WRMarketplace
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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Wealth Transfer Planning with Carried Interests.

MARKET TREND: As private equity and hedge funds continue to grow in popularity, more principals from these firms are entering the planning arena, creating a need for estate plans that can accommodate the unique composition of their compensation and investment portfolios.

SYNOPSIS: Carried interests are a common form of incentive compensation paid to managers of hedge funds, private equity funds, venture capital funds, etc., which allows managers to share in the fund's investment "upside." Given their individual net worth, fund managers typically are taxed at the highest income tax rates and continue to face estate tax exposure even with increased exemptions. The unique income and transfer tax features of carried interests, however, make them suitable for wealth transfer planning, which can help manage this overall tax exposure.

TAKE AWAY: Carried interests offer significant wealth transfer planning opportunities for fund managers. Early planning and the guidance of experienced tax and financial advisors, however, are crucial to achieving success. In addition, complementary planning, including the acquisition of life insurance, is often key to provide liquidity for, and a hedge against, potential estate tax exposure and other liquidity needs.

Carried interests are a common form of incentive compensation paid to managers of hedge funds, private equity funds, venture capital funds, etc. (collectively, "**funds**"), which allows managers to share in the fund's investment "upside." Given their individual net worth, fund managers typically are taxed at the highest income tax rates and continue to face estate tax exposure even with increased exemptions. The unique income and transfer tax features of carried interests, however, make them suitable for wealth transfer planning, which can help manage this overall tax exposure.[1]

CARRIED INTERESTS GENERALLY

Most funds are structured as pass-through entities, such as limited partnerships,[2] in which investors become limited partners. The fund's sponsor, often itself organized as a pass through entity, typically becomes the general partner. The principals of the fund sponsors are responsible for the investment management of the fund assets ("**managers**").[3]

The "carried interest" refers to a share of the fund's profits awarded to the fund sponsor, generally after the fund's investors have attained a threshold level of return (the "**hurdle rate**") on their investment. For example, in a common "2/20" structure, the sponsor receives an annual 2% management fee (which may initially be based on the value of the capital committed by investors) and 20% of the yearly gains after prior allocations and distributions and/or achievement of the hurdle rate required in the fund's governing documents. The managers of the fund sponsor, as principals, share in this compensation. The following, very simplified example illustrates this structure:

- ***Example.*** A fund has an individual manager and five limited partners. Each limited partner commits $10 million in capital for a $50 million portfolio. The fund sponsor is entitled to 2/20 compensation, and each limited partner is guaranteed a 10% return. During the year, the fund has gain of $50 million. At year-end, each limited partner receives $5 million (10% of $50 million), leaving $25 million of gain. The sponsor receives $1 million as a management fee (2% of the $50 million in committed capital) and 20% of the $24 million of gain remaining after all required payments and distributions ($4.8 million), for total payment of $5.8 million.

CURRENT TAXATION

Capital Gains Tax. A pass-through entity's gains and losses generally are not taxed at the entity level but are passed through and taxed to the partners based on their respective shares. Thus, if gains from the fund's underlying assets are long-term capital gains, they ultimately pass through to the managers, who can take advantage of the current 20% long-term capital gains rate on their carried interest allocations. Carried interest returns are often taxed at this capital gains rate.

However, ***there have been several legislative and budget proposals to change the tax treatment of carried interest income from long-term capital gain to ordinary income*** (see discussion in *WRMarketplace No. 2014-10*). Although none have gained traction to date, developments in this area should be monitored, as they would impact carried interest planning (see below).

Net Investment Income (NII) Tax. Income from carried interests generally will be subject to the 3.8% NII tax, as NII includes capital gains and income from a trade or business that is a passive activity or a trade or business in financial instruments and commodities.

Estate Tax. At death, the carried interest held by a manager is taxable in his or her estate, based on the fair market value of the interest as of the date of death. Currently, the carried interest will receive a basis step-up to date-of-death value, eliminating income tax on any inherent gain.[4]

WEALTH TRANSFER PLANNING

Wealth transfer and estate reduction planning remain critical to managing the potential estate tax exposure of managers. Carried interests have a combination of features that make them particularly suited to this type of planning – a low initial value with the potential for substantial future appreciation. Thus, many traditional wealth transfer planning alternatives can complement carried interest planning.

Gifts to Irrevocable Trusts. Subject to valuation issues and the application of Internal Revenue Code ("**Code**") § 2701 (discussed below), a gift of the carried interest to an irrevocable trust, especially if structured as a perpetual dynasty trust, can dramatically impact a manager's gift and generation skipping transfer ("**GST**") tax exemptions if the fund performs well and removes the

carried interest, along with its subsequent appreciation and income, from the manager's taxable estate.

Using Grantor Trusts. If the trust holding the carried interest is structured as a grantor trust for income tax purposes, the manager will pay the trust's income tax liability, allowing the trust assets to grow without imposition of income tax. Application of the capital gains rate to the carried interest income should make the overall tax burden on the grantor more manageable. As this tax treatment could change or the burden to the grantor could still become significant, however, the trust should include provisions allowing the "toggling-off" of grantor trust status.

Zero-Gift Techniques. Higher income, capital gains, and NII taxes on investment income, along with potential estate tax exposure, require clients to consider the eventual income tax impact to the recipient of lifetime gifts of property, particularly if that property has a low income tax basis and/or substantial potential for growth (such as a carried interest). Preserving the federal estate tax exemption until death, however, can allow clients to protect more property from estate taxes while also obtaining the benefit of a basis step-up for their heirs. Thus, for clients who face significant estate taxes, like many managers, a premium will be placed on wealth transfer techniques that reduce the estate but result in minimal or no taxable gifts (thereby preserving the estate tax exemption). Zeroed-out grantor retained annuity trusts ("**GRATs**") and installment sales to grantor trusts are suitable for this approach.

Zeroed-Out GRATs. With a zeroed-out GRAT, the grantor transfers assets to the trust, retaining a right to an annuity payment for a specified term with a present value equal to the fair market value of the assets transferred.[5] GRATs allow asset appreciation in excess of the applicable 7520 rate to pass to the trust's remainder beneficiaries without imposition of gift or estate tax. The current low interest rates and the potential for significant growth in the transferred asset, as with a carried interest, increase the chance that a GRAT will produce a positive result.

Planners, however, must address several specific issues, particularly when the carried interest will serve as the bulk of the GRAT assets:

- Funding a GRAT with carried interest may create liquidity issues for funding annuity payments until the carried interest begins to generate income. In-kind distributions can satisfy the annuity but can undermine the GRAT's chances of success by removing the growth asset from the trust. There are options for managing this issue, including using a longer-term GRAT, providing for annually increasing annuity payments, and funding the GRAT with some cash to meet the initial payments until the interests generate liquidity.

- The transferor must survive term of the retained annuity term to ensure that all trust assets are removed from his or her estate.

- GRATs, alone, generally are not efficient for GST tax planning, since the GST exemption generally cannot be allocated to the assets until termination of the retained annuity term.

Installment Sales to Grantor Trusts. With an installment sale, the grantor sells assets to a grantor trust in exchange for a promissory note bearing interest at the Applicable Federal Rate ("**AFR**"). If the asset sold appreciates at a rate higher than the AFR, the seller successfully transfers wealth, without imposition of transfer taxes, to the trust.

Low AFRs and the sale of assets with low values and significant growth potential, like carried interest, will increase the chances of successfully transferring wealth to the grantor trust.

Initial liquidity needs can be better managed by using an interest-only note. Unlike GRATs, installment sales immediately remove the assets sold from the seller's estate (only the value of the note will be included if the seller dies during the note term) and are efficient for GST planning.

ALL ABOUT THE VALUE

Much of the planning benefits from transferring carried interests depend on early planning, due to the relatively low value of the interests for gift tax purposes at the formation of the fund. The contingent aspects of the carried interest's value, however, can subject its valuation and use in transfer planning to IRS review and challenge, with a successful challenge creating additional gift tax liabilities for the manager. Accordingly, obtaining an accurate valuation from an experienced professional appraiser will be key to any transfer planning.

Further, clients gifting or selling carried interests will place a premium on planning that protects against the adverse tax consequences of subsequent valuation adjustments. For example:

- *Formula transfer or allocation clauses*. As discussed in *WR Marketplace Nos. 2012-34* and *2012-52*, these clauses limit the gift tax value of hard-to-value assets to a fixed dollar amount, so that a subsequent valuation adjustment does not affect the value of the taxable gift (or the donor's potential gift tax exposure). They may be particularly useful for installment sale planning. Keep in mind, however, that while the Tax Court upheld the use of formula transfer clauses in *Wandry v. Commissioner*, the IRS did not acquiesce in that decision.

- *Mandatory Valuation Adjustments with GRATs*. If a GRAT annuity is structured as a fixed percentage of the trust's initial value and the trustee incorrectly values the trust assets, the GRAT must require the trustee to make a compensating payment to the grantor within a reasonable time of the valuation adjustment. Thus, GRATs have a regulatory-sanctioned formula valuation clause that protects them from adverse tax consequences due to IRS valuation challenges, ***which may make them particularly suitable for carried interest planning***.

SPECIAL VALUATION RULES: CODE §2701

Operation. Apart from the above valuation issues, the special valuation rules of Chapter 14 of the Code, particularly Code § 2701, can significantly complicate wealth transfer planning with carried interests. Code § 2701 provides specific rules for determining the gift tax value of the transfer of a junior equity interest in a closely held entity, when the transferor (1) has direct or indirect control over the entity, (2) transfers the junior interest to or for the benefit of junior family members, and (3) retains (or other senior family members retain) a preferred interest (an "applicable retained interest") in the entity.

If Code § 2701 applies, the value of the transferred junior interest equals the total value of all interests owned by the transferor, less the value of the retained preferred interest. The retained preferred interest is valued at $0 (unless it includes a qualified payment right).[6] Accordingly, the transferor would be deemed to make a taxable gift of the entire value of all the ownership interests in the entity upon transfer of the junior interest.

> ***Basic Example***. Dad holds all the outstanding stock of X Co., which has a fair market value of $1.5 million prior to any transfers. X Co. is recapitalized so that Dad holds 1,000 shares of non-cumulative preferred stock (valued at $1 million) and 1,000 shares of voting common stock. Dad gives all common stock to his children. Code § 2701 applies,

effectively valuing the preferred stock at $0 because it does not include a qualified payment right. Thus, rather than making a gift of $500,000 ($1.5 million - $1 million of preferred stock value), Dad's gift is $1.5 million ($1.5 million - $0).

Application. ***Carried interests likely will qualify as junior equity interests under Code §2701 in many cases; accordingly, a § 2701 analysis should be undertaken with the assistance of experience tax counsel prior to any transfer planning.*** The analysis should consider whether the manager transferring the carried interest (1) controls the entity, and (2) will retain a preferred interest (e.g., the manager may have invested his own capital in the fund or be entitled to other distributions that take priority to the carried interest).

Planning Alternatives. The potential application of Code §2701 does not prevent transfer planning with carried interests but does add another level of complexity to avoid extreme gift tax results. Anticipating the desire to plan with carried interests and customizing fund documents accordingly will provide the most flexibility for managers. Potential methods to avoid the applicability of Code §2701 include the following:

The "Vertical Slice." Managers likely will have heard of the "vertical slice" exception to Code §2701, which requires the manager who is transferring a portion of his carried interest to transfer, proportionately, all his other equity interests in the applicable entity (i.e., both preferred and junior equity interest). While often used in carried interest planning, it may be difficult to accomplish with some fund structures if the manager wants to retain certain rights or the entity's agreement restricts transfers of certain interests. To the extent possible, initially structuring the entity and its documents to contemplate vertical slice transfers will facilitate planning.

Derivative Planning.[7] This plan involves an installment sale to a grantor trust of a derivative contract tied to the economic performance of the carried interest, rather than a transfer of the carried interest itself. At the designated settlement date for the contract, assuming the contract is "in the money" (*i.e.*, the performance of the carried interest has met the specified hurdle rate), the manager pays the trust the agreed upon amount. This plan can allow the manager to contribute the economic value of the carried interest to the trust, without imposition of transfer taxes, while not running afoul of Code §2701 and/or any transfer restrictions in the fund documents.

Example. Manager owns a non-transferable carried interest in a new private equity fund. Manager sells a derivative contract based on the carried interest to an irrevocable grantor trust in exchange for an installment note. The contract has a 6-year term and a hurdle amount of $2 million (the appraised fair market value of the carried interest). At settlement, the trust is entitled to the total return on the carried interests, less the hurdle amount. An appraiser determines the contract's value is $600,000, and client gives the trust $600,000 to fund the sale.

If the total return on the contract at settlement is $6 million, manager pays the trust $4 million ($6 million - $2 million hurdle), without imposition of transfer taxes. The transaction is income tax neutral since the trust is a grantor trust. If the contract is out of the money at settlement, however, the trust receives nothing from the manger but must still pay its obligation on the note. Manager loses any gift tax exemption allocated to funding the trust.

The derivative concept may provide several benefits, including avoiding the applicability of transfer restrictions (under Code §2701 or fund documents), providing an even lower valuation for transfer purposes than the carried interest, and offering the ability to customize the transaction. However, it provides additional planning complexity, is largely untested, and must

address several issues. For example, the manager must have sufficient funds to satisfy an "in the money" contract at settlement, which could be a substantial burden if the carried interest has performed well.

INCORPORATING LIFE INSURANCE

Facing significant tax burdens, managers with carried interests can benefit from life insurance planning as follows:

Liquidity Needs. Managers often have much of their wealth concentrated in the funds they manage. Those funds may not provide call rights or may otherwise initially restrict or limit distributions, leaving managers (and their estates, at death) with few liquidity sources. Life insurance can provided needed cash to pay tax liabilities and other expenses.

Hedging Features. The success of many transfer techniques for carried interests depends on investment performance and the manager's survival, neither of which can be controlled. Life insurance can act as a non-correlated asset in this context – neither dependent on mortality or market performance – and thus provides a unique hedge for these transfer strategies.

Tax Management. Life insurance provides for the payment of death benefits without the imposition of income tax and the ability to limit estate and GST taxes on those benefits if held in a properly structured trust, which, when combined with the above, make life insurance a suitable complement to carried interest planning.

TAKE-AWAYS

- Carried interests offer significant wealth transfer planning opportunities for fund managers.
- Early planning and the guidance of experienced tax and financial advisors, however, are crucial to achieving success.
- In addition, complementary planning, including the acquisition of life insurance, is often key to provide liquidity for, and a hedge against, potential estate tax exposure and other liquidity needs.

NOTES

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[1] *See e.g.,* Robert M. Heinrich, Dawn R. Jinsky, & Richard L. Lies, "Estate Tax Reduction Strategies for Private Equity Owners," April 2013; Kevin Matz, "Estate Planning Strategies for Private Equity Fund Managers," *Estate Planning Journal*, Nov. 2007.

[2] While other pass-through entities may be used, for simplicity, this discussion will refer to partnerships.

[3] Fund sponsors themselves are often organized as pass-through entities, with the principals of the fund sponsor receiving an applicable percentage of the management fee and carried interest through the sponsor entity.

[4] If certain proposed tax legislation were enacted, as noted above, the amount of inherent gain that would have been treated as ordinary income upon sale by the deceased manager will be treated as income in respect of a decedent, which is not eligible for a basis step up.

[5] See *WRMarketplace No. 2014-08* for a general discussion of planning with GRATs.

[6] Means any dividend payable on a periodic basis under any cumulative preferred stock (or comparable payment under any partnership interest) to the extent that such dividend/comparable payment is determined at a fixed rate.

[7] *See generally* David A. Handler & Angelo F. Tiesi, "Using Derivative to 'Transfer' Carried Interests in Private Equity, LBO and Venture Capital Funds," Venture Capital Review, Spring 2006.

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