cash to the seller partnership in redemption of its continuation fund interest (and a subsequent distribution of that cash to the selling investors).

Under Section 707(a)(2)(B), a contribution of cash or assets by one partner to a partnership and a related distribution by the partnership to another partner are likely to be treated as a "disguised sale" of a partnership interest. Thus, in the transaction described in Exhibit 1, the seller partnership is expected to be treated as selling its partnership interest in the continuation fund to the new investors in a taxable transaction. The seller partnership will recognize gain or loss on the transaction and will allocate that gain or loss to the selling investors.[28]

This disguised sale treatment could potentially create withholding tax obligations for the new investors under Section 1445 and Section 1446(f). However, as described below, the use of a seller partnership to act as the "seller" in the disguised sale in lieu of the selling investors mitigates this issue.

One benefit of structuring the transaction as a deemed sale of partnership interests in the continuation fund by selling partners (via the seller partnership) to the new investors, as opposed to a sale of the existing fund's underlying assets to the continuation fund, is that the continuation fund generally retains the existing fund's holding period in its assets.[29] If the existing fund simply sells its assets to the continuation fund, the continuation fund's holding period will start anew.

Tax Points of Negotiation.

Continuation fund transactions create a unique mix of tax issues to be negotiated between the sponsor (in the role of "seller") and new investors (in the role of "buyer"). These negotiated tax points are commonly found in two operative documents: (1) the transaction agreement pursuant to which the new investors acquire interests in the continuation fund; and (2) the limited partnership agreement of the continuation fund. The former is essentially a purchase agreement, comparable to a partnership interest purchase agreement in the M&A context; the latter involves the same negotiated issues as a typical fund formation. Because the transaction agreement is more specific to the continuation fund context, this article will focus on certain tax points negotiated in that document and will not address tax issues in the limited partnership agreement.

Continuation fund transactions create a unique mix of tax issues to be negotiated between the sponsor (in the role of "seller") and new investors (in the role of "buyer"). These negotiated tax points are commonly found in two operative documents: (1) a transaction agreement and (2) a limited partnership agreement.

Tax Representations / Tax Indemnity / Excluded Obligations. Initially, as with standard agreements for purchases of secondary interests in funds, continuation fund transactions often had limited tax representations. New investors were usually comfortable relying on their interests being aligned with those of the fund sponsor, which customarily would maintain, or even increase, its investment in the underlying assets. More recently, new investors have begun to insist on fulsome tax representations more in line with those in a typical private acquisition. And, as with other purchases of entities, RWI to cover breaches of these tax representations and other liabilities has become commonplace in continuation fund transactions.

One aspect of secondary transactions that remains in continuation fund transactions is the concept of "excluded obligations." Excluded obligations are a defined set of liabilities that the new investors explicitly do not assume in the transaction, and for which the existing fund is required to provide indemnification (or that are covered by RWI). Excluded obligations include certain tax liabilities – typically any tax liabilities attributable to the selling investors' ownership of their interests in the existing fund before the transaction (including imputed underpayments assessed against the continuation fund for pre-closing tax periods), as well as any tax liabilities attributable to the existing investors' sale of their interests in the continuation fund (including withholding taxes attributable to the sale).

Withholding Taxes. From a federal tax perspective, continuation fund transactions implicate the withholding regimes under Section 1446(f) and Section 1445. New investors will insist on the right to withhold applicable taxes from the purchase price unless the sellers or the continuation fund provide documentation confirming that no withholding is due.

Section 1446(f) requires the buyer of an interest in a partnership to withhold 10% of the amount realized from the purchase price absent (1) the provision by the seller of IRS Form W-9 indicating that the seller is a U.S. person, or (2) the provision by the seller or the partnership of a certificate under Section 1446(f) indicating that no withholding is due.[30]

Section 1445 requires the buyer of an interest in a partnership from a non-U.S. seller to withhold 15% from the purchase price if 50% or more of the value of the partnership's gross assets consist of U.S. real property interests, and 90% or more of the value of the partnership's gross assets consist of U.S. real property interests plus cash or cash equivalents (such a partnership, a "50/90 Partnership").[31] Withholding under Section 1445 is not required if either (1) the seller provides IRS Form W-9 to the buyer indicating that the

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seller is a U.S. person, or (2) the partnership provides to the buyer a certificate indicating that the partnership is not a 50/90 Partnership.

The use of a seller partnership, as described in Exhibit 1, eliminates the need for the provision of certificates under Section 1446(f) and Section 1445, because the seller partnership, not the existing investors, is treated as the seller of interests in the continuation fund. The seller partnership is typically formed as a Delaware limited partnership and therefore can provide an IRS Form W-9 to the new investors. The new investors should be able to rely on this IRS Form W-9 to not withhold under Sections 1446(f) and 1445. The seller partnership itself may have withholding obligations in respect of its non-U.S. partners under Section 1446.

The use of a seller partnership has the added benefit of preventing the new investors from having to obtain IRS Forms W-9 or W-8 from all of the selling investors. Often, the sponsor will prefer to keep the identities of the selling investors confidential from the new investors.

Tax Elections. As discussed above, in certain circumstances the continuation fund could be treated as a continuation of the existing fund for U.S. federal income tax purposes. As a result, the continuation fund could be liable for an imputed underpayment under Section 6225 in respect of a pre-closing tax period of the existing fund. Normally, any such tax liability would be an excluded obligation for which the selling investors would be required to indemnify the continuation fund or new investors or that is covered by RWI. However, because such indemnification or insurance typically is limited, new investors will want the continuation fund to agree to make a "push-out" election under Section 6226 in respect of any pre-closing imputed underpayment, so that the tax is owed by the pre-closing partners of the existing fund and no indemnification or insurance coverage is necessary.

In addition, because the new investors are normally treated as purchasing interests in the continuation fund in a disguised sale, as described above, assuming the value of the underlying assets is higher than their pre-closing basis, the new investors will typically also want the continuation fund to make an election under Section 754 for the year in which the closing takes place. Generally, a Section 754 election requires the continuation fund to adjust the basis of its assets in respect of the new investors to reflect the new investors' basis in their partnership interests, and to give the new investors the benefit of that basis step up.[32] However, Section 754 elections increase annual tax accounting costs, and the sponsor may insist that any such increased costs be borne solely by the new investors who are getting the benefit of the basis adjustment.

Continuation fund transactions implicate the withholding regimes under Section 1446(f) and Section 1445.

If the continuation fund owns interests in other partnerships, those partnerships will also need to make Section 754 elections for the basis adjustments to apply to their assets. In some cases, the continuation fund may not control those lower-tier partnerships and thus may not be able to cause them to make Section 754 elections. In such cases, the continuation fund may agree to use reasonable efforts (or a similar standard of efforts) to cause such partnerships to make Section 754 elections.

Transfer Taxes. Depending on the location and type of assets being transferred, the continuation fund transaction may trigger transfer taxes. Most commonly, transfer taxes are triggered when the underlying assets include real property located in jurisdictions that apply transfer taxes to indirect transfers of interests in real property. However, other transfer taxes can also apply, such as stamp taxes in the United Kingdom. Which party bears the transfer taxes is a negotiated point – often the new investors and existing fund agree to split the transfer taxes 50/50.

Lockbox Calculations. The price at which new investors "purchase" interests in the continuation fund is typically set based on a value (normally a percentage of the existing fund's reported net asset value) as of a specific reference date. The price is increased to the extent the existing investors make capital contributions to the existing fund in respect of the transferred assets and decreased to the extent the existing fund makes distributions to the existing investors attributable to the transferred assets, in each case between the reference date and the closing date. For this purpose, distributions are typically counted on a gross-of-tax basis, not net of any taxes withheld from such distributions or other taxes imposed on the distributions. The theory behind this principle is that any cash or assets distributed out of the existing fund in respect of the transferred assets, whether paid to the existing investors or to the tax authorities, reduces the value of what the new investors are buying.

Any post-closing distributions are for the account of the new investors. However, if any of those post-closing distributions are refunds of pre-closing taxes, those refunds are typically for the account of the selling investors who bore those taxes.

Carried Interest.

Typically, the fund sponsor will roll into the continuation fund the portion of its carried interest in the existing fund attributable to the transferred assets. This "crystallization" of the carried interest potentially implicates several tax issues for the beneficial owners of the carried interest.

The sponsor's carried interest in the existing fund likely would initially have been issued as a "profits interest" within the meaning of IRS Revenue Procedure 93-27.[33] Similarly, individual owners of indirect interests in the carried interest likely would have been issued their indirect interests in the carried interest as "profits interests." Revenue Procedure 93-27 provides that if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the receipt of

that profits interest will not be a taxable event for the partnership or the partner. However, by its terms Revenue Procedure 93-27 does not apply if, within two years of receipt, the partner "disposes of" the profits interest. The crystallization of carried interest in the existing fund by rolling it into the continuation fund, on its face, would seem to be a disposition of a profits interest that, if it occurred within two years after the carried interest was issued, could cause that initial issuance to fall outside the protection of Revenue Procedure 93-27. In our experience, most practitioners take the view that non-taxable transfers of profits interests where the beneficial owner still retains his or her direct or indirect interest in the profits interest, should not fall within the Revenue Procedure 93-27 prohibition of "dispositions." Nevertheless, this issue should be examined carefully in any continuation fund transaction.

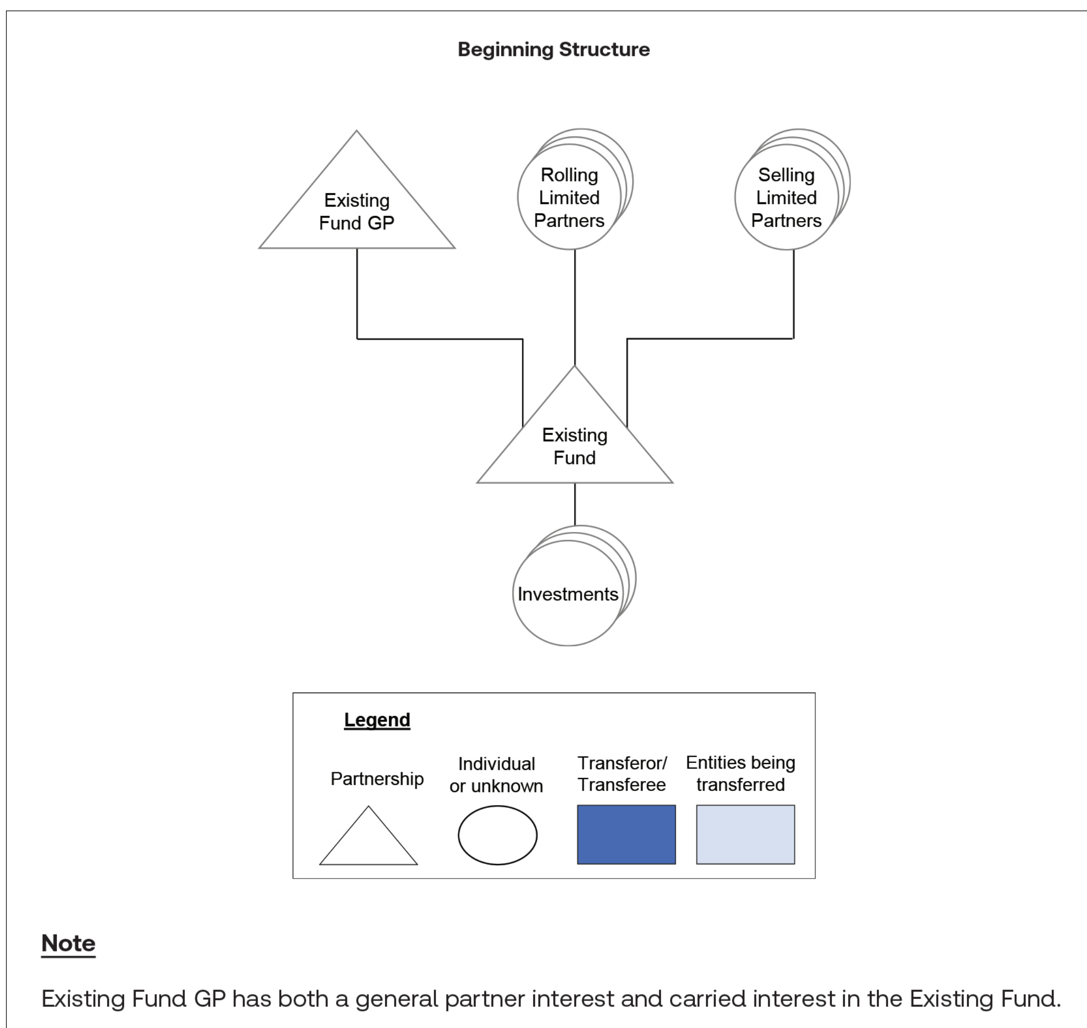
Separately, Section 1061 generally requires that assets be held by a partnership for at least three years before sale for carried interest owners to be able to treat their allocable share of gain on sale from the assets as long-term capital gain.[34] This is longer than the one-year holding period that would otherwise be required.[35] Thus, an important consideration in structuring a continuation fund transaction is ensuring that the holding period for the transferred assets is not reset. Fortunately, in the typical continuation fund transaction, the continuation fund's holding period for the underlying assets tacks the existing fund's previous holding period, as discussed above. Nevertheless, because each continuation fund transaction is unique, Section 1061 issues must be examined fresh in each case.

Section 1061 can also cause a carried interest owner to be treated as recognizing short-term capital gain, rather than long-term capital gain if he or she disposes of his or her carried interest within three years.[36] This can be an important consideration in a continuation fund transaction that does trigger gain from the disposition of a carried interest, even though such transactions are not typical.

CONCLUSION

The tax considerations described above are some of the more common issues that arise in continuation fund transactions, but they are not an exhaustive list. Each transaction has its own unique set of issues that may require specialized solutions. As continuation fund transactions become more common, structures and market practices may continue to evolve. Tax practitioners will continue to have an important role to play in this burgeoning space.

EXHIBIT 1 : Continuation Fund Illustrative Structure



Note

Existing Fund GP has both a general partner interest and carried interest in the Existing Fund.

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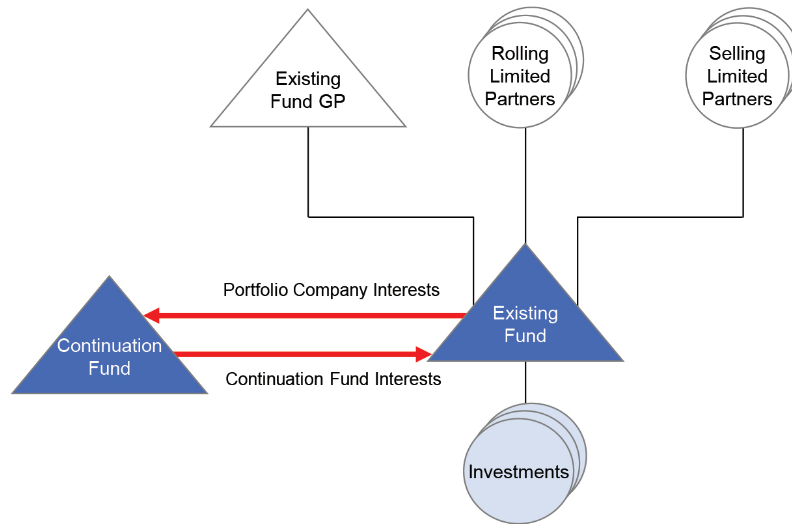
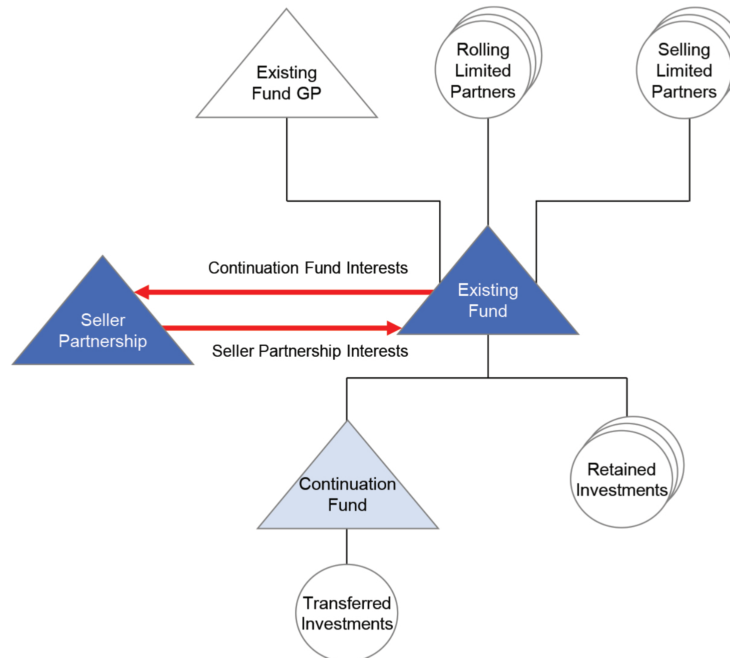
Step 1: Contribution of Investments to Continuation Fund



Step:

Existing Fund contributes interests in certain of its investments to Continuation Fund in exchange for limited partner interests in Continuation Fund.

Step 2: Contribution of Portion of Continuation Fund Interests to Seller Partnership



Step:

Existing Fund contributes the portion of its interests in Continuation Fund attributable to Selling Limited Partners to Seller Partnership in exchange for limited partner interests in Seller Partnership.

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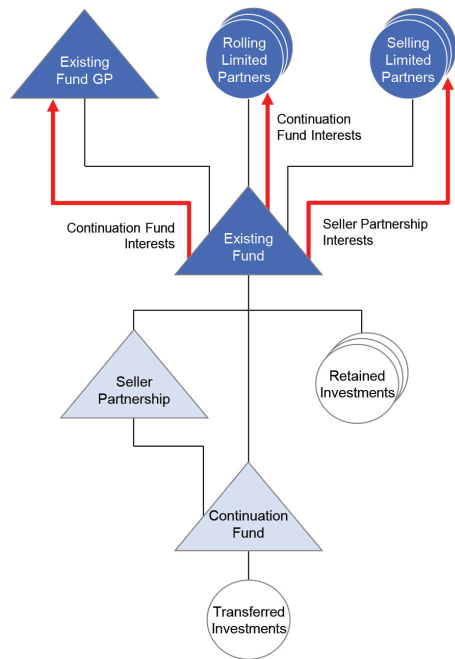
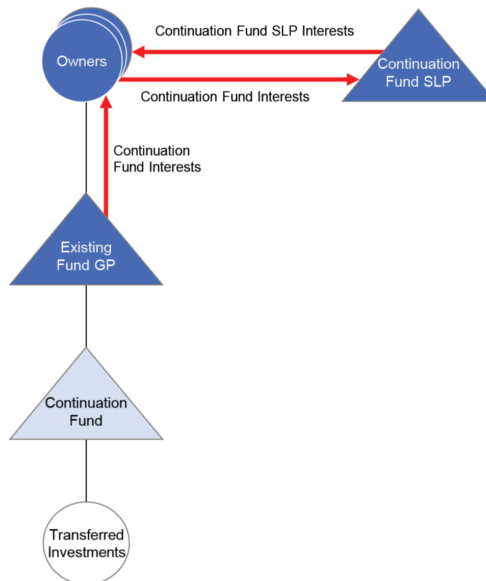
Step 3: Distribution of Continuation Fund Interests and Seller Partnership Interests to Partners



Steps:

- Existing Fund distributes interests in Continuation Fund to Rolling Limited Partners and Existing Fund GP.
- Existing Fund distributes interests in Seller Partnership to Selling Limited Partners.

Step 4: Distribution of Continuation Fund Interests to Owners of Existing Fund GP and Formation of Continuation Fund SLP



Steps:

- Existing Fund GP distributes interests in Continuation Fund to its Owners.
- Owners contribute interests in Continuation Fund to Continuation Fund SLP in exchange for limited partner interests in Continuation Fund SLP.

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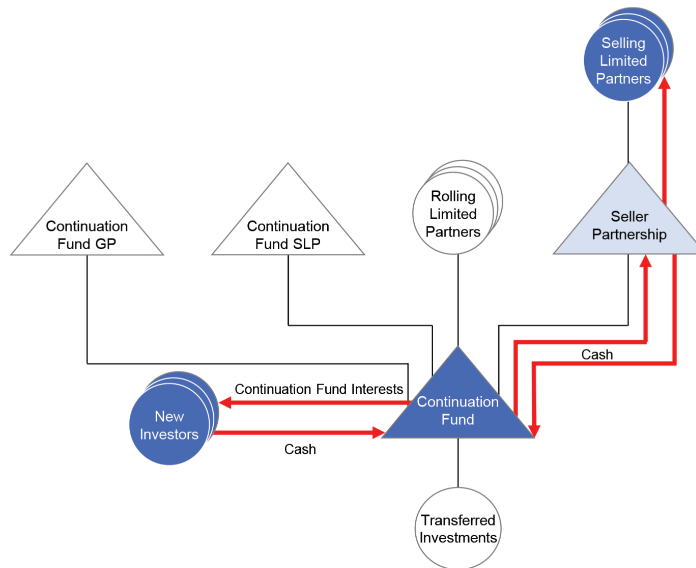
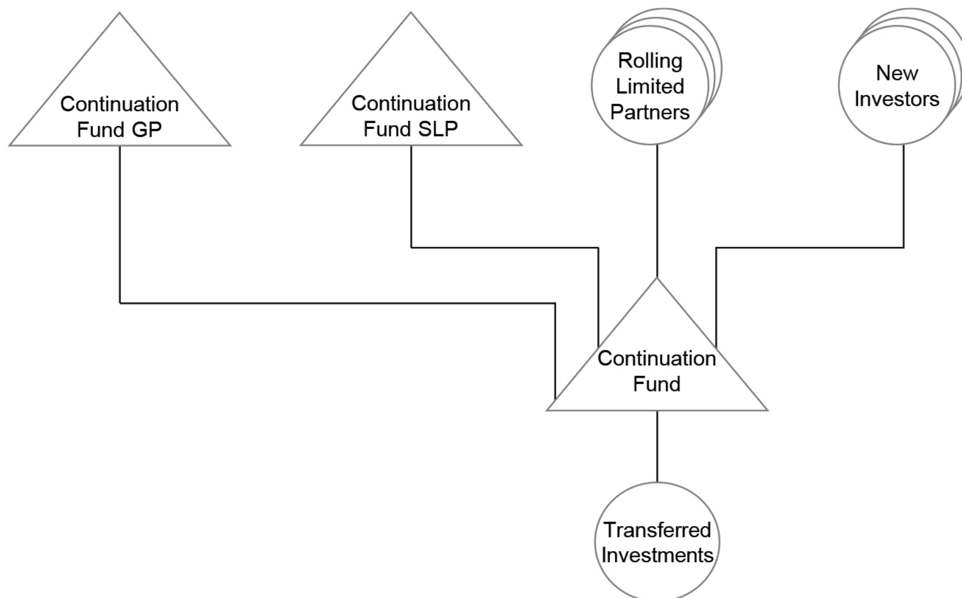
Step 5: Contribution of Cash by New Investors in exchange for Continuation Fund Interests and Redemption of Continuation Fund Interests from Seller Partnership



<u>Steps:</u>

- New Investors contribute cash to Continuation Fund in exchange for limited partner interests in Continuation Fund.
- Continuation Fund distributes cash to Seller Partnership in redemption of Seller Partnership's interest in Continuation Fund.
- Seller Partnership distributes cash to Selling Limited Partners.

Final Structure



End Notes

[1] Holcombe Green III, et al., *Secondary Market Report 2023*, Lazard Private Capital Advisory (2/1/2024), available on https://www.lazard.com.

[2] These are the least common type of continuation fund transaction, comprising only 2% of GP-led secondaries in 2023. Holcombe Green III, et al., *Secondary Market Report 2023*, Lazard Private Capital Advisory (2/1/2024), available on https://www.lazard.com.

[3] Commonly, a fund that has non-U.S. or tax-exempt investors and that owns assets expected to generate income effectively connected with a U.S. trade or business ("ECI") or unrelated business taxable income ("UBTI") would own those assets at least partially through one or more "blocker" corporations to protect the non-U.S. and tax-exempt investors from that ECI or UBTI, respectively.

[4] Non-U.S. investors generally are not subject to U.S. tax on gain from the sale of stock in a U.S. corporation, unless the corporation is a United States real property holding corporation. Section 871, Section 881, Section 897(a). Tax-exempt investors generally are not subject to U.S. tax on gain from the sale of stock in a corporation, unless their (or the fund's) investment in the corporation is debt-financed. Section 501, Section 511, Section 512, Section 514. Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986 (the "Code"), and all "Treas. Reg.," "Temp. Treas. Reg.," and "Prop. Treas. Reg." references are to the regulations promulgated or proposed under the Code by the U.S. Department of the Treasury and the Internal Revenue Service ("IRS"), all as in effect as of the date of this article.

[5] The discussion in this part of the article assumes that both the existing fund and the continuation fund are partnerships for U.S. federal income tax purposes.

[6] Treas. Reg. 1.708-1(d).

[7] Treas. Reg. 1.708-1(d)(3)(i).

[8] Treas. Reg. 1.708-1(d)(3)(ii).

[9] *Id.*

[10] It is possible for more than one resulting partnership to be treated as a continuation of the existing fund. Treas. Reg. 1.708-1(d).

[11] Treas. Reg. 1.708-1(d)(1).

[12] *Id.*

[13] And, in the transaction depicted in Exhibit 1, the seller partnership.

[14] Treas. Reg. 1.708-1(d)(1), (3)(i)(A), (4).

[15] Although the existing fund is deemed to be the sole owner of the continuation fund for a moment in time following the existing fund's deemed contribution of assets to the continuation fund, which normally would make the continuation fund a disregarded entity for U.S. federal income tax purposes, the Treasury Regulations implicitly ignore this inconvenience and treat the continuation fund as a partnership immediately following the deemed contribution. *See, e.g*, Treas. Reg. 1.708-1(d)(1), examples 3 – 6. *See also* Notice of Proposed Rulemaking, 65 FR 1572 (1/11/2000) (discussing Section 721 in the context of partnership divisions and the potential applicability of mixing bowl rules).

[16] Section 721(b).

[17] Section 731(a)(1), (c).

[18] Treas. Reg. 1.708-1(d)(1), (3)(i)(A), (4).

[19] Treas. Reg. 1.708-1(d)(4).

[20] Treas. Reg. 1.708-1(d)(1), (3)(i)(B).

[21] Treas. Reg. 1.708-1(d)(2).

[22] *Id.*; Section 6225.

[23] *See* Treas. Regs. 1.708-1(d)(4)(i); 1.708-1(d)(5), Example 5.

[24] Section 723; Section 1223(2).

[25] Section 732(b); Treas. Reg. 1.732-1(b).

[26] Section 731; Section 1223(1), Section 735(b); Treas. Reg. 1.1223-3.

[27] Section 732(a); Treas. Reg. 1.732-1(a).

[28] Section 741; Section 704.

[29] Section 723; Section 1223(2). This also assumes the deemed contribution to the continuation fund qualified under Section 721(a).

[30] Treas. Reg. 1.1446(f)-2. Under Treas. Reg. 1.1446(f)-2 there are various certificates that can be delivered to avoid withholding but, depending on the structure of the fund and the status of the investors, these certificates may not always be available.

[31] Treas. Reg. 1.1445-11T(b).

[32] Section 754; Section 743(b). The basis adjustment is actually more complicated than simply matching the asset basis to the new investors' outside basis, but the general effect is to give the new investors the benefit of a basis step up (assuming the value of the assets is higher than their pre-closing basis).

[33] 1993-2 C.B. 343. Interests that do not comply with Revenue Procedure 93-27 are subject to unclear treatment under existing case law and their receipt may well be taxable, a result sponsors seek to avoid. For an in-depth discussion of this history of partnership profits interests, *see* Afshin Beyzaee, "Practical Considerations for Issuing Profits Interests, Part 1," Tax Notes, 6/9/2014, p. 1157.

[34] Section 1061(a); Treas. Reg. 1061-4(a)(3)(ii)(A). Note, however, that Treas. Reg. 1061-4(b)(7) specifically excludes certain types of income, such as long-term capital gain and loss under Section 1231, from the three-year requirement.

[35] Section 1222(3).

[36] Section 1061(a); Treas. Reg. 1061-4(a).

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