A third route to exit: tax consequences of continuation fund transactions

In recent years, continuation funds have become a third route for private equity buy-out funds to exit their investments, especially when traditional M&A or IPO exits are not feasible or desirable. These funds allow sponsors to extend their holding period for assets with significant future value creation opportunities. These transactions can often give tax advisors plenty to think about, from an investor and fund manager perspective and also at an asset level. It seems likely that continuation funds will become a more common exit option for sponsors.

What are continuation funds?

Over the last couple of years it has become more challenging for private equity buy-out funds to exit from their investments. M&A and IPO markets have been sluggish due to the impact of a high interest rate and high inflationary environment together with other macro and geopolitical factors, which have in turn led to a value gap between buyers and sellers. Some sponsors have in any event eschewed these traditional exit routes for assets where they see significant future value creation opportunity and upside beyond the typical holding period, even where there might be a willing third-party buyer.

The traditional 3-5 year hold period for a buy-out fund has therefore lengthened, and it is now not uncommon for funds to be holding assets seven or more years after they first acquired them.

That presents a problem for the sponsors of those funds. Without an exit opportunity for their assets they cannot provide their investors with liquidity. Failure to provide liquidity for their investors could then in turn impede their success in future fundraising.

Enter the continuation fund. This is a fund set up by the same sponsor in order to purchase one or more assets from the buy-out fund. The sale of the asset to the continuation fund enables the outgoing fund to deliver liquidity to existing investors who wish to realise the asset, whilst giving the opportunity to new secondary investors to invest in the asset. Existing investors will be given the option to elect to roll their investment into the new continuation fund, which some will typically take up.

Most of the new investors will invest in the continuation fund in the usual way. A small number of co-investors may invest directly in the asset alongside the continuation fund. Typically the lead or co-lead secondary investors, investing via the continuation fund, will negotiate the deal and drive the terms – thereby helping mitigate the potential risk of conflict on terms with existing investors. Third-party bids or fairness opinions may be sought to mitigate the conflicts risk on pricing.

A continuation fund transaction is not the same as a fund to fund transaction: see figure 1 below for some typical key differences between the two.

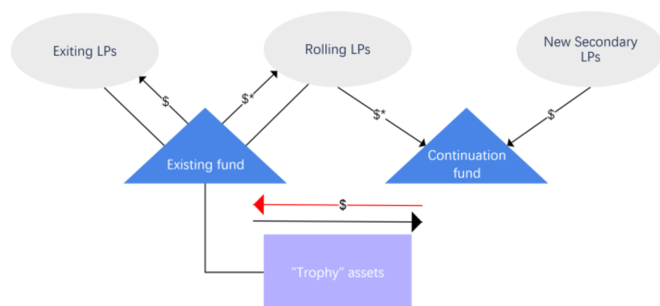
Figure 1: Continuation fund or fund-to-fund?

There are similarities between these types of transaction, but they are distinct. Some typical key differences are set out below. In practice, the choice between them will usually be a commercial one, based on, for example, whether the sponsor has a successor ‘blind pool’ fund with an appropriate strategy and capacity to acquire the asset(s) at the relevant time and whether existing investors will object if they are not given the opportunity to roll over.

Continuation fund	Fund-to-fund
GP-led transaction, with relevant sponsor continuing to manage asset(s)	
Buying fund set up for transaction	Buying fund is a ‘blind pool’ fund that already exists, and has a settled investor base
Existing investors have a right to invest in continuation fund	Existing investors may also be investors in new fund, but no right to invest
Continuation fund investors will be investing specifically in relevant assets	New fund will be a ‘blind pool’ fund: investors in the fund do not know what assets it will acquire
New investors in the continuation fund, who tend to be specialised ‘secondaries’ investors	No new investors in buying fund as part of transaction, though there may be co-investors introduced at asset level
Only selling fund LPAC consent required	Selling and buying fund LPAC consent required

In this article, we consider some of the key tax considerations that arise in relation to the transfer of assets into a continuation fund. Our focus is on UK tax, though in practice these deals typically have international elements, and we have assumed a (fairly typical) partnership-based structure (per figure 2 below).

Figure 2



*Depending on the situation, this might be an in-kind distribution by the existing fund and an in-kind contribution to the continuation fund.

Investor-level considerations

As with any disposal of a fund asset, the tax treatment in the hands of existing investors (limited partners or 'LPs') will be an important consideration. Typical questions around the form of any return (for example, whether capital or income) will be relevant for LPs who will cease to have an economic exposure to the asset(s) (***exiting LPs***). However, an additional hurdle on a continuation fund transaction is how to deal with LPs who want to retain their interest (***rolling LPs***): they will be keen to ensure dry tax charges do not arise when economically they continue to hold their stake in the assets.

From that perspective, much will depend on the profile of the relevant LPs – in particular, the relevant jurisdictions and the extent to which they include tax-exempts – and structuring can be complex. A sale by the existing fund for cash, which is distributed to LPs, with rolling LPs investing their share in the continuation fund, is unlikely to achieve a tax-neutral result. Consideration may therefore be given to, for example, the existing fund distributing the relevant asset(s) to the LPs, with them then selling their stakes to the continuation fund (in the case of exiting LPs) or contributing them (in the case of rolling LPs).

Rolling LPs will be interested in whether the new structure will give rise to any different tax treatment for them going forward, including understanding what elections might be made in this respect, whereas new investors may have different requirements altogether that will need to be identified and catered for in the fund documentation.

Fund manager-level considerations

Taxes on transaction

To the extent managers hold co-invest, similar considerations to those set out above apply. However, managers are also likely to be focused on continuation fund transactions from a carry perspective. Where such a transaction crystallises carry in the existing fund, there is typically an obligation to reinvest a large proportion, perhaps all, of that carry in the continuation fund. This is regarded as a powerful tool to ensure continued alignment of economic interests – rolling LPs can have confidence that managers are not exiting their position at a time when the rolling LPs are not taking cash out. However, the crystallisation of the carry is likely to trigger tax charges for managers. As such, mechanisms are likely to be required to ensure that – notwithstanding any reinvestment obligation – managers are released enough cash to satisfy any associated tax liabilities.

Go-forward carry treatment

For UK managers who are employees, the considerations in respect of carry in the continuation fund are (currently) likely to be familiar ones. In particular, there is likely to be focus on whether any carry will fall within the HMRC/BVCA Memorandum of Understanding on the Income tax treatment of PE and VC limited partnerships and carried interest (the ***Carry MoU***). This will depend on the terms of the carry in the continuation fund – noting that these are often different from those in the original fund (for example, tiered returns based on multiples and usually on a deal-by-deal basis). If it does not meet the Carry MoU conditions, careful thought will be needed to navigate potential employment-related securities points.

For UK managers who are *partners* in the investment manager vehicle, the Carry MoU and employment-related securities rules are not relevant. However, they have a different challenge, in the form of the income-based carried interest (***IBCI***) rules at Chapter 5F Part 13 ITA 2007. Broadly, these rules can treat all or part of a (UK) manager's carry returns as trading income rather than capital gains where the relevant fund's average holding period is less than 40 months. Depending on the expected life of the continuation fund, this could mean a worse treatment for non-employee managers' carry post-transaction.

This can cause complexity, which may well increase going forward. In their summary of responses and next steps document published at the Autumn Budget 2024 in respect of the tax treatment of carried interest, the Government announced its intention to repeal the exclusion from the IBCI rules for employees (currently in section 809FZU ITA 2007). In addition, it was announced that a consultation will take place on whether managers will be required to hold their carry for a prescribed period to access preferential tax

treatment. We would expect sponsors and managers to be focused on ensuring that any minimum holding periods (either for investments or for the carry itself) introduced as part of the reform to the IBCI rules appropriately take into account continuation fund structures. However, it remains to be seen how the Government proposals will evolve. The risk is that the treatment of continuation fund carry from April 2026 may prove less favourable than that for carry more generally.

Asset-level considerations

Turning to asset-level considerations, the sale of a group of companies to the continuation fund is often more structurally complex than the purchase of that group by the original buy-out fund.

Debt

The companies in the group will likely already be leveraged with external debt. Whilst the continuation fund and any co-investors will be writing equity cheques for the deal (which may be contributed into any new holding structure by way of a combination of equity and shareholder debt), the existing external debt will often be amended and extended in order to re-lever the group by reference to the deal equity value. Some of that debt may be used to fund the purchase of the asset, and some may be used for general working capital purposes and/or for 'bolt-on' transactions.

This raises structural complexities. If the debt is being raised at group level, the funds will need to get into the hands of the continuation fund so it can purchase the asset. This may require bridge financing or another structural solution, which will need to be considered from a tax perspective, and there is the potential for tax leakage as the increased debt is distributed up the structure (for example, if the borrower is in a jurisdiction such as the US that imposes withholding tax on dividends).

Determining whether or not the various types of debt (both the external debt and the shareholder debt) are expected to be deductible will require ticking through what is now a rather long checklist of statutory provisions, including transfer pricing and thin cap, unallowable purpose rules, corporate interest restriction, anti-hybrid rules and the distribution rules. The withholding tax position on the debt will also need to be considered, including whether any of the shareholder debt will need to be listed in order to fall within the quoted eurobond exemption at section 987 ITA 2007.

Impact on losses

Advisors will also need to be mindful of any impact on the losses of the underlying group (and this will be a particular focus if the continuation fund is being asked to place some value on those losses as part of discussions on price). There will be a question as to whether this transaction gives rise to a change in ownership for the purposes of the major change in the nature or conduct of trade rules (Part 14 CTA 2010) and if so there will need to be an assessment as to whether or not such major change has already or may occur (noting that this needs to be assessed across a five year period commencing no more than three years before the change of ownership).

Impact of a change in the tax profile of investors

The overall tax profile of the continuation fund and its investors may well change significantly as a result of this transaction.

The group will need to understand whether the nature or jurisdiction of the new investors could change the withholding tax obligations of the group on distributions to the continuation fund.

There are also now a number of UK tax regimes for which a group can only qualify if they have a certain investor base, including the UK Qualifying Asset Holding Company regime (Schedule 2 Finance Act 2022) and the Qualifying Institutional Investor substantial shareholding exemption (paragraph 3A Schedule 7AC TCGA 1992). If the fund had originally set up its investment on the assumption that it could benefit from one of these regimes, then the new investor composition will need to be checked (or, equally, the group may now find themselves able to avail themselves of a regime that was not previously available).

Managers

What about the managers of the group itself? Any management incentive plan (***MIP***) put in place by the existing fund is likely to be rolled into the new structure underneath the continuation fund (the terms of which will of course be the subject of commercial negotiation).

If the MIP cannot remain untouched, managers will need to decide whether they want to roll under section 135 TCGA 1992 or cash out and re-invest their post-tax proceeds. In this post-Budget era, now there is more certainty over the capital gains tax rate, we expect that it will become common again for management to want to achieve rollover relief. There will be points to consider around the potential application of section 137 TCGA 1992 (including whether clearance under section 138 TCGA 1992 might be sought) and managers will need to get comfortable with the transactions in securities position (including whether the transaction could constitute a fundamental change of ownership for the purposes of section 686 ITA 2007).

The usual employment-related securities points will also need to be considered, including checking that management are receiving no more than market value

for their shares on the transaction (and therefore avoiding any charges under Part 7 ITEPA 2003) and that they are making appropriate section 431(1) ITEPA 2003 elections for their new securities. Unless reliance is being placed on the HMRC/BVCA Memorandum of Understanding on the Income tax treatment of managers' equity investments in venture capital and private equity backed companies, an independent valuation will need to be obtained in relation to any sweet equity.

Where next?

We expect to see continuation funds featuring more heavily on the menu of exit options that sponsors are considering going forward, as an alternative to an exit via M&A or IPO. Whilst many sponsors have a go-to buy-out structure that can be rolled out for most of their investments, the structuring of continuation fund transactions tends to be more bespoke as it will depend on the circumstances of the investors and the tax profile of the group itself. That typically gives tax advisors a lot to think about.

Those active in this space may also want to engage proactively with the consultation on reforms to the IBCI rules; if those do not properly cater for continuation funds, that could impact on whether we continue to see quite so many of these deals in the future.

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