Planning with carried interest

By Ann Bjerke
Head of Advanced Planning
Advanced Planning Group

Advanced Planning Group

UBS

The ownership of carried interest by managers of private equity funds, venture capital firms, and hedge funds presents unique wealth transfer opportunities. Carried interest provides the potential to leverage gifts to younger generations at a low gift tax cost—but also poses some complications that can present challenges if applicable rules aren't navigated carefully.

How is carried interest typically structured?

A manager of an investment fund often has an economic interest in the fund known as a carried interest. This carried interest is commonly a 20% allocation of the fund's profits or gains. Frequently, this is in addition to the 2% asset management fee earned by the fund's management company (together with the carried interest, this creates the fee structure commonly referred to as two and twenty arrangement). Funds are typically organized as limited partnerships, with the carried interest allocated to the general partner (GP) entity.[1] It is the manager's ownership of a portion of the GP that entitles the manager to a share of the carried interest.

Structure of typical investment fund

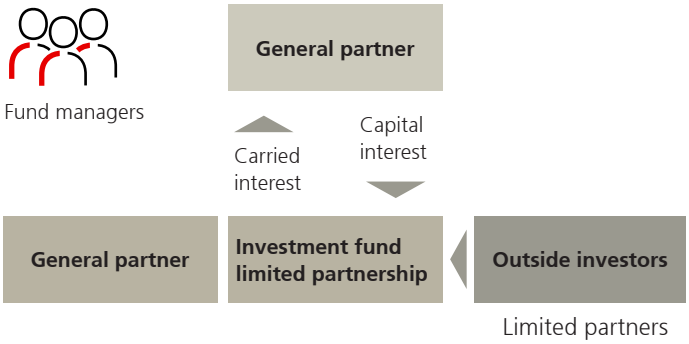
Carried interest can be structured in many ways. Some funds do not permit the GP to begin earning carry until the limited partners have earned a return from the fund equal to their capital investment in the fund. In contrast, some permit the GP to earn carry right away but have a clawback that requires the GP to return distributed profits in the event of a future loss. And some funds, particularly private equity funds, have a hurdle or a certain minimum rate of return to be earned before carried interest is earned. Also, a particular manager's share of the carried interest allocated to the GP may be vested immediately or subject to vesting restrictions and a vesting schedule. The manager's share of carry is generally taxed at long-term capital gain rates for income tax purposes (but note that there has been much discussion about whether Congress may change the income taxation of carried interest in the future).[2]

Valuation

Due to the uncertainty as to whether the fund will be successful and whether the GP, in turn, will earn any carry, the initial value of a manager's share of the carried interest for gift tax purposes will likely be low compared to its potential future value. Yet, if the

[1] Investment funds can also be structured as limited liability companies (LLCs). Because the income taxation and planning concepts are the same for LLCs (that, for federal tax purposes, are classified as partnerships) and limited partnerships, for the sake of simplicity, this whitepaper discusses only funds set up as limited partnerships.
[2] The Tax Cuts and Jobs Act increased the holding period for long-term capital gains treatment of a carried interest from one year to three years.

fund is successful, eventually the carried interest could be worth tens or hundreds of times its value in the early stage of the fund. The manager may be able to transfer a portion of the manager's interest in the GP (including the associated carried interest) to the GP's family members prior to a substantial increase in value to shift significant wealth out of the GP's estate for gift and estate tax purposes.



As with all gift tax planning, valuation is a critical factor in evaluating and structuring a gift. Generally, the standard for determining the value of a gift for gift tax purposes is based on its fair market value, which is the price at which property would change hands between a willing buyer and seller, with both having knowledge of the relevant facts and neither under a compulsion to buy or sell.

There are several methods to determine the fair market value of partnership interests, which can include valuation based on (1) capitalized earnings, (2) liquidation value, (3) projected cash flow based on prior fund performance, and (4) comparable sales. Although the value of a capital interest in a partnership is typically its purchase price, making it relatively easy to determine, the value of carried interest can be uncertain since it is based on a possible future return realized only if the fund is successful. It is therefore critical to engage a qualified appraiser who understands the structure of the fund and has experience in valuing these types of interests. Moreover, because the Internal Revenue Service (IRS) may challenge the value of the asset (as well as any discounts taken) upon an audit, it will likely be preferable to disclose the transfer and the valuation as soon as possible on a timely filed gift tax return to start the running of the statute of limitations.

How does the federal tax law affect planning with carried interest?

When engaging in wealth transfer planning, the optimal scenario is to make a gift of an asset that has a low value relative to its future potential value, thereby reducing the gift tax consequences and shifting the future appreciation in an asset to future generations. Theoretically then, it would be ideal to transfer only the carried interest in a fund (which should have a very low value since it is only an expectation of future profits) to children while retaining the capital interest in the fund (that may already have a significant value).[3] Unfortunately, Congress has already thought of this and created a set of complex rules to prohibit this type of planning—and failure to comply strictly with these rules could result in severe adverse tax consequences.

When engaging in any gift tax planning, you want to avoid the application of Section 2701 of the Internal Revenue Code. Basically, section 2701 provides that if you own a junior subordinated interest in an entity (i.e., the carried interest) and a senior preferred interest in an entity (i.e., the capital interest) that you control, and attempt to transfer only the junior interest in a gift transaction, you may be treated as having transferred your entire interest (i.e., both the carried interest and the capital interest). This result is undesirable from a gift tax perspective: though you transferred only the junior interest (i.e., the carried interest), you are subject to gift tax (or use lifetime gift tax exemption) on the value of your combined junior and senior interests in the entity.

If a fund manager plans to transfer a carried interest in a fund, the fund manager should consider whether the provisions of section 2701 apply. As noted above, section 2701 is intended to prevent a transferor from manipulating the gift tax value of the transferred interest by artificially inflating the value of a retained interest, if any. Section 2701 may apply to determine the gift tax value of a transferred interest if the transferor or certain close family members retain an interest in the same fund that confers an extraordinary payment right, such as a put or conversion right, or a distribution right, such as a preferred return.

The vertical slice (i.e., how to avoid application of the dreaded section 2701)

Federal tax law provides a safe harbor for managers to transfer their carried interest as long as they also transfer their other interests in the fund. If you transfer a proportionate amount of all of your ownership interests in the fund, then you can make a gift without application of section 2701. Practically speaking, this may be the simplest way to go in any event, because a carried interest is an economic right tied to the legal ownership interest in a GP,

[3] For a discussion of reporting requirements for transfers to children and other beneficiaries see Todd D. Mayo, *Reporting Requirements for Gifts and Other Transfers* (a publication of the UBS Advanced Planning Group).

and a transfer of the legal ownership interest in the GP will typically include all of the economic interests associated with it, including carried interests and capital interests.

Of course, the value of a gift of a combined capital and carried interest will be much greater than the value of just the carried interest alone, and it may therefore be tempting to try to structure the fund so that the GP has only a very small capital interest in the fund, with the managers investing their capital directly in the fund rather than through the GP. But that wouldn't help: Section 2701 requires a vertical slice of all of your ownership interests, at both the GP and the fund level.[4] In some cases, the dilutive effect of the transfer of the capital interest with the carried interest will make the cost of the gift prohibitive. However, with the current $12.92 million lifetime gift tax exemption available in 2023 (which will be indexed for inflation annually but is scheduled to sunset at the end of 2025 at which time it will be set to $5 million, indexed for inflation after 2011), fund managers may have increased capacity to make a larger gift without paying gift tax.[5]

In order to structure a successful estate planning strategy involving carried interest, the manager should have a thorough understanding of the fund's complex economic arrangement so that the tax risks and opportunities can be managed.

Transferring a vertical slice

If the manager's interest in the fund (both capital and carried) is capable of being transferred and the manager wants to transfer 10% of the manager's ownership interest in the GP of a fund (and the manager owns no other interests in affiliated entities) to their children, what strategies might be appropriate? After addressing the hurdles and risks associated with making transfers of carried interest, a fund manager may wish to consider the following estate planning strategies.

Outright gift to children

A simple strategy may be to transfer 10% of the fund manager's GP interest in equal shares among the manager's children, free of trust. The value of the gift would be the fair market value of the GP interest on the date of transfer and would use some or all the manager's lifetime gift tax exemption. However, the fund's operating agreement may prohibit third parties from owning any interest in the GP, so outright gifts may not be possible.

Gift to a trust for the benefit of the children

The fund's operating agreement may permit a transfer of the GP interest to a trust for the benefit of family members, provided that the fund manager or certain permitted individuals remain responsible for the disposition of and voting control associated with the GP interest. Then, a gift of the GP interest to a trust for the benefit of the fund manager's children would exclude the value of the transferred interest (and all future appreciation) from the fund manager's estate for estate tax purposes while also protecting the interest from claims of the beneficiaries' creditors.

Moreover, the trust could be structured in a way to require the fund manager who created the trust to remain responsible for the income tax liability resulting from the trust assets (known as a grantor trust), thereby allowing the trust assets to grow and compound free from income tax liability.[6]

[4] It may be possible to set up a side-by-side vehicle for the managers to invest their capital directly in the underlying portfolio companies, bypassing the fund entirely. Even that may not get around the vertical slice rule depending on the structure of those underlying companies, and, in any event it creates a level of administrative complexity that could be unduly burdensome.

[5] This assumes the individual is a US person for gift and estate tax purposes.

[6] For a discussion of sales to intentionally defective grantor trusts see Casey Verst, *Sales to Grantor Trusts* (a publication of the UBS Advanced Planning Group).

Installment sale to a trust for the benefit of the children

If the fund manager wants to leverage a gift to the trust, it may be possible to sell GP interests to the trust in exchange for a promissory note.[7] The note typically provides for payment of interest at the applicable federal rate over a fixed term and a balloon payment of principal at the end of the term. The applicable federal rate for a promissory note the term of which is more than three years and not more than nine years is 4.43% in October 2023.[8]

If the assets sold to the grantor trust appreciate at a rate that exceeds the applicable federal rate, all appreciation above that threshold amount passes free of transfer tax. The trust would need to be seeded up front with assets to a certain degree, however, so the debt-to-equity ratio after the sale is not commercially unreasonable.

Grantor retained annuity trust

With a grantor retained annuity trust (GRAT), the manager transfers GP interests to an irrevocable trust, retaining the right to receive an annuity for a fixed number of years.[9] A GRAT can be structured so that there is little or no transfer tax cost. The present value of the stream of annuity payments from the GRAT is structured to be almost equal to the value of the property with which the GRAT is initially funded.[10] If the assets in the GRAT appreciate at a rate that exceeds the 7520 rate used to value the annuity interest, which is 5.8% in December 2023, the appreciation in excess of the 7520 rate generally passes to the remainder beneficiary free from gift tax.

However, because the assets will need to be valued annually to determine the annuity payment (if the annuity will be paid out in kind), the administrative costs associated with obtaining updated appraisals each year may make this strategy less attractive. (If the cash flow from the GP interest is sufficiently large to satisfy the annuity, there would be no need for updated appraisals, but it could be difficult for a fund to generate that magnitude of cash flow, particularly in the early years.)

Other estate planning strategies

There are several creative (but untested) strategies that have been developed to make gifts of carried interests. Those creative strategies are intended to avoid application of section 2701 without requiring the manager to transfer a vertical slice of the entire interest in the fund.

Entering into a derivative transaction with a grantor trust

One such strategy involves the manager selling a derivative tied to the performance of the carried interest to a grantor trust created for family members. The manager would enter into a contract with the trust pursuant to which the trust purchases a right to receive, at a predetermined future date, a payment based on the total value of the carried interest on that date. An existing grantor trust that has already been funded could enter the contract and pay the purchase price to the manager, or a new grantor trust can be funded with a gift that could be used to purchase the trust's right to the future payment under the contract. The manager retains all of the GP interest (including the carried interest), thereby possibly avoiding concerns related to section 2701, transfer restrictions in the fund's governing documents, and valuation concerns relating to the vesting of the carried interest.[11]

Creating a new family-owned entity to own the manager's interest

Another possible strategy involves creating a new family-owned entity, such as a limited liability company, into which the fund manager would contribute all of the manager's interests in the fund (GP and limited partner interests) in return for junior and senior interests in the LLC. The fund manager would then transfer some of the senior interests in the LLC to family members (likely a trust for children and future generations). Because the fund manager retains the junior interests, the transfer should fall under an exception to the provisions of section 2701. There are several variations on this approach, but all serve to provide potential additional approaches to the more commonly used vertical slice strategy.[12]

[7] Id.

[8] Applicable federal rates are published monthly by the IRS.

[9] For a discussion of GRATs see Jennifer Lan, *Grantor Retained Annuity Trusts* (a publication of the UBS Advanced Planning Group).

[10] The present value of the annuity interest is determined (in part) using the 7520 rate. More specifically, the 7520 rate is 120% of the federal midterm rate (subject to rounding). IRC § 7520(a)(2). The federal midterm rate is based on the average market yield on outstanding marketable obligations of the United States with a remaining maturity period of more than three years and not more than nine years. IRC § 1274(d)(1)(C)(ii). When valuing the annuity interest, the grantor must use the 7520 rate that's in effect for the month in which the grantor contributes money or other property to the GRAT.

[11] For a discussion of the use of private derivatives with carried interest, see David Handler, "Using Derivatives to 'Transfer' Carried Interests in Private Equity, LBO and Venture Capital Funds," *Venture Capital Review*, Spring 2006. For a general discussion of the use of private derivatives in wealth transfer planning, see Todd D. Mayo, "Derive Time," *STEP Journal*, August 2023, pp. 49-51. (Todd is a Senior Wealth Strategist in the UBS Advanced Planning Group.)

[12] See N. Todd Angkatavanich and David A. Stein, "Going Non-Vertical With Fund Interests," *Trusts and Estates*, November 2010.

Potential pitfalls

While the most significant risk associated with fund managers making gifts of interests in their funds is getting tripped up in the complex rules of section 2701, there are many other potential pitfalls that the manager needs to avoid.

Vesting
A gift of an unvested carried interest may be deemed to be completed for gift tax purposes only when vesting occurs (based on the position of the IRS with respect to gifts of unvested stock options). While the carried interest in the fund is allocated to the GP, the fund manager's share of the carried interest in the GP may be subject to a vesting schedule. Because the value of the carried interest may have appreciated significantly by the time the interest is vested, gifts of unvested GP carried interest could result in an unintended large taxable gift in later years. Accordingly, many managers make gifts only after the GP carried interest is vested.

Transfer restrictions in the fund agreement
Some fund agreements prohibit or restrict transfers of interests in the GP. Accordingly, the manager needs to review the fund's operating agreements to determine whether the contemplated transfer is permitted.

Capital calls
By virtue of a fund manager's interest in the GP or management company, the manager may have ongoing obligations to meet fund capital calls. If the manager transfers an interest which is subject to future capital call commitments, the transferee (potentially a trust for the manager's children) would then assume those commitments—the fund manager cannot make those payments on behalf of the transferee without a deemed additional gift.

Avoiding the pitfalls
It is possible to avoid many of these issues by structuring the fund at the outset to facilitate estate planning transfers.

Final thoughts

Issues involving investment funds and transfers of carried interest involve several specialized areas of the law. Nonetheless, due to the significant potential growth in value, carried interest remains an attractive asset to consider deploying in estate planning strategies.

About the Advanced Planning Group

The Advanced Planning Group consists of former practicing estate planning and tax attorneys with extensive private practice experience and diverse areas of specialization, including estate planning strategies, income and transfer tax planning, family office structuring, business succession planning, charitable planning and family governance.

The Advanced Planning Group provides comprehensive planning and sophisticated advice and education to ultra high net worth (UHNW) clients of the firm. The Advanced Planning Group also serves as a think tank for the firm, providing thought leadership and creating a robust intellectual capital library on estate planning, tax and related topics of interest to UHNW families.

Disclosures

Purpose of this document.
This report is provided for informational and educational purposes only. It should be used solely for the purposes of discussion with your UBS Financial Advisor and your independent consideration. UBS does not intend this to be fiduciary or best interest investment advice or a recommendation that you take a particular course of action. The information is current as of the date indicated and is subject to change without notice.

Personalized recommendations or advice.
If you would like more details about any of the information provided, or personalized recommendations or advice, please contact your UBS Financial Advisor.

Conflicts of interest.
UBS Financial Services Inc. is in the business of establishing and maintaining investment accounts (including retirement accounts) and we will receive compensation from you in connection with investments that you make, as well as additional compensation from third parties whose investments we distribute. This presents a conflict of interest when we recommend that you move your assets to UBS from another financial institution or employer retirement plan, and also when we make investment recommendations for assets you hold at, or purchase through, UBS. For more information on how we are compensated by clients and third parties, conflicts of interest and investments available at UBS please refer to the "Your relationship with UBS" booklet provided at **ubs.com/relationshipwithubs**, or ask your UBS Financial Advisor for a copy.

No tax or legal advice.
UBS Financial Services Inc., its affiliates and its employees do not provide tax or legal advice. You should consult with your personal tax and/or legal advisors regarding your particular situation.

Important additional information applicable to retirement plan assets (including assets eligible for potential rollover, distribution or conversion).
This information is provided for educational and discussion purposes only and are not intended to be fiduciary or best interest investment advice or a recommendation that you take a particular course of action (including to roll out, distribute or transfer retirement plan assets to UBS). UBS does not intend (or agree) to act in a fiduciary capacity under ERISA or the Code when providing this educational information. Moreover, a UBS recommendation as to the advisability of rolling assets out of a retirement plan is only valid when made in a written UBS Rollover Recommendation Letter to you provided by your UBS Financial Advisor after a review of detailed information that you provide about your plan and that includes the reasons the rollover is in your best interest. UBS and your UBS Financial Advisor do not provide rollover recommendations verbally.

With respect to plan assets eligible to be rolled over or distributed, you should review the IRA Rollover Guide UBS provides at **ubs.com/irainformation** which outlines the many factors you should consider (including the management of fees and costs of your retirement plan investments) before making a decision to roll out of a retirement plan. Your UBS Financial Advisor will provide a copy upon request.

Important information about brokerage and advisory services.
As a firm providing wealth management services to clients, UBS Financial Services Inc. offers investment advisory services in its capacity as an SEC-registered investment adviser and brokerage services in its capacity as an SEC-registered broker-dealer. Investment advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate arrangements. It is important that you understand the ways in which we conduct business, and that you carefully read the agreements and disclosures that we provide to you about the products or services we offer. For more information, please review the client relationship summary provided at **ubs.com/relationshipsummary**, or ask your UBS Financial Advisor for a copy.