

## M&A Tax Talk

### Continuation funds

#### *Continuation funds: Potential tax opportunities and considerations*

##### **Key takeaway**

When evaluating or negotiating a continuation fund, appropriate consideration should be given to the tax implications, including desired outcomes for investors associated with potential structure alternatives. Early tax planning guides structuring alternatives and may serve to mitigate potential adverse tax consequences, including the tax characterization of proceeds received by exiting investors and strategies to achieve tax-deferred treatment for rolling investors.

##### **What is a continuation fund?**

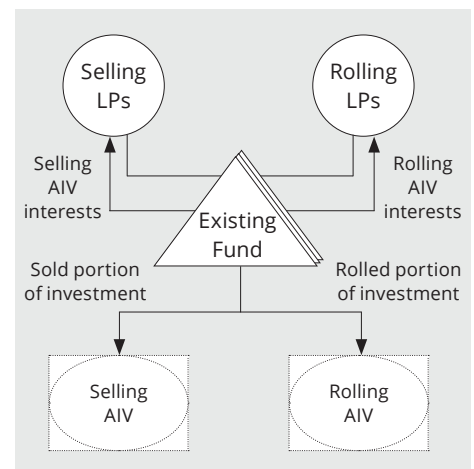
While the term “continuation fund” may encompass different forms, one common structure is where the continuation fund is a newly formed vehicle, generally a partnership for tax purposes, to acquire an investment (or several investments) from an original fund vehicle. The original fund sponsor generally continues to manage the investment, and the original fund general partner (GP) and limited partners (LPs) who wish to continue indirectly holding the investment may elect to do so. The other interests in the continuation fund are offered to new investors. New investors’ cash contributions are used to acquire interests from investors who wish to monetize all or a portion of their investment.

Private equity (PE) funds may use the continuation fund strategy to set a value for an investment, provide liquidity for investors, crystallize carry, and allow potential tax deferral for rolling investors.

In addition to analyzing the financial benefits, execution of a continuation fund requires careful evaluation of the anticipated tax consequences to a PE fund, its GP, LPs, and its new and old co-investors.

##### **Continuation fund structuring**

Typically, after an election period, investors (LPs and GP) are given the option to sell or roll over their interests in an investment while new investors commit funding to the continuation fund. Investors who wish to sell their investment (“Selling LPs”) and investors who wish to roll over their investment (“Rolling LPs”) may receive a distribution of the relevant investment from the original fund. Then, depending on the structure and composition of the investment being sold, Selling LPs may receive cash in exchange for their share of the investment (as depicted below) or contribute what they received into a new selling alternate investment vehicle (“Selling AIV”), which would be sold. Rolling LPs contribute their share of the investment to the continuation fund. New investors are then given the opportunity to purchase interests in the continuation fund. See the “Partnership considerations” section for discussion on potential partnership divisions, application of the anti-deferral rules, and other potential partnership tax matters that may need further analysis.



##### **Corporate considerations**

In a situation where the portfolio entity is a privately held corporation there are certain strategies that may be used to monetize a portion of the investment held by investors, including cash on the balance sheet, the provision of a new source of capital from a new investor, a leveraged recapitalization/distribution, or all of the above. Leveraged distributions take place when new or incremental debt is issued in order to buy back existing shares. Depending on the number of LPs looking to exit, a combination of these strategies could also be used, with the leveraged distribution first, followed by new investors contributing capital. A leveraged distribution would generally be treated first as a dividend to the extent of earnings and profits (E&P), then a return of capital, and finally capital gain to the extent the distribution exceeds basis. [Refer to the recent M&A Tax Talk on leveraged distributions for further discussion.](#)

At the corporate level, redemption treatment under section 302 could provide sale or exchange treatment to certain investors. For example, it may be possible to distribute stock to certain investors who desire to exit and monetize their investment. Such stock could then be redeemed directly by the issuing corporation. In certain situations, the tax treatment of the redemption may be eligible for capital gain treatment pursuant to section 302(b). Consideration should also be given to compliance and information reporting requirements under sections 302(d) and 301.

Lastly, a section 368(a)(1)(e) recapitalization can provide ways to restructure the debt and equity within the investment. Common shareholders can exchange their interests into preferred shares, thus bifurcating the basis in shares and enabling redemption in a certain class of shares. Further, if there are multiple businesses in the portfolio company, a recapitalization with tracking stock of the economics of the businesses could help investors bifurcate what may be sold at a later exit event.

### Partnership considerations

At the investment fund level, there are a host of additional considerations when determining whether to distribute interests in the investment to the LPs and GP, including:

**Basis:** Depending on the structure, new investors may be deemed to contribute cash to the new continuation fund, which then buys interests in the portfolio company, or new investors may be deemed to buy interests in the continuation fund, which now holds interests in the portfolio

company. Consideration should be given to the structure and whether a section 754 election is necessary for adjustments to the tax basis in the assets held by the continuation fund.

**Holding period:** Depending on the structure, the continuation fund may hold interests in the portfolio company with a partial or entirely tacked holding period. This can be important especially to investors who might be subject to section 1061 (i.e., long-term vs. short-term capital gains).

**Rolling vs. Selling LPs:** It is often possible to form new entities to manage the different desired outcomes of Rolling LPs and Selling LPs. However, as in any restructuring of a partnership, consideration should be given to the partnership continuation and division rules under section 708, and also the partnership anti-deferral rules (e.g., potential disguised sale rules under section 707). We recommend starting these conversations early with your tax adviser as such analyses may take time and may impact tax reporting requirements for all parties.

In situations where the continuation fund is treated as a continuation of an existing partnership (e.g., the original fund), the continuing partnership will retain certain tax characteristics of the original partnership, including taxpayer ID number and prior methods and elections.

Thus, we recommend a full analysis, including consultation with legal counsel, be performed to discuss the risk of the characterization of such transfers to ensure unexpected gains are not triggered and that the transfers are properly reported.

### Our approach

The material presented in this article is an overview, and the tax planning considerations are nuanced and complex. If you are looking to evaluate or execute a continuation fund, Deloitte can help you analyze and understand the US tax implications of your desired transaction(s).

### Want to learn more?

Reach out to our contacts below.

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