Key Tax Considerations For Secondary Sales Of Private Funds

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COVID-19 is not only a global health crisis but also an economic crisis. In the coming months, certain fund investors may prefer to seek liquidity options with respect to their investments in order to weather the storm.

Perhaps the simplest way for a fund investor to achieve liquidity is by selling its fund interests in the secondary market. The secondary sale accelerates liquidity for an investor before the fund disposes of its underlying investments.

Over the last 10 years that market has matured, driven not only by limited partners but by the rise of sophisticated funds and advisers focused on secondary market opportunities. As a result, in the current environment, many limited partners may take it for granted that a secondary sale is a routine transaction that will be available to address liquidity as long as the underlying fund investment fundamentals remain sound.

Secondary sales, however, raise a bevy of tax and structuring considerations that can impact not only the buyer and seller, but also the underlying fund itself. This article briefly highlights what both funds and fund investors should consider when confronted with a secondary sale of fund interests.

Transfer Restrictions

A secondary sale is generally subject to the general partner's consent and other restrictions. Therefore, a seller should coordinate with the fund in advance to make sure that it can obtain any necessary consents from the general partner and conduct any necessary diligence to confirm that such secondary sale can satisfy all of the compliance requirements in the relevant fund documents.

In particular, fund documents typically impose certain restrictions on any transfer to prevent the fund from being treated as a publicly traded partnership, or PTP, as a result of the transfer.

While the goal of avoiding PTP status is virtually universal, actual restrictions may vary from fund to fund. Therefore, it is important to look at the fund documents to confirm that a proposed transfer can satisfy the PTP restrictions set forth in the fund documents and, if not, whether a waiver can be obtained from the general partner.

This analysis needs to be undertaken in all taxable transaction scenarios, including a transfer that generates a loss for tax purposes, as well as transfers to other limited partners of the fund, the general partner of the fund, and, in some cases, one or more affiliates of the transferor.

For example, if the fund documents specifically require that a transfer must satisfy certain PTP safe harbors in the tax regulations, and the general partner does not have any ability to waive this requirement, it becomes critical to structure the proposed transfer in a manner that is within such PTP safe harbors.

On the other hand, if the fund documents simply require the general partner to make a determination that a transfer should not result in the fund being treated as a PTP, the general partner may have some leeway to bless a transfer, even if the transfer does not technically satisfy one of the PTP safe harbors. Generally, a fund that has less than 100 partners tends to have more flexibility on transfers because the fund is generally expected to satisfy the private placement PTP safe harbor.

A transfer can satisfy the lack-of-actual-trading safe harbor if the total interests in the fund transferred during the taxable year of the fund (other than in certain excluded transfers) do not exceed 2% of the total interests in the fund.

For investors holding only a small position in a fund, it may be worthwhile to note that the requirements of the lack-of-actual-trading safe harbor may be more easily satisfied in the beginning of the year, rather than toward the end of the year.

Funds tend to allow transfers until the total transfers hit the 2% threshold and to defer any remaining transfer requests into the following taxable year to satisfy this 2% safe harbor. Thus, a small investor in a fund will likely have a better chance of having its transfer blessed if it can close earlier in the taxable year.

Funds may impose other tax-related restrictions on transfers. For example, funds that utilize real estate investment trust, or REIT, structures typically restrict transfers that could jeopardize a REIT subsidiary's status as a REIT.

In addition, funds that seek to maintain REIT subsidiaries as domestically controlled REITs may limit transfers that would cause foreign ownership of the fund to exceed prescribed thresholds. While it is less common for these types of transfer restrictions to present a practical limitation on secondary market transfers, particularly in large commingled funds, they should also be considered where the context requires.

Fund Structure and Tax Elections

Once it is determined that a proposed transfer satisfies all of the transfer restrictions in the fund documents, the next step is to determine whether the fund structure that is in place for the seller's interest will be appropriate for the buyer.

If a U.S. taxable investor transfers its interest to another U.S. taxable investor, there is typically not much to be done in this regard.

However, if a U.S. taxable investor transfers its interest to a non-U.S. or a tax-exempt investor, or vice versa, the parties may need to make adjustments to how the interest is structured so as to avoid adverse tax consequences to the buyer.

For example, if the fund or its alternative investment vehicle holds investments in one or more U.S. pass-through entities on an unblocked basis on behalf of the seller, a non-U.S. buyer may want such investments to be held through one or more blockers to protect the buyer from potential exposure to effectively connected income, or ECI — income that is effectively connected with a U.S. trade or business.

If the fund already has a blocker structure through which other non-U.S. or tax-exempt investors hold interests in such investments, the seller may first transfer its unblocked interest to such blocker structure in exchange for a blocked interest and then transfer the blocked interest to the buyer.

The seller may be required to recognize gains on such interim transfer to a blocked structure and may be subject to additional reporting requirements.

In certain cases, the fund may decide to take certain measures to equitably allocate any adjustment in the basis resulting from the interim transfer to the blocked structure so that investors in the blocked structure are allocated their fair share of any tax liabilities attributable to the blocked structure.

In addition, if certain other elections have been made by the seller with respect to the transferred interest, parties should discuss whether such elections are compatible with the buyer's tax profile, and if not, whether the transfer should be structured in a way to effectuate the buyer's preferred tax elections. The parties should note that any special side letter provisions that the seller has negotiated are generally not transferable to the buyer.

Allocation of Taxes and Expenses Between Buyer and Seller

Once it is confirmed that the transfer is permitted under the fund documents and the sale structure is determined, the next question is how the parties should share any tax liabilities with respect to the transferred interest and any expenses or risks associated with such interest or transfer.

For example, any gain triggered as a result of a transfer is typically borne by the seller because the seller is compensated for the gain through the payment of the purchase price.

If an adjustment is made pursuant to Section 754 of the Internal Revenue Code of 1986[1] to step up the tax basis for the buyer, any incremental expenses to account for such adjustment are typically chargeable to the buyer because the buyer is getting the benefits from the basis step up.

There may be other tax-related expenses, and it is not always clear whether the buyer or the seller should bear any such expenses. In that case, such expenses may be shared between the buyer and the seller equally. These are also commercial considerations that should be discussed by the buyer and seller up front.

If the magnitude of an expense item can be determined through the diligence process, it generally helps the parties to determine how to handle such expense.

If a transfer occurs during a taxable year, taxable income earned by the fund during that year is typically allocated between the buyer and the seller based on the interim- closing-of-the-books method or any other method permitted under the tax code.

If the buyer and the seller have agreed to use an interim closing of the books method, it is prudent to add a provision to the purchase agreement that requires the parties to use a certain level of effort to cause the fund to use the same approach, as the fund is not otherwise generally required to use the method agreed to by the buyer and the seller.

Rather, it is not uncommon for a fund to use a pure proration method or a modified (simplified) interim closing of the books method for administrative convenience.

Sometimes it is helpful for the buyer and seller to discuss any fallback position if the fund is not willing to use the interim closing of the books method. In this case, the parties may want to assess the impact and, if necessary, reflect such assessment in the pricing.

In other instances, the fund may be open to using the closing of the books method but the fund may require the buyer and the seller to pay for any incremental administrative expenses, in which case, the buyer and seller should discuss in advance how that expense will be shared.

In addition, the parties should make sure that the tax indemnity for preclosing periods is drafted consistently with the pricing assumptions. For example, the purchase price is typically determined based on a cut-off date, which may be well before the closing date. The purchase price will then be adjusted up to reflect any contribution made by the seller to the fund and down to reflect any distribution made by the fund to the seller from the cut-off date through the closing.

This true-up mechanism is intended to make sure that any economic consequences generated post-cut-off date belong to the buyer.

If the purchase price is already discounted to take into account any tax liabilities for built-in gains, the seller may find it unfair to indemnify the buyer for any tax liabilities for periods after the cut-off date because the seller is not getting any economic benefits for the value appreciation or income generated between the cut-off date and the closing.

On the other hand, the buyer may ask for a tax indemnity through the closing because the seller will be allocated income from the fund until the closing and any such income allocation will increase the basis of the fund interests to be transferred, thereby reducing the seller's capital gains (or triggering capital loss) upon exit.

Since it is the seller who receives the tax benefits of the basis increase, the buyer may think it is reasonable for the seller to bear any tax liabilities on any income generated between the cut-off date and the closing.

There is no one-size-fits-all solution or market practice on this issue, and the approach may vary case-by-case depending on the seller's tax profile, the structure of the applicable fund, the magnitude of potential income during such period, state and local tax considerations, and other commercial or accounting considerations.

In any event, it is important to communicate the intended treatment with the business team to make sure that the tax allocation methods provided in the purchase agreement are consistent with the relevant pricing assumptions.

Relatedly, parties have to consider how this tax indemnity would interact with future tax audits of the fund and related tax liabilities. In particular, partnership audit rules may cause the fund to pay tax liabilities on behalf of its partners, in which case, any income that should have been allocated to the fund's partners in the audited year will instead be paid by the fund in the year the audit is settled, which would be economically borne by the buyer.

Fund documents may already address how this tax liability will be allocated between former and current partners, but in many cases, the fund documents leave the decision to the general partner's discretion. Therefore, it is helpful to understand the fund's position and past practice on this issue to negotiate and draft tax indemnity provisions in the purchase agreement appropriately.

Withholding Tax Certifications

Withholding tax is another important topic to discuss upfront. In a secondary sale context, there are usually two potential withholding taxes where the seller is a non-U.S. person.

First, a 10% withholding tax may be imposed on the gross amount realized on a sale of a fund interest if any portion of the sale gain would be treated as ECI. This withholding tax can generally be eliminated if, among other things:

- The seller certifies that it is a U.S. person, which can be done by providing an Internal Revenue Service Form W-9;
- The seller certifies that it will not recognize any gain in connection with the transfer;
- The seller provides a certificate stating that a relatively small percent of the seller's allocable share of net income from the fund (e.g., less than 10% or 25% depending on the applicable guidance) over the three immediately prior taxable years was ECI and, depending on the applicable guidance, the seller's allocable share of ECI was less than $1 million in each such year; or
- The fund provides a certification that a relatively small percent of the fund's assets (e.g., less than 10% or 25% depending on the applicable guidance) is connected with a U.S. trade or business.

Second, a 15% withholding tax may be imposed (in lieu of the 10% withholding described above) on the amount realized on a sale of a fund interest if the fund interest is treated as a U.S. real property interest, or USRPI. This withholding tax can be eliminated if the seller certifies that it is a U.S. person or if the fund certifies:

- That 50% or more of the value of its gross assets does not consist of USRPIs; or
- That 90% or more of the value of its gross assets does not consist of USRPIs plus any cash or cash equivalents.

Other certifications may be appropriate where the seller is a foreign government.

These withholding taxes can be imposed regardless of actual gain on the sale. Theoretically, a taxpayer can get a refund of any withholding tax in excess of its actual tax liability by filing tax returns in the U.S. However, for non-U.S. investors, these withholding taxes may be pure tax leakage as they have no way to get refunds unless they decide to file U.S. tax returns. Therefore, non-U.S. sellers generally want to avoid these withholding taxes by issuing certificates or, if that's not practical, by receiving certificates from the fund.

As non-U.S. sellers may not always be in a position to issue certificates to the buyer, it is very important for the seller to communicate this with the fund in advance and receive any necessary assistance from the fund.

Unfortunately, not all general partners are willing to provide these certificates, sometimes for good reason. If the seller has already negotiated a side letter provision that requires the fund to issue withholding certificates or provide some level of assistance to reduce or eliminate withholding taxes with respect to a transfer, the fund may already have an established practice to issue any necessary certificates. Absent such an express undertaking, market practices vary.

Some funds are willing to issue the requested certificates, but they may ask the seller to bear any expenses associated therewith (e.g., any diligence expense of the fund accountant).

Certain other funds, instead of issuing certificates signed under penalties of perjury, may be more willing to provide confirmation from the fund's accountants that the fund does not have ECI assets or the fund is not a USRPI. Any expenses to produce such confirmation are generally charged to the seller.

Other funds may be willing to provide only informal confirmations, instead of certificates signed under penalties of perjury. These funds take the view that the fund may provide assistance to facilitate a transfer but should not bear any risk associated therewith, including providing a certification under penalties of perjury. In this case, the funds typically do not charge any expenses to the seller.

Some funds simply do not provide any assistance on a transfer because they believe that fund resources in general, not just out-of-pocket costs, should not be expended to facilitate a transfer.

Funds may take various factors into account in arriving at a particular approach, including internal policies, the relationship with the seller, the volume of transfers, and the fund's structure (e.g., blockers) or position on ECI. A non-U.S. seller should discuss upfront with the fund what kind of assistance it can get from the fund with respect to withholding.

If the fund is unwilling to provide necessary certificates to avoid withholding, the seller should coordinate with the fund and the buyer to make sure that the buyer can get comfortable closing the transfer without withholding by providing any necessary information or arrangement.

For example, certain buyers may be willing to move forward without withholding based on informal confirmations from the fund combined with the seller's withholding tax indemnity.

Conclusion

Fund investors that are contemplating selling their fund interests need to consider the tax implications of such a sale. Often, upfront discussions with the fund and the buyer will be necessary to properly assess and address the various tax considerations.

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[1] IRC Section 754.