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Estate Planning with Carried Interests and Derivatives[1]

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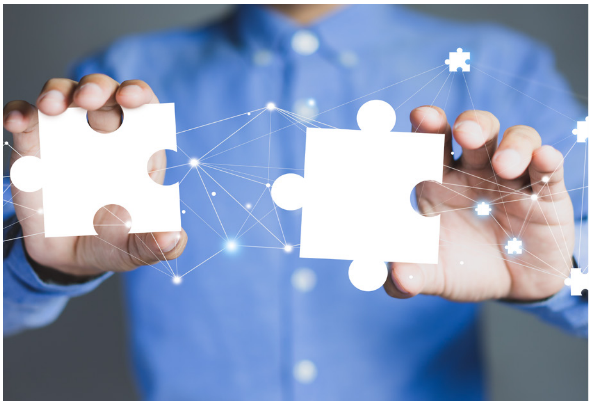
Carried interest is an ideal estate planning asset for fund owners and GPs, given its appreciation potential. There are several accepted best practices for estate planning when it comes to carried interest. However, using a carry derivative may offer several advantages over the other approaches.

Private equity and venture capital continue to be a favored alternative investment class of high net worth investors and family offices, often offering higher returns and additional portfolio diversification. The tradeoff for such returns and diversification is severely limited liquidity as an investor's capital may be locked up for five-, ten-, or more years.



The principals of a private equity or venture capital firm commonly have a financial stake in the investment vehicle (i.e., the "Fund") comprised of a **capital** interest and a **carried** interest. A principal's **capital** interest is invested pari-passu with the limited partners (LPs) of the Fund through the Fund's general partner (GP) or another parallel investment vehicle. A principal's **carried** interest is a performance allocation that is typically realizable after the LPs receive both a return of their invested capital and a hurdle (e.g., a preferred return). This carried interest aligns the goals of the Fund's LPs with the Fund's management as a form of incentive compensation to the Fund's principals.

Attractive Asset for Estate Planning

When engaging in estate planning, it is usually more tax-efficient to transfer assets before such assets increase in value. **Carried interest can be a very attractive asset to transfer,** either as a taxable gift or outside of a taxable estate, for the benefit of one's children or grandchildren. This is especially true when a Fund is at or near its inception, as the carried interest is considered highly speculative with potentially significant upside. For many funds, if carried interest is to be realized, it is far into the future, often five to ten years after a Fund begins making portfolio investments. The risk and speculative characteristics of carried interest means its value, at the time of transfer, may be small relative to its eventual realizable value if the Fund's investments are successful.

Limitations Caused by Section 2701

Some estate planning advisors believe that transfers or gifts of carried interest are subject to Section 2701 of the Internal Revenue Code (IRC), while some believe these interests are too different to have it apply. Section 2701 focuses on the value of intra-family transfers in privately held companies and partnerships when the entity has multiple classes of equity. This was enacted by Congress in the 1990s to deal with potential valuation abuses that were perceived to be present in preferred stock recapitalizations. Specifically, the concern was that post-gift, the senior interest holder would shift value to the junior interest. In a Fund structure, the capital interest is typically considered to be senior to the carried interest.

If a principal only transfers the carried interest and not the capital (i.e., senior) interest, and Section 2701 is applicable, it stipulates that because the principal retained an underlying ownership in the GP or Fund, the principal may be treated (deemed) as though they gifted all of their interests in the Fund (both capital and carried) that were owned prior to the transfer, despite not actually gifting those interests. This means significantly more, or all, of the principal's interests could be included by the IRS as part of the transaction, even when not actually gifted.

Safe Harbor – the Vertical Slice

To avoid the "deemed" gift provisions, and detrimental valuation rules, Section 2701 allows for a safe harbor approach commonly called the "vertical slice." The vertical slice rule requires that the transferor proportionally reduce all of their equity interests in the Fund when making a gift to a family member. For example, the private equity principal would gift or transfer 30% of their ownership in the carried interest and capital interest.

Drawbacks of the Vertical Slice

As stated above, when using the vertical slice approach, the principal must transfer a ratable capital interest if they wish to transfer a carried interest. The capital interest may have less appreciation potential and a lower risk profile than the carried interest. The transferee may then be liable for funding future capital calls. Further, if the transferee is not capable of funding such capital calls, the IRS may consider the gift "incomplete."

Vesting Considerations

Most carried interests have time-based vesting provisions, ensuring the principal remains with the GP through the eventual realization of the Fund's portfolio investments. The IRS's position is that a gift of unvested stock options is incomplete until vesting has occurred. If this rule is applied to carried interest, the gift of any unvested carried interest will become effective once it vests, and the value of such carried interest will likely have appreciated in value at its vesting date (i.e., its effective gift date). Application of this vesting rule diminishes the golden rule of estate planning: that it is usually more tax-efficient to transfer assets before such assets increase in value.

However, there are some estate planning advisors that believe the vesting issue is not applicable to carried interest. They believe the nature of unvested carried interest is distinct from unvested non-statutory stock options (as no enforceable property right exists), whereby the carried interest in the GP immediately confers legal rights to its owner (including the right to receive current distributions). The primary distinction is that the carried interest "rights" are immediately owned (i.e., vested) but subject to curtailment if the principal withdraws from the GP.

An Elegant Solution – the Carry Derivative

A financial derivative is a contract between two (or more) parties that derives its value from an underlying financial asset or indicator (e.g., a benchmark such as the S&P 500). The purchaser of a financial derivative is typically entitled to cash payment(s) based on the fluctuations or events of the underlying financial asset.

The carry derivative is linked to the carry distributions associated with the principal's interest in the Fund. With a derivative contract, the carried interest does not change ownership, but rather the economic return on the carried interest is transferred. Compared to a direct transfer, there is added flexibility and customization when using a derivative as the contract can stipulate a hurdle, splits of the distributions (e.g., the principal retains a portion of the carry distributions), a cap, and specific cash settlement dates. With the presence of a hurdle, the derivative's value would typically be lower than the value of the carried interest itself.

Further, using a carry derivative appears to avoid many of the issues discussed above, again, because the ownership of the carried interest is not transferred from the private equity principal. Whether the carried interest is vested or unvested is irrelevant as the principal will continue to own the carried interest throughout the derivative contract. And the potential issues of Section 2701, which requires the vertical slice as a safe harbor, do not appear to be applicable, as the principal has retained full ownership of both the junior and senior equity.

Please note that Empire does not portend to provide legal advice regarding the applicability of 2701 or other legal issues here, and the reader should consult with their estate planning attorney regarding the many factors and issues regarding these kinds of gifts and tools.

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[1] *Relevant sources: (1) Estate Planning for Private Equity Fund Principals,* by David Scott Sloan, Holland & Knight LLP, November 2009; (2) *Using Derivatives to "Transfer" Carried Interests in Private Equity, LBO, and Venture Capital Funds,* by David A. Handler and Angelo F. Tiesi of Kirkland & Ellis LLP, Venture Capital Review, Issue 17, Spring 2006 and (3) *Carry Derivatives: Using your Carried Interest in your Estate Plan,* by David A. Handler, Anna Salek and Angelo F. Tiesi of Kirkland & Ellis LLP, Venture Capital Review, Issue 31, 2015.

Nathan is a Managing Director at Empire Valuation Consultants, where he has worked since 2008.

Nathan has prepared a wide variety of closely held business valuations across a broad spectrum of industries. He has valued derivative instruments, carried interests, intangible assets, and equity and debt interests for diverse purposes, including those of tax planning and reporting, lending purposes, financial and Securities and Exchange (SEC) reporting (including ASC 350-20 impairment testing and ASC 820 fair value measurements), ESOP purposes, and other corporate planning and reporting purposes.

Nathan has extensive experience in valuing carried interests in private equity and hedge funds, as well as valuations of limited partnership interests in such funds.

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