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Tax

With PE Secondary Sales, Tax Is a Primary Concern

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Although a traditionally illiquid asset, investors in PE and other closed-end funds sometimes need to cash out prior to the end of a PE fund's term. Secondary sales of PE fund interests offer a straightforward pathway for an investor to achieve liquidity. Several key U.S. federal income tax considerations must be weighed, however, by PE sponsors and investors planning to engage in secondary sales of PE fund interests. In addition, there are non-tax issues that should be considered when structuring a secondary sale of a PE fund interest.

This article discusses common tax-driven transfer restrictions contained in PE fund operating documents; U.S. federal withholding taxes and related withholding certificates; optional and mandatory tax basis adjustments; and allocation methodology and indemnification considerations when drafting purchase and sale agreements (PSAs) of PE fund interests.

See "Asset Managers' Perspectives on Secondary Market Challenges and Product Expansion" (Jan. 11, 2024); and "Prevailing Trends in Transactions, Terms and Considerations in the Secondary Market (Part One of Two)" (Dec. 29, 2022).

Common Transfer Restrictions for Secondary Sales

Most PE funds restrict transfers and withdrawals by LPs without GP approval. One of the reasons for those restrictions is to prevent the PE fund from being classified as a publicly traded partnership (PTP) for U.S. federal income tax purposes. A PTP is a partnership in which the equity interests are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof). PTPs may be taxed as corporations for U.S. federal income tax purposes unless an exception applies.

For more on side letter provisions in secondary transactions, see "Affiliate Versus Third Party Debate and Other Topics in Transfer Right Provision Negotiations" (Jul. 16, 2019).

Whether interests are considered readily tradable on a secondary market (or the substantial equivalent thereof) generally requires a facts and circumstances analysis unless an exception to PTP status otherwise applies. There are three primary exceptions that PE funds rely on to avoid being taxed as a corporation for U.S. federal income tax purposes:

1. the "private placement" safe harbor;
2. the "lack of actual trading" safe harbor; and
3. the "qualifying income" exception.

Three PTP Exceptions

Generally, the "private placement" safe harbor applies to partnerships with:

- interests that were not required to be registered under the Securities Act of 1933; and
- fewer than 100 partners.

For purposes of the safe harbor, special rules apply to pass-through entities when counting partners. Certain beneficial owners of pass-through entities will be counted as partners only if the owners' interests in the pass-through entity are primarily attributable to the partnership and the use of the tiered pass-through entity was designed to satisfy the 100-partner limit. Otherwise, the pass-through entity itself can generally be counted as one partner. It is not uncommon for PE fund subscription documents to include representations relating to these pass-through entity rules, which are intended to enable a PE fund to count any LP that is a pass-through entity as one partner for this purpose.

Under the "lack of actual trading" safe harbor, interests will not be deemed readily tradable on a secondary market (or the substantial equivalent thereof) if the partnership interests transferred in the applicable taxable year do not exceed 2% of total partnership interests. Certain transfers are excluded from this tracking, such as:

- transfers at death;
- certain carryover basis transfers; and
- block transfers (*i.e.*, transfers representing more than 2% of the interests in partnership capital or profits).

PE funds that rely on this safe harbor will track transfers on an annual basis and may opt to push requested transfers above the threshold into the following taxable year to stay within the safe harbor.

Pursuant to the "qualifying income" exception, a PTP will not be taxable as a corporation if 90% or more of its income is "qualifying income," which includes:

- capital gains from the sale of certain assets, including real property, capital assets or certain property held to produce passive income;
- dividends;
- interest;
- real property rents;
- income from securities lending;
- income from options, forwards and futures derived from its business of investing in such stock, securities or currencies;
- income from certain swaps and commodities transactions; and
- certain other routine, investment income.

Generally, a PE fund that does not invest into pass-through entities operating businesses would be expected to satisfy the "qualifying income" exception.

See "Key Withholding, PTP and Other Tax Considerations in Secondary Transactions" (Feb. 23, 2023).

Transfer and Ownership Restrictions

Although many PE funds would likely satisfy one of the three PTP exceptions, virtually all PE funds restrict transfers. As the tax treatment of an investment in a PE fund depends on it being classified as a partnership for U.S. federal income tax purposes, PE funds will generally require GP consent to a secondary sale to ensure, among other things, that partnership tax classification is maintained.

In addition to the PTP risks described above, PE fund structures that include real estate investment trusts (REITs) often incorporate additional transfer and ownership restrictions. Those restrictions relate to continued REIT qualification, avoidance of pension-held REIT status and/or continued qualification as a domestically controlled REIT.

Withholdings Under Sections 1445 and 1446(f)

Tax withholding must be considered when selling a PE fund interest in a secondary sale. Failure of the buyer and seller to comply with tax withholding rules can, in certain circumstances, result in the PE fund having to withhold on the buyer's distributive share of fund income. Historically, the Foreign Investment in Real Property Tax Act has imposed a withholding tax on the sale of interests in certain partnerships that owned significant U.S. real property. Starting in 2018, U.S. federal withholding taxes now apply to the sale of interests in partnerships that are engaged in a U.S. trade or business.

Statutory Requirements

Withholding requirements under Sections 1445 and 1446(f) of the Internal Revenue Code (Code) are imposed on the buyer in connection with the sale of a partnership interest unless a certification is provided by the seller or the partnership that establishes an exception from withholding. Failure to establish an exception from withholding will result in withholding of 15% (under Section 1445) or 10% (under Section 1446(f)) of the gross proceeds in the secondary sale. If both regimes apply to a secondary sale, a buyer generally must withhold under Section 1445 unless it has applied for a special withholding certificate under the Section 1445 rules, in which case the buyer must generally withhold the greater of the amounts required to be withheld under the two regimes.

Beginning in 2023, if a buyer fails to withhold under Section 1446(f), there can be a secondary withholding obligation imposed on the partnership itself. However, the Section 1446(f) regulations offer some relief for failure to withhold where certifications were not obtained but it can nonetheless be established that the seller was not subject to U.S. federal income tax on the transfer. In any event, identifying potential withholding obligations and collecting certifications to establish an exemption from withholding is an important component of a secondary transaction.

Eliminating or Reducing Withholding Taxes

Sellers that are U.S. taxpayers may either provide a Form W-9 or otherwise certify that the seller is not a foreign person. Sellers that are non-U.S. persons have several options to eliminate or reduce U.S. federal withholding taxes under Sections 1445 and 1446(f).

First, for Section 1446(f) purposes, a non-U.S. person can certify that it will not recognize any gain on the transfer for U.S. federal income tax purposes or that it is exempt from withholding pursuant to a treaty. Alternatively, a non-U.S. seller can certify that it has been allocated insignificant income that is effectively connected with a U.S. trade or business (ECI) on its Schedule K-1s for the prior three taxable years. Finally, for Section 1445 or Section 1446(f) purposes, a non-U.S. seller can also certify that the transfer of the fund interest is subject to tax-free treatment for U.S. federal income tax purposes.

See our two-part series on tax withholdings on foreign partners: "Partnership-Level Duties and Consequences As the Requirement Has Evolved Over Time" (Mar. 2, 2021); and "Overview of Various Exemption Certifications and Tips for Reducing Withholdings" (Mar. 9, 2021).

As an alternative to the seller providing a certificate, the PE fund itself may certify that no Section 1445 and 1446(f) withholding is required in certain circumstances. Specifically, the PE fund can certify that:

1. for Section 1445 purposes:
    a. less than 50% of the value of its gross assets are U.S. real property interests; and

   b. less than 90% of the value of its gross assets consists of U.S. real property interests plus any cash or cash equivalents; and
2. for Section 1446(f) purposes:
   a. it was not engaged in a U.S. trade or business at any time during the taxable year through the date of the secondary sale;
   b. it would have de minimis ECI if it were to sell all of its assets at their fair market value; and/or
   c. the seller's distributive share of ECI in a hypothetical sale of its assets at their fair market value would be de minimis.

See "Hot Topics in Tax and Negotiating Tips for Private Fund LPs (Part One of Two)" (Aug. 10, 2023).

Investors in new PE funds often request a side letter provision stating that the fund manager or GP will cooperate in providing these certifications. The side letter provision may help expedite a secondary sale by enabling the selling investor to obtain tax information to make its own certifications or causing the PE fund to produce partnership certifications. For older PE funds, however, similar side letter provisions are unlikely to be present.

In addition to seller and PE fund certifications, buyers in secondary transactions are required to certify to the PE fund within ten days of closing on the secondary transaction that the buyer has satisfied its Section 1446(f) withholding tax obligations or that no withholding is required. That obligation should be incorporated into a PSA.

Optional and Mandatory Basis Adjustments

When a partnership interest is transferred, the transferee partner may request an election under Section 754 (754 Election). A 754 Election allows a partnership to step up the basis of the assets within the partnership with respect to the incoming partner. In that regard, the incoming partner's aggregate share of inside basis of the partnership's assets will equal the amount of consideration paid to acquire the partnership interest.

Although a 754 Election may result in potential tax benefits for the incoming partner, the 754 Election imposes recordkeeping and other administrative burdens on the partnership. For those reasons, few PE funds commit to make a 754 Election or, when they agree to do so, they may require the incoming partner to reimburse the PE fund for expenses associated with making and maintaining the election.

Even without making a 754 Election, a PE fund must write down its assets if the fund has a "substantial built-in loss" immediately after the secondary sale. A PE fund has a "substantial built-in loss" if its assets, in the aggregate, have an unrealized embedded loss greater than $250,000 immediately after the transfer of the PE fund interest. A second test provides a "substantial built-in loss"

exists if the transferee would be allocated a loss greater than $250,000 if the partnership sold its assets for cash at their fair market value immediately after the transfer of the partnership interest. Because the second test is applied at the partner level, it could potentially cause a partnership to have mandatory basis write-down when the partnership overall does not have a substantial built-in loss.

Certain PE funds can avoid those basis write-down rules by electing to be treated as an "electing investment partnership," which requires the PE fund to:

- elect to be an electing investment partnership;
- be a "3(c)(1)" or "(3)(c)(7)" fund;
- never have engaged in a trade or business;
- hold substantially all its assets for investment;
- have received at least 95% of its capital contributions in cash (not in kind);
- not have had any in-kind contribution with a built-in loss at the time of contribution;
- have had all subsequent closings occur within 24 months of the initial capital contribution; and
- have a term that is no more than 15 years.

Given those requirements, not every PE fund will be able to escape application of the mandatory basis write-down rules. Therefore, a PE fund should be aware whether its portfolio, in the aggregate, has appreciated or depreciated since its inception when considering the approval of a secondary sale.

See our two-part series: "Importance of Diligencing Transfer Restrictions in Secondaries to Avoid PTP, REIT and Other Negative Tax Issues" (Sep. 29, 2020); and "The Need to Parse Tax Elections, Allocate Taxes and Obtain Withholding Certificates Early in a Secondary Transaction" (Oct. 6, 2020).

Taxes Liabilities, PSA Indemnitees and Side Letters

PE funds and parties to a secondary sale must consider the allocation of income for pre-closing and post-closing periods, tax indemnification and the handling of tax controversies. Those concepts are relevant for both the taxable year in which the secondary sale occurs and tax liabilities resulting from tax audits of prior taxable years.

Income Allocations

When partnership interests are transferred, the Code allows the partnership to allocate income in the taxable year of the transfer either based on (1) an interim closing of the books, or (2) prorating ownership to the relative number of days during the taxable year that the seller and buyer were

partners (subject to certain "extraordinary items" that cannot be prorated). The seller and buyer of a PE fund's limited partnership interests likely would prefer the fund to allocate income based on an interim closing of the books, while fund managers may prefer to allocate based on pro-rata ownership.

If the PE fund does not consent to the desired income allocation methodology in the PSA, the parties may need to assess the impact of the fund's allocation methodology. Any material differences resulting from the PE fund's choice of tax allocation methodology can be addressed through a purchase price adjustment or be factored into the purchase price.

Payment of Tax Liabilities

Regardless of the chosen income allocation methodology, income tax liabilities resulting from tax audits of pre-closing periods could flow to the transferee partner. PE funds, sellers and buyers can address that potential liability with an indemnity provision in the PSA or a side letter covenant from the PE sponsor, or both.

Under U.S. federal income tax rules governing partnership audits, a partnership can either pay the tax due or make an election to push out the tax liability to parties who were partners in the taxable year being audited. If the push-out election is made, the tax liability should flow to the transferor partner. If the push-out election is not made, then it is possible that the transferee partner could bear the economic burden for taxes from a period when the transferee was not a partner in the fund. It should be noted that other procedures may be available during a tax audit that may have an effect on former or current partners, including amended return procedures, imputed underpayment modifications and certain other elections.

If the PE fund does not make the push-out election, the buyer would benefit from a carefully drafted tax indemnity in the PSA. Although the seller may have a side letter provision obligating the PE fund to make the push-out election, side letters are generally not transferable in a secondary sale. Therefore, an incoming LP may have to negotiate a new side letter containing a tax audit provision tailored to its interests. Note that PE funds will want to be able to exercise their rights as to any income tax liability against either the transferor or the transferee.

See "Modifications, Amended Returns and Push-Out Elections As Cures for Imputed Underpayments From IRS Partnership Audits (Part Two of Two)" (Apr. 19, 2022).

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