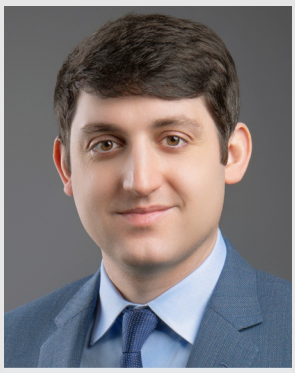
The Tax Lawyer's Guide to LP Secondaries

by James Manzione



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In this report, Manzione examines the transfer of private equity fund interests by one limited partner to another and explains critical tax considerations that advisers for those transactions must understand to effectively represent clients.

Any opinions expressed in this report are the author's and not necessarily those of DLA Piper.

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I. Introduction

Limited partner secondaries are like hobbits. You can learn all there is to know about their ways in a month, and yet after a hundred deals they can still surprise you.[1] This report discusses a seemingly simple type of transaction — the transfer of a private equity[2] fund interest by one limited partner to another limited partner, here called an "LP secondary" — and explains critical tax considerations that tax lawyers advising on those transactions must understand to effectively represent their clients.

II. Overview of LP Secondaries

A. Private Equity Fund Basics

To understand LP secondaries, you must understand a bit about private equity funds. For purposes of this report, the term "private equity fund" means an arrangement between a general partner[3] and one or more limited partners with at least the following characteristics:

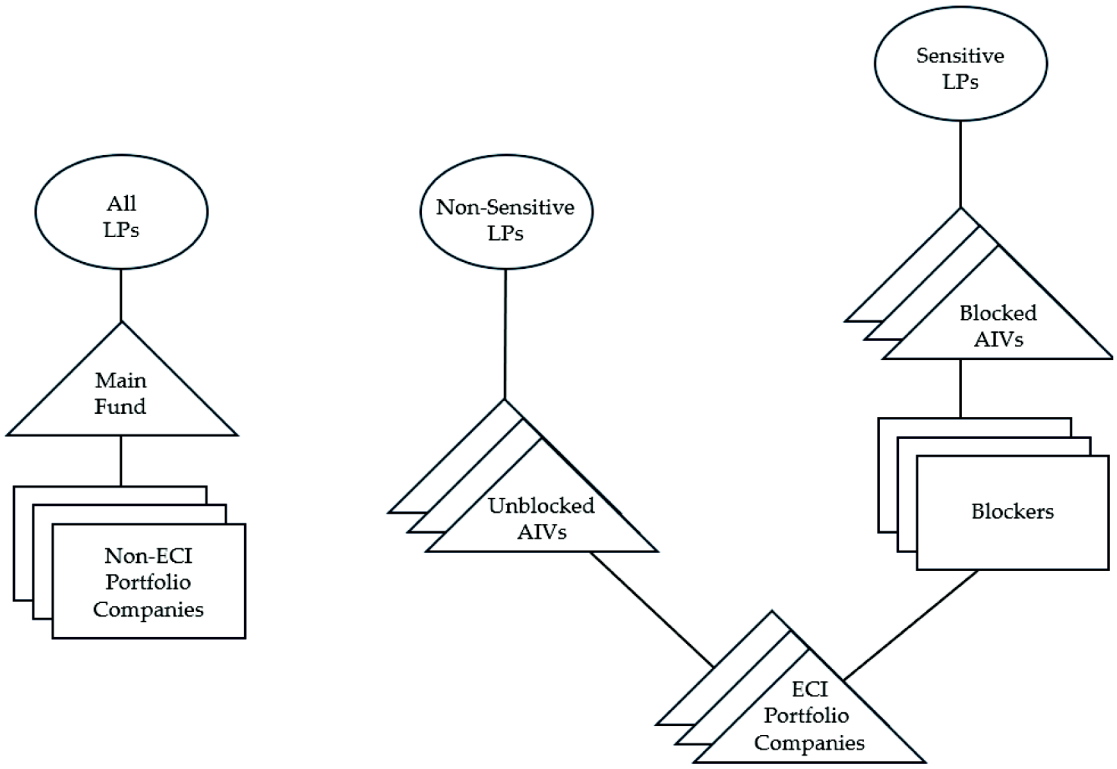
- the purpose of the private equity fund is to acquire portfolio company interests and later sell or otherwise monetize those interests;
- the general partner makes most decisions for, and runs the day-to-day business of, the private equity fund, with the limited partners playing a mostly passive role;
- interests in the private equity fund are not publicly traded and are subject to various

[1] *See* J.R.R. Tolkien, *The Fellowship of the Ring* (1954).

[2] This report focuses on transfers of private equity fund interests. Transfers of private credit fund interests raise some of the same issues raised here.

[3] This report uses the terms "partner," "limited partner," and "general partner" throughout because most private equity funds are organized as limited partnerships. For private equity funds with other legal forms, substitute the appropriate terms.

Figure 1



transfer restrictions (including that the general partner must consent to the transfer);
- the private equity fund is a closed-end fund (that is, partners cannot elect to redeem their interests in the private equity fund); and
- the private equity fund's governing documents obligate the partners to contribute cash in an amount up to an agreed-on commitment to the private equity fund to finance the purchase of investments (when those commitments are called by the general partner) and obligate the private equity fund to distribute the proceeds generated by investments to the partners in repayment of their contributions and in respect of their shares of the private equity fund's profits (which, for limited partners, are typically reduced by carried interest payable to the general partner or its affiliates if a specified return threshold is met) as investments are sold or otherwise monetized.[4]

There are many ways to structure a private equity fund for legal and tax purposes. See Figure 1 for an example of a private equity fund structure that will help illustrate some of the topics discussed here.[5]

Many limited partners are sensitive to incurring income that is effectively connected with the conduct of a U.S. trade or business given that it triggers federal income tax payment and filing obligations.[6] The private equity fund in Figure 1 is structured to prevent limited partners

[4]For a guide to the economics of private equity funds, see John Gilligan and Mike Wright, *Private Equity Demystified: An Explanatory Guide* (2021).

[5]This report uses the usual conventions for depicting federal income tax classification. That is, rectangles are entities classified as corporations for federal income tax purposes, triangles are entities classified as partnerships for federal income tax purposes, and ovals are persons or entities for which the federal income tax classification is not specified.

[6]*See* sections 864, 871, 875, and 882.

sensitive to effectively connected income from incurring ECI.[7] To do this, the private equity fund ensures that its main fund entity invests only in portfolio companies that do not generate ECI and sets up alternative investment vehicles (AIVs) to hold portfolio companies that generate ECI.[8] The private equity fund places the ECI-sensitive limited partners into AIVs that hold the ECI-generating portfolio companies through entities treated as corporations (called "blockers" because they block the ECI by converting it to dividend income and capital gain) and places the other limited partners into AIVs that hold the ECI-generating portfolio companies without interposing blockers.[9]

Each AIV may own more than one ECI-generating portfolio company; however, it is common to have a separate blocker for each ECI-generating portfolio company so that the sale of the ECI-generating portfolio company can be structured to involve a sale of the blocker if doing so is more beneficial from an after-tax standpoint than a direct sale of the ECI-generating portfolio company. This can be the case because, even though there may be a discount to the purchase price imposed as a result of selling the blocker rather than the underlying portfolio company, the discount is often lower than the taxes that the blocker would have paid if the underlying portfolio company were sold directly. To understand how this is possible, consider a simple example. Assume a blocker owns appreciated land. If the blocker were to sell the land, it would be required to pay tax on the gain triggered by the sale. If the owners of the blocker instead sell the blocker, they would not pay any tax as a result of the blocker sale (assuming they are not subject to tax on the gain from the sale of the blocker, as is often the case), and the buyer would not pay tax on the imbedded gain in the land until a disposition of the land. If the buyer does not expect to cause the blocker to dispose of the land until a date in the future, under time value of money principles, the discount imposed on the purchase price of the deal because of the blocker taxes on the imbedded gain would be lower than the amount of blocker taxes that would be imposed if the land were sold immediately. If the discount imposed on the purchase price of the deal as a result of the future blocker taxes, coupled with the discount imposed on the purchase price of the deal as a result of owning the land through a corporation that is ineligible for the same preferential tax rates that some investors would be eligible for if they owned the land directly, is less than the tax that the blocker would have to pay if it sold the land directly, it makes sense to structure the deal as a sale of the blocker rather than a direct sale of the land, assuming the owners of the blocker are not taxed on a sale of the blocker. The math gets more complicated when the blocker's assets are amortizable, but the same general principle applies.[10]

Because it is not relevant to the topics discussed here, Figure 1 does not depict how any recipients of carried interest, such as the general partner, hold their interests in the private equity fund (which might involve the insertion of a splitter entity between the blockers and the ECI-generating portfolio companies).[11]

B. Transfer Basics and Documentation

When a selling limited partner sells its private equity fund interest to a buying limited partner in an LP secondary, the buying limited partner steps into the shoes of the selling limited partner with respect to the transferred private equity fund interest. In other words, the buying limited partner becomes entitled to any distributions that the selling limited partner would have been entitled to because of the selling limited partner's prior contributions to the private equity fund and becomes obligated to make any future

[7] There are other ways to block ECI and other types of income that get blocked (such as, for example, unrelated business taxable income). For simplicity, this report refers to ECI-generating portfolio companies but much of the same could be said about UBTI-generating portfolio companies.

[8] In the real world, AIVs are used for a variety of reasons, including nontax reasons.

[9] For additional information on blockers, *see, e.g.*, Willard B. Taylor, "'Blockers,' 'Stoppers,' and the Entity Classification Rules," 64 *Tax Law.* 1 (2010); David Mattingly, "Blocker Alchemy," *Tax Notes Federal*, Aug. 31, 2020, p. 1585; Mattingly, "Blocker Alchemy, Part 2," *Tax Notes Federal*, Sept. 7, 2020, p. 1771.

[10] For further discussion of blocker sales, see Erin Cleary et al., "Thinking Through the Tax-Blocker Endgame," 20(3) Debevoise & Plimpton Private Equity Report Quarterly (2020).

[11] For a discussion of tax planning applicable to recipients of carried interest, see Andrew W. Needham, "Private Equity Funds," Bloomberg Tax Portfolio 735, at VI.

contributions that the selling limited partner would have been obligated to make because of the selling limited partner's outstanding commitment to the private equity fund. The buying limited partner also acquires a direct interest in each of the private equity fund entities in which the selling limited partner owns a direct interest (that is, the main fund and any AIVs). As a result, if there are AIVs being transferred, the transfer of a single private equity fund interest involves the transfer of multiple entities for legal and tax purposes.

The two key legal documents governing an LP secondary are the purchase and sale agreement (PSA) between the buying limited partner and selling limited partner and the transfer agreement between the general partner, buying limited partner, and selling limited partner. PSAs often cover multiple private equity fund interests, but there is a separate transfer agreement for each private equity fund interest that is part of the transaction.

The typical PSA includes at least the following:

- identification of the private equity fund interests being transferred;
- calculation of the purchase price;
- specification of the closing mechanics and required closing deliverables;
- stipulation that the buying limited partner assumes all obligations with respect to the transferred private equity fund interests except for excluded obligations defined in the PSA;
- stipulation that the buying limited partner may withhold from the purchase price as permitted by law and that any amounts withheld in accordance with law are treated as paid to the selling limited partner for all purposes under the PSA;
- representations and warranties from both the buying limited partner and selling limited partner;
- covenants from both the buying limited partner and selling limited partner;
- indemnification of the buying limited partner for excluded obligations and for breaches of the selling limited partner's representations, warranties, and covenants;
- indemnification of the selling limited partner for obligations regarding the transferred private equity fund interests other than excluded obligations and for breaches of the buying limited partner's representations, warranties, and covenants; and
- specification of how expenses associated with the transfer are allocated between the buying limited partner and the selling limited partner.

The typical transfer agreement includes at least the following:

- identification of the private equity fund interest being transferred;
- stipulation that the buying limited partner assumes all obligations with respect to the transferred private equity fund interest (with no mention of excluded obligations);
- representations and warranties from both the buying limited partner and selling limited partner;
- covenants from both the buying limited partner and selling limited partner;
- indemnification of the private equity fund for taxes, liabilities, and expenses arising in connection with the transfer; and
- stipulation that the buying limited partner will deliver various forms and information requested by the general partner.

Note that the general partner must approve the transfer for it to be effective and has limited incentive to accept deviations from its form transfer agreement. As a result, typical transfer agreements are one-sided documents that make the buying limited partner and selling limited partner jointly and severally liable for nearly all risks of the transfer. The buying limited partner and selling limited partner mitigate the effect of the expansive liability imposed on them by the transfer agreement by negotiating for a specific allocation of the transfer risks among themselves in the PSA.

C. LP Secondary Pricing

A typical private equity fund provides periodic reports of its net asset value to its limited partners. Although reported net asset value calculations generally conform to established

valuation standards, they nonetheless reflect the value of the private equity fund's underlying assets as determined by the private equity fund. Buying limited partners and selling limited partners typically look beyond the reported net asset value by performing their own valuation analysis of the private equity fund and its portfolio companies to determine the purchase price for the private equity fund interest. This valuation is generally based on a variety of data points and calculations, including relevant financial statements and the expected timing of future distributions. As a result of the independent valuation analysis performed by the buying limited partner and selling limited partner, private equity fund interests are often purchased in LP secondaries at either a discount or premium to reported net asset value.

Most PSAs refer to the date of the financial statements that the buying limited partner and selling limited partner analyzed to determine the initial purchase price as the cutoff date. As depicted in Figure 2, most PSAs include provisions that increase the purchase price by contributions made by the selling limited partner to the private equity fund between the cutoff date and the closing date and decrease the purchase price by distributions received by the selling limited partner from the private equity fund between the cutoff date and the closing date.[12] The tax aspects of what should be counted as a distribution that reduces the purchase price are discussed in Section III below.

It is worth noting that, at least until the tax lawyers get involved in the transaction, the purchase price for a private equity fund interest in an LP secondary is typically expressed as a single price for all the entities being transferred and not allocated across the main fund and the AIVs. An agreed-on allocation across the main fund and the AIVs may be required for tax purposes, however, as discussed further in Section III below.

Figure 2

Initial Purchase Price
(Based on Cut-Off Date Valuation)

+

Contributions by Selling Limited Partner Between Cut-Off Date and Closing Date

-

Distributions to Selling Limited Partner Between Cut-Off Date and Closing Date

=

Final Purchase Price

III. Tax Considerations

A. Blockers

A buying limited partner in an LP secondary must understand the tax considerations associated with what it is buying. For a buying limited partner sensitive to ECI, perhaps the most critical tax considerations are whether the private equity fund makes investments that generate ECI and, if so, whether the selling limited partner has elected for the private equity fund to structure its ECI-generating investments through blockers that prevent the selling limited partner from incurring that ECI. For a buying limited partner not sensitive to ECI, the first consideration is not relevant, but the second consideration is, given that a blocked interest in a private equity fund could have more tax drag than an unblocked interest.[13]

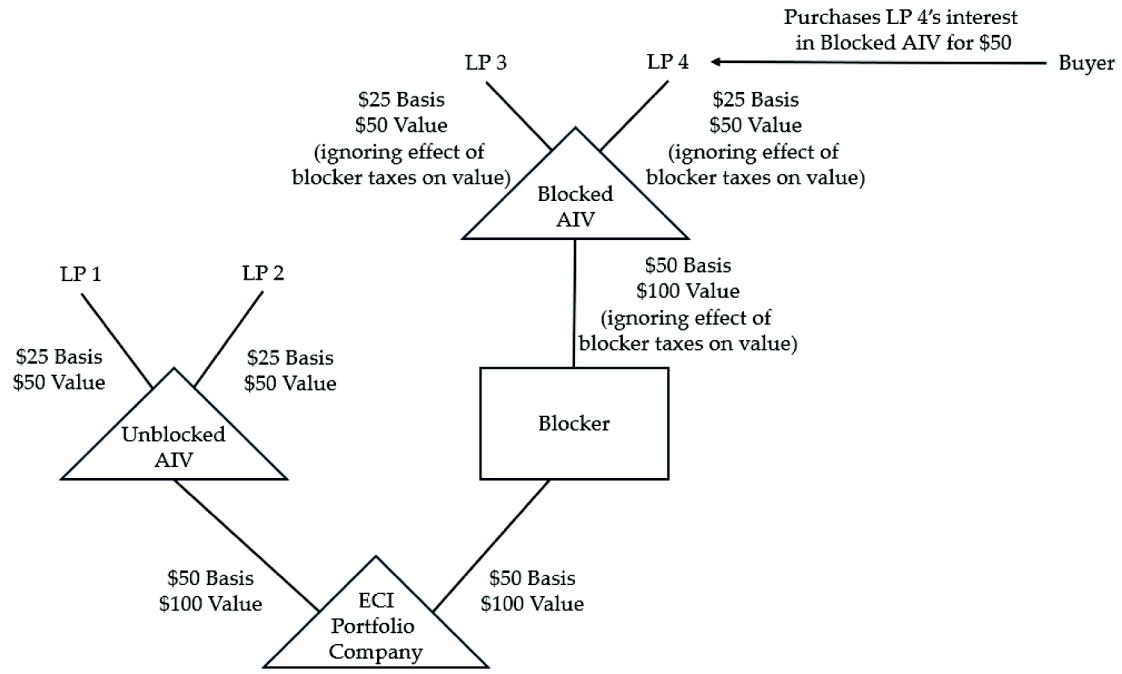
1. Built-in appreciation.

If there is appreciation in the private equity fund's blocked portfolio companies at the time of

[12]This can introduce an element of gamesmanship. Given that the parties may not agree on a price until several months after the net asset value is reported, buying limited partners often know whether material distributions have been made after the date the net asset value was reported and so will offer a price that reflects a high percentage of the net asset value as of the reported date with the knowledge that the distributions made after that date will result in a price paid at closing that reflects a significantly lower percentage of the reported net asset value. This can fool inexperienced selling limited partners into believing that they have sold their private equity fund interests for a higher percentage of reported net asset value than they have.

[13]For tax and other reasons beyond the scope of this report, private equity funds generally do not permit buying limited partners to "unblock" blocked interests after acquiring them in LP secondaries.

Figure 3



the LP secondary, buyers of blocked private equity fund interests will inherit built-in blocker taxes.[14] To understand why, consider the example below.

Assume the following: A private equity fund holds a single ECI-generating portfolio company in an AIV structure similar to Figure 1. Ignore the general partner and its carried interest for simplicity. The unblocked AIV has two 50-50 partners who each funded $25, the blocked AIV has two 50-50 partners who also each funded $25, and the blocked AIV invests the combined $50 into the blocker. The blocker and unblocked AIV purchase the ECI-generating portfolio company for $100, the ECI-generating portfolio company appreciates to $200, and a buyer ignorant of the effect of blocker taxes purchases the entire interest of one of the partners in the blocked AIV for $50.[15] See Figure 3 for a depiction of these facts.

Now assume that immediately after the purchase of 50 percent of the blocked AIV by the buyer, the blocker and unblocked AIV sell their interests in the ECI-generating portfolio company for $100 each. Assume the blocker's basis in its interest in the ECI-generating portfolio company at the time of the sale is equal to its $50 initial cost of acquiring its interest in the ECI-generating portfolio company. As a result of this sale, the blocker would have $50 of gain.[16] Assuming a combined federal and state corporate tax rate of 25 percent, the blocker would pay $12.50 in tax on the $50 of gain, leaving the blocker with $87.50 of the $100 sale proceeds it received. Assuming this $87.50 was distributed in redemption of the blocked AIV's interest in the blocker, it would be taxed as a sale of the blocker by the blocked AIV[17] that would generate $37.50 of gain to the blocked AIV.[18] The blocked AIV, as a 50-50 partnership, would allocate $18.75 of the $37.50 of gain to each of its partners, including the buyer. This $18.75

[14]This assumes the private equity fund does not intend to structure the sale of the blocked portfolio companies to involve a sale of the blockers. If it does, the buying limited partner would instead inherit whatever blocker sale discount that the selling limited partner would have borne.

[15]The blocked AIV owns 100 percent of a blocker that owns 50 percent of a portfolio company worth $200. If you ignore the built-in blocker taxes, the blocked AIV is worth $100, and a 50 percent interest in the blocked AIV is worth $50.

[16]The $100 sale proceeds received by the blocker minus the $50 basis in the blocker's interest in the ECI-generating portfolio company equals $50 of gain.

[17]*See* section 302(b)(3).

[18]The sale proceeds ($87.50) received by blocked AIV minus $50 basis in blocker equals $37.50 of gain.

allocation of gain would increase the buyer's tax basis in the blocked AIV from its $50 cost basis to $68.75.[19] Upon the blocked AIV's distribution of $43.75 (that is, one-half of the $87.50 the blocked AIV received from the blocker) to the buyer in liquidation of the buyer's interest in the blocked AIV, the buyer would have a capital loss equal to $25.[20] After the buyer uses $18.75 of the $25 capital loss to offset the $18.75 capital gain allocated to the buyer by the blocked AIV as a result of the blocker liquidation, the buyer is left with a capital loss of $6.25, which perfectly matches the difference between what the buyer invested ($50) and what the buyer got back ($43.75).

While a $6.25 capital loss on a $50 investment that generates only $43.75 makes perfect sense from a tax perspective, paying $50 for an investment that generates only $43.75 does not. Tax lawyers sometimes try to write an indemnity for built-in blocker taxes into the PSA. This is generally inappropriate. By the time the parties have started to negotiate the PSA, they have agreed on a purchase price (subject to adjustments for contributions and distributions). If the private equity fund interest is burdened by built-in blocker taxes, an indemnity for those taxes effectively acts as a purchase price reduction that changes the economic deal struck by the parties, possibly in a way that would make the deal unattractive to the selling limited partner. The more commercial approach is for the buying limited partner to analyze the presence of built-in blocker taxes and take them into account when agreeing to a purchase price.[21]

2. Future appreciation.

If there is no appreciation in the private equity fund's blocked portfolio companies at the time of the LP secondary, buyers of blocked private equity fund interests will not inherit built-in blocker taxes. Whether and to what extent purchasing a blocked interest with no built-in blocker taxes is detrimental depends on the tax status of the buying limited partner. To state the obvious, a buying limited partner that is sensitive to ECI will want to purchase a blocked interest with no built-in blocker taxes. For buying limited partners that are not sensitive to ECI, the effect of buying a blocked interest with no built-in blocker taxes is more complex. Table 1 summarizes the effect of blockers on the federal income tax burden (assuming the applicability of the highest marginal federal income tax rates) for ECI eligible for long-term capital gain rates[22] for common types of investors in the LP secondary market that are not sensitive to ECI.[23]

Table 1 does not pick up every nuance but makes clear the general point that blocking affects different investors differently. Tax lawyers advising buying limited partners in LP secondaries should ensure their clients analyze the presence of blockers and understand how blockers can affect the after-tax returns of the deal.

[19] *See* section 705(a)(1).

[20] Under section 731(a)(2) loss is recognized by a distributee partner as a result of a partnership liquidating distribution when solely money is distributed to the distributee partner to the extent the distributee partner's basis in its partnership interest exceeds the amount of money received by the distributee partner. Here, the distributee partner's basis in its partnership interest is $68.75, and it receives $43.75 of cash (and no other property) in the liquidating distribution. It therefore has a loss of $25, which is a capital loss under section 741 given the blocker is not section 751 property.

[21] In practice, many buying limited partners do not discount the purchase price as a result of blockers when they are comfortable that the private equity fund will structure the exit of ECI-generating portfolio companies to involve a sale of the blockers (which is becoming more common in traditional private equity but is still rare in private equity focused on real estate and infrastructure) and that selling the blockers will not result in a material discount to the purchase price received by the private equity fund (which is also becoming more common).

[22] Table 1 ignores unrecaptured section 1250 gain and 28 percent rate gain, each as defined in section 1(h). It is common for the bulk of a private equity fund's income to constitute long-term capital gain that is not unrecaptured section 1250 gain or 28 percent rate gain.

[23] You might be surprised by the inclusion of non-U.S. corporations that are ineligible for treaty benefits. They are included because entities treated as corporations for federal income tax purposes and formed in no-tax jurisdictions without treaties are often used as above-the-fund blockers in funds of funds that commonly engage in LP secondaries.

Table 1. Blocker Taxes' Effect on Different Investors' Income Tax Burden

Type of Investor	Tax Rate Applicable to Blocked Long-Term Capital Gain	Tax Rate Applicable to Unblocked Long-Term Capital Gain
"Super" tax exempt[a]	21%[b]	0%[c]
U.S. individual	39.8%[d]	23.8%[e]
U.S. corporation	37.6% or 29.3%[f]	21%[g]
UBTI-sensitive tax exempt	21%[h] (if no debt financing)	0%[i] (if no debt financing)
Non-U.S. corporation (ineligible for treaty)	44.7% or 21%[j]	44.7% or 21%[k]

[a]Super tax-exempt investors take the position that they are not subject to federal income tax, including on UBTI. See section 115 for a provision that investors rely on to claim super tax-exempt status.

[b]The blocker will pay federal income tax at 21 percent under section 11 and distribute the after-tax proceeds. A super tax-exempt investor will pay no tax on the distribution.

[c]A super tax-exempt investor will never directly pay federal income tax, so has an effective federal income tax rate of 0 percent on unblocked ECI.

[d]The blocker will pay federal income tax at 21 percent under section 11 and distribute the after-tax proceeds. Assuming applicable holding period requirements are met, the U.S. individual will be subject to a maximum federal income tax rate of 23.8 percent on the distribution regardless of whether it is characterized as a dividend under section 301 or a redemption under section 302. *See* sections 1(h)(1), 1(h)(11), and 1411. Taken together, the U.S. individual will bear federal income tax at 39.8 percent (21% + (79% * 23.8%)).

[e]*See* sections 1(h)(1) and 1411.

[f]The blocker will pay federal income tax at 21 percent under section 11 and distribute the after-tax proceeds. If the distribution is a dividend under section 301, assuming the U.S. corporation owns less than 20 percent of the blocker for purposes of section 243(c)(2), the U.S. corporation will be entitled to a 50 percent dividends-received deduction for the distribution (and as a result pay 21 percent tax under section 11 on only half of the distribution). *See* section 243(a)(1). Taken together, when the distribution is a dividend under section 301, the U.S. corporation will bear federal income tax at 29.3 percent (21% + (50% * 79% * 21%)). If the distribution is a redemption under section 302, the U.S. corporation will pay tax at 21 percent on the distribution under section 11. Taken together, when the distribution is a redemption under section 302, the U.S. corporation will bear federal income tax at 37.6 percent (21% + (79% * 21%)).

[g]Without a blocker, the U.S. corporation will bear the same tax that the blocker would have borne — 21 percent under section 11.

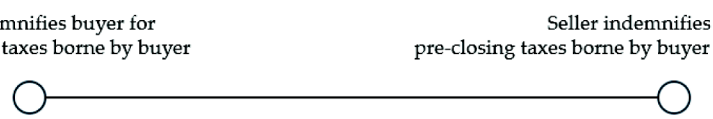
[h]This assumes there is no debt financing in connection with the investment in the blocker. The blocker will pay federal income tax at 21 percent under section 11 and distribute the after-tax proceeds. A UBTI-sensitive investor would pay no tax on the distribution regardless of whether it is characterized as a dividend under section 301 or a redemption under section 302. *See* sections 512(b)(1) and 512(b)(5).

[i]This assumes there is no debt financing by the ECI-generating portfolio company or in connection with the investment in the ECI-generating portfolio company. If this is the case, even if the ECI-generating portfolio company generates UBTI from its operations (as is often the case), long-term capital gain from its sale or from the sale of its assets is generally not UBTI. *See* section 512(b)(5).

[j]The blocker will pay federal income tax at 21 percent under section 11 and distribute the after-tax proceeds. If the distribution is treated as a dividend under section 301, it will be subject to 30 percent withholding, given the lack of treaty eligibility. *See* sections 871(a)(1)(A) and 881(a)(1)(A). Taken together, if the distribution is treated as a dividend under section 301, the non-U.S. corporation will bear federal income tax at 44.7 percent (21% + (30% * 79%)). If the distribution is treated as a redemption under section 302 (and assuming section 897 is not implicated), the distribution will not be subject to federal income tax, and the 21% tax paid by the blocker will represent the non-U.S. corporation's entire federal tax burden. *See* section 865(a)(2).

[k]The non-U.S. corporation will pay federal tax at 21 percent under section 882(a)(1). Assuming the branch profits tax applies, the non-U.S. corporation will pay an additional 30 percent branch profits tax on the dividend equivalent amount under section 884(a). Assuming a dividend equivalent amount equal to the non-U.S. corporation's after-tax proceeds, the non-U.S. corporation will bear federal income tax at 44.7 percent (21% + (30% * 79%)). If the branch profits tax does not apply (because, for example, the exception for branch terminations applies), the non-U.S. corporation will bear federal tax at just 21 percent.

Figure 4



B. Pre-Closing Taxes Treated as Excluded Obligations

The selling limited partner typically agrees in the PSA to indemnify the buying limited partner for excluded obligations associated with the transferred private equity fund interest. This indemnity is typically not subject to a floor or cap and survives indefinitely. PSAs typically define excluded obligations to include certain pre-closing taxes.[24] The scope of pre-closing taxes treated as excluded obligations varies from PSA to PSA, with the typical PSA providing coverage falling somewhere between (but rarely at either end of) the two poles shown in Figure 4.

For the reasons noted in Section III.A above, it is generally not appropriate to include built-in taxes that can be taken into account when agreeing on the purchase price. This would mean excluding built-in taxes (including built-in blocker taxes and built-in portfolio company taxes) from treatment as excluded obligations. The appropriate treatment of other pre-closing taxes is less clear. The treatment of partnership audit liabilities, for example, raises several hard questions. In most PSAs the list of pre-closing taxes treated as excluded obligations includes the selling limited partner's attributable share of pre-closing taxes imposed on the private equity fund under sections 6221 through 6241 (and corresponding provisions of other laws). But how should the selling limited partner's attributable share of these taxes be determined? If the general partner takes an aggressive tax position categorizing some income in a pre-closing period as long-term capital gain that should have been categorized as ordinary, and the private equity fund pays tax to the government to settle an audit of this position in a post-closing period that is borne by all partners in the private equity fund pro rata based on their percentage ownership of the private equity fund at the time of the audit, is the buying limited partner entitled to an indemnity payment from the selling limited partner for the amount of the tax the buying limited partner bears as a result of this audit even though the tax's proximate cause is an aggressive tax position taken by the general partner with respect to which the selling limited partner had no input?[25] Is the answer different if the selling limited partner's tax status would have allowed the general partner to reduce the amount of the tax but the general partner neglects to do so?[26] This report does not answer these questions or otherwise take a position on the appropriate scope of taxes treated as excluded obligations. A tax lawyer advising on an LP secondary, however, should consider these questions and ensure that the PSA does not contain language that could be interpreted to frustrate the client's expectations.

C. Taxes Treated as Distributions

As noted in Section II.C above, the initial purchase price in an LP secondary is typically decreased by distributions that occur between the cutoff date and the closing date. The term "distribution" is typically defined broadly in the PSA. The definition usually references taxes in one of the following ways:

- Variation 1 says that distributions are determined gross of withholding taxes with respect to distributions.

[24] Other taxes that may not be viewed as pre-closing taxes, such as any liability for withholding taxes imposed in connection with the transfer, are also often included in the definition of excluded obligations.

[25] The character of income reported on the private equity fund's Schedule K-1 by the general partner would be a partnership item that could give rise to an imputed underpayment for which the private equity fund is liable. *See* sections 6221 and 6225. Many private equity fund partnership agreements would permit the general partner to allocate the burden of the imputed underpayment pro rata among the partners based on their percentage ownership of the private equity fund at the time of the audit.

[26] *See* section 6225(c). Many private equity fund partnership agreements would permit the general partner to not request modifications of the imputed underpayment.

- Variation 2 says that distributions are determined gross of any taxes with respect to distributions.
- Variation 3 says that distributions are determined gross of taxes with respect to distributions that are deemed distributed to the selling limited partner under the private equity fund's governing documents.

Variation 1 is, for the most part, straightforward. If the selling limited partner is entitled to a $100 distribution, but the private equity fund is required to withhold $30 of taxes from that distribution so that $70 goes to the selling limited partner and $30 goes to the government, the purchase price is reduced by the whole $100 rather than just the $70 received by the selling limited partner.[27] If the initial purchase price represents the present value of the cash flows to be received by an owner of the private equity fund interest as of the cutoff date, and parties priced the deal assuming those cash flows would not be subject to withholding, then variation 1 is fair. Given the applicability of withholding varies depending on the identity of the limited partner (which could cause it to apply to distributions to the selling limited partner but not to distributions to the buying limited partner), it is generally reasonable to assume that parties to LP secondaries do not consider withholding on future distributions when pricing deals. For this reason, it is generally reasonable to accept variation 1 in the PSA when representing a selling limited partner. Variation 2, on the other hand, is incredibly broad. Are portfolio company taxes that reduce distributable proceeds "taxes with respect to distributions"? Are blocker taxes? These taxes do not vary depending on the identity of the limited partner and should be priced into the deal. Because of how broadly variation 2 could be interpreted, it is generally not reasonable to accept variation 2 in the PSA when representing a selling limited partner. Variation 3 likely stems from a concern that a tax may be specific to a selling limited partner but not technically a withholding tax. One example of this kind of tax is a tax imposed under the partnership audit rules that the private equity fund determines is attributable to the status or actions of the selling limited partner. Most private equity fund agreements would allow the private equity fund to pay this tax and cause the selling limited partner to bear it by reducing distributions to the selling limited partner. A buying limited partner would have no reason to price this tax into the deal if it was not known as of the cutoff date, so it seems reasonable for this tax to reduce the initial purchase price. The problem with variation 3, however, is that it can also pick up blocker and similar taxes (given many private equity fund agreements treat blocker and similar taxes as distributed for purposes of calculating carried interest). As noted, blocker and similar taxes should be priced into the deal rather than reduce the purchase price. For this reason, a selling limited partner should avoid agreeing to variation 3 unless it explicitly carves out taxes, such as blocker taxes, that should have been priced into the deal.

D. Withholding on the Purchase Price

There are two federal withholding tax regimes that must be considered when advising on an LP secondary involving the sale of a private equity fund interest. One is governed by section 1446(f) and targets sales of partnerships that generate ECI but do not own substantial U.S. real estate (and is referred to as ECI withholding in this report).[28] Another is governed by section 1445(e)(5) and targets sales of partnerships that own substantial U.S. real estate (and is referred to as FIRPTA (Foreign Investment in Real Property Tax Act) withholding in this report).[29]

1. ECI withholding.

ECI withholding is a major consideration in LP secondaries. If a buying limited partner is required to withhold under section 1446(f) and fails to do so, the transferred entity is required to withhold from distributions to the buying limited partner.[30] To avoid this burden, most general partners will not consent to a transfer unless the

[27] The private equity fund may be required to withhold from distributions to the selling limited partner under reg. section 1.1441-5(b)(2)(i)(A), for example.

[28] *See* section 1446(f) and its regulations.

[29] *See* section 1445(e)(5) and reg. section 1.1445-11T.

[30] *See* section 1446(f)(4) and reg. section 1.1446(f)-3(a)(1).

buying limited partner certifies that it has satisfied its obligation to withhold under section 1446(f) or establishes that the transfer is not subject to withholding under section 1446(f).[31]

It is easy to establish that the transfer is not subject to ECI withholding if the selling limited partner is a U.S. person.[32] In that case, the selling limited partner should provide its Form W-9 to the buying limited partner to establish that ECI withholding is not required.[33] The transferred entity should already have this Form W-9 on file, so it should not need anything further from the buying limited partner to establish that no withholding is required on distributions to the buying limited partner under section 1446(f)(4).[34]

When the selling limited partner is not a U.S. person, establishing that ECI withholding is not required is a more involved process. The simplest route is for each entity being transferred to provide a certification establishing that no ECI withholding is required.[35] Although common practice in the LP secondary market is for general partners to provide this certification when the requirements for providing it are met, some general partners (particularly general partners based outside the United States) are hesitant to do so, given the certification must be signed under penalties of perjury and requires an assessment of technical aspects of federal income tax law.[36] When a general partner is unwilling to provide this certification, the next option is for the selling limited partner to provide a certification establishing that no withholding is required. To provide this certification, a selling limited partner must meet a series of requirements, summarized as follows:

- The selling limited partner was a partner in the transferred entity for the prior tax year and the two tax years before the prior tax year.
- The selling limited partner received Schedules K-1 from the transferred entity in each of the three relevant tax years.
- The selling limited partner had a distributive share of gross income from the transferred entity in each of the three relevant tax years.
- The selling limited partner (together with certain related parties) had a distributive share of gross ECI from the transferred entity of less than $1 million in each of the three relevant tax years.
- The selling limited partner's distributive share of gross ECI from the transferred entity was less than 10 percent of the selling limited partner's distributive share of gross income from the transferred entity in each of the three relevant tax years.
- The selling limited partner complied with its federal income tax payment and reporting obligations with respect to its distributive share of ECI from the transferred entity in each of the three relevant tax years.[37]

These requirements will not be met in many cases, including many in which the transferred entity has never generated ECI, such as when the transferred entity is newly formed and has not issued three years of Schedules K-1, when the selling limited partner acquired its interest in the transferred entity in a recent prior LP secondary and has not yet received three years of Schedules K-1, or when the selling limited partner did not have a distributive share of gross income in one of the relevant tax years because the transferred entity did not dispose of any investments or earn any other income in one of the relevant tax years. When these requirements are not met, there are a few other certifications that the selling limited partner could theoretically provide to eliminate ECI withholding, but the requirements for

[31] *See* reg. section 1.1446(f)-2(d)(2), discussed later, for the procedures relevant to this certification and establishment.

[32] A U.S. person is defined in section 7701(a)(30). It does not include a disregarded entity. In the event of a transfer by a disregarded entity, the regarded owner must be a U.S. person for the transfer to be treated as a transfer by a U.S. person.

[33] *See* reg. section 1.1446(f)-2(b)(2).

[34] *See* reg. section 1.1446(f)-3(a)(1) (third sentence).

[35] The specific requirements of this certification are set forth in reg. section 1.1446(f)-2(b)(4) and relate, broadly speaking, to the potential of the entity providing the certification to generate more than de minimis ECI.

[36] See reg. section 1.1446(f)-1(c)(2)(i) for the requirement that the certification be signed under penalties of perjury.

[37] *See* reg. section 1.1446(f)-2(b)(5).

providing those certifications are rarely met in typical LP secondaries.[38]

In cases in which an exception to ECI withholding cannot be established on the transfer, the buying limited partner is required to withhold.[39] The rate applicable to ECI withholding is 10 percent of the amount realized on the transfer.[40] This amount includes the cash paid by the buying limited partner and the reduction in the selling limited partner's share of the transferred entity's liabilities (as well as other amounts not typically relevant in LP secondaries).[41] A buying limited partner generally will not be able to determine the selling limited partner's share of the transferred entity's liabilities without the help of the selling limited partner or the private equity fund. In anticipation of this, the ECI withholding regulations permit the buying limited partner to rely on a certification by either the selling limited partner or the entity being transferred to determine the selling limited partner's share of those liabilities.[42] The liability certification provided by the selling limited partner requires the selling limited partner to have received a Schedule K-1 from the transferred entity, which presents some of the same challenges discussed previously regarding newly formed entities or newly acquired interests.[43] The liability certification provided by the transferred entity requires the transferred entity to be willing to make a certification about technical federal income tax matters under penalties of perjury, which many non-U.S. general partners are unwilling to do.[44] When the buying limited partner does not have actual knowledge of the selling limited partner's share of the transferred entity's liabilities and does not receive a certification regarding those liabilities from the selling limited partner or transferred entity, the buying limited partner is required to withhold the entire purchase price.[45]

The buying limited partner must report the amount of ECI withholding on Form 8288, "U.S. Withholding Tax Return for Certain Dispositions by Foreign Persons," and Form 8288-A, "Statement of Withholding on Certain Dispositions by Foreign Persons," and remit the amount withheld to the IRS by the 20th day after the transfer date.[46] The buying limited partner must also provide a certification to the transferred entity establishing that it has satisfied its obligation to withhold no later than 10 days after the transfer, and the certification must include a copy of the Form 8288-A filed by the buying limited partner or state the amount realized and the amount withheld on the transfer.[47] This certification also must include any certifications that the buying limited partner relied on to apply an exception to withholding.[48] Private equity funds often have their own form for this certification and, based on a literal reading of the relevant section of the regulations, sometimes require the buying limited partner to state the selling limited partner's amount realized on the transfer even when there is no ECI withholding. Given that this amount includes the selling limited partner's share of the transferred entity's liabilities, the buying limited partner often must seek the cooperation of either the transferred entity or the selling limited partner to complete the certification.

2. FIRPTA withholding.

Though certainly worth considering, FIRPTA withholding is less frequently a major issue in LP secondaries than ECI withholding. The FIRPTA withholding regime does not include a rule like section 1446(f)(4) requiring the transferred entity to withhold from distributions to the buying limited partner if the buying limited partner did

[38] One example that selling limited partners often believe is available when the transferred private equity fund interest has not appreciated is the certification of no realized gain contemplated by reg. section 1.1446(f)-2(b)(3). However, this certification requires the transferred entity to certify that the transfer will not result in ordinary income to the selling limited partner under section 751. This is often not true, even when the private equity fund interest has not appreciated, given that section 751 will require the recognition of ordinary income if there is appreciation in the partnership's section 751 property regardless of whether this appreciation is offset by depreciation in other property that causes the partnership interest to be sold at no overall gain.

[39] *See* section 1446(f)(1) and reg. section 1.1446(f)-2(a).

[40] *Id.*

[41] *See* reg. section 1.1446(f)-2(c)(2)(i).

[42] *See* reg. section 1.1446(f)-2(c)(2)(ii).

[43] *See* reg. section 1.1446(f)-2(c)(2)(ii)(B).

[44] *See* reg. section 1.1446(f)-2(c)(2)(ii)(C).

[45] *See* reg. section 1.1446(f)-2(c)(3).

[46] *See* reg. section 1.1446(f)-2(d)(1).

[47] *See* reg. section 1.1446(f)-2(d)(2).

[48] *Id.*

Figure 5

$$\text{Initial Purchase Price for All Entities Being Transferred} * \frac{\text{NAV of Specific Entity Being Transferred}}{\text{NAV of All Entities Being Transferred}} = \text{Initial Purchase Price for Specific Entity Being Transferred}$$

not withhold from the amount paid to the selling limited partner. As a result, private equity funds generally do not investigate whether the buying limited partner complied with FIRPTA withholding on the transfer. FIRPTA withholding applies to transferred entities treated as partnerships for federal income tax purposes only when 50 percent or more of the value of the gross assets of the transferred entity consist of U.S. real property interests and 90 percent or more of the value of the gross assets of the transferred entity consist of U.S. real property interests plus any cash or cash equivalents, making it relevant only in the case of a transferred entity with a substantial real estate focus.[49] The FIRPTA withholding regulations allow the buying limited partner to rely on a certification from the transferred entity signed under penalties of perjury that states that this test is not met.[50] Participants in the LP secondary market, however, are generally comfortable relying on an email confirmation from the general partner stating that the test is not met. When FIRPTA withholding is applicable for a transferred entity, it trumps ECI withholding for that entity.[51] The rate applicable to FIRPTA withholding is 15 percent of the amount realized on the transfer.[52] The buying limited partner must report the amount of FIRPTA withholding on forms 8288 and 8288-A and remit the amount withheld to the IRS by the 20th day after the transfer date.[53]

3. AIVs.

Recall that the transfer of a single private equity fund interest often involves the direct transfer of several distinct entities for legal and tax purposes, as explained in Section II.B above. The ECI and FIRPTA withholding rules apply separately to each entity treated as a partnership for federal income tax purposes that is directly transferred to the buying limited partner by the selling limited partner. This means that a separate withholding amount, or a separate exception to withholding, must be determined for each separate directly transferred entity. As mentioned in Section II.C above, before the tax lawyers get involved, the purchase price for a private equity fund interest being transferred in an LP secondary is typically expressed as a single price for all the entities being transferred and not allocated across the main fund and the AIVs. When this is the case and one or more of the transferred entities is subject to ECI or FIRPTA withholding, the purchase price must be allocated across the main fund and the AIVs to determine the proper amount of withholding for each entity. This is usually done in accordance with reported net asset value by applying the formula shown in Figure 5 and tracing contributions and distributions on an entity-by-entity basis. In cases in which the net asset value reporting or contribution and distribution data are not broken out by entity, there is often a scramble to find a method suitable for a reasonable allocation. Whatever the method, the prudent tax lawyer will ensure that all parties (including the general partner) agree on the purchase price allocation (and the withholding calculations that it drives) before closing.

E. Basis Adjustments

Under section 743 an entity treated as a partnership for federal income tax purposes adjusts the basis of its property as a result of a transfer of its interests only if either an election

[49] *See* reg. section 1.1445-11T(d)(1).

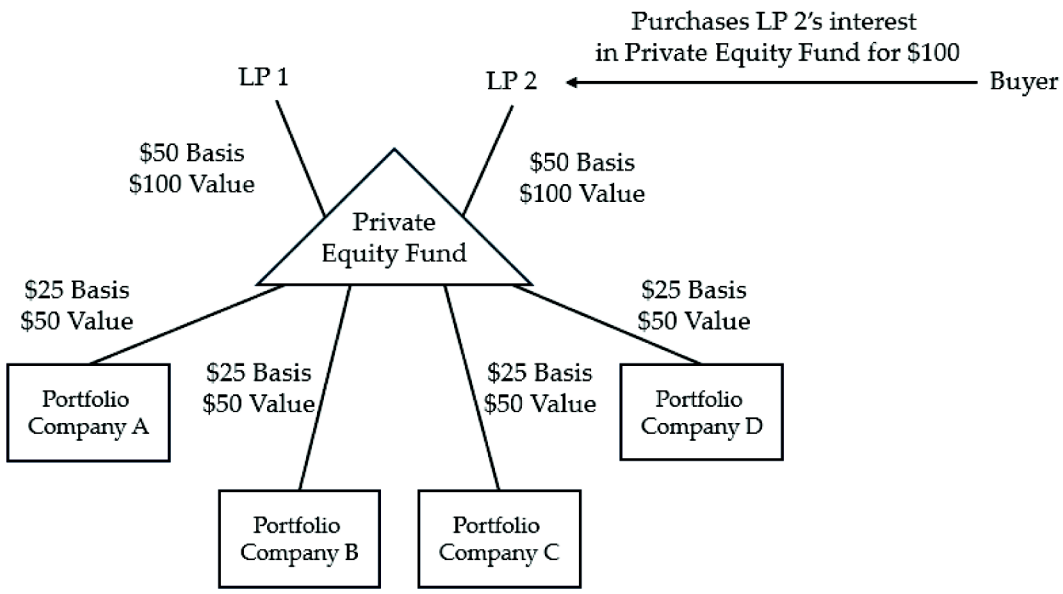
[50] *See* reg. section 1.1445-11T(d)(2).

[51] *See* reg. section 1.1446(f)-1(d).

[52] *See* section 1445(e)(5).

[53] *See* reg. sections 1.1445-1(c)(1) and 1.1445-5(b)(5)(i).

Figure 6



under section 754 is in effect for the partnership or there is a substantial built-in loss immediately after the transfer.[54] This basis adjustment benefits the transferee partner only.[55] The basis adjustment either (1) increases the basis of the partnership property by the excess of the buying partner's basis in its partnership interest over the buying partner's proportionate share of the adjusted basis of the partnership property or (2) decreases the basis of the partnership property by the excess of the buying partner's proportionate share of the adjusted basis of the partnership property over the buying partner's basis in its partnership interest.[56] Citing the burden of tracking myriad basis adjustments arising from myriad transfers, most private equity funds do not make section 754 elections and thus do not adjust the basis of their property as a result of LP secondaries unless there is a substantial built-in loss immediately after the transfer. To understand the effect this could have on a buying limited partner, consider the example below.

Assume the following: A private equity fund entity treated as a partnership for federal income tax purposes has two limited partners. Ignore the general partner and its carried interest for simplicity. Each limited partner contributes $50 to acquire a 50 percent interest in the private equity fund, the private equity fund uses the $100 of total contributions to acquire four portfolio companies — each treated as a corporation for federal income tax purposes — for $25 each, and each portfolio company appreciates to $50 so that the private equity fund is worth $200. A buyer then purchases a limited partner's 50 percent interest in the private equity fund for $100. See Figure 6 for a depiction of these facts.

Assume the private equity fund sells portfolio company A for $50 one year after the purchase (and distributes $25 of the $50 proceeds to the buyer), portfolio company B for $50 two years after the purchase (and distributes $25 of the $50 proceeds to the buyer), portfolio company C for $50 three years after the purchase (and distributes $25 of the $50 proceeds to the buyer), and portfolio company D for $50 four years after the purchase and then immediately liquidates (while distributing $25 of the $50 liquidation proceeds to the buyer). Assume the buyer is subject to a combined 24 percent tax rate on the gain from the sale of each portfolio company. Each sale would generate $25 of gain, with $12.50 of gain allocated

[54] *See* section 743(b). Under section 743(d) a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of that property or the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their FMV immediately after the transfer.

[55] *Id.*

[56] *Id.*

Table 2. Example Cash Flows and Present Values

	Year 1	Year 2	Year 3	Year 4	Total
Cash flow	-$3	-$3	-$3	$9	$0
Present value	-$2.78	-$2.57	-$2.38	$6.62	-$1.12

to the buyer in respect of its 50 percent interest in the private equity fund. The buyer would pay $3 in tax for year 1, $3 in tax for year 2, and $3 in tax for year 3.[57] After the first three years, the buyer's basis would have increased by a combined $37.50 (three years of $12.50 of gain in each year) and decreased by a combined $75 (three years of $25 of distributions in each year), with the buyer's basis equal to $62.50 at the beginning of year 4.[58] As a result of the $12.50 of gain allocated to the buyer in year 4, the buyer's basis would be $75 immediately before the distribution of the $25 proceeds in liquidation of the private equity fund in year 4. The buyer would realize a capital loss on this liquidation equal to the $50 difference between its $75 basis and the $25 cash received.[59] It would use $12.50 of this $50 capital loss to offset the $12.50 of year 4 gain. Assuming the buyer had $37.50 of capital gain from other sources that was also subject to tax at 24 percent, the buyer could offset that gain with the remaining $37.50 of capital losses and realize tax savings of $9 in year 4. Table 2 summarizes these tax cash flows and their present values, assuming a discount rate of 8 percent compounded annually.

As shown by Table 2, even though the tax cash flows sum to zero — assuming the buyer can use the capital loss realized on the private equity fund's liquidation — the lack of a basis adjustment still introduces a present value tax drag to a taxable buyer. If the private equity fund had a section 754 election in effect when the buyer purchased its interest, there would be no gain or loss recognized by the buyer on any of the portfolio company sales or on the liquidation of the private equity fund, which would eliminate this present value tax drag (and cause all the numbers in Table 2 to be zero).

That said, as nice as it would be for the buying limited partner to get the benefit of a section 754 election, tax lawyers advising on LP secondaries should understand that the lack of a section 754 election is outside the control of the buying limited partner and the selling limited partner. Few, if any, private equity funds will decide to make a section 754 election because of a request made in connection with an LP secondary.

Occasionally, a private equity fund entity treated as a partnership for federal income tax purposes is so allergic to the burden introduced by making basis adjustments that, in addition to not making a section 754 election, it makes an election under section 743(e) to be treated as an electing investment partnership (EIP). EIPs are exempt from making basis adjustments in the event of a substantial built-in loss.[60] Several requirements must be satisfied for an entity to elect to be treated as an EIP.[61] The primary cost associated with the EIP election is that buyers of interests in EIPs cannot deduct their distributive share of losses from the sale of the EIP's property except to the extent that those losses exceed the loss recognized by the seller (or any prior seller to the extent not fully offset by a prior disallowance under the EIP rules) on the transfer of the EIP interest.[62] Notice 2005-32, 2005-1 C.B. 895, requires EIP sellers to provide tax information to buyers of EIP interests so that those buyers can determine the amount of the EIP losses subject to disallowance (including information on the amount of loss recognized by any prior sellers of the EIP interest).[63] A selling limited partner in an LP secondary may struggle to provide all the tax information required by Notice 2005-32 because, for example, it is a super tax-exempt entity that

[57] This is calculated by multiplying the $12.50 of gain in each year by the 24 percent tax rate.

[58] *See* section 705. This is calculated by increasing the $100 initial basis by $37.50 and decreasing it by $75.

[59] *See* section 731(a)(2).

[60] *See* section 743(e)(1).

[61] *See* section 743(e)(5).

[62] *See* section 743(e)(2).

[63] *See* Notice 2005-32, section 5.A.

does not have a tax function responsible for tracking the relevant tax information or because it also acquired the interest in an LP secondary and did not ascertain the amount of loss recognized by the seller in that prior transaction. If a seller of an EIP does not provide the information required by Notice 2005-32, the buyer must treat all losses allocated from the EIP as disallowed unless the buyer is otherwise able to obtain the information necessary to determine the proper amount of disallowed losses.[64] This is not ideal for a buying limited partner that could otherwise use the losses and is often addressed in the PSA by including provisions requiring the selling limited partner to provide the information necessary for the buying limited partner to determine the amount of disallowed losses.

F. PTP Delays

A publicly traded partnership is treated as a corporation for federal income tax purposes unless 90 percent or more of its gross income consists of certain types of generally passive income.[65] Because most private equity funds do not want to incur corporate tax drag and either do not satisfy the gross income requirement or are unwilling to restrict their activities to ensure compliance with it, most private equity funds seek to prevent each of their entities from being treated as a PTP. A PTP is defined as any partnership if (1) interests in the partnership are traded on an established securities market or (2) interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.[66] Private equity funds are not traded on established securities markets, so the relevant question is whether they are readily tradable on a secondary market or the substantial equivalent thereof. Determining whether a partnership is readily tradable on a secondary market or the substantial equivalent thereof generally requires an analysis of the facts and circumstances.[67] However, the PTP regulations provide a safe harbor treating interests in a partnership as not readily tradable on a secondary market or the substantial equivalent thereof if the sum of the percentage interests in partnership capital or profits transferred during the tax year of the partnership (ignoring certain exempt transfers) does not exceed 2 percent of the total interests in partnership capital or profits.[68] Many private equity funds will delay transfers until a subsequent tax year if those transfers would result in a violation of this safe harbor in the current tax year.

Buying limited partners and selling limited partners often have specific reasons for needing to close on a transfer by a certain time and are often curious if there are any workarounds to PTP delays. One promising workaround relies on language in the PTP regulations providing that an interest in a partnership that holds an interest in a lower-tier partnership is not considered an interest in the lower-tier partnership.[69] The implication of this rule is that the PTP rules are generally not triggered at the level of a lower-tier partnership by transfers of an upper-tier partnership. This raises the question of whether a selling limited partner can structure the transfer of its private equity fund interest as a transfer of an upper-tier partnership to avoid a PTP delay. Consider the example below.

Assume the following: A selling limited partner owns interests in several private equity funds, some of which it would like to sell in an LP secondary and some of which it would like to keep. The interests it would like to sell are subject to PTP delays but the selling limited partner has compelling business reasons for requiring a sale of those interests as soon as possible. The selling limited partner contributes the interests it wants to sell to a subsidiary flow-through entity, a subsidiary corporation of the selling limited partner with no material assets other than cash contributes its cash to the subsidiary flow-through entity so that the subsidiary flow-through entity is treated as a partnership, and the buying limited partner purchases the selling limited partner's interest in the subsidiary flow-through entity and subsidiary corporation from the buying limited partner. See Figures 7a, 7b, and 7c for a depiction of these facts.

[64] *See id.* at section 5.D.

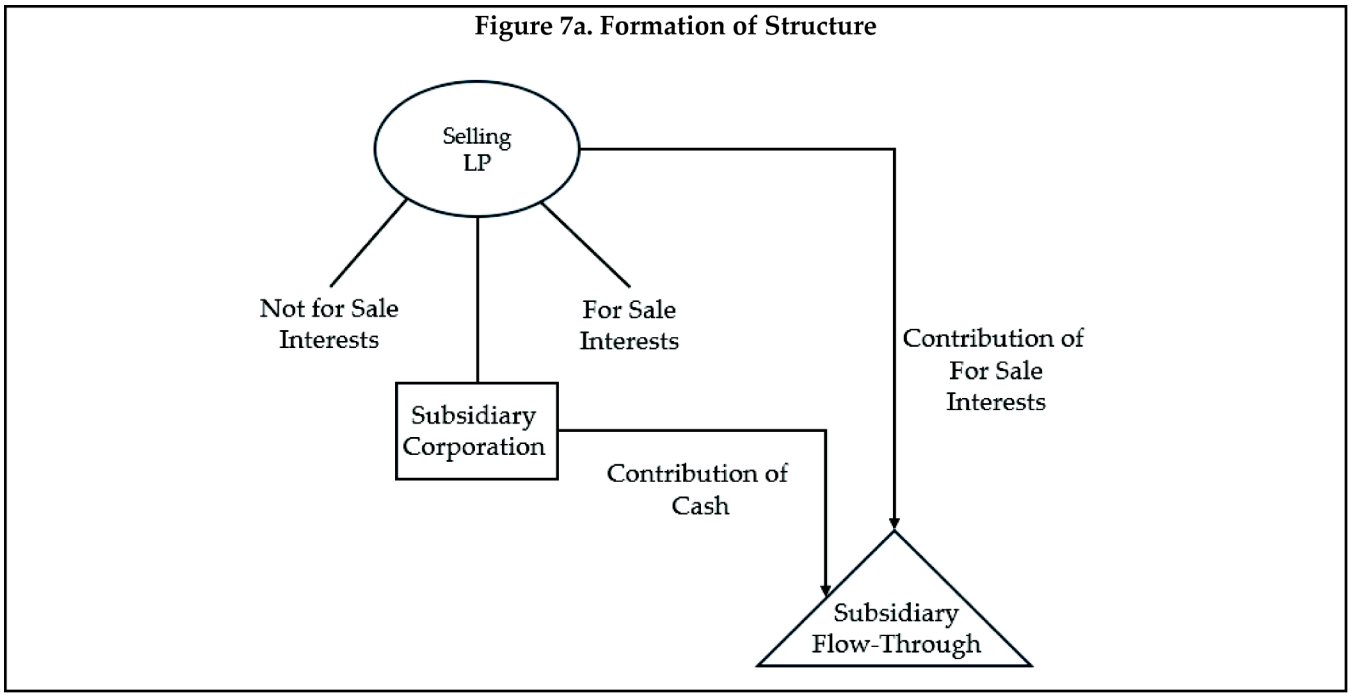
[65] *See* section 7704.

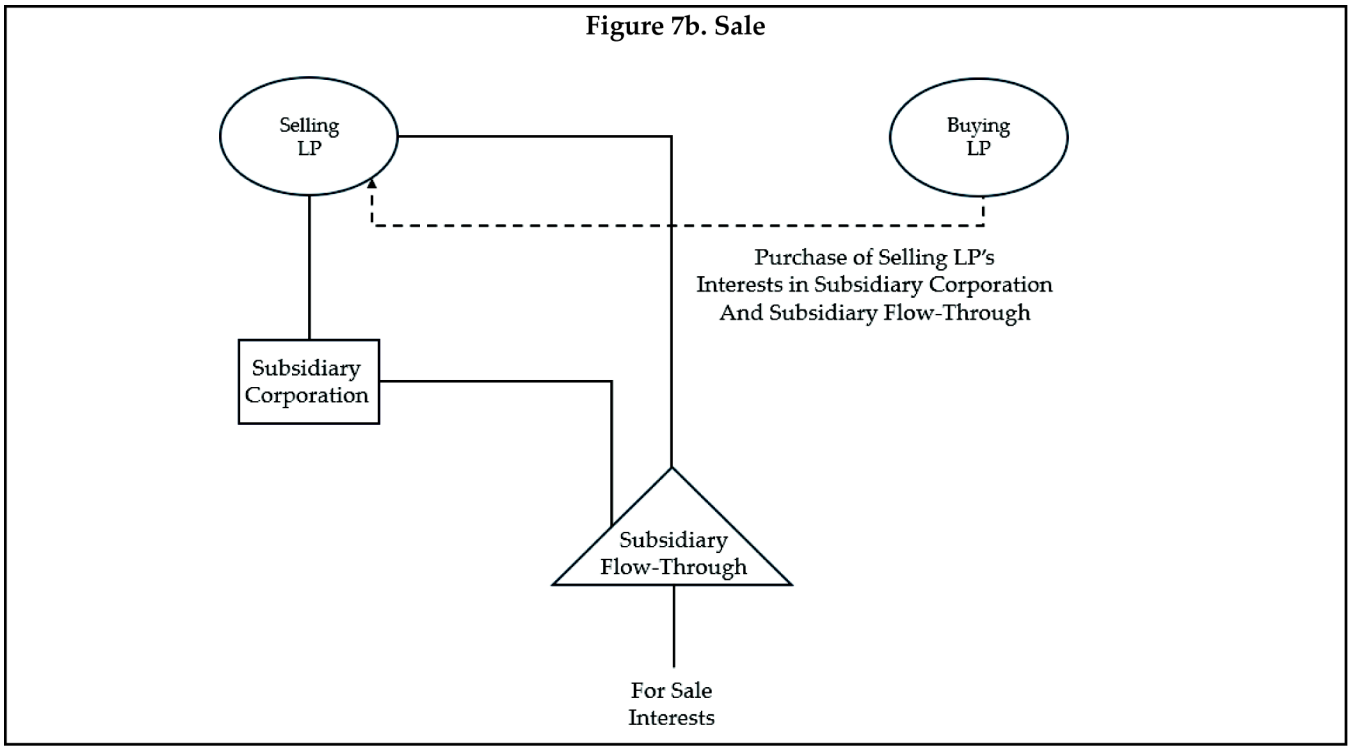
[66] *See* section 7704(b).

[67] *See* reg. section 1.7704-1(c).

[68] *See* reg. section 1.7704-1(j)(1). Reg. section 1.7704-1(h) provides another safe harbor for partnerships with 100 or fewer partners.

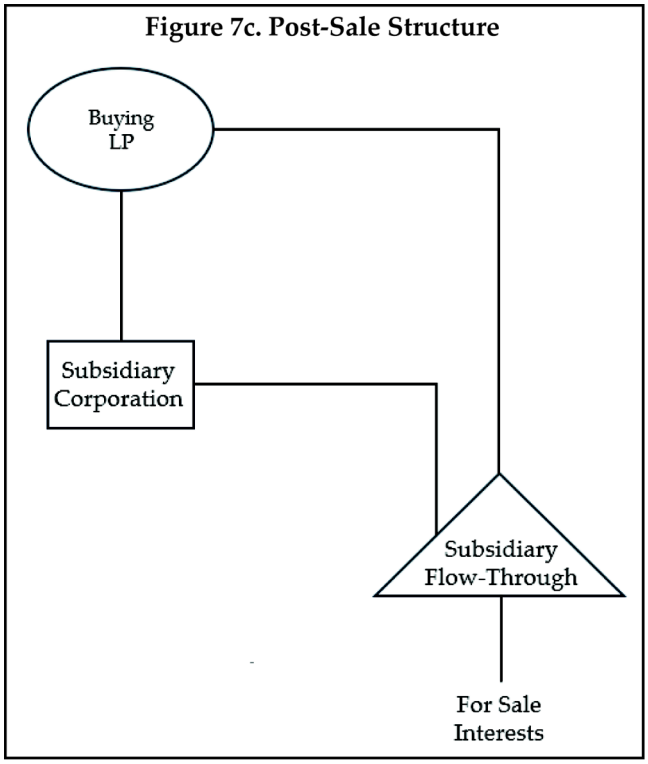
[69] *See* reg. section 1.7704-1(a)(2)(iii).





If all these steps are respected for federal income tax purposes, the PTP rules are not implicated. The contribution of the private equity fund interests by the selling limited partner into the subsidiary flow-through entity is treated as a contribution to a partnership under section 721 and is not taken into account for purposes of the PTP safe harbor.[70] The subsidiary corporation is used to preserve the status of the subsidiary flow-

[70] *See* reg. section 1.7704-1(e)(1)(i).



through as a partnership throughout the transaction so that the transaction can benefit from the rule regarding upper-tier entities discussed previously. If the subsidiary flow-through were a disregarded entity (or became one as a result of the sale), reliance on this rule would not be possible, as the transaction would be treated for tax purposes as a sale of the underlying private equity fund interests.[71] Whether these steps should be respected is beyond the scope of this report, but it is worth considering how the IRS could argue that a private equity fund interest is readily tradable if the only way to trade it is to jump through all of the structuring hoops just described.

IV. Conclusion

The LP secondary market is booming. As a result, many tax lawyers have been, and will continue to be, asked to advise on LP secondary transactions. To effectively serve their clients, tax lawyers advising on those transactions should be aware of the tax issues discussed here. This report, however, does not include a discussion of every potential tax issue that could arise in an LP secondary. Even an LP secondary for a single private equity fund interest sold by a U.S. person could involve unique tax issues not discussed here. When an LP secondary involves a large portfolio of private equity fund interests sold by one or more non-U.S. persons, which is often the case, unique tax issues are all but guaranteed. ■

[71] *See* Rev. Rul. 99-6, 1999-1 C.B. 432, Situation 2.