KEEP CALM AND CARRY ON:
PLANNING WITH CARRIED INTEREST

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I. INTRODUCTION

Private equity funds, hedge funds and other investment funds offer their fund managers a golden opportunity for wealth that is generally derived from the carried interest included as a part of a fund manager's compensation package. Carried interest in a fund has this unique and exceptional ability to grow exponentially in value based on the success of the fund. The wealth creation from these funds can be staggering. In 2020, twenty-five members of The Forbes 400 who earned their wealth from hedge funds were worth a combined $185 billion, up $2.8 billion from 2019.[1] However, there is a significant amount of risk and uncertainty inherently aligned with these types of profits interests. For example, carried interest is typically issued with a plethora of restrictions, and the ultimate value of the carry, though initially miniscule, is based on the success and accomplishment of the fund manager's performance.

Despite these challenges, carried interest provides a distinctive opportunity to transfer assets to a fund manager's loved ones at a very low gift tax cost. With the current historically high exemption amounts and Federal Reserve's interest rate hikes slowing the economy and effecting the fair market value of hard to value assets, now may be an opportune time to transfer assets to the next generation. This article discusses fundamental concepts when planning with carried interest, potential tax traps under section 2701 of the Internal Revenue Code and planning techniques that may be utilized to maximize the value of carried interest.[2]

II. FUNDAMENTAL CONCEPTS

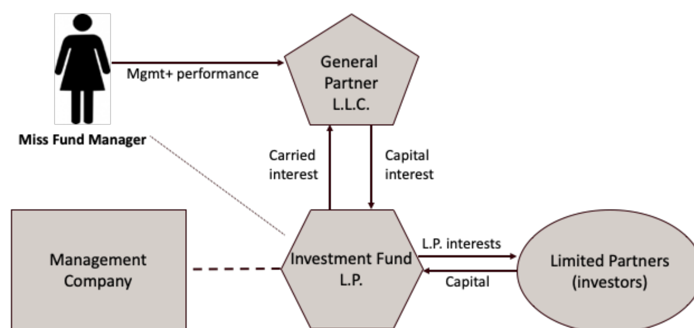
A. Investment Funds

An investment fund is a pooled investment vehicle with multiple investor-participants, and one party who manages the investments. Generally, fund management is accomplished through a managing partner or principal who is responsible for all activities of the fund including acquisitions, capital calls and divestitures.[3] These funds can be structured in a variety of ways and some common forms include private equity funds, hedge funds, real estate funds, mutual funds, exchange traded funds and venture capital funds. This article will focus on private equity and hedge funds. Typically high net-worth individuals and families invest in these vehicles and in many cases, they are structured as limited partnerships ("LP").[4] Although these funds have many similarities, there are significant differences between fund types.

1. <u>Private Equity Funds</u>

By way of example, private equity is a vanilla term encompassing an investment fund with a mandate to identify alternative methods of investing. Private equity funds have a long-term investment horizon and may invest directly in private companies or acquire controlling interests in publicly traded companies through stock purchases. They are also classified based on each fund's specific investment strategy, such as leveraged buy outs of financially distressed companies or venture capital funds. Investors in private equity funds may also be responsible for making capital contributions in addition to the initial contribution through capital calls. A common structure of a private equity fund takes the form of an LP, whereby individuals contribute capital in exchange for an LP interest. The fund manager will also contribute a small amount of capital to the LP for an LP interest and will manage the fund through a general partner ("GP") limited liability company ("LLC"). A management company can be formed as a separate entity, the GP can own the management company or the GP and the management company can be separate entities that are owned by the same individuals.

A simplistic example of a private equity fund structure is below:



2. <u>Hedge Funds</u>

Hedge funds on the other hand are akin to mutual funds in that they are pooled funds with the goal of

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[1] Jonathan Ponciano, "The Richest Hedge Fund Managers on the 2020 Forbes 400 List," Forbes Magazine, September 8, 2020.

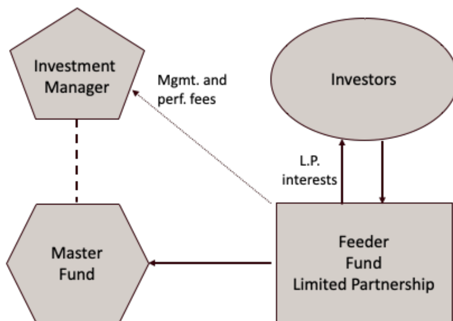
[2] All "section" references to the "Code" or "I.R.C." are to the United States Internal Revenue Code of 1986, as amended, and to the Treasury Regulations promulgated thereunder, unless otherwise stated.

[3] This article uses the terms "managers," "principals," "general partners" and "GPs" interchangeably for ease of illustration.

[4] The Securities and Exchange Commission has rules and requirements regarding who is qualified or accredited to invest in these types of funds or securities. A discussion of these requirements is beyond the scope of this article.

achieving returns through diversification, but hedge funds tend to have a more aggressive investment strategy. A primary goal of many hedge funds is to provide high returns to the investors as soon as reasonably possible. To that end, a hedge fund may invest in readily liquid assets such as stocks, bonds, futures, derivatives and may employ other more sophisticated investment strategies. Hedge funds generally use a "master-feeder" structure whereby investors contribute capital to an LP or an LLC, known as the "feeder fund," in exchange for LP interests or LLC units. The feeder fund then contributes the capital to a centralized "master fund" which is managed by a fund manager or general partner. The master fund is tasked with making all investment decisions and conducting all trading activity, while the management and performance fees are paid at the feeder level. Separate feeders can be established for each group of investors.

A simplistic example of a master feeder hedge fund structure is below:



B. Manager Compensation

The managing partner or principal of an investment fund is compensated in a combination of ways. As mentioned above, the fund manager or GP of a private equity fund may receive (i) LP interests based on his or her capital contribution to the LP ("capital interest"), (ii) a management fee for managing the investments, which is sometimes paid to a separate management company, and (iii) a profits interest specific to investment funds called "carried interest." Similarly, a hedge fund manager or GP may receive a management fee, which ranges based on the fund's capital or its net asset value and carried interest. This general compensation structure is sometimes referred as "two and twenty" because in many cases a manager receives a 2% management fee based on the assets under management and a 20% carried interest performance fee. The remaining 80% is generally divided among and distributed to the investors. In recent years, some large funds such as The Carlyle Group have been providing managers with higher carried interest rates, up to 30% which has been dubbed a "super carry."[5] Carried interest can be a primary source of earnings for managers, while the management fee is used to cover salaries, administrative expenses and other operational expenses.

For example, initially proceeds for the sale or other disposition of an investment are allocated pro rata between a GP and the LP based on their respective capital contributions. Then the proceeds initially allocated the LP are divided between the LP and GP (1) first as a return of capital, (2) then to the limited partners until they have received a certain percentage of return (e.g. 7%) on their capital contributions, (3) then to the GP until he or she has received 20% of the amount distributed to the limited partners and (4) then the residue is divided and distributed 80% to the limited partners and 20% to the GP.

1. Carried Interest

Carried interest is a type of profits interest that entitles the general partner of an investment fund to share in the success of the fund.[6] The term is derived from the structure of the investment where the GP is "carried" on the back of the capital contributed by the investors. It's designed to attract experienced managers and motivate their performance. However, in many cases carried interest is not automatically earned, and is only issued if the fund performs at or above a certain threshold. If the fund does not perform well, this effects the manager's compensation.

The terms of the fund agreement and grant agreement between the fund and the manager govern the manager's interest in the carry. For example, the document should address the grant of the carry, when it is earned, when it vests, and restrictions on transferability. Therefore it is crucial to review all governing documents in detail when planning with carried interests.

a. Can carried interest be transferred?

An initial consideration should be to review the governing documents of the fund (and any other documents that govern ownership both directly and indirectly, capital and carry) to determine if the fund manager may transfer his or her interests. The governing documents may not permit transfer or may restrict transfer of the limited partnership interests or the carried interests to the manager's spouse, descendants or trusts for the benefit of those individuals. Some agreements may permit transfer to charitable organizations as well.

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5 Javier Espinoza, "The Rise of 'Super Carry' Unsettles Private Equity Investors," Financial Times, April 21, 2019.

6 These types of profits interests for investment funds are also sometimes called "carry," "profits interests," "promote interests," "performance fees," "incentive fees," or "incentive allocations."

Should a fund manager wish to transfer interests for estate planning purposes and the document contains severe restrictions, it may be possible to modify the agreement(s) to enable transfer for specified limited circumstances. As wealth transfer planning with carried interest has become more popular, documents have become more flexible to allow fund managers to be thoughtful and creative with their estate planning needs.

b. When is carry earned?

A fund can allow a GP to earn carry immediately but may have provisions requiring the GP to return any distributed profits in the event of underperformance, known as "carry claw-back" provisions. From a practical perspective, these provisions are difficult to enforce, especially with departed managers or if he or she suffered major financial difficulties. In other funds, the GP does not earn carry until the investors have earned a return equal to their capital investments in the fund. Additionally, some funds use a "hurdle" rate (a specific internal rate of return) that must be satisfied before the carried interest can be earned by the GP.

c. When does carry vest?

Vesting is a critical consideration for gift tax purposes because similar to unvested stock, a gift made with unvested carried interest is an incomplete gift for federal gift tax purposes. Some funds allow the carry to vest immediately, while others restrict vesting and provide a vesting schedule. If not immediately vested, carry may vest over anywhere from a year to six years, with three to four years being the average. Investors of private equity funds may prefer multi-year vesting periods to keep fund managers focused on long-term performance.

2. <u>Income Tax Treatment</u>

a. Current income tax treatment.

The current tax treatment of carried interest is a spiderweb comprised of several interrelated sections of the Internal Revenue Code and Treasury Regulations governing partnership taxation, capital assets, qualified dividends, and compensation for services.[7] Under current law, a fund manager who receives carried interest in a partnership in exchange for services is not subject to ordinary income tax upon receipt, and may be allocated capital gains from the partnership or realize capital gains upon a sale of the carried interest. Generally, under section 1061 of the Code, certain holders of carried interests are entitled to long-term capital gains treatment once they satisfy a three-year holding period, in contrast to the normal one-year period.[8] The three-year holding period was included in the Tax Cuts and Jobs Act of 2017, and if not held for three years carried interest will be taxed at short-term capital gains rates.[9] Conversely, management fees are taxed using ordinary income tax rates. The theory behind carried interest being taxed as capital gains is that it is considered a return on investment, while management fees are characterized as employment income. Though capital gains income is included when calculating the net investment income tax ("NIIT"), carried interest received by fund managers is likely exempt from this additional 3.8% tax.[10] NIIT does not apply to active partnership income, which is a huge boon to fund managers who actively manage investment funds.

b. Final Treasury Regulations.

On January 7, 2021, the Treasury issued the much anticipated final regulations that provide guidance on section 1061, and which modify the proposed regulations released in 2020.[11] Most of the provisions became effective January 1, 2022. Taxpayers are allowed to apply the Final Regulations prior to that date if they are applied consistently.[12]

For purposes of this paper, let's focus on how the final Regulations effect transfer of carried interest.[13] Section 1061(d) generally provides that, if a taxpayer transfers, directly or indirectly, any Applicable Partnership Interest ("API")[14] that has been held for

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[7] U.S. Congress, Joint Committee on Taxation, Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests, committee print, 110th Cong., July 10, 2007, JCX-41-07.

[8] Tax Cuts and Jobs Act of 2017, P.L. 115-97 (2017); I.R.C. § 1061(a).

[9] This applies to carried interests in private equity, hedge funds and other investment funds. When applicable I.R.C. § 1061 recharacterizes gains from the sale of capital assets held for one to three years, otherwise eligible for taxation at long-term capital gains rates, as short-term capital gains typically taxed as ordinary income.

[10] I.R.C. § 1411.

[11] I.R.C. § 1061; Final Treas. Reg. §§ 1.1061-1(b), 1.1061-2(c), 1.1061-3(f)(1), 1.1061-4(d), 1.1061-5(g), 1.1061-6(e).

[12] *Id*.

[13] For a more detailed discussion on the Final Treasury Regulations, please see Kelly Perez, Thomas Cooper, Marissa Dungey, Naomita Yadav, "Potential Partnership Pitfalls for Planners," American Bar Association 33rd Annual Real Property Trusts & Estates Virtual National CLE Conference, April 22, 2021.

[14] An API generally refers to any interest in a partnership that, directly or indirectly, is transferred to (or held by) an owner taxpayer or pass-through taxpayer for the performance of substantial services by the owner taxpayer, a passthrough taxpayer or any related person, including services performed

three years or less, to a person related to the taxpayer (defined to include a taxpayer's spouse, children, grandchildren, and parents, as well as colleagues), the transfer is taxable.[15] The Proposed Regulations broadly defined "transfer" in this context to include nonrecognition transactions such as gifts or contributions to partnerships. As a result, under the Proposed Regulations, the gift of a profits interest would accelerate the transferor's gain.[16]

The mostly taxpayer friendly Final Regulations helpfully clarify that section 1061(d) does not accelerate gain on a transfer and applies only to transfers where gain is recognized.[17] As a result, section 1061(d) does not trigger the recognition of gain in otherwise tax-free transfers such as common estate planning techniques such as contributions to partnerships or gifts by fund managers. Keep in mind though, that any future realized gains in respect of such transferred APIs remain subject to potential section 1061 recharacterization.

c. Legislative views on carried interest

Whether carried interest should be taxed as capital gains or ordinary income is an ongoing subject of debate. On one side, proponents of the current tax treatment argue that general partners are similar to business owners and may treat part of their return as capital built on the sweat of their brow. On the other hand, many argue that it is more equitable to tax carried interest like wage and salary income. In any event, it will be interesting to watch developments in the area of carried interest tax treatment. On February 15, 2021, the House Ways and Means Committee introduced the proposed Carried Interest Fairness Act of 2021.[18] Similar bills have been introduced in the past and include modifications such as taxing carried interest at ordinary income tax rates and increased penalties for underpayment.

President Joseph Biden has suggested comprehensive changes to the tax Code such as ending preferential treatment for long-term capital gains and proposing a top individual ordinary income tax rate of 39.6%.[19] Additionally, the American Families Plan proposes to close the carried interest loophole so that hedge fund partners will pay ordinary income rates on their income just like every other worker.[20] Questions remain as to whether the proposal will apply to all carried interest or only the carried interests currently subject to section 1061 of the Code, and it is also uncertain what the mechanism for the change will be. If the tax rates for carried interest are increased, fund managers may opt to receive their compensation in the form of deferred compensation or may look to move their funds to friendlier jurisdictions.

III. VALUATION FOR TRANSFER TAX PURPOSES

As stated in the introduction of this paper, receiving carried interests as part of a compensation package presents a rare opportunity for fund managers to transfer significant wealth from their taxable estate in a tax-efficient manner. Because the value of the carried interest is based upon the future profitability of the fund, the initial value will be significantly lower compared to its potential value over time. If the fund flourishes, then the carried interest could experience exponential growth. This begs the question how to value the carried interest should the manager wish to transfer or gift his or interest to loved ones or charity.

When employing any transfer strategy, though, the first crucial analysis is determining the fair market value of the transferred asset. "Fair market value" for transfer tax purposes is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[21] The value of a capital interest in a partnership is generally its purchase price, and is far easier to determine. Valuing a manager's interest in the carry presents many difficult challenges for estate planning and valuation professionals.[22] Carried interest generally maintains a lower current value compared to the inherent risk in the relationship between fund

as an employee, in any applicable trade or business ("ATB"). An ATB generally refers to certain specified investment activities and includes the actions taken by related persons, including combining activities occurring in separate partnership tiers or entities as a single ATB.

[15] Prop. Treas. Reg. § 1.1061-5(e).

[16] Prop. Treas. Reg. § 1.1061-5(b).

[17] Final Treas. Reg. § 1.1061-5(a).

[18] Carried Interest Fairness Act of 2021, H.R. 1068, 117th Cong. (2021-2022). https://www.congress.gov/bill/117th-congress/house-bill/1068. There has been no further action other than introduction.

[19] The White House, "Fact Sheet: The American Families Plan," Statements and Releases, April 28, 2021. https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/28/fact-sheet-the-american-families-plan/

[20] Sabrina Wilmer and Melissa Karsh, "Biden's Plan Would Eliminate Private Equity's Coveted Tax Break," Bloomberg Wealth, April 28, 2021.

[21] Treas. Reg. § 20.2031-1(b); § 25.2512-1. For purposes of a gift, *see United States v. Cartwright*, 411 U.S. 546, 551 (1973).

[22] David Rudman, "Common Errors in the Valuation of Carried Interests and Fund Management Structures," American Bar Association, Real Property Trusts & Estates eReport, December 2, 2016.

entities. These types of profits interests are subject to many speculative factors and tend to be junior interests to the capital interest based on the success of the fund. As described above, there are also often restrictions on transferability, when they are earned and when they vest. Another important consideration for valuation purposes is there is usually no meaningful historical track record of performance for comparison. A fund manager assumes a significant amount of risk as to whether the carried interest will be fully realized, especially when the fund is first created. Many fund managers believe that that the carry is valued at nothing at the time of start-up, but that is not accurate or practical, and using a qualified appraiser is the best practice. The best time to value the manager's various interests, though, is as soon as possible after closing the fund.

A. Valuation Method

In spite of these challenges, the valuation of a carried interest may be similar to the valuation of other assets because the asset's ability to generate returns in the form of cash flow plays a lead role. As such, the most common valuation methodologies include the discounted cash flow ("DCF") method and the option pricing method ("OPM").[23] To quickly summarize, the DCF method projects the carry's expected future cash flows and then discounts it at a rate of return proportionate with the risk involved in realizing those cash flows. The future cash flow is based on the notion that carried interest is a portion of the residual claim on a fund's distributions only after the return of capital to the investors and the payment of fees and accrued preferred returns to the limited partners. The future cash flow capability of the carried interest is based on the rate of the return of the fund, which has to be sufficient to cover fees and preferred returns. An experienced valuation professional will analyze the governing documents, all ownership, both direct and indirect, committed capital, the internal rate of return, as well as when the fund can be exited. A valuation professional may also take into account potential legislative actions.[24]

By contrast, the OPM compares carried interest to a call option. A carried interest is likened to a call option because it embodies the right to the value of a security or other investment above a fixed level such as a "strike price."[25] The strike price for carried interest is the committed capital plus the hurdle rate. Generally, the Black-Scholes OPM is used as an option to value carried interest.[26] It should also be noted that hedge funds, tend to use Monte Carlo methods for valuation because hedge funds can be vastly different from private equity funds, and the more statistical based simulations of the Monte Carlo method complement the structure and purpose of hedge funds more accurately.[27]

B. Other Considerations

The key takeaway here is to use a qualified valuation professional with specific experience in valuing investment funds for federal transfer tax purposes. A competent appraiser is a vital component of any estate planning transaction involving the transfer of hard to value assets. Additionally, as with any transfer of a closely-held hard to value asset, the Internal Revenue Service may scrutinize the fair market value of these assets, and any methods to reduce the initial fair market value such as valuation discounts. Estate planning and tax professionals should consider adequately disclosing the transaction on a timely filed gift tax return to begin the running of the statute of limitations as soon as possible as well.[28]

IV. ANTI-ABUSE RULES: SECTION 2701

Transferring carried interests in an investment fund requires a thorough understanding and analysis of the section 2701 special valuation rules.[29] These rules are often described as thorny, difficult and tricky, and much has been written about avoiding the traps and pitfalls of 2701. Section 2701 is a gift tax anti-abuse rule at its core. It does not determine whether a taxable gift has actually been made, but instead provides a method for

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[23] Philip Zhou and Steven Kam, "Carried Interest Valuation Techniques," Cogent Valuation Insights, 2013.

[24] Marcus Ewald and Brendan Smith, "The Starting Five: A Winning Strategy with Carried Interest and Alternative Assets," Stout Insights, September 1, 2016.

[25] The strike price on an options contract is the price at which the underlying security can be either bought or sold once exercised.

[26] Also called Black-Scholes-Merton (BSM), it was the first widely used model for option pricing. It's used to calculate the theoretical value of options using current stock prices, expected dividends, the option's strike price, expected interest rates, time to expiration, and expected volatility. "Black-Scholes Model," Investopedia, May 16, 2021.https://www.investopedia.com/terms/b/blackscholes.asp

[27] A Monte Carlo simulation is a model used to predict the probability of a variety of outcomes when the potential for random variables is present.

[28] The statute of limitations for a federal gift tax return begins and generally runs for three years after the return is filed (six years if the amount of unreported items exceeds 25% of the amount of the reported items). I.R.C. 6501.

[29] For a detailed discussion on section 2701, please see Tax Management Portfolio, Transfers of Interests in Family Entities Under Chapter 14: Sections 2701, 2703 and 2704, No. 835-4th.

valuing any deemed gift that may have occurred. Section 2701 essentially values certain interests retained by the donor-taxpayer at zero using a "subtraction method" of valuation to determine the value of the transferred interest. The subtraction method determines the gift tax value of the transferred interest by subtracting the value of all equity interests in the entity retained by the transferor immediately *after* the transfer from the aggregate value of all equity interests in the entity held by the transferor immediately *before* the transfer. If the retained equity interest is an "applicable retained interest," its value for purposes of applying the subtraction method is zero (the "zero value rule"). So, for gift tax purposes, the transferor is treated as transferring not only the portion he or she intended to gift, but all of the applicable retained interests. As a result, section 2701 may create a deemed gift for gift tax purposes where a tax professional may not expect a taxable gift to have occurred.

Section 2701 applies when a taxpayer, such as a fund manager, transfers certain types of equity interests in a corporation or partnership to certain classes of family members or to trusts for their benefit. The term "transfer" is defined so broadly under section 2701 that bona fide sales to certain family members or trusts for their benefit could result in a taxable gift. As anyone can guess, section 2701 was enacted to prevent intrafamily transactions that transfer wealth to the next generation with little transfer tax consequence by artificially engineering the value between different economic classes of interests in an entity, such as senior and junior interests. It should be noted that section 2701 should not affect minority discounts or other discounts available under normal valuation rules (including, presumably, lack of marketability discounts).[30]

A. Section 2701 Generally

At its core, the purpose of 2701 is to prevent abusive wealth transfer from senior members to the next generation by way of preventing the manipulation in value of an interest or an entity. Section 2701(a)(1) provides that for the purpose of determining whether a "transfer" of an "interest" in a corporation or partnership to (or for the benefit of) a "member of the transferor's family" is a gift (and the value of such transfer), the value of any right which is described in subparagraph (A) or (B) of subsection (b)(1), and which is with respect to any "applicable retained interest" that is held by the transferor or an "applicable family member" immediately after the transfer, shall be determined under 2701(a)(3).

Subparagraphs (A) and (B) of (b)(1) offers a definition for "applicable retained interest." If the interest has a distribution right but only if immediately before the transfer, the transferor and the applicable family holds control of the entity, it is characterized as an applicable retained interest. Also any liquidation, put, call or conversion right is considered an applicable retained interest.

Section 2701(2) provides several exceptions to the zero valuation rule. It does not apply to (i) the transfer of any interest for which market quotations are readily available (as of the date of transfer) on an established securities market; (ii) interests of the same class as the transferred interest; and (iii) where such interest is proportionally the same as the transferred interest, without regard to non-lapsing differences in voting power (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).[31] The exception in (iii) of the previous sentence does not apply to any interest in a partnership if the transferor or an applicable family member has the right to alter the liability of the transferee of the transferred property.[32] As one can see, there is a lot to unpack in section 2701.

1. <u>Transfer</u>

As stated above, the term transfer is quite broad and even covers situations where the transfer would not otherwise be considered a taxable gift by many practitioners. It can also include other transactions such as capital contributions to existing or new entities and other changes in the capital structures of the fund. Treasury Regulation section 25.2701-1(b)(1) provides examples of when a capital structure transaction constitutes a transfer under 2701.[33] Interestingly, the termination of an indirect interest could also trigger 2701 as seen with grantor trusts where the grantor ceases to be attributed ownership.[34]

2. <u>Equity Interest</u>

The term equity interest typically includes a limited

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[30] Staff on Senate Finance Comm. 101st Cong., Information Report on S. 3209 (1990).

[31] I.R.C. § 2701(a)(2)(A), (B), (C).

[32] *Id*.

[33] Per Treas. Reg. § 25.2701-1(b)(1), (i) the transferor (or an applicable family member) receives an applicable retained interest in the transaction; (ii) the transferor (or an applicable family member) holds an applicable retained interest before the transaction, surrenders an equity interest junior to the applicable retained interest and receives property (other than an applicable retained interest, as that situation is already covered by the bullet above); or (iii) the transferor (or an applicable family member) holds an applicable retained interest before the transaction, surrenders an interest (other than one covered by the second bullet above) and the value of the applicable retained interest is increased.

[34] Treas. Reg. § 25.2701-1(b)(2)(i)(C)(1). There are specific attribution rules regarding ownership.

partner or general partner interest, and a member interest in a limited liability company. There are additional state law considerations related to this, and similar to many provisions on 2701, this analysis can become increasingly complicated depending on the complexity of the fund structure. Other financial compensation or arrangements should also be analyzed to determine if they should be characterized as an equity interest such management fees, performance fees, other contractual financial arrangements, options, derivatives relating to equity interests and certain debt instruments. These items should be viewed on a case by case basis based upon the "economic substance" of the agreement when determining whether 2701 applies.

Moreover, section 2701 provides a list of rules for when ownership interests are owned through vehicles such as partnerships, corporations limited liability companies, and trusts.[35] Generally, a taxpayer is treated as owning an equity interest in an entity if it is owned indirectly and held in an entity such as a corporation, LP or LLC.[36] There are specific attribution rules for trusts, grantor trusts and estates as well.[37]

3. Member of the Family/Applicable Family Member

Interestingly, section 2701 contains two terms used to identify persons related to the transferor. These groups of people are used to identify and are aggregated with the transferor in determining whether an applicable retained interest is held by the senior members of the family for purposes of 2701. Under section 2701(e)(2) and Treasury Regulation section 25.2701-1(d)(1), the term "member of the family" includes the transferor's spouse, his or her lineal descendants, and the spouse of any such descendant. The term "applicable family member" incudes the transferor's spouse, any of the transferor's ancestors or the ancestors of the transferor's spouse, and the spouse of any such ancestor.[38]

4. Applicable Retained Interest

Section 2701 applies if the equity interest is held as an "applicable retained interest" immediately after the transfer. This generally refers to certain discretionary rights retained by senior generation family members that are extraordinary payment rights and distribution rights.[39] In other words, the retained rights have the ability to reduce the value of the transferred interest.

Extraordinary payment rights include the ability to liquidate the entity, buy or sell equity interests to or from the entity, conversion rights or any other right where action or inaction affects the underlying value of the transferor's interest. Discretion is a key factor here, where the person who holds such right has the ability to take action or decline to take action. Such discretion may permit the holder to benefit but may reduce the underlying value of the entity. Section 2701(c)(2)(B) and (C) of the Code provide that extraordinary payment rights do not include (1) a right that must be exercised at a specific time in a specific amount like a mandatory payment right or (2) a non-lapsing right to convert the interest into a fixed number of shares of the same class as the transferred interest, since these types of rights do not result in the transferred interests having an altered value.

Distribution rights are generally characterized as dividends and are similar to extraordinary payment rights because the exercise or non-exercise of distribution rights effects the value of the entity. Distribution rights, however, differ from extraordinary payment rights because distribution rights are held by the entity itself, as opposed to being held by the individual. The theory of distribution rights manipulating the value of the entity stems from the notion that a family owned company or entity will not make distributions to more senior family members, despite their rights to receive distributions, to increase the value of the company for more junior family members. Section 2701(c)(1)(B) specifically states that the term "distribution rights" does not include (1) the right to receive distributions with respect to any interest of the same class, or that is subordinate to the transferred interest, (2) any liquidation, put, call or conversation right (an extraordinary payment right and the exceptions), or (3) any right to receive a fixed guaranteed payment. These three rights do not alter the underlying value of the entity.

Additionally, when analyzing whether a distribution right qualifies as an applicable retained interest, one must determine the extent of the control of the entity immediately before the transfer by the transferor, his or her spouse, applicable family members, and the lineal descendants of the transferor's parents. For a corporation, control means at least 50% of the total voting power or total fair market value of the equity interest, and for a partnership at least 50% of the capital or profit interest, except for rights to any guaranteed payment, or any equity interest as a GP of an

[35] Treas. Reg. § 25.2701-6. For a deeper discussion of the attribution rules, please see N. Todd Angkatavanich, "Fun with Section 2701 – Planning Alternatives and Issues with Preferred Partnerships, Carried Interest Transfer Planning and Profits Interests," 51st Annual Heckerling Institute on Estate Planning, 2019.

[36] Treas. Reg. § 25.2701-6(a)(1). If the individual holds directly and indirectly in multiple capacities, the rules are applied in a manner that results in the individual being treated as having the largest possible total ownership.

[37] Treas. Reg. § 25.2701-6(a)(4)(ii)(B).

[38] I.R.C. § 2701(e)(2) and Treas. Reg. § 25.2701-1(d)(2).

[39] I.R.C. § 2701(b)(1).

LP.[40]

Treasury Regulation section 25-2701-2(a)(2) also provides two exceptions to the zero value rules for distribution rights for "qualified payment rights" and "qualified payment right elections." Qualified payment rights are payments that are required to be made, such as a dividend paid at least annually under cumulative preferred stock. A qualified payment right election is where a taxpayer elects to treat a retained distribution right as a qualified payment right on a gift tax return.

5. Exceptions to Section 2701

Because the purpose of 2701 is to prevent abuse, there will be certain circumstances where abuse is inherently improbable and, therefore, section 2701 does not apply. Section 2702(a)(2) and Treasury Regulation section 25.2701-1(c) provide for the following exceptions where 2701 does not apply: (1) where there are readily available market quotations on an established securities market for the transferred interest or the retained interest, (2) if the rights associated with the retained interest and the transferred interest are of the same class (apart from non-lapsing voting rights differences), or (3) if the outcome of the transfer is that there was a proportionate reduction of each class of equity held by the transferor and applicable family members immediately prior to the transfer. These statutory and regulatory exceptions provide the base for wealth transfer planning with carried interests.

V. TRANSFER OF CARRIED INTERESTS

In a perfect world, a fund manager would be able to transfer his or her carried interest to the next generation while retaining the LP interest in fund. However, section 2701 prevents this ideal planning concept from coming to fruition because if the transferor retains all of the LP interest, he or she would be subject to the deemed taxable gift rules. Due to the complex rules of section 2701, there is an onus on estate planning professions to implement a wealth transfer plan that avoids the application of 2701. This section of the article discusses various estate planning techniques that are commonly used when planning with carried interest.

1. Vertical Slice

The most common technique of transferring carried interest is known as the "vertical slice" technique. This is generally the most commonly used method it is lower risk as it is included in the safe harbor of 2701.[41] Section 2701 is not applicable if the transferor (and any applicable family members) transfers a "proportionate" amount of each class of equity ownership. Here, the transferor transfers a proportionate part, or all, of his or her equity interests in the investment fund to the recipient. The transferor in essence cuts out a vertical slice of all of his or her interests in the applicable entity and transfers it to the recipient using various estate planning vehicles to be discussed later. A key here is to analyze all equity ownership of the transferor (directly and indirectly owned), including items such as management fee waivers, in order to accurately reflect all equity ownership in the vertical slice. Because the transferor has reduced all of his or her equity interest in the entity pro-rata, the ability to alter the value of the transferred interest by that individual does not exist. Both transferor and recipient will share proportionately in the success or failure of the investment fund.

One must keep in mind though, that as with any sophisticated estate planning technique, the client's overall goals and needs must be taken into account prior to implementing a vertical slice. For example, a fund manager may have substantial capital invested in the fund through the LP, which would in turn increase the value of the gift for gift tax purposes on transfer. This may also present a challenge for fund managers who are managing a fund for the first time in their career and who may rely on the proceeds from a sale or other disposition of an asset for their own lifestyle or liquidity needs.

a. Vertical slice holding company.

A transferor may also consider using a holding company in conjunction with vertical slice planning. The transferor could transfer all of his or her interests, or a proportionate interest to a holding company, and then instead of transferring a direct ownership interest to the recipient, could transfer interests in the holding company. The result is that the transferred interest in the holding company qualifies as a vertical slice but can be less burdensome from an administrative standpoint for the transferor.

2. Transferring a Vertical Slice

Once it has been determined that the transferor's interest may be transferred and such transfer will not run afoul section 2701, the next logical step in the analysis is to determine the proper vehicle to hold the transferred interests. A fund manager has a variety of traditional wealth planning structures at his or her disposal.

a. Outright gifts.

If a fund manager has a strong desire to keep things as simple as possible, an outright gift to loved ones, generally children, tends to be the most uncomplicated method of transfer. The gift tax value of the gift would be the fair market value of all of the equity interests

[40] I.R.C. § 2701(b)(2)(A); Treas. Reg. §§ 25.2701-2(b)(5)(ii) and (iii).

[41] I.R.C. § 2701(a)(2)(C); Treas. Reg. § 25.2701-1(c)(4).

transferred as of the date of transfer, preferably made by a qualified appraiser, and the gift would mostly likely use a portion of the transferor's gift tax exemption amount. The governing documents, however, will govern whether an outright gift to an individual like this can be made. Some agreements prevent third-parties from owning an interest in the GP.

b. Irrevocable trusts.

In contrast to an outright gift to a third-party, many governing documents permit transfer of a GP interest to a trust for the benefit of the fund manager's family, so long as the fund manager is still accountable for the voting control and disposition of the GP interest. This option has several advantages such as removing the equity interest and its future appreciation from the transferor's estate, having the appreciation balloon inside an irrevocable trust that is likely exempt from estate tax and generation-skipping transfer tax, setting parameters and perhaps providing flexibility for future use of the assets or proceeds by the transferor's descendants, and the trust may provide creditor protection for the beneficiaries so long as the assets stay inside the trust. For income tax purposes, the trust can be structured as a grantor trust so that the fund manager remains liable for the income, deductions and credits otherwise allocated to the trust, which allows the assets in the trust to grow and compound free of income tax liability.

(i) *Sales to intentionally defective grantor trusts.*

Additionally, if the trust is a grantor trust for income tax purposes than certain transactions between the grantor and the trust are disregarded for income tax purposes allowing the grantor to enter into installment sale transactions with the trust. This way, the grantor/fund manager can leverage his or her gift to the trust. Once a trust is funded with a suitable amount of assets and becomes a worthy creditor, the grantor may sell assets to the trust in exchange for a promissory note. The note is typically a 9-year interest-only note, with a balloon payment of principal (and any remaining unpaid interest) in the 9th year. The interest rate is generally the applicable federal rate ("AFR"). If the assets held in the trust grow in excess of the AFR hurdle rate, the appreciation in excess of this hurdle rate remains in the trust and passes to the trust beneficiaries free of transfer tax.

c. Grantor retained annuity trusts.

The fund manager may also decide that he or she would like to retain the initial value of the equity interests for his or her own use or may wish to limit the value of the wealth transferred to the next generation. As such, a grantor retained annuity trust ("GRAT") may be an ideal option. The fund manager would transfer a vertical slice of his or her interests to an irrevocable trust but retain the right to annuity for a fixed number of years based on the initial contribution and the 7520 rate in effect at the time of the transfer. The present value of the annuity payments from the GRAT to the grantor during the initial term are structured in most cases to nearly equal the value of the property transferred to the GRAT. Therefore, there is little to no gift tax cost. If the assets in the GRAT appreciate above the annuity payments due to the grantor, the excess appreciation transfers to the intended beneficiaries free of gift tax.

3. Family Holding Company

Capitalizing on the mandatory payment right and qualified payment right exceptions in section 2701, another common technique is to create a family holding company and structure the new entity to take advantage of these two safe harbors. Similar to the example above, a transferor creates a holding company and transfers all of his or her equity interest into the new entity. Once the entity is created and funded, the entity will issue two classes of equity interests, typically a preferred interest and a common interest. Individuals holding a preferred interest are granted a payment of a specific sum on a certain date, which is classified as a mandatory payment right. Conversely, the individuals owning a common interest will receive the amount above what is paid to the preferred owners.

The same structure can be used with a qualified payment right. The primary difference is that the preferred interest owner has a qualified payment right, which is a right to a periodic distribution, at least on an annual basis, and with a fixed rate. If the rights associated with this ownership are qualified payment rights, then they will not fall under section 2701.

When implementing these strategies, the value of the qualified payment right should be appropriate, and not excessive, to avoid the "minimum value rule" in 2701. Treasury Regulation section 25.2701-3(c)(1) works in conjunction with section 2701 to require that the value of the common interest cannot be less than the pro-rata share of the 10% of the sum of (1) the total value of equity interests and (2) the total amount of debt owed to the transferor and any and all applicable family members. This is known as the minimum value rule. Because of this, gifts of common interests using this technique could be deemed greater than the transferred interest's fair market value.

4. Non-Member of the Family Trusts

Section 2701 applies to gifts made to members of the transferor's family. Under the Code, the term "members of the family" does not include non-family members, ancestors of the transferor (i.e. parents), or descendants of those ancestors (siblings, nieces, nephews). Gifts to these individuals would be outside the scope of section 2701 so long as the trust was structured so that the beneficiary would not have legal entitlement to the trust's assets and any power of

appointment contained in the document would be limited, and the exercise of which would not constitute a taxable gift. Theoretically, the transferor can transfer only his or her carried interest if he or she so chooses to a trust for the benefit of these types of individuals. Though this appears to be a relatively straight forward planning technique, in real world application many fund managers are not willing to transfer assets to parents, siblings or non-family members for a variety of reasons.

This structure may also be implemented with charitable planning such as by way of a charitable lead annuity trust. For a detailed discussion of this concept, please see N. Todd Angkatavanich, Christine R.W. Quigley and Marissa Dungey, "The Rising Tide Carry CLAT," which appeared in Trusts & Estates Magazine in the October 2016 issue.

5. Derivatives

Many practitioners have written on the strategy whereby one sells a derivative that is tied to the performance of the carried interest to a trust.[42] Derivatives are financial instruments the grant the holder a right to payment if a certain event happens during the term of the agreement. David Handler provides, a "carry derivative can be thought of as a cash settled option" on the carried interest that that avoids section 2701 and provides further that a derivative contract works best with a grantor trust to avoid potential income tax consequences. For example, a manager could sell a private derivative contact to a grantor trust that he or she created, for a term not tied to the duration of the fund but long enough to capture the fund's gains. A hurdle rate of success would be included that would be paid before the trust received any benefit, and generally a set share of the profits is agreed upon by the parties. The trust would purchase the contract based upon a value set by a qualified appraiser. On the settlement date, the carried interest is revalued and the proceeds are divided between the fund manager/seller and the trust/purchaser.

There are several advantages to using a derivative contract. Some advantages include (i) derivative transfers may avoid restrictions in the governing documents since the underlying assets are not transferred, (ii) an outside third-party does not become a fund partner and (iii) less gift tax exemption is used with derivatives than with vertical slice planning. However, this strategy includes many risks and is generally considered more aggressive planning. Some of the major risks include the following considerations: (i) the general risk that the fund manager could leave the fund either voluntarily, involuntarily or because of death, (ii) valuation risk on the appraised value of the contract, (iii) a potential fund claw back if success milestones are not met as described in this paper, (iv) a situation could arise where the seller lacks liquidity to pay the contract settlement, (v) the retention of the full income tax liability and (v) lack of guidance or rulings from the Internal Revenue Service.

VI. BEST PRACTICES

Carried interest is an appealing asset to use for wealth transfer due to its unique and exceptional potential for growth and appreciation. However, the transfer of carried interest requires a careful daisy-chain analysis of several considerations ranging from restrictions in the governing documents to the tangled web of section 2701. Here are a few key takeaways and best practices to implement when planning with carried interests:

i. Analyze the client's balance sheet, financial plan and overall goals to determine if wealth transfer makes sense at this time
ii. Review the governing documents carefully to determine:
   a. all interests related to the fund that are owned directly or indirectly by the fund manager (e.g., all classes, all rights)
   b. restrictions on transferability, if any
   c. when the carry has been earned
   d. vesting restrictions, if any, and the effect on completed gifts for gift tax purposes
iii. Consider ongoing commitments to contribute additional capital and who will have the obligation if interests are transferred
iv. Review section 2701 in detail to ensure that any planning technique either (a) that 2701 does not apply to the transfer or (b) falls within the safe harbors of 2701
v. Determine which portion, or whether all of the interests, should be transferred based on the above considerations
vi. Engage a qualified appraiser with experience specific to investment funds
vii. Ensure sufficient liquidity to pay income tax
viii. Disclose the transaction on a timely filed federal gift tax return

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[42] David Handler and Angelo F. Tiesi, "Using Derivatives to 'Transfer Carried Interests in Private Equity, LBO and Venture Capital Funds," Kirkland and Ellis LLP, June 12, 2006.

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