

## **Estate Planning with the Carried Interests for the Private Equity and Venture Capital Client**

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A manager of a private equity fund or venture capital fund (collectively “Funds”) is able to take advantage of substantial gift and estate planning opportunities by gifting their Carried Interest to family members. A Fund Manager will often receive a Carried Interest for a small amount of contributed capital. The Carried Interest may be valued for gift tax purposes at a low value. Over time, the Fund may return a multiple of the original value, thereby substantially increasing the value of the Carried Interest that was gifted to the family members. This provides substantial leveraging opportunities for the Fund manager because the appreciation on the interest has been shifted to future generations.

The “Carried Interest” is a special allocation of investment gains and distributions to the general partner. This interest is also called the “promote”, an “override”, an “incentive allocation” or a “profits interest”. The Carried Interest entitles the holder to receive a portion of the income and appreciation in the value of the partnership arising after the date the interest is granted. A significant portion of the income earned by fund managers and others who provide services to private equity, venture capital and hedge funds comes from Carried Interests. The benefit is to shift the tax of the carried interest from the ordinary income rate of 35% to 39% to the capital gains rate of 15%. In addition, the gains are not subject to employment taxes.

The Fund manager typically receives a Carried Interest in the Fund’s general partner or manager. Generally, it is a 20 percent allocation of residual investment gains after prior allocations and distributions as detailed in the Fund agreement. Please refer to the attached chart for an overview.

### **Estate Planning Strategies for the Carried Interest**

There are a number of estate planning strategies to implement with a Carried Interest.

#### **Family Limited Partnerships and Limited Liability Companies (the “Entities”)**

The Fund Manager establishes an entity to hold the Carried Interest. This arrangement creates an opportunity for the Fund Manager to discount the Carried Interest initially when it is transferred into the entity. The valuation discounts arise from the lack of control and marketability. The Fund Manager should be mindful of control after a transfer.

## **Gift or Sale of Carried Interests to a Defective Irrevocable Grantor Trust**

A gift or sale transaction to a Defective Irrevocable Grantor Trust provides a number of benefits outlined below:

- the technique enables the Fund Manager to transfer substantial assets out of his\ her estate at a very favorable time (early stage of the Fund) and presumably at a very low value;
- the sale transaction will not be a taxable event to the Fund Manager;
- the advantageous characterization of the Carried Interest as a profits interest will be maintained;
- interest income on the promissory note will be disregarded for federal income tax purposes;
- the full value of the Defective Irrevocable Grantor Trust will be excluded from the Fund Manager's estate (except for the value of the outstanding promissory notes);
- the Fund Manager's spouse has the ability to use or have the benefit of the trust property;
- the appreciation in the Carried Interest above the interest rate on the promissory note effectively transfers wealth to the remainder beneficiaries of the trust; and
- income earned in the Trust would remain taxed to the Fund Manager for income tax purposes allowing the tax free build up of wealth within the trust outside of the Fund manager's taxable estate.

A gift of Carried Interest to a Defective Irrevocable Grantor Trust is an excellent estate planning technique to leverage life time gifting opportunities. In the initial stages of the Fund, there are a number of factors that may significantly reduce the federal gift tax value of the Carried Interest to be transferred to the Defective Irrevocable Grantor Trust as follows:

- uncertainty as to the anticipated capital appreciation of the portfolio companies
- uncertainty as to whether the return of the Fund will be greater than the preferred return or the hurdle rate
- uncertainty as to whether the Carried Interest will be subject to a clawback

- Carried Interests on the general partner by the individual participants may be subject to vesting restrictions and reallocation of percentage interests
- General Partner's (or Manager's) interests in the Carried Interest may be discounted to reflect the lack of marketability and lack of control

### **Grantor Retained Annuity Trust**

A Grantor Retained Annuity Trust (GRAT) can provide an excellent planning opportunity to transfer the appreciation potential of Carried Interests (which exceeds the monthly IRS benchmark interest rate) without incurring any gift or estate tax. With this technique, the Fund Manager transfers property to a GRAT for a specified number of years retaining the right to receive an annual annuity. It would typically be preferable to have a longer term GRAT since the Fund's portfolio companies do not anticipate selling for a number of years.

The GRAT may be structured as a "zeroed out" GRAT in order to reduce the gift tax consequences to the grantor. To achieve this, the annuity payments would be payable to the estate of the grantor if the grantor dies before the end of the GRAT term. Upon termination of the GRAT, the remaining trust assets are paid to the remainder beneficiaries (usually the next family generation).

### **Structuring Risks Associated with Planning with the Carried Interest**

There are a number of potential risks that you must anticipate when planning with the Carried Interests including valuation issues, deemed gifts and transfers of unvested interests. These risks need to be analyzed and carefully addressed to make sure the gift of the Carried Interest is properly planned.

President and U.S. Congress both have discussed changing the tax of the Carried Interest from 15% to a much higher rate of 35% similar to other compensation. In addition, there is discussion in Congress to have this income be subject to employment taxes. Over the next few months, we will have a clearer picture to determine what will happen with the Carried Interest.

If you would like more information regarding planning for the Carried Interest, please call Stephen Wilchins or Imelda Monaghan at Seegel Lipshutz & Wilchins LLP at 781 - 237-4400 or email us at [swilchins@slwllp.com](mailto:swilchins@slwllp.com) and [imonaghan@slwllp.com](mailto:imonaghan@slwllp.com) as it would be our pleasure to assist you.