Estate Planning Ideas for Private Equity Fund Managers

Sophisticated planning techniques can improve the transfer tax consequences of passing carried interests to younger generations.

IVAN TABACK AND NATHAN R. BROWN, ATTORNEYS

Relatively low interest rates, together with continued growth in forming private equity funds (and hedge funds), make this an ideal time for the private equity fund manager to review estate planning strategies with a goal towards preserving family wealth by minimizing estate and gift taxes. This is the case for both individuals who already have engaged in some degree of estate planning and for those who have not done any planning.

Under current law, federal gift and estate taxes are imposed on the transfer of assets during life or at death.[1] However, every individual U.S. citizen is entitled to an inflation-adjusted gift and estate tax exemption of $5 million ($5.43 million for 2015). This effectively permits the private equity fund manager to transfer up to $5.43 million (in 2015) during life or at death without the imposition of federal gift or estate tax. Any amounts transferred in excess of the exemption will, however, be subject to a 40% federal gift or estate tax.

Without proper planning, many private equity fund managers will have estates in excess of the estate tax exemption amount upon their deaths, which can result in a significant estate tax liability. Thus, private equity fund managers and their advisors should consider techniques to minimize federal estate taxes in connection with the transfer of their wealth to the next generation and beyond.

The private equity fund—overview

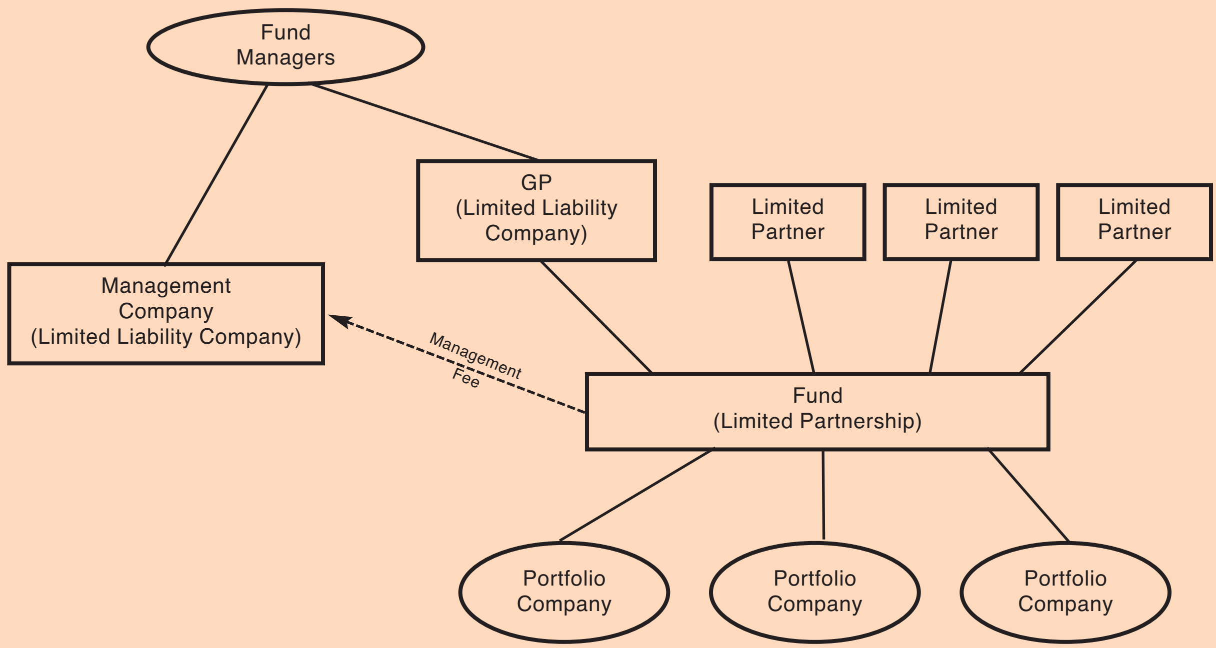
In order to effectively and efficiently implement estate planning techniques for private equity fund managers, one must understand the structure and economic arrangement of a private equity fund. What follows is a brief overview of the structure and economics of a typical, plain vanilla, private equity fund.

General structure of a private equity fund. A private equity fund is an investment vehicle formed by investment managers to invest large pools of capital in various portfolio companies. The fund managers generally structure the fund as a limited partnership for income tax purposes. As such, all income, gains, losses, and deductions of the fund flow through the fund to the partners, and escape taxation at the fund level.[2] (The typical structure is illustrated in Exhibit 1.)

The general partner (GP) of the fund is generally structured as a limited liability company (LLC), of which the fund managers are members and managers. Thus, the fund managers control the fund through the GP. The primary purpose of the GP typically is to hold the fund manager's profits interest, or "carried interest," which is the fund

IVAN TABACK is a partner in Skadden, Arps, Slate, Meagher & Flom LLP's New York City office. NATHAN R. BROWN is an associate in Proskauer Rose LLP's Boca Raton, Florida, office.

EXHIBIT 1
General Structure of a Private Equity Fund



manager's primary economic incentive for managing the fund. The fund managers, however, through the GP, may also invest capital in the fund in order to show potential investors that the fund managers have some "skin in the game." This is attractive to investors (and may be required by investors) because the fund managers presumably are less likely to take unnecessary risks with the fund's investments when some of their own capital is at risk.

The limited partners (LPs) of the fund typically consist of outside investors, such as pension plans, university endowments, insurance companies, and wealthy individuals who agree to commit a fixed amount of capital to the fund.[3] Unlike hedge funds, where the committed capital is contributed in one up-front installment, the capital commitment of an investor in a private equity fund is typically contributed in a series of separate installments during the "investment period" on an as-needed basis (as determined by the fund managers) to fund various investments identified by the fund managers. In addition to investing capital in the fund through the GP, a fund manager may also invest directly in the fund as an LP.

In addition to forming the GP, the fund managers will usually form a separate entity, typically an LLC, to serve as a management company for the fund. The management company (which will not have any equity ownership interest in the fund) will act as the fund's investment advisor and provide other basic operational services to the fund in exchange for an annual management fee of approximately 2% of assets under management.

Economics of a private equity fund. A successful fund will have substantial amounts of cash proceeds to distribute between the GP and LPs. The manner in which these distributions are made is set forth in the fund's partnership agreement and is often referred to as the "distribution waterfall." Although distribution waterfall provisions vary from fund to fund, one example of such a provision would be as follows:

1 Generation-skipping transfer (GST) tax is also imposed on certain transfers during life and at death. A complete explanation of the GST tax is beyond the scope of this article. In general, the tax is imposed on direct transfers, or transfers from trusts, to "skip" persons (i.e., those persons more than one generation younger than the transferor or donor to the trust). The tax is imposed at a flat rate equal to the then highest estate tax rate. (In 2015 the rate is 40%.) Each individual is entitled to a GST tax exemption which can be applied to lifetime or death transfers. (In 2015, this amount is $5.43 million.)

2 Fund managers may also create a parallel fund in a non-U.S. jurisdiction to accommodate certain non-U.S. investors. The use of a parallel fund may allow the non-U.S. investors to avoid certain U.S. tax compliance obligations that would apply if the non-U.S. investor invested in the U.S. fund.

3 While the LPs generally invest directly in the fund, non-U.S. investors (and U.S. tax-exempt investors) may prefer to invest through an upper-tier corporate "blocker" entity to avoid certain negative income tax and estate tax implications.

1. All investors receive a return of their invested capital. This includes any capital invested by the fund managers, either through the GP or directly in the fund.
2. All investors receive distributions until they have received a certain preferred return on their capital investment (e.g., 8% or 9%).
3. The GP (the holder of the carried interest) is entitled to a "catch-up" distribution to make up for the preferred return paid to investors.
4. Of the remaining profits, 20% is distributed to the GP as the carried interest and 80% is allocated among and paid to the capital investors.

Because the GP is not entitled to its carried interest unless the fund's investments generate sufficient profit to return all invested capital plus a specified preferred return, at the time the fund is created (and throughout the fund's early stages) the carried interest has little or no value. If the fund is successful, however, the value of the carried interest could become substantial. It is exactly this characteristic of a carried interest (i.e., the high appreciation potential), that uniquely positions fund managers to take advantage of lifetime gifting techniques.

Transfer of a carried interest

Because of the economic nature of a fund manager's interest in a fund, transfers of carried interests are subject to complex provisions of federal estate and gift tax laws. These transfers should not be undertaken without the supervision of an attorney experienced in the intricacies of such provisions.

Section 2701 and the vertical slice. When a fund manager makes a lifetime gift of a carried interest in a fund's GP to a family member or entity, such as a trust for the benefit of family members (often referred to in the GP agreement as an affiliated entity), and retains an interest in the GP or in the fund directly, caution must be taken to avoid (or navigate) application of Section 2701.

Section 2701 applies a set of special valuation rules when the following two conditions are met:

1. A subordinate equity interest in a corporation or partnership (which includes an LLC) is transferred to or for the benefit of the transferor's spouse or a younger generation member of the transferor's family (a "member of the family").[4]
2. The transferor, the transferor's spouse, or an older generation member of the transferor's family (an "applicable family member")[5] retains an "applicable retained interest" in the corporation or partnership.[6]

An applicable retained interest is an equity interest in a corporation or partnership that confers upon its holder (1) a right to receive distributions that has preference over the transferred interest (but only if immediately before the transfer the transferor and applicable family members "control" the entity) (a "distribution right")[7] or (2) a discretionary put, call, conversion right, or right to compel liquidation of the entity (an "extraordinary payment right").[8]

If Section 2701 applies, the gift tax value of the transferred subordinate equity interest is determined under the "subtraction method."[9] In its most simple form, the subtraction method determines the gift tax value of the transferred interest by subtracting the value of all interests in the entity retained by the transferor immediately after the transfer from the aggregate value of all interests in the entity held by the transferor immediately before the transfer.

Because of the economic nature of a fund manager's interest in a fund, transfers of carried interests are subject to complex provisions of federal estate and gift tax laws.

If the retained interest is an applicable retained interest, its value for purposes of applying the subtraction method is zero. The result of this zero valuation rule is that, for gift tax purposes, the transferor is treated as transferring not only the actual gifted interest, but all applicable retained interests as well.

This is an important issue when a fund manager gifts his or her carried interest to a family member or affiliated entity because the fund manager typically will retain a capital interest in the fund. The retained capital interest will generally include a distribution right (i.e., a preferred right to distributions of profits from the fund). Accordingly, if the fund manager (and applicable family members) controls the fund immediately after the fund manager transfers the carried interest, the retained capital interest will be an applicable retained interest and Section 2701 will apply, resulting in a potentially significant increase in gift tax.

4 Section 2701(e)(1).
5 Section 2701(e)(2).
6 Section 2701 does not apply if the retained interest is junior to or of the same class as the transferred interest. Section 2701(a)(2).
7 Section 2701(b)(1)(A); Reg. 25.2701-2(b)(3).
8 Section 2701(b)(1)(B); Reg. 25.2701-2(b)(2).
9 Reg. 25.2701-3.

As noted above, funds are generally structured as limited partnerships. A fund manager will be treated as controlling a fund immediately before a transfer if the fund manager holds an interest in the fund "as a general partner."[10] The GP of a fund will typically be structured as an LLC and, as a result, a fund manager generally will not hold an interest "as a general partner" in the fund. Rather, the fund manager will hold an interest "in the general partner" of the fund. Despite the statute's lack of direct application to the typical fund structure, the conservative approach is that the fund manager may be deemed to control the fund for Section 2701 purposes if the fund manager is a member of the GP.

In order to avoid the application of Section 2701, the fund manager must transfer not only his or her carried interest, but also a proportionate amount of all other equity interests in the fund owned by the fund manager, including any percentage interest in the capital interest and any related obligation to contribute capital.[11] This technique is commonly referred to as transferring a "vertical slice" of the fund manager's interest in the fund. For a fund manager who has significant capital invested in the fund, either through the GP or as an LP in the fund directly, structuring the transfer as a vertical slice can result in a significant gift tax liability (or the use of a significant portion of the fund manager's lifetime gift tax exemption).

Fund managers may be reluctant to transfer to a family member or affiliated entity a portion of his or her capital interest because of the capital interest's commitment to make future capital calls. However, through proper planning, the fund manager can later assist with payment of these capital calls by making additional gifts or loans to the family member or affiliated entity.

Planning Tip

One way to avoid a hefty gift tax liability is for the fund manager to invest most of his or her capital investment directly in the portfolio companies on a side-by-side basis with the fund rather than through the GP or directly in the fund. Although the fund manager will likely still invest some of his or her capital investment through the GP or the fund, this technique can greatly reduce the gift tax resulting from the transfer of a vertical slice of the fund manager's interest in the fund.

This technique works because the interest retained by the fund manager in the portfolio companies through the fund manager's side-by-side investment will not be an applicable retained interest (there will be no extraordinary payment right and it is unlikely that the fund manager will control any of the portfolio companies immediately after the transfer of the carried interest). Therefore, the retained interest is not taken into consideration for purposes of applying Section 2701. This means no portion of the retained interest has to be included in the vertical slice.

Thus, the Section 2701 analysis would be restricted to the GP and the fund, where the fund manager's capital investment would be relatively modest. If, however, the fund will control a portfolio company, this structure may not avoid the need for a vertical slice.

The vesting issue

Generally, the interest of a fund manager in the GP's carried interest is subject to a vesting schedule. Many commentators have suggested that the presence of such a vesting schedule creates a risk that the IRS may argue that a transfer of the fund manager's carried interest is not a completed gift for federal gift tax purposes until such interest has vested. Unfortunately, there is no authority directly addressing this issue with carried interests.

The IRS ruled in Rev. Rul. 98-21[12] that a gift of an unvested employee stock option is not complete for gift tax purposes until the exercise of the option is no longer conditioned on the performance of services by the employee. In an often-criticized analysis, the IRS stated that until the employee has performed such services, an unvested employee stock option has "not acquired the character of enforceable rights susceptible of valuation for federal gift tax purposes."[13] Furthermore, if "the option were to become exercisable in stages, each portion of the option that becomes exercisable at a different time is treated as a separate option" for gift tax purposes.[14]

While Rev. Rul. 98-21 by its terms deals only with nonqualified stock options, the principle—that no enforceable property right exists until vesting occurs upon completion of services—is one that could be analogized by the IRS to the vesting of a fund manager's interest in the GP. The potential gift tax liability could be quite significant if the gift of the carried interest is held to be complete only in stages, months or years after the actual transfer as vesting occurs.

The conservative approach is to transfer only the vested portion of a carried interest. In reality, however, this is often not possible if one seeks, for valuation purposes, to transfer a GP interest as soon as possible after the inception of the fund (a time when its value is arguably at its low point), when frequently no vesting has occurred.

10 Regs. 25.2701-2(b)(5)(i) and (iii).
11 Reg. 25.2701-1(c)(4).
12 1998-18 IRB 7.
13 *Id.*
14 *Id.*

It can be argued, however, that unlike an unvested stock option with no enforceable rights, an unvested GP interest almost invariably entitles its holder to property rights, including immediate rights to allocations and distributions as if the interest were fully vested. It is not until the fund manager resigns that the vesting schedule is triggered, reducing future property rights in allocations and distributions. In fact, many GP agreements do not require the fund manager to return capital account allocations or distributions made prior to resignation.

The ability to retain pre-vesting allocations and distributions, however unlikely it may be that such allocations and distributions would occur in the early stages of a particular fund, is a property right and creates a basis on which to distinguish the vesting associated with a carried interest from the vesting of stock options. Nevertheless, a fund manager always should review any vesting schedule applicable to a transferred carried interest and evaluate the potential risk. If possible, the fund and GP agreement provisions regarding recovery of allocations or distributions previously allocated to an interest that later divests should be structured to minimize the risk of making an incomplete gift.

Management fee offset arrangements

As discussed above, fund managers are often entitled to a management fee of approximately 2% of assets under management for the services they provide to the fund, which is paid to the fund managers through a management company created by some or all of the fund managers that is separate from the GP. In some structures, however, fund managers may opt to forego receipt of a portion of management fees in exchange for an offset against the GP's capital contributions to the fund.[15] The structure of the offset arrangement must be analyzed with care in the case of a proposed transfer by a fund manager of a portion of his or her interest in the GP, as the offset arrangement could be viewed by the IRS as a series of future gifts by the fund manager if the offset also applies to later capital contributions required of the affiliated entity.

Gifting strategies

Private equity fund managers can take advantage of various gift-giving strategies to reduce the overall transfer tax liabilities arising from their wealth.

Gift to irrevocable grantor trust. The most straightforward method for transferring the fund manager's carried interest (and a proportionate share of all other interests in the fund owned by the fund manager if Section 2701 is applicable) is to gift such interests to an existing or newly created irrevocable trust for the benefit of the fund manager's family (or other desired beneficiaries). This technique may require the use of all or a portion of the fund manager's lifetime gift tax exemption, and, depending on how much capital the fund manager has invested in the fund, could result in gift tax exposure if the aggregate value of the fund manager's carried interest and capital interest transferred to the trust exceeds $5.43 million (in 2015, as adjusted for inflation).

In order to optimize the potential estate tax savings, the trust should be structured as a "grantor trust" for income tax purposes with respect to the fund manager. As such, all of the income earned by the trust will be taxed to the fund manager, thereby allowing the carried interest and capital interest transferred to the trust to continue to appreciate tax-free (to the trust). Furthermore, the fund manager's payments of the income tax liability of the trust are not treated as additional gifts made by the fund manager,[16] effectively allowing the fund manager to make additional tax-free gifts to the trust, further reducing the fund manager's taxable estate.

A fund manager's carried interest is a highly speculative investment, with potential for significant appreciation within a short time frame, making a GRAT a potentially attractive gifting technique.

Despite the simplicity of a gift to an irrevocable grantor trust, fund managers who have capital invested in the fund with a value in excess of the $5.43 million (in 2015, as adjusted for inflation) lifetime gift tax exemption, or, for those fund managers who have other plans for using the lifetime gift tax exemption, may be better served using gifting techniques that more effectively leverage their lifetime gift tax exemption, thereby allowing more value to be passed to the fund manager's children and more remote descendants gift and estate tax-free.

Grantor retained annuity trust (GRAT). A fund manager's carried interest is a highly speculative investment, with potential for significant appreciation within

15 The offset arrangement is intended to potentially reduce the overall income tax liability of the members of the general partner by converting ordinary income into capital gain.

16 Rev. Rul. 2004-64, 2004-2 CB 7.

a short time frame, making a GRAT a potentially attractive gifting technique.

A GRAT is an irrevocable trust to which an individual (in this case the fund manager) transfers assets and retains the right to receive fixed annuity payments from the GRAT for a specified number of years.[17] The value of the fund manager's gift to the GRAT is equal to the entire value of the interest transferred to the GRAT reduced by the value of the fund manager's retained annuity interest. The value of the fund manager's retained annuity interest is determined using the federal statutory interest rate under Section 7520 (the "Section 7520 rate").

The fund manager's retained annuity interest is often structured to absorb substantially all of the value of the transferred assets, so that for gift tax purposes, the value of the fund manager's gift is zero. This is often referred to as a "zeroed-out GRAT."[18]

If the total return (appreciation and income) on the GRAT assets exceeds the Section 7520 rate used to determine the present value of the fund manager's retained annuity interest, the excess value passes to the remainder beneficiaries gift tax-free. If the assets of the GRAT fail to beat the Section 7520 rate or decrease in value, all of the trust assets will return to the fund manager as annuity payments and he or she will be in the same position economically as if he or she had never made the transfer.

The primary risk with using a GRAT is that, if the fund manager dies during the GRAT term, all of the assets in the GRAT will be included in his or her estate.[19] For this reason, long-term GRATs are often not as attractive as short-term GRATs (due to the mortality risk), and it is always important to consider the fund manager's health in setting the term. One can structure a GRAT with a term as short as two years; however, the nature of the fund manager's carried interest may require the use of longer-term GRATs in order to successfully capture the appreciation in the carried interest.

For the fund manager who is charitably inclined, the CLAT presents an additional planning opportunity.

In satisfying the annuity payments to the fund manager, the GRAT is prohibited from using a note, other debt instrument, option, or other similar financial instrument.[20] Due to the economic nature of a fund, which will typically have little or no cash flow until the fund managers start divesting the fund's investments, the GRAT may be required to distribute in-kind assets (such as the carried interest) to the fund manager in satisfaction of the annuity payment.

This would require additional appraisals of the carried interest each time an annuity payment was due and would defeat the planning by transferring the carried interest (or entire "vertical slice") back into the fund manager's estate. Thus a GRAT may be more appropriate in the context of a "mature" fund where there may be liquidity available to fund the annual annuity payments.

An additional concern caused by the fund's illiquid nature in its early stages is the inability of the GRAT to satisfy its capital commitment associated with the capital interest in the fund transferred to the GRAT (as part of the vertical slice). A GRAT is prohibited from receiving additional contributions and, therefore, if a GRAT will be obligated to contribute capital to the fund, it may be advisable for the fund manager to contribute cash to the GRAT in addition to his or her carried interest and capital interest upon initial funding of the GRAT.[21]

Despite the gift and estate tax benefits of using a GRAT, if the grantor ultimately desires to include his or her grandchildren or great-grandchildren as remainder beneficiaries, a GRAT may not be the most effective gifting technique due to the inability to leverage one's GST tax exemption.[22] In general, allocation of an individual's GST tax exemption can be made only at the termination of the GRAT (when the "estate tax inclusion period" or "ETIP" closes).

If, at the termination of a GRAT, a distribution is made to a remainder beneficiary who is a "skip person," such as a grandchild, GST tax will be assessed. In a successful GRAT, this may result in unintended use of the grantor's GST tax exemption or a substantial GST tax liability if no GST tax exemption is available.

Also, under GST tax exemption allocation rules, GST tax exemption will be automatically allocated at the termination of a GRAT if the remainder beneficiary of the

17 GRATs are governed by Section 2702 and Regs. 25.2702-2 and 25.2702-3.

18 The use of a zeroed-out GRAT was sanctioned under Walton, 115 TC 589 (2000), *acq. on dec.* Notice 2003-72, 2003-44 IRB 964.

19 More specifically, if the grantor dies during the term of the GRAT, the amount included in his or her gross estate is the amount necessary to generate the annuity payments without invasion of principal. Reg. 20.2036-1(c). In the case of a GRAT, this will typically result in the inclusion of the entire value of the assets, unless the assets have increased significantly in value.

20 Reg. 25.2702-3(d)(6).

21 As discussed above, if the fund manager invests most of his or her capital directly in the portfolio companies in side-by-side investments with the fund, the GRAT's liability for future capital calls should be limited, requiring only a minimal cash contribution to the GRAT.

22 For those individuals who wish to transfer assets for the benefit of grandchildren and younger generations, alternative planning techniques exist such as the installment sale to an intentionally defective grantor trust.

GRAT is deemed to be a GST trust. Again, this automatic allocation may not be desired or intended. The issue should be reviewed by counsel no later than the year of termination of any GRAT that has a trust as a remainder beneficiary to determine if an election out of the automatic GST tax allocation rules is appropriate.

There also are income tax benefits to creating GRATs. GRATs are grantor trusts for income tax purposes, meaning the grantor is treated as the owner of the underlying trust assets. As a result, transactions between the grantor and the GRAT are ignored for income tax purposes. Therefore, no capital gains are triggered upon the grantor's contributing assets to the trust or upon distribution of in-kind assets from the trust to the grantor in satisfaction of annuity payments. Furthermore, capital gains on any sale of assets in the GRAT during the trust term are taxable to the grantor.

As with a gift to an irrevocable grantor trust, by the grantor (and not the GRAT) paying these income taxes, the GRAT assets are allowed to appreciate tax-free for the benefit of the remainder beneficiaries. Each payment of the income tax by the grantor essentially is an additional tax-free gift to the trust beneficiaries.

Charitable lead annuity trusts (CLAT). For the fund manager who is charitably inclined, the CLAT presents an additional planning opportunity. A CLAT offers many of the same advantages of the GRAT in a low interest rate environment. The concept is similar to a GRAT, but the lead annuity interest is paid to a charity rather than retained by the fund manager. The term of the charitable lead interest can be for a term of years or a term measured by the life of one or more individuals.[23] Like a GRAT, a CLAT may be more appropriate in the context of a mature fund where there may be liquidity available to fund the annual annuity payments to charity rather than having to value in-kind property distributions.

If the family member or affiliated entity does not have available liquid assets, it may be necessary to make a gift of cash or cash equivalents to the donee prior to entering into the loan.

As with a GRAT, the value of the gift to the CLAT is equal to the entire value of the property transferred reduced by the present value of the annuity interest payable to the charity, which qualifies for the gift tax charitable deduction. The value of the annuity interest payable to the charity, and the corresponding charitable deduction, is determined using the Section 7520 rate. The annuity payable to the charity can be set at a rate sufficiently high to reduce the taxable gift to a minimal amount.

For example, for a trust created in January 2015, an annuity payable to charity each year equal to 6.116% of the initial value of the trust principal for 20 years will allow the remainder of the trust to pass to family members at the end of the 20-year term free of all gift tax. While this may be extreme, it is often possible to obtain deductions of 60% to 70% without having the annuity amount exceed a reasonable rate of return.

Any total return on the assets transferred to the CLAT in excess of the Section 7520 rate will pass to the remainderman of the CLAT gift-tax free.

Installment sale to intentionally defective grantor trust. An additional estate planning technique that is effective in a low interest rate environment is known as an installment sale to an intentionally defective grantor trust. To implement this technique, the fund manager would sell his or her interest in the GP (and in the fund if the fund manager is investing directly therein) to an irrevocable trust for the benefit of his or her family members (sometimes referred to as a family trust) in exchange for a promissory note, typically having a nine-year term.

The family trust would be drafted as a grantor trust for income tax purposes. Thus, any transactions between the grantor and the family trust would be ignored for income tax purposes—so there is no reporting of gain on the sale of the carried interest or capital interest by the fund manager to the family trust or of interest income on the promissory note. When the promissory note matures, the principal balance is paid and the family trust retains the remaining assets.

The required interest rate to be used on a promissory note which has a term of greater than three years, but not greater than nine years (the mid-term "AFR" (as hereinafter defined)) is less than the Section 7520 rate required for a GRAT; therefore these transactions require less total return to be successful. The promissory note can be structured as a balloon note, with interest payments due annually, but no payments of principal due until the end of the promissory

[23] Reg. 1.170A-6(c) and Reg. 25.2522(c)-3(c)(2)(vi) outline the requirements for charitable lead trusts.

note term. This permits the trust to retain more principal, which increases the likelihood that the family trust will benefit from total return from the assets transferred.

Unlike GRATs, whose terms are clearly defined by the Code and Regulations, there is no road map provided in the Code and Regulations as to how to structure an installment sale. As a result, an installment sale to an intentionally defective grantor trust as an estate planning technique can involve more risk and exposure on audit than a GRAT. If the IRS successfully argues that a valid loan arrangement does not exist, the transaction may be recharacterized as a gift with a retained interest, which could result in an unexpected and substantial gift tax liability.

If the fund manager does not have an existing and funded irrevocable grantor trust, the fund manager will need to create a new trust and make an initial gift of cash, cash equivalents, or interests in the GP (or in the fund if the fund manager is investing directly therein) to the trust. This "seed fund" reduces the risk that the sale will be treated as a transfer with a retained interest which could cause the entire value of the property transferred to be included in the grantor's estate.

It is strongly recommended that the seed fund equal at least 10% of the total value intended to be sold to the trust. A portion of the grantor's lifetime gift tax exemption would be applied to the seed fund, and no gift tax would be due. The grantor would also allocate a portion of his or her GST tax exemption to the trust equal to the value of the seed gift.

The estate tax consequences to the fund manager with respect to the promissory note he or she receives in the transaction will depend on whether the fund manager survives the term of the promissory note. If the fund manager does not survive the term of the promissory note, the value of the promissory note should be included in the fund manager's estate upon his or her death. Of course, any portion of the interest received that was not spent or gifted during the fund manager's life would also be included. If the fund manager outlives the term of the promissory note, the promissory note proceeds will be included in the fund manager's estate upon his or her death to the extent that such funds are not spent or gifted during the fund manager's life.

Regardless of whether the fund manager outlives the promissory note term, the sale freezes the maximum value that would be included in the fund manager's gross estate at the principal amount of the promissory note plus the annual payments of interest at the AFR. Thus, any appreciation in excess of the AFR will pass to the fund manager's children or more remote descendants without the imposition of estate or gift tax.

Intra-family loans—satisfying capital call obligations. As discussed above, when a fund manager transfers an interest in the GP (or in the fund if the fund manager is investing directly therein) to a family member or an affiliated entity pursuant to one of the above gifting techniques, the family member or affiliated entity receiving the interest in the fund usually will be responsible for contributing additional capital to the fund whenever a capital call is made. Frequently, however, the family member or affiliated entity will have insufficient funds to meet the capital call obligation. The fund manager could make an additional cash gift to the family member or affiliated entity to enable the family member or entity to satisfy its capital call obligation; however, such gift would be subject to gift tax or use up a portion of the fund manager's lifetime gift tax exemption.

An ideal alternative to an outright gift is an intra-family loan. The terms of the loan can provide for periodic or a single balloon payment of interest and principal. It also can include prepayment options for the borrower and allow flexibility to renegotiate the loan if interest rates change. Demand loans, while presenting the most options for the lender, present more complicated administrative and gift tax issues than term loans. It should be noted, that in order for the loan to be respected, there must be a high likelihood of repayment. Thus, if the family member or affiliated entity does not have available liquid assets, it may be necessary to make a gift of cash or cash equivalents to the donee prior to entering into the loan.[24]

Intra-family loans are governed by Section 7872, which requires that the "applicable federal rate" (AFR) be used to calculate the interest on the loan. Such rates are issued monthly and vary depending on the term of the loan and the interest compounding period. It is important that the Section 7872 provisions are followed to avoid the loan being treated as a gift loan, resulting in the interest being deemed a gift from the lender to the borrower.

There are income tax issues for the lender and borrower in any term or demand loan arrangement. The original issue discount rules generally will require the lender to report in each calendar year a pro rata share of the interest accrued even if no payment is required of the borrower. In some cases, interest payments also may be a deduc-

[24] It is recommended that at least 10% of the affiliated entity's assets be acquired independently of the loan.

tion to the borrower.[25] However, if the loan is made to a grantor trust, the loan will be disregarded for income tax purposes and the fund manager will not be required to report the receipt of the interest payments.

Use of derivatives to transfer economic interest in fund. As discussed above, a fund manager's transfer of his or her interest in a fund is complicated by several issues, including possible application of Section 2701; the need for subsequent gifts or loans to meet capital call obligations; and the risk that the IRS may succeed in arguing that the transfer of an unvested carried interest is not a completed gift until the carried interest vests, at which time the carried interest could have significantly increased in value. An alternative planning technique to consider that may minimize these risks is the sale of a derivative (tied to the performance of the fund manager's carried interest) to an irrevocable grantor trust for the benefit of the fund manager's children and more remote descendants.

Unlike all of the planning techniques discussed above, the use of a derivative contract to transfer the value of the carried interest does not require the actual transfer of the carried interest itself, thereby alleviating the Section 2701 and vesting concerns. Furthermore, because the fund manager does not have to transfer his or her capital interest in the fund, all of the future capital call obligations would remain with the fund manager, eliminating the need for future gifts of loans.[26]

To implement this technique, the fund manager would first create an irrevocable grantor trust. As with the grantor trusts discussed above, any transaction between the fund manager and the trust would be disregarded for income tax purposes and the fund manager would be liable for the payment of the trust's income taxes (the payment of which would not constitute taxable gifts by the fund manager). After the trust is created, the fund manager would enter into a derivative contract with the trust pursuant to which the fund manager would agree to pay to the trust, at a set future date (usually the first to occur of the fund manager's death or a fixed date near the end of the fund's life) (the "settlement date"), an amount of cash equal to the fair market value of the fund manager's carried interest on the settlement date, plus the amount of any distributions received by the fund manager with respect to the carried interest.

The contract can be structured so that the fund manager is not required to make any payments to the trust until the carried interest has exceeded a certain total return (the "hurdle amount"). The hurdle amount, which is similar to the strike price in a standard option contract, is often set at the fair market value of the carried interest at the time the contract is entered into.

In exchange for the right to the future payment under the contract, the trust would pay the fund manager an amount equal to the fair market value of the trust's rights under the contract at the time the contract is entered into. This payment is similar to the option premium in a standard option contact. The value of the trust's right to future payment under the contact would have to be determined by a professional appraiser, who would take into consideration the hurdle amount or strike price, the volatility of the fund, current interest rates, and the term of the contract.

The fund manager would make a cash gift to the trust to enable the trust to purchase its rights under the contract. This gift would require use of some of the fund manager's lifetime gift tax exemption, or, result in a taxable gift if the fund manager had insufficient lifetime gift tax exemption remaining. If the fund manager intends for the trust to eventually benefit grandchildren and more remote descendants, he or she should allocate GST tax exemption to the trust in an amount equal to the cash gift.

The use of a derivative contract to transfer the value of the carried interest does not require the actual transfer of the carried interest itself, thereby alleviating the Section 2701 and vesting concerns.

For example, assume a fund manager holds a carried interest, which he desires to transfer to his children. The fair market value of the carried interest is $1 million (this is also the hurdle amount under the derivative contract). The fund manager creates an irrevocable grantor trust for the benefit of his or her children and then enters into a derivative contract (with a six-year term) with the trust pursuant to which the fund manager agrees to pay to the trust cash equal to the fair market value of the carried interest on the settlement date (reduced by the hurdle amount), plus all distributions received by the fund manager with respect to the carried interest prior to the settlement date. A professional appraiser determines that the value of the trust's right to future payment under the contract is $400,000.

[25] Section 7872(b); Reg. 1.7872-7.

[26] No published guidance addresses the use of a derivative contract in this manner, and therefore, such a transaction may be at a greater risk of audit.

The fund manager gifts $400,000 of cash to the trust (using $400,000 of the fund manager's lifetime gift tax exemption), which the trust then uses to pay for its rights under the contract. On the settlement date, the fair market value of the carried interest is $10 million and the fund manager has received $1 million of distributions with respect to the carried interest. Accordingly, the fund manager would be required to pay to the trust $10 million ($11 milion less the $1 million hurdle amount), which would pass gift tax-free.

Thus, a derivatives contract can be an interesting alternative to traditional gifting techniques for fund managers, allowing the fund manager to remove the economic value of the carried interest from his or her taxable estate without having to deal with complications that arise when the carried interest itself is transferred. Despite its apparent appeal, however, the use of a derivative contract is not without risk, and careful consideration should be given as to whether a derivative contract is appropriate for use with any particular fund.

Family limited partnerships and family LLCs. In planning for fund managers, it is often recommended that the fund manager form a family limited partnership (FLP)—or a family LLC—prior to implementing the above gifting techniques. The general partner of the FLP may be an LLC of which the fund manager is a member and manager. The limited partners of the FLP would be the fund manager and family members or affiliated entities.

After forming the FLP, the fund manager would transfer his or her interest in the GP (and in the fund if the fund manager is investing directly therein) to the FLP. The fund manager would then implement the above discussed planning techniques by gifting or selling the fund manager's limited partnership interests in the FLP rather than his or her interests in the fund.

The use of an FLP, if properly structured and implemented, can permit the fund manager to retain a significant degree of indirect control over the fund while allowing the fund manager to take advantage of often very generous valuation discounts. For example, after the fund manager transfers his or her interests in the fund to the FLP, the FLP, as the owner of the interests in the fund, would receive any distributions from the fund with respect to the carried interest or capital interest held by the FLP. The general partner of the FLP, of which the fund manager is a member and manager, could have control over the timing of distributions to the partners of the FLP. Thus, the fund manager, will, in effect, be able to turn cash flow on and off.

Despite the significant benefits that can be achieved through the use of an FLP, they must be used with caution. For years, the prevailing view was that the fund manager could serve as the general partner or manager of the FLP without the same estate tax inclusion risks associated with his or her retention of control as trustee of a trust to which he or she transferred assets. Recently, however, the IRS has been attacking FLPs, arguing that the assets owned by the FLP are includable in the transferor's gross estate under Section 2036 when the transferor dies owning an interest in the FLP.[27]

Conclusion

Due to the characteristics of a carried interest, fund managers are uniquely positioned to take advantage of advanced planning techniques that will enable them to transfer wealth to younger generations while minimizing estate and gift taxes. The techniques discussed herein are particularly useful in the private equity setting. These techniques maximize use of one's available gift tax exemption and take advantage of low federal statutory interest rates and the potential for significant growth in the gifted carried interest. Any program to transfer wealth, however, must be analyzed in the context of the current estate and gift tax sections of the Code, Regulations, IRS rulings, and current case law to determine whether the desired estate planning results can be achieved without triggering any unintended adverse tax consequences. ■

[27] Section 2036 causes inclusion of assets in an individual's estate where that individual transfers assets but either (1) retains the possession or enjoyment of, or the right to income from, the transferred assets, or (2) retains the right, alone or in conjunction with another person, to designate who would possess or enjoy such property or the income therefrom. Challenges to FLPs/FLLCs have focused on both of these elements. Section 2036(b) is another area for concern for the fund manager. Section 2036(b) provides that if a decedent retains the right to vote (directly or indirectly) shares of stock in a controlled corporation (defined as a corporation in which the decedent possessed at least 20% of the total combined voting power), such retention will be treated as a retention of enjoyment of the transferred property.