Keeping up with Alternative Investment Funds

June 2022

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Introduction

Welcome to our June edition of Keeping up with Alternative Investment Funds.

Our June newsletter looks in depth at a number of topics ranging from ATAD III to the impact of the Russia-Ukraine Crisis.

We have also included a couple of news pieces on the next slide that may be relevant in the context of alternative investment funds.

See the full list of articles in this newsletter below:

- ATAD 3: The European Parliament provides initial thoughts
- Battle of the buyers - considerations for corporate and AIF purchasers in M&A transactions
- The Russia-Ukraine Crisis - Key Implications for Asset Managers
- Continuation Funds - popular but surprisingly complex

Please do continue to reach out to your usual PwC contacts if you would like to discuss any of the above, and please do share your feedback with us if there is a particular topic or issue you would like us to cover in the future.

Kind regards,

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News Bulletin

New UK-Lux tax treaty agreed

On 7th June the UK and Luxembourg agreed a new Double Tax Treaty between the two countries. The new DTT will come into force once it has been formally ratified by both countries. Full details can be found here. The new DTT includes updated provisions in relation to the tax residency of pension funds in both countries and the tie breaker clause in relation to tax residency. It also includes a clarification as to the definition of a “dividend” under the DTT and removes the previous provision for a 5% withholding tax on dividends between two companies, so that there will be zero dividend wht where the recipient is the beneficial owner. The DTT has also been amended to allow the UK to have capital gains taxing rights over a UK “real estate rich” company.

The DTT has been updated to bring in a Principal Purpose Test in relation to the denial of access to the tax benefits within the DTT if the obtaining of a benefit under the treaty was one of the principal purposes of any arrangement, this is in line with the new OECD Multilateral Instrument for implementing BEPS in DTT’s.

UK announces a deferral of the OECD’s Pillar 2 regime

The UK Treasury announced on 14th June that the UK’s adoption of the OCED’s Pillar 2 framework would be deferred until accounting periods beginning on or after 31/12/23, this is a welcome deferral given the uncertainty that exists in relation to the precise details of the regime and the expected adoption dates for other key jurisdictions but also the complexity of the rules means that there is a significant amount of work required by those who might be subject to the Pillar 2 regime.

The Treasury also confirmed that the UK will issue draft Pillar 2 legislation in the next few months for consultation ahead of the new commencement date.

July is a key month for employer tax reporting deadlines

There are several key employer tax reporting deadlines in early July including:

4 July - Last date for employees to reimburse any taxes paid by employer on their behalf before a tax charge arises

5 July - Last date for agreeing PSA arrangements

6 July
- P11Ds to be issued and P11D(b) to be filed with HMRC
- Online reporting of employment related securities including grant and vest of restricted securities, including carry and co-invest, and award and exercise of securities options.
- Notification of termination payments to HMRC

22 July - Payment of NICs on P11D benefits

31 July (will be 1 Aug due to weekend) - Submit calculation of taxes due on PSA items

Please contact your usual PwC contact should you need any assistance with any of the above employer tax reporting deadlines.

ATAD 3: The European Parliament provides initial thoughts

In last month's edition, our colleagues Gareth Hughes and John Holt penned an insightful article 'Corporate Substance - time to get it right'. If you haven't read it, we would recommend doing so for a broad summary on implications of having or being unable to demonstrate sufficient substance in jurisdictions in the international tax landscape. This is particularly important considering the mooted third instalment of the EU's Anti-Tax Avoidance Directives, the unsurprisingly named "ATAD 3" (or "ATAD III" if you like Roman numerals and extra keystrokes).

At the time when Gareth and John had written their article, ATAD 3 had been drafted by the European Commission and was sent down to the European Parliament. May's KUWAIF article summarised this Directive and identified a few features that may cause concern for investment managers, such as the apparent restriction on the outsourcing of operations by entities within a fund structure or having another EU Directive (remember DAC 6?) which requires them to look back at their arrangements since 1 January 2022 and apply "gateway" tests which are yet to be finalised in the legislation.

Gareth and John's article did feature a warning to the reader that by the time of reading some of these features may have been resolved; this was prophetic as the Europe Parliament's Committee on Economic and Monetary Affairs ("ECON") released a draft report setting out their proposed amendments to ATAD 3. A link to the draft report can be found here. Please note, however, that this is a draft report and further amendments can be made by ECON until 6 September 2022. A vote isn't due to be taken until 17 November 2022 and even then, the European Commission can then decide to reject the amendments. Once the Directive is ratified by the European Council, there still may be some derogations when Member States implement ATAD 3 into their domestic laws, so there is some way to go.

Please find a table below setting out a selection of ECON's amendments, but for those who cannot contain their excitement about the big announcements, there are key relaxations for outsourcing to associated enterprises in the same jurisdiction and a deferral of the implementation of ATAD 3 to 1 January 2025 and whilst the two year "look back" period remains, at least this new date isn't in the past (at the time of publishing). The relaxation on outsourcing would be particularly welcomed by the alternative investment management industry as whilst many fund structures may have ample substance and activities "in-country", ATAD 3 would seemingly only permit those of a company's in-country parent to be considered.

ATAD 3: The European Parliament provides initial thoughts (continued)

Item	Per Draft ATAD 3	ECON's draft amendment	Relaxation or tightening?
Outsourcing of administration of day-to-day operations and the decision making on significant functions	See previous article for more information, but broadly only to parent companies in same jurisdiction	Can be outsourced in jurisdiction to associated enterprises	Relaxation
Exclusions for regulated financial undertakings	None	Yes	Relaxation
Gateway conditions:			
Revenue of "shell" being "relevant income"company	More than 75%	More than 80%	Relaxation
Relevant income of shell company being outside its jurisdiction	At least 60%	More than 65%	Relaxation
Headcount generating relevant income	At least five full time workers carrying on activities for company	Same as draft but the workers need to work in the state of residence of the entity	Tightening
Assets of shell company being outside its jurisdiction	More than 60%	More than 55%	Relaxation

Assuming the proposed and welcome amendments by the European Parliament are accepted by the European Commission and European Council as the draft Directive makes its way through the EU legislative machinery, please note that businesses are still going to have to assess their structures against the gateway tests and document their analysis, so this adds another compliance and governance process to be built out and implemented.

We will keep you posted as and when further developments happen in relation to ATAD 3, but if you have any queries in the meantime, please do reach out to your PwC contact or to Rob Mellor and Dan Jones, whose contact details are below.

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Battle of the buyers - considerations for corporate and AIF purchasers in M&A transactions

A prized asset for sale can attract interest from a range of potential suitors. This has been very apparent in the buoyant deals market of the past couple of years.

There's always been different considerations for competing types of M&A buyers but recent UK legislative changes have added further emphasis to these distinctions. This article seeks to highlight and compare some of the key features for corporate buyers versus alternative investment funds ("AIFs").

Understanding where your competitors may have an edge is valuable. Identifying your competitive advantages and leveraging them effectively can be the key to a successful bid.

The tax issues

Tax synergies - better together?

In a corporate acquisition, the M&A target is joining an existing corporate group. The commercial and financial synergies available are frequently a driver for the buyer but there can also be pros and cons from a tax perspective depending on the tax profile of both the acquiring group and the target.

A simple example in a UK context is where the acquiring group includes existing UK companies; these will form a tax group with UK target companies from closing. This can allow "loss sharing" between the entities for post-closing losses (anti avoidance rules limit the use of pre closing losses). It's noteworthy that the UK's grouping rules are relatively generous in comparison to other jurisdictions as they allow groups to be formed without requiring direct UK-UK ownership. This can be useful in a multinational context and avoids the need for internal restructuring to remove intermediate overseas companies.

Similarly, the acquisition may allow excess debt capacity elsewhere in the existing corporate group to be utilised by the new borrowing to fund the acquisition. Benefits may also be possible under the UK corporate interest restriction rules whereby a group ratio election may allow >30% of tax EBITDA to be deductible if there is additional external leverage in the wider group outside of the UK. Whilst in practice listed MNCs tend to have less gearing than PE businesses, it is worth remembering that the genesis of the UK debt cap restrictions was US corporate groups pushing their excess debt to the UK. For example, using a UK Bidco to borrow and buy non-UK assets and surrender the interest deductions to a UK business. By comparison, interest deductions for acquisition debt borrowed in an AIF owned structure are likely to be limited to the debt capacity of the target portfolio company on a standalone basis.

Better apart?

Joining a larger corporate group is not always good news. For example, if it means tripping over certain size thresholds, that can bring tax complexities or compliance requirements. Examples include the impending BEPS Pillar Two minimum taxation rules and Country by Country Reporting ("CBCR") thresholds (both apply, or will apply, to multinational groups with turnover >€750m). Pillar 2 not only presents additional compliance requirements but can result in material "top up" taxes for multinational groups. We've seen a number of instances where top up taxes could become due even where companies are not based in "low tax" jurisdictions.

An AIF held structure will often have additional complexity of its own, including consideration of the UK close company rules which may need to be managed in respect of certain lending transactions or international restructuring. Often AIF structures are also much more constrained by investor considerations - typically managing the potentially competing needs of investors across multiple geographies.

Impact of tax on pricing

A typical AIF will be primarily focussed on cash taxes to be paid over their expected holding period. Less cash tax leaves more cash to pay interest. Listed corporate investors may be more sensitive to total taxes and the impact on effective tax rate in the statutory accounts. In general, AIF investors care more about cash tax than accounting impact of tax items and the recognition of deferred taxes. Ultimately as a corporate purchaser's cost of capital is usually lower they may be willing to attribute more value to discounted deferred tax assets which are expected to unwind over a number of years. That can put an AIF investor at a disadvantage.

Battle of the buyers - considerations for corporate and AIF purchasers in M&A transactions (continued)

Capital gains taxes on exit

To state the obvious, Corporate buyers usually buy to hold, AIFs buy to sell and perhaps to restructure. Tax free exits are a driver for one but not the other.

The investor objective is capital gains on exit. For taxable UK LPs that means falling outside the offshore funds rules if investing via a foreign platform (QAHC to the rescue? - see below). Sometimes that requires the target to tweak its structure pre-acquisition, for example US LLCs to have share capital. Whilst these are difficult messages to convey to a vendor, they should not impact the deal.

The starting position for the disposal of shares by UK companies is that chargeable gains are subject to corporation tax unless an exemption is available. The UK Substantial Shareholding Exemption ("SSE") is widely utilised for the disposal of shares in trading companies, however the trading requirement can result in a complex analysis being required in practice and is a less competitive aspect of the regime in comparison to the participation exemptions of other common European holding company locations (e.g. Luxembourg, Netherlands et al).

As a result of recent efforts to increase the UK's competitiveness, there are 2 other routes to exempt UK gains which are potentially available to AIFs and are unlikely to be available to corporate purchasers. Each comes with more onerous ownership requirements.

The first is a targeted relief within the UK SSE regime itself, which removes the trading requirement for disposals of shares by companies which are directly or indirectly owned by Qualifying Institutional Investors ("QIIs") from 1 April 2017. QIIs include pension schemes, life assurance businesses, sovereign wealth funds, charities, investment trusts, authorised investment funds and exempt authorised unit trusts. The relief available is tapered depending on the ownership held by QIIs with 80% being required for a full exemption and partial relief available for ownership between 25% - 80%.

The second is the freshly minted, and thus untested, UK Qualifying Asset Holding Company ("QAHC") regime which UK companies can elect into from 1 April 2022 if they meet certain ownership criteria. Such criteria and the QAHC regime as a whole have been covered in a previous article. The tax benefits of the QAHC regime are much broader than just the availability of a participation exemption on non-trading assets with no holding period or investment size tests. They include no UK WHT on interest payments, the availability of interest deductions on profit participating debt, capital treatment of share redemptions for UK investors.

Cash extraction

AIFs may have differing objectives across different classes in terms of regular cash extraction. There may be regular dividend flows from an infra asset but private equity controlled assets would more typically use excess cashflow to pay down debt ahead of exit. In longer holding periods, a debt refinancing may lead to a leveraged dividend to the AIF. To the extent cash extraction or tax free exits rely on treaty benefits, corporate groups are often better placed to meet increasingly tough purpose and substance tests.

Broader considerations

AIFMD

One issue which corporate purchasers do not have to contend with is the Alternative Investment Fund Manager Directive ("AIFMD"). In particular, the AIFMD asset stripping rules which (if applicable) can restrict the ability to extract funds from a newly acquired target (which includes EEA companies) for a period of 2 years following the obtaining of control. Brexit has complicated matters as the UK has its own standalone implementation. The restrictions include distributions (including dividends), capital reductions, buybacks and redemptions. Dividend restrictions are based on the distributable reserves shown in the prior year-end financial statements. The asset stripping rules can be a key consideration for target's acquired by AIFs where a later part disposal or recapitalisation forms an important part of the investment thesis. It's surprising the number of corporate vendors who fail to take this into account in their pre-sale restructuring. A debt free target package is not necessarily a good thing!

The AIFMD Asset Stripping rules simply are not a concern to a corporate buyer.

Battle of the buyers - considerations for corporate and AIF purchasers in M&A transactions (continued)

Speed of execution

There is a reason the author works for AIFS… In a competitive process, deal certainty and speed of execution can be important factors in differentiating competing bids. Here it is AIFs that would traditionally be seen as being able to move quickest, both by design but also with their corporate counterparts potentially being subject to lengthy competition / antitrust clearance processes. However, if a multinational corporate buyer is funding a purchase from its own balance sheet / readily available resources, there could be circumstances where it can transact more quickly than an AIF which is reliant on obtaining external acquisition financing.

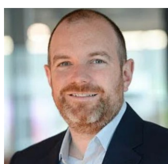
A related point is that the strength of a multinational corporation's balance sheet may also prove advantageous in certain deal negotiations, for example with the pension trustees of a target's defined benefit pension scheme. Corporate vendors need to be aware of this and plan ahead if they wish to attract a wide pool of potential buyers.

Management incentivisation

One of the perceived advantages of AIFs vs corporates in a bidding process is the ability to effectively incentivise key management. As an example, a typical private equity buyout will include a management incentive plan ("MIP"). This gives key management the opportunity to obtain equity in the structure which aligns their interests with the private equity sponsor and gives them the opportunity to realise a capital return on a future exit. How important this is at the bid stage depends on whether existing management are decision makers.

Next steps

- It won't come as a surprise that there isn't a clear winner and we have seen a huge amount of successful M&A activity from both corporate and AIF purchasers in recent times. Every M&A transaction is different and there will be advantages and disadvantages for both corporate and AIF buyers depending on the specific circumstances. There are clearly a number of factors to consider for each specific type of purchaser, some of which can turn into material deal issues whereas others may just introduce additional complexity which will need to be worked through as part of the M&A process.
- What is important is to have an adviser alert to these differentiators and we're happy to help.



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The Russia-Ukraine Crisis - Key Implications for Asset Managers

Amidst the geopolitical climate of recent months, global financial markets have entered a period of increased uncertainty. Sustained market volatility coupled with some assets becoming less liquid and/or difficult to value has left fund managers with a complex range of issues to navigate. In this briefing we will explore some of the more significant issues fund managers are currently facing.

Identifying and Managing Restricted Investors

Fund managers continue to grapple with identifying whether investors are subject to new restrictions and/or sanctions across the globe. Sanctions lists are continuously being monitored and updated, whilst regulators are also seeking additional measures to restrict Russian involvement in markets. For example, on 13 April the EU introduced sanctions prohibiting EU investment funds that invest in transferable securities denominated in a Member State currency from accepting new investments from Russian or Belarusian persons. Moreover, the various approaches taken by governments to sanctions regimes creates challenges for fund managers in identifying and monitoring how products are compliant across jurisdictions.

Fund managers are being asked by regulators to remain proactive in identifying the source of incoming investment, and to look beyond the initial investor entity to the ultimate 'control' of entities within corporate structures in order to ascertain whether a prohibited investor may be indirectly seeking to invest in the fund via nominee or other intermediate arrangements.

If a manager identifies a prohibited investor within one of its fund products, an analysis is required in order to manage the investor in a way that will not trigger global sanctions regimes. For example, any redemption of a prohibited investor's interest in a fund could constitute 'dealing' under sanctions regimes. Managers should treat each investor independently based on the facts, but generally their fund interests would be treated as frozen assets.

Managing Distressed Assets

Where funds have significant exposure to assets that have become illiquid and/or hard to value due to sanctions or other activity, fund managers may consider suspending dealing until liquidity and solid valuations return. Once a suspension is in effect, a fund's governing legal documentation and investor relations considerations will dictate whether the fund manager may continue to take its management fee.

If excessive exposure has resulted in a material adverse impact on a fund that cannot be remedied in the foreseeable future, a manager may consider it to be in line with the best interests of its investors to liquidate the fund.

When examining if/how to divest of Russian linked assets, fund managers should take into account the fund's mandate as well as applicable ESG considerations.

As an alternative to divesting of these assets, managers might consider segregating distressed assets in a side pocket so the fund can continue to trade. (See "Side Pockets" for further discussion.)

Decisions around NAV Calculations

Fund managers may struggle with their fund's NAV calculations where a material portion of a fund's portfolio is difficult to value as a result of recent events. Such uncertainty raises questions as to whether a fund manager is acting responsibly in satisfying redemptions and obtaining subscriptions when they cannot confidently determine the NAV of the fund.

Fund managers may wish to suspend fund NAV until certainty is regained, but a manager's ability to do so will be contingent on what the fund's governing documents permit. In addition, a suspension of NAV is only likely to be used as an interim and temporary solution given the conflict is likely to continue for a prolonged period of time.

One solution available to fund managers is to segregate affected assets in a side pocket and then reintroduce these assets to the main fund once asset valuation becomes clearer.

The Russia-Ukraine Crisis - Key Implications for Asset Managers (continued)

ESG

The conflict will also challenge fund managers' ESG policies. Managers may consider that the conflict provides grounds to cease new investment in Russia, or divest from the country when they are able to do so.

The conflict may also lead managers to recalibrate their approach to investment in certain sectors. For example, the continued absence of Russian oil and gas in the market raises questions as to the ESG value of energy self-sufficiency, meaning nuclear and coal energy sources may be considered in ESG taxonomies.

State investment in defence in support of Ukraine could also lead to a reassessment of whether weapons could be included in sustainable investing categories, due to a perception that their political and social value has increased. Inversely, state investment in weapons could also change managers' perspective on investment in sovereign bonds. This range of issues highlights how important it is for managers to be engaging with clients to determine what sort of asset allocation is appropriate given the ESG issues resulting from the conflict.

Managers may also consider pricing ESG risks into future investment decisions, as some have received criticism for not doing so despite the longstanding Russian aggression towards Ukraine.

Side Pockets

How can they be set up?

Managers can deploy side pocket arrangements to enable a fund to continue to trade, whilst also preventing opportunistic investors from joining a fund late in the day only to benefit from participating in the potential uptick in the value of distressed assets.

If side pocket language is already incorporated into the fund's governing documents, then a manager would issue a new class of non-redeemable shares to all existing investors entitling the holder to participate in the 'side pocketed' assets. The NAV of the distressed assets would then be deducted from the fund's main pool of liquid assets. Side-pocketed assets therefore remain within the existing legal entity (albeit with profits and losses allocable solely to the new side pocket class of shares), with fees to be calculated in accordance with the terms of the existing fund documents. New investors would not receive shares associated with side pockets established prior to their investment in the fund.

A fund's governing documents may not necessarily provide for side pocket arrangements; in such cases, fund managers may consider the creation of a 'synthetic' side pocket. In this scenario, depending on the structure of the fund, distressed assets can be placed into a new SPV or sub-fund and then existing investors are issued a distribution-in-kind of non-redeemable shares in such SPV or sub-fund. This allows the fund to continue to trade, but creates the additional burden of having to set up and administer another fund entity.

Regulatory Considerations

Managers should take care to consider regulatory implications when creating a new side pocket arrangement, as these may differ region to region. As recently announced, the FCA is undertaking a consultation to enable UK fund managers who manage undertakings for the collective investment in transferable securities ("UCITS") and other non-UCITs retail schemes to use side pockets as a result of the current market challenges. The Irish regulator is also considering this area. Side pockets are generally permitted in both Cayman and Luxembourg regulated funds, but care should to taken to engage with legal and regulatory advisers nonetheless. For example, in Cayman, the prevailing court opinion suggests with 'synthetic' side pockets, any new vehicle must be created before the redemption date, and cannot be created by the main fund entity simply issuing participation interests directly to investors.

The Russia-Ukraine Crisis - Key Implications for Asset Managers (continued)

Potential Benefits and Areas of Concern

Side pockets could be a valuable tool for fund managers in navigating liquidity issues whilst avoiding suspensions. However, the practice has proved controversial in the past as managers have used side pockets to hide poorly performing assets while charging fees on more liquid assets. The FCA further acknowledges that allowing funds to open side pockets could potentially increase the fees and charges being paid by investors, whilst investors may also find it harder to keep track of the fund's NAV.

The FCA does qualify that it does not expect funds to charge investors a fee for being placed in the side pocket share class or an exit charge for selling side pocketed investments, or a performance fee. The FCA then adds that any forthcoming rule change could allow fund managers to create side pockets without a requirement to notify or consult with investors, as the time and cost involved in seeking approval from investors could be significant.

Next steps

- The ability of managers to utilise liquidity tools such as suspensions and side-pocketing will be dictated by a fund's documents. It is therefore important for a fund manager to evaluate its policy surrounding these issues on a dynamic basis, especially when considering new engagements.
- Care should be taken when drafting fund documentation, paying particular attention to risk factors, redemptions and NAV calculation provisions to ensure wider impacts relating to the Russia-Ukraine conflict (and wider geopolitical conflicts) are being appropriately assessed, accounted for and disclosed to investors.
- Managers should consider incorporating side pocket language into fund documentation.
- Managers should consider integrating ESG risks into decision making and engaging with risks on a dynamic basis, especially if markets in Russia begin to reopen.
- Managers should continue to engage with clients to consider changes to investment programs and risk allocations given the issues highlighted by the conflict.
- In relation to potential tax implications, managers should also:
    - monitor changes in taxation for any relevant assets;
    - consider investor reporting requirements with respect to side pockets; and
    - check whether the creation of any synthetic side pocket results in a taxable event.

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Continuation Funds – popular but surprisingly complex

Our April 2021 edition of KUWAIF introduced the concept of continuation funds. Since then their popularity has continued and they are now firmly party of the General Partner ("GP") toolkit when evaluating exit opportunities. This view was vindicated at our Alternative Investment Funds Conference, where our Continuation Funds workshop turned out to be extremely popular with attendees demonstrating considerable interest in the subject matter.

Continuation Funds - Revisited

The secondary market has grown by 48% over the last two years to a $130BN industry, with two fund managers recently raising $19BN and $14BN funds respectively dedicated to secondary transactions. More than half of this deal volume is attributed to GP-led secondaries, and is expected to continue to exceed Limited Partner ("LP")-led secondaries going forward. Continuation funds make up the vast majority of GP-led secondary transactions, representing 85% of the space.

Continuation fund transactions are where an existing GP of a close-ended fund wants to avoid a forced exit of one or more of their portfolio companies by establishing a new vehicle that can hold the relevant asset(s). The terms of the new vehicle allow the GP to continue holding the relevant asset(s) beyond the fixed term of the fund that originally held the assets.

LPs are offered the opportunity to re-invest in the continuation fund, or realise their share of the value of the relevant underlying asset(s). The continuation fund is then marketed to new investors given the expectation that some of the existing LPs will want to cash out.

This is not a novel strategy. In fact, continuation funds have been around for a while. What has changed is the shift in perception amongst the investing community - it is no longer a way of segregating the "bad apples" that still needed love from the well-performing investments. Rather, it is a tool to separate the "crown jewels," where the expectation is that returns will be greater in the future, especially in an uncertain macroeconomic environment. Put bluntly the stigma of a transferring assets to a continuation fund has gone.

COVID-19 has definitely played a key role in terms of driving the popularity of continuation funds as GPs were faced with valuation issues on what they considered to be good businesses and the near shutdown of the IPO and M&A market. Therefore, private equity identified continuation funds as an alternative exit route to hold assets in funds that had reached the end of their life cycles.

However, not all continuation funds are the result of the past few year's unique volatility. Many firms had either already undertaken a continuation fund or had already started planning for their continuation fund pre-pandemic and there are good reasons why they are so popular:

- Exiting legacy portfolio investments benefits GPs:

- GPs love their assets and often believe that they can do a better job than selling them to another fund – they want to sell them under their terms not a forced exit;
- by making it easier to raise new funds, since prospective investors generally attribute more weight to a GP's realized track record than its unrealized one;
- the funds also enable GPs to reset their fee clocks — allowing them to continue to charge management fees and ultimately carried interest on known, high-growth-potential companies; and
- for some GPs it has also been an opportunity to realise some carry, especially ahead of potential rate increases.

- For LPs it provides an opportunity:

- for liquidity,
- allows LPs to reconstruct their portfolios; and
- prolongs exposure to the turbo-charged end of the investment J-curve.

Structuring a continuation fund is a lengthy process, and can often require disproportionately large advisory teams (relative to the transaction size) to implement the strategy - given a 6-12 month timeline to set one up, we strongly recommend starting the process early. Teams will primarily comprise individuals with an M&A and Funds background.

Continuation Funds – popular but surprisingly complex (continued)

Tax free vs. a taxable reinvestment

An early decision that must be made by the GP is whether or not the GP will offer existing LPs the opportunity to potentially reinvest on a tax free or a taxable basis. This decision will have a significant impact on how the continuation fund transaction will proceed. To facilitate the decision-making process, it is important that the GP, alongside their investor relations ("IR") or placement agent team consider how many of their existing LPs are likely to rollover. Then of these potential reinvesting LPs, how many of them are likely to be incentivised to reinvest if they were given the opportunity to do so on a tax free basis. Frequently GPs want to offer a tax-free reinvestment, but in some instances the LP might either be indifferent (as in a low-taxed jurisdiction) or they will reinvest using capital from a different vintage/product.

A tax neutral basis will add a complexity to the transaction. GPs should also expect a significant amount of due diligence from reinvesting LPs on the proposed legal steps and tax implications where a GP indicates that the transfer should achieve a tax-free reinvestment.

Broadly speaking, bifurcating cash and assets between cashing out and reinvesting LPs is a mechanism for delivering the desired outcomes for reinvesting LPs where the GP has indicated that the continuation fund transaction should achieve a tax-free reinvestment. From a legal perspective, fund documentation will need to be analysed to understand if a disproportionate distribution in specie would be possible to bifurcate the underlying returns between reinvesting and cashing out LPs. The Limited Partnership Agreement ("LPA") would also need to be reviewed to see whether it would be possible to do distribution in specie of illiquid assets. Where LP consents are required to enable the legal steps to be performed to effect a tax-free reinvestment then this could further complicate the approach to delivering on the continuation fund transaction.

Red Flag Due Diligence Process

So once settled on whether to offer tax neutral or taxable basis what next? The GP should obtain a red flag report to flush out any transfer issues from a tax, legal and regulatory perspective – naturally the report will be impacted by the level of the transfer, rollover will disturb the structures less vs a taxable transaction that is a sale at a level within the investment chain.

From a tax perspective, the red flag report will typically consider issues such as stamp duty, real estate transfer taxes, non-resident CGT and impact. The transaction could also have an adverse effect on operational tax within the portfolio company, for example, operating tax losses that are now unusable due to the change in ownership. Whereas from a legal and regulatory perspective, we would expect the red flag report to consider the fund, investment structure and portfolio documentation regarding transfer restrictions and debt agreements, as well as the impact on management incentive schemes need to be reviewed in depth. Moreover, where the assets in question are regulated, the transaction could trigger local regulatory notifications.

Post Red Flag Considerations

Where no red flags are identified, advisors then typically turn to documenting the proposed legal steps and tax implications for establishing the continuation fund and for transferring the relevant asset(s) on a taxable or (potentially) tax-free basis for reinvesting LPs.

New investors will expect to see a buy-side paper of the continuation fund and its asset(s). Existing LPs will expect to see a sell-side paper covering where the transfer will occur, and how cash and profits will be returned to them. Reinvesting fund investors will need to understand both sides of the transaction.

Where the transaction is not being structured to (potentially) deliver a tax-free rollover for reinvesting LPs then consideration will need to be given as to the legal form, location and capital structure of the holding/acquisition vehicles or will the continuation fund simply acquire the existing holding entity or entities.

Prior to finalisation the continuation fund's holding structure it is important to revisit the anti-hybrid rules. A widely held blind-pool fund transferring an asset to a continuation fund vehicle with a single majority LP could result in a very different position when thinking about the anti-hybrid rules.

Continuation Funds – popular but surprisingly complex (continued)

Establishing a continuation fund is in itself, a difficult task when it comes to balancing the terms and the amount of old and new capital. Existing fund terms may be leveraged as a baseline for certain provisions, but the key terms will be bespoke. Will there be status quo between reinvesting investors and new investors? If not, would the continuation fund need to ring-fence the different sets of LPs in parallel partnerships to reflect their specific terms?

It is important to think through the cash movement on a continuation fund transaction. Would a GP want to approach reinvesting LPs (where the transaction has been structured on a taxable basis) to reinvest their proportionate share of the purchase price consideration when they would, in effect, be paying themselves? An LP who is themselves a fund would be comfortable with such an arrangement as likely to be using different vintages/products. However, for all other LPs, they may expect to reinvest on a cashless basis. There are a variety of mechanisms for delivering this – in particular payment direction letters or daylight facilities.

Where the continuation fund transaction triggers carried interest to arise this is likely to be a tax point for a UK based executive. Where such an individual is required to reinvest their share of the carried interest they should do so on net of tax basis as in all likelihood the executive would be taxable on the amount reinvested.

From an income based carried interest perspective, a continuation fund transaction would most likely result in resetting the "clock" (i.e. the clock will restart from the date of the continuation fund transaction). With continuation funds often having a shorter life-span than a normal blind-pool PE style fund there is likely to be additional pressure on the continuation fund's weighted average holding period. In short, the lower the holding period, the more likely the carried interest will be taxed as income.

Next steps

- Worth considering whether continuation funds are a viable exit option, which LPs could be interested in reinvesting or where new sources of capital could come from.
- Given the complexity of completing a continuation fund transaction, we recommend starting the conversation with advisors as soon as possible where you are considering such an exit route.

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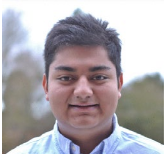

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