



{ Estate Tax Reduction Strategies }

for Private Equity Owners

plantemoran.com

plante
moran

audit • tax • consulting

HONIGMAN®



TABLE OF CONTENTS

PART ONE THE CARRIED INTEREST	p. 2
PART TWO ESTATE TAX REDUCTION	p. 5
PART THREE VALUATION CONSIDERATIONS	p. 8
PART FOUR IRS SPECIAL VALUATION RULES	p. 12



One of the basic aspects of the structure of almost every private equity or venture capital fund is the “carried interest” provided to the fund sponsors. The carried interest is a share in the profits of the fund granted to the fund sponsors once the fund’s investors have achieved a certain base level of return on their cumulative investment in the fund. By tying the bulk of the fund sponsor’s compensation to the carried interest, the incentives of the fund management are directly linked to the goals of the fund investors: higher returns to the investors generate higher returns to the fund sponsor.

Under current income tax laws, the return on a carried interest will be taxed at capital gains rates. In addition to the existing income tax advantages, a carried interest also presents interesting opportunities for wealth transfer, including asset protection.

Because of its speculative nature, a carried interest will typically have a relatively low value initially. However, if the fund is successful, it could be worth many multiples of its current value — making it an ideal asset to transfer to one’s heirs. This article addresses the wealth transfer benefits and issues in connection with moving carried interests out of the estate of a fund sponsor principal. ■

In addition to the existing income tax advantages, a carried interest also presents interesting opportunities for wealth transfer, including asset protection.



PART ONE: THE CARRIED INTEREST

BASIC STRUCTURE OF A FUND

The vast majority of private equity funds are structured as “pass-through” entities for tax purposes: either limited liability companies (LLCs) or limited partnerships, with management centralized in the fund sponsor. In certain states (such as Texas and Tennessee), state franchise or entity-level taxes make LLCs less attractive than limited partnerships. Regardless of the structure, the fund sponsor will create an entity to serve as the general partner or manager of the investment entity. This will generally be a special purpose entity dedicated to the fund being raised. The manager/general partner will be entitled to an annual fee based on a specified percentage of the total fund raised or the funds deployed. The fee is designed to reimburse the fund sponsor for the annual cost of operating the fund. Additional closing and transaction fees may be paid to the manager in connection with the funding of particular transactions. Depending upon the structure of the fund, these fees may also be shared with the investors. As a general principle, the fees are not designed to be the primary form of compensation for the fund sponsors.

The investors will generally be paid through a “Class A” interest that will be structured to give them 100 percent of all net distributable cash until the investors have received a return of all invested cash plus a designated return (the “hurdle rate”). The hurdle rate is generally a specified internal rate of return (IRR) on invested funds. The calculation of the IRR on the Class A Interest will vary depending upon how the fund is designed. The most common structure will involve a commitment by the investor to fund a specific percentage of equity for each transaction up to a maximum dollar amount as required by the fund from time to time. In this case the IRR will be determined based on the committed funds actually invested. In unusual cases, the fund may require that all commitments be funded upfront. Where the fund sponsor is well established, it is common for the principals of the fund sponsor to make capital commitments to the fund through direct ownership of Class A interests.

FUND SPONSOR AND CARRIED INTERESTS

In addition to the Class A interests, most funds will have a “Class B” interest that represents the “Carried Interest.” This interest will be owned by the fund sponsor or another entity created by the fund sponsor for the benefit of the principals of the fund sponsor as well as key employees or agents of the fund sponsor. The Class B interest allows the holders of this interest to participate in the upside of the fund once the Class A interests have realized the hurdle rate. For example, a fund might provide that all funds are distributed to the Class A holders until the Class A holders received a cumulative IRR of 8 percent, at which point the Class B holders will receive 100 percent of all distributions until the Class B holders have received 20 percent of all distributions. Thereafter, all distributions shall be divided 80 percent to the Class A interests and 20 percent to the Class B interests. These structures are referred to as “waterfalls” in that one pool is filled up before the excess spills into the next pool.

While there’s no fixed standard for how waterfalls and carried interests are structured, a basic distinction can be drawn between “European Waterfalls” and “American Waterfalls.” In a European Waterfall, the carried interest doesn’t begin to receive a share of the profits until the Class A interests have received the hurdle rate on all capital that’s been drawn down. In contrast, in an American Waterfall, the carried interest receives a share of the profits (carry) as soon as they have returned the drawn-down capital and paid the hurdle rate on the fund’s realized investments. The fund sponsor does not have to return capital on investments that still remain unrealized within the fund. This difference can be very favorable to the fund sponsor by bringing forward carried interest payments by many years. On the downside, the use of an American Waterfall often entails the use of a clawback.

CLAWBACKS

In general, a clawback provision requires the holders of Class B interests to return a portion of their distributions to the holders of the Class A interest if the Class A interests ultimately earn less than the hurdle rate or the holders of the Class B interest receive more than their maximum share of overall distributions (20 percent in the example above). With an American Waterfall, the risk of a clawback is significant because strong returns realized on early transactions can be offset by substandard results on deals that have subsequent liquidity events. The drafting of clawbacks can be quite complex, particularly where the carried interest is held in a multi-tier structure by a number of principals and affiliates of the fund sponsor. When a principal of a fund sponsor contemplates transferring a direct or indirect interest in a carried interest subject to a clawback, he or she needs to consider whether the transferee (generally a trust for the benefit of the children) will be liable for any clawback obligations. This clawback obligation is an offsetting liability to the value of the carried interest.

ARE CARRIED INTERESTS WORTHLESS?

Many private equity sponsors assume that the carried interest has no or nominal value upon the formation of the fund. After all, there can be no assurances that the fund will be successful and that any carried interest will be earned. This argument has some validity in the case of a new fund created by fund sponsors with no track record. With respect to a fund created by experienced fund sponsors, however, this argument can be challenged by the Internal Revenue Service (IRS). The carried interest is like an option with a strike price above market. This interest must have some value, particularly where the fund sponsor has a strong track record. It would be difficult to argue that a carried interest in the next Blackstone, KKR, or Bain Capital fund would have no value if such interest were available in the open market.

The carried interest is like an option with a strike price above market.

Finally, the risk of treating a carried interest as valueless may be significant. Upon audit, the IRS could take the position that the taxpayer underreported the value of the interest at the time of the initial gift and assess gift taxes, if any, and penalties based on the value of the carried interest at the time of the transfer. Alternatively, the IRS could take the position that there was no completed gift at the time of the transfer and that all that was transferred was a future right to receive payments. Under this theory, the IRS would attempt to treat the actual payments in respect of the carried interest as gifts at the time they were actually received. For these reasons, we feel it's prudent to ascribe a value to the carried interest at the time of transfer and file a gift tax return with the IRS on Form 709. ■



PART TWO: ESTATE TAX REDUCTION

Within the American Taxpayer Relief Act of 2012 (ATRA), the gift and estate tax basic exclusion amount was set at \$5 million per person, permanently indexed for inflation from 2011. The basic exclusion amount is the amount that each individual can transfer, either during one's lifetime or upon death, free of estate or gift tax. For 2013 this amount is \$5.25 million per person; a married couple can transfer wealth of \$10.5 million free from estate or gift tax. The ATRA also set the top marginal estate and gift tax rate at 40 percent.

The generation skipping exemption amount was once again unified with the estate and gift amount at \$5 million per person, permanently indexed for inflation from 2011. This exemption amount allows individuals to transfer wealth to generations beyond their children; it can provide opportunities to shelter assets not only from one's estate but also provides protection from estate tax within one's children's estates.

A successful estate tax reduction plan begins with two key items: choosing assets with significant appreciation potential and then transferring those assets at a point in time when they're undervalued. Finding the right moment to transfer is key, and with a maximum estate tax of 40 percent, sheltering appreciation and growth will result in significant estate tax savings.

Let's assume that we value the carried interest of the fund today at \$500,000. If this fund grows substantially in value and ultimately the carried interest realizes a return of \$5 million, that's \$4.5 million of wealth transferred out of the estate, using just a small amount of the available exemption. This creates an estate tax savings of \$1.8 million at the time of realization of the return — and that's before we factor in future growth, appreciation and, as you'll see in the next section, the ability to provide for income-tax free appreciation of those assets.

A successful estate tax reduction plan begins with two key items: choosing assets with significant appreciation potential and then transferring those assets at a point in time when they're undervalued.

GRANTOR TRUST

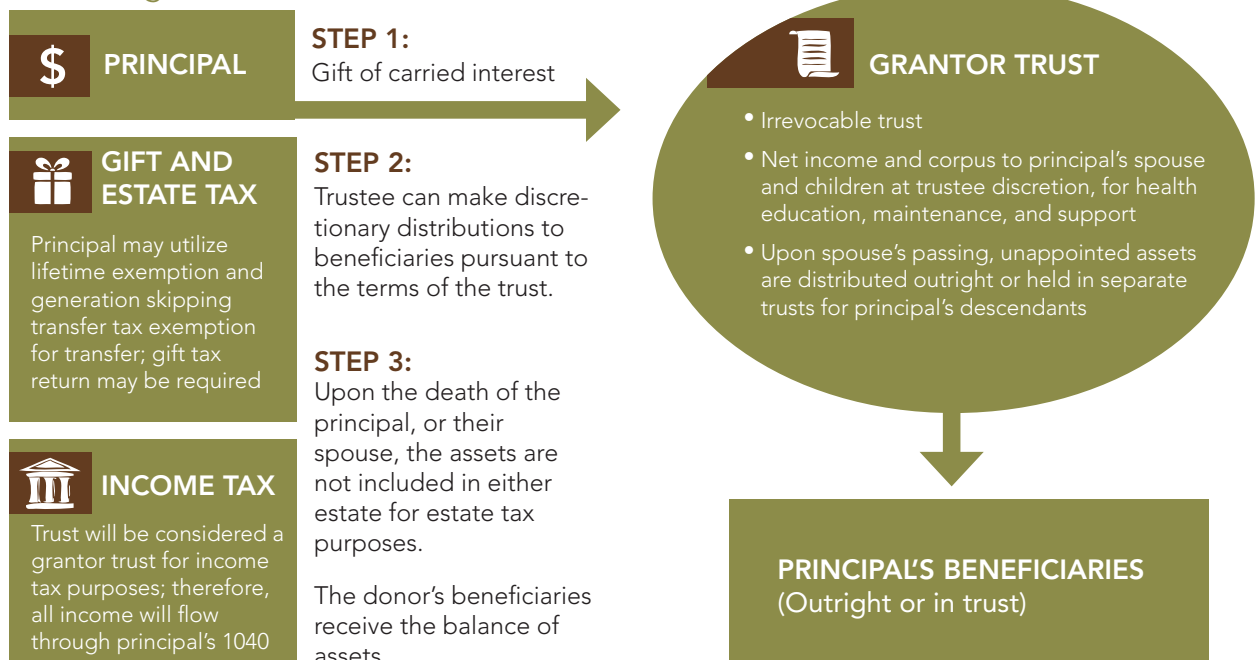
The next step is to find the right vehicle to provide not only asset protection for one’s heirs but also simplicity on a day-to-day basis. Some consider transferring directly to their heirs; however, concerns quickly ensue of wanting to provide creditor, marital, or general asset protection. There may also be age or maturity concerns—it’s not always wise to put assets directly into one’s heirs’ hands. Trusts can be a way for individuals to protect the assets for benefit of their heirs and can also provide some additional flexibility if the future is uncertain, especially with regard to the value and the ultimate appreciation. Finally, fund documents may prohibit direct transfers to individual money funds, therefore, only permitting transfers to trusts using structures that allow the fund sponsor principal to vote the interest.

Trusts can be structured in such a way that they’re excluded from one’s gross estate for estate tax purposes and are still taxable for federal income tax purposes to the trust settlor. This ability to pay the income taxes on behalf of the trust can provide individuals a significant estate tax-savings opportunity, as they’re reducing their estate with each income tax payment and allowing the asset within the irrevocable trust to grow free from both income and estate tax.

From a practical perspective, all the activity within the grantor trust would simply flow through to the principal’s 1040 as it would have prior to the transfer. If, at some point, there’s a desire to turn off this grantor status and have the trust pay its own taxes, the trust document can allow for this through an irrevocable disclaimer of the powers that created the grantor trust.

Using our example above, the principal would take their carried interest, which has subsequently been valued at \$500,000, and make a direct gift to the irrevocable grantor trust for benefit of their children. For further leverage, they may choose to make it a dynasty trust for the benefit of their children and then, subsequently, their grandchildren can use the generation skipping exemption amount discussed above.

Gift to a grantor trust



INSTALLMENT SALE USING A GRANTOR TRUST

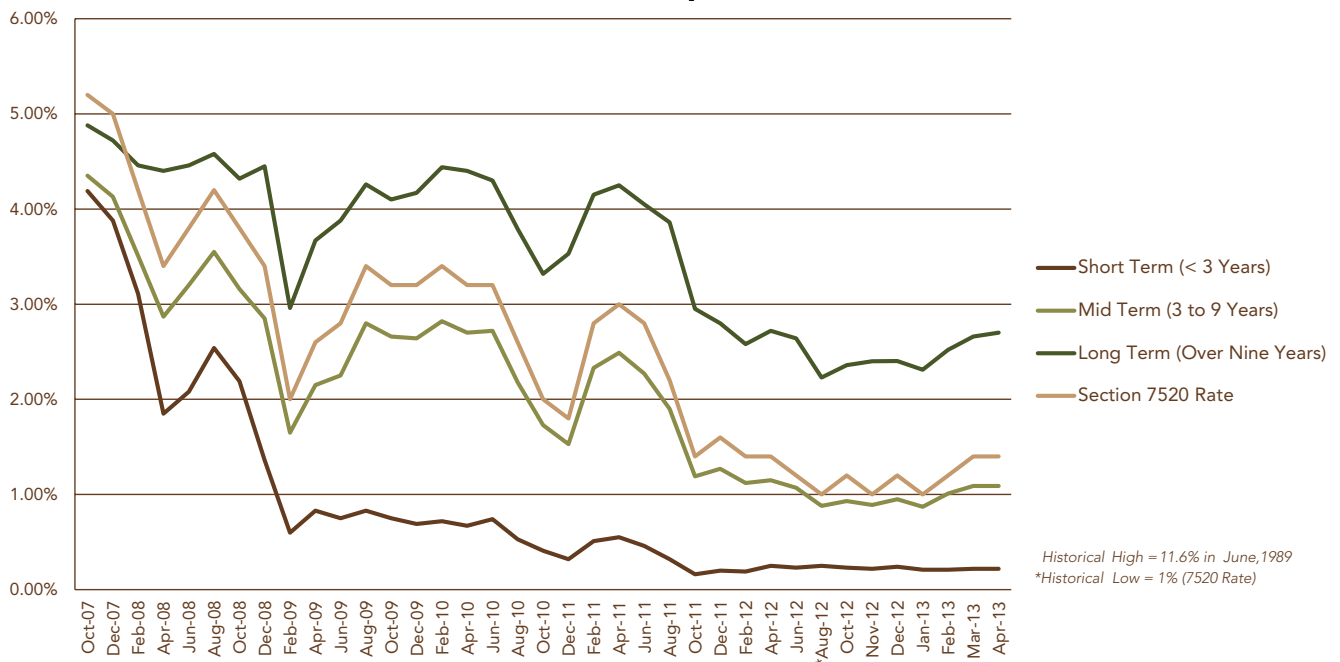
There may be some instances where a sale rather than an outright gift makes sense, whether it's to preserve the gift tax exemption amount or to ensure a portion of the liquidity generated from the carried interest goes back to the principal upon liquidity of the fund. It can also be a way of providing further leverage for the transaction by taking advantage of the historically low interest rate environment. As you can see from the chart below, the ability for the newly created irrevocable trust to borrow funds from the principal at such a low rate provides for a capping of the principal's returns, allowing for all additional appreciation above and beyond to be sheltered from estate tax.

In order for the grantor trust to enter into a sale transaction, it must have seed money, generally recommended to be at least 10 percent of the overall transaction amount. As an example, for a sale of a carried interest valued at \$1 million, there must first be a gift of \$100,000 to the trust. This gift can be a portion of the carried interest but does not need to be. (It can be other assets such as cash or marketable securities.) A promissory note would then be established for the balance reflecting \$900,000 due from the irrevocable trust to the principal at then current interest rates. This note may be structured with interest payable annually, but with a balloon note at the end of the term, providing for a delay tied to the fund's liquidity.

Because of the grantor status of the trust, the sale transaction does not result in a taxable event in and of itself, and the interest income on the promissory note is fully disregarded for federal income tax purposes. ■

Falling Interest Rates Signal Potential Opportunity to Transfer Assets

Applicable Federal Rates
(October 2007 – April 2013)





PART THREE: VALUATION CONSIDERATIONS

Due to the high level of risk associated with this type of asset, the valuation of a carried interest must take into account the likelihood of realizing any proceeds from the carried interest. Conditional situations often create uncertainty, which contribute to the higher level of risk. An analysis of the likelihood that the carried interest will ultimately realize proceeds must consider all the parties in the capital structure standing ahead of a carried interest. Further, newly formed funds have an additional obstacle as they don't have a history of success against these risks. Together, these factors result in a lower value, relative to its potential value, to be assigned to a carried interest. By gifting the carried interest at a low value, the holder of the interest can mitigate gift and estate taxes in the event of future appreciation of the carried interest's value.

In this section, we will discuss the considerations and one of the valuation methods used to determine the value of a carried interest.

The fund sponsors of a private equity fund are responsible for making all decisions surrounding the activities of the fund. In exchange for overseeing the operation of the fund, the sponsors commonly receive a management fee (e.g., 2 percent of assets under management) and a carried interest. However, the carried interest only receives distributions when the fund generates an annualized return in excess of the preferred return (i.e., the hurdle rate). The most commonly used hurdle rate in the industry is 8 percent per year and generally ranges from 7 percent to 10 percent per year.

Once capital is called, the preferred return clock starts running. Therefore, in order for the carry to have value, it must generate a return greater than the management fee and the preferred return. It's common for the carried interest to receive 20 percent of the private

By gifting the carried interest at a low value, the holder of the interest can circumvent gift and estate taxes in the event of future appreciation of the carried interest's value.

equity fund's distributions after clearing the required returns, but this amount can vary. The value of an asset is derived from the future economic benefits that it's expected to accrue after consideration of risk. The characteristics of a carried interest are akin to those of a call option as both of these assets receive economic benefits once the value of an underlying asset reaches a "strike price." In the case of the carried interest, its strike price is the capital invested plus the hurdle rate. Therefore, one of the methods that can be used to value a carry is to use an option-pricing model.

THE BLACK-SCHOLES OPTION-PRICING MODEL

The Black-Scholes Option-Pricing Model ("Black-Scholes") is currently the most recognized and widely used theoretical model for the valuation of options. Fischer Black and Myron Scholes hypothesized that it was possible to establish a riskless portfolio consisting of two positions: a long position in the shares of a given stock and a short position in a call option on the stock.

If the call option is correctly priced, any movements in the price of the stock would be offset by opposing movements in the call option value so that the investor would be perfectly hedged and the investment would yield a risk-free rate of return. Therefore, the Black-Scholes Model prices options by requiring that neither position produce an excess profit (e.g., the price of the call option will move to eliminate arbitrage opportunities). As such, the model calculates the value of the option as that which equates the value of the two positions at a specific point in time.

The Black-Scholes equation applicable to the valuation of a call option on a non-dividend-paying stock is as follows:

$$\text{Call Value} = [S * N(d1)] - [E * e^{-r * t} * N(d2)]$$

Where:

S = Current Asset Value: A private equity fund often has several investment phases. A separate call option can be used for each investment phase. Therefore, the asset price is equal to the capital invested for each phase.

E = Exercise (Strike) Price: The strike price will be based on the terms of the fund agreement. However, like the valuation of any asset, the devil is in the details. Fundamentally, the strike price will be the original invested capital plus the preferred return in excess of the hurdle rate. The key is correctly capturing the terms of a complicated agreement (e.g., catch-up provisions, complex pay-off structures, clawbacks, etc.).

r = Risk-Free Interest Rate: This rate is based on U.S. Treasury securities with a term the same as the expected holding period of the investment phase.

t = Time to Expiration: The estimated holding period for each investment phase.

N(d1) & N(d2) = Measurements of Volatility: Of all the inputs in the Black-Scholes Model, this is the most subjective. The expected volatility of the asset should be derived from market data with characteristics similar to the investments of the private equity fund.

To summarize, the variables of the Black-Scholes Model are: the value of the underlying asset, the strike price at the option's expiration date, the expected volatility of the underlying asset, and the risk-free rate. The following is a simplified example of the valuation of a carried interest using an option-pricing model.

A SIMPLIFIED EXAMPLE

Assume a single investment phase of \$100 million and a hurdle rate of 10 percent per year where the carry receives 20 percent of the residual profits. The management of the fund expects the holding period to be five years. Therefore, the strike price would be the initial investment plus the hurdle for a total of \$161 million ($\$100 * (1+10 \text{ percent})^5$). Finally, assume the expected volatility is 40 percent, and the risk-free rate is 1 percent, based on market evidence. The resulting indicated current value of the carried interest is \$4.3 million. Below is a chart showing how different expected holding periods and volatilities affect the implied value.

		VOLATILITY					
		30%	35%	40%	45%	50%	55%
HOLDING PERIOD	4	\$9.9	\$13.7	\$17.6	\$21.5	\$25.5	\$29.5
	5	\$12.8	\$17.2	\$21.6	\$26.0	\$30.5	\$34.8
	6	\$15.5	\$20.4	\$25.3	\$30.1	\$34.9	\$39.5
	7	\$18.1	\$23.4	\$28.7	\$33.8	\$38.9	\$43.7
	8	\$20.6	\$26.2	\$31.8	\$37.2	\$42.5	\$47.5

Further, the appropriate standard of value for estate and gift tax purposes is "fair market value." Fair market value is defined as "the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts." To determine the fair market value of a carried interest, one should consider adjusting for lack of marketability.

The volatility of returns from the equities of public companies is used to determine the appropriate volatility for the carried interest in the Black-Scholes option-pricing model.

The volatility of returns from the equities of public companies is used to determine the appropriate volatility for the carried interest in the Black-Scholes Option-Pricing Model. Furthermore, the Black-Scholes Option-Pricing Model was created to value publicly traded options. The value resulting from the analysis is on a publicly traded equivalent. However, a carry is not freely traded. Therefore, the fair market value of the carried interest must also consider a discount due to a lack of marketability.

Back to our simplified example, if a discount of marketability of 30 percent were applied to the indicated value of \$4.3 million, the fair market value would be \$3 million. To examine the possible tax savings, let's assume that five years after the start of the fund, the investment is successfully realized at 2x (i.e., \$200 million). After payment of the initial investment and hurdle for a total of \$161 million, the carried interest would receive 20 percent of the residual proceeds equal to \$7.8 million ($\$200 \text{ less } \$161 \text{ million} \times 20 \text{ percent}$). Thus, gifting the carried interest at the inception of this example results in a tax savings of \$1.9 million ($\$7.8 \text{ million less } \$3 \text{ million} \times 40 \text{ percent}$). ■



tax

PART FOUR: IRS SPECIAL VALUATION RULES

One of the major obstacles to wealth transfer planning with carried interests are the Special Valuation Rules of Chapter 14 of the Internal Revenue Code and, in particular, Section 2701 – “Special Valuation Rules in Case of Transfers of Certain Interests in Corporations or Partnerships.” The Chapter 14 rules are quite complex, but in their simplest form, Section 2701 provides that if a person with direct or indirect control over an entity transfers a non-marketable junior equity interest in the entity to a member of his or her family and retains an “applicable retained interest,” the junior equity interest transferred will be valued by subtracting the value of the retained interest from the value of the entity (i.e., the junior equity would be valued at the residual value of the entity under Section 2701). Unless the retained interest is a qualified payment under section 2701, the returned interest is valued at zero. In the classic example, father owns 100 percent of the 10 percent non-cumulative preferred stock of ABC Co. and 100 percent of the common stock. ABC Co. is worth \$20 million and the preferred stock has a \$15 million preference. The father transfers (by gift or sale) all of the common stock to his children; under Section 2701 the preferred stock is not a qualified payment, because it is noncumulative, and is valued at zero. The common stock is valued at \$20 million. The father would be deemed to have made a gift to the children of the difference between \$20 million and the amount of any consideration he received from the transfer. This is a draconian result and exactly what the IRS intended. Section 2701 was designed to eliminate “corporate freeze” transactions.

	Pre- Section 2701 Rules	Post-Section 2701 Rules
Value of ABC Company	\$20,000,000	\$20,000,000
Less: Value of preferred stock	(\$15,000,000)	0
Gift Value of Common Stock	\$5,000,000	\$20,000,000

To understand how this relates to carried interests, we need to examine three key aspects of Section 2701 as they relate to private equity and carried interests: control, the definition of junior equity, and the meaning of an applicable retained interest.

CONTROL

Under Section 2701, “control” is determined prior to the transaction and means holding 50 percent or more of the stock of the corporation by vote or value. In the case of a partnership, it means holding 50 percent of the capital or the profits interests in the partnership, or in the case of a limited partnership holding any general partnership interest. In the case of a fund structured as a limited partnership, all general partners will be subject to Section 2701. In the case of a corporate or LLC structure, the determination is more complex. It will be very rare that any of the principals of the fund sponsor own more than 50 percent of the fund, but the calculation is made at the level of the entity in which the transfer is made. In a typical structure, the fund sponsor will hold its piece of the fund (including the carried interest) in a separate entity owned by the principals of the fund sponsor. If any of the principals owns more than 50 percent of such entity, Section 2701 applies to that principal. In other situations, each individual principal in the fund sponsor may hold his or her individual interest in a separate entity. In this case, any transfer of an interest in this separate entity (regardless of what percentage it represents in the fund) could be subject to Section 2701.

JUNIOR EQUITY INTEREST

A “junior equity interest” is any common stock or other equity interest that is junior to the rights of all other classes of equity interests. The typical “carried interest” in an LLC or limited partnership is by definition a junior equity interest. If the only interest in the fund held by a principal of the fund sponsor is its carried interest and there is only one class of equity in the entity, the principal can transfer all or a portion of his or her share. There should be no concern about Section 2701 because the transferor does not hold any interests senior to the interest being transferred. If the transferor does hold an additional interest, we have to determine whether that interest is an “applicable retained interest.”

The typical “carried interest” in an LLC or limited partnership is by definition a junior equity interest.

APPLICABLE RETAINED INTEREST

An “applicable retained interest” is any interest in a controlled entity with respect to which there’s a distribution right or a liquidation, put, call, or conversion right. A distribution right generally means any right to distributions in respect of an equity interest senior to the transferred junior equity interest. If a principal in a fund sponsor co-invests in the fund with the outside investors, the principal will hold an applicable interest. If the principal is a general partner of a fund set up as a limited partnership, the principal will hold an applicable interest. One area of complexity that needs to be reviewed is management and other fees paid to the fund sponsor. Depending upon the structure of the fund’s operating agreement, fees can be structured as part of the equity interest (e.g., the Class B Holder shall receive an annual fee

expressed as a percent of capital) or a separate payment. More commonly the fee income will be paid to the same entity that holds the carried interest. This can complicate wealth transfer planning if the transferor is interested in transferring an interest in the carried interest but wants to retain fee income.

How to Deal with Section 2701

There are several ways to address the potential applicability of Section 2701:

- 1. Pre-formation Planning.** If any of the principals in the fund sponsor are aware of their desire to engage in wealth planning with respect to a carried interest, the most effective way to address this is at the formation of the fund. Remember that Section 2701 applies to transfers. A properly structured initial investment by a trust for the benefit of heirs in the entity that will manage the fund and receive the carried interest can eliminate or reduce complex tax and valuation issues.
- 2. Structuring to Eliminate Control.** In most private equity transactions, Section 2701 issues arise due to how the principals in the fund sponsor structured their ownership in the fund. If the fund sponsor ownership entity is structured so that the parties' desire to make transfers are not in "control" of the entity, Section 2701 issues can be eliminated.
- 3. Vertical Slice.** There is an exception to Section 2701 for "vertical slices" of the deal. If the transferor transfers a fixed percentage of every interest he or she owns in the entity in question, Section 2701 does not apply. This is easier said than done in most private equity structures due to a desire to retain certain types of income (e.g., fees) or restrictions in the operating agreement related to transfers of certain equity interest that are tied to fund management rights.
- 4. Carried Interest Derivatives.** Over the past several years, a concept has been developing in which a principal in a fund sponsor who would otherwise be subject to Section 2701 sells a derivative based on the value of the underlying carried interest to an intentionally defective trust for the benefit of the principal's heirs.¹ This strategy is based on the concept that a sale of a derivative is a contract right under the Internal Revenue Code and not an equity security in the underlying entity. The derivative is a promise by the principal (not the fund) to pay the trust an amount of money based upon the value of the carried interest at a fixed point in time. It is essential that the carried interest derivative be structured as a sale and not be deemed a gift. If the transaction is deemed a gift, the carried interest derivative could be viewed as nothing more than a promise to pay in the future, which under the Internal Revenue Code is an "incomplete gift" that will be valued at the time the payment is actually made. With respect to a carried interest this could be a very large number. In a typical carried interest derivative, the seller will agree to pay an amount computed nominally on the performance of the carried interest at a date after the expected termination of the fund. The structure of the derivative is quite flexible and affords the seller latitude in setting the parameters (e.g., 80 percent of the value of the Class B interest in XYZ fund over \$5 million as determined on the 10th anniversary of the derivative contract).

The trust will purchase the derivative for cash or a promissory note. If a promissory note is used, the trust should have adequate assets to make the note real for tax purposes. This is usually accomplished with a significant seed gift to the trust.

In structuring a carried interest derivative, a proper third-party valuation is critical. The valuation report must be done by a valuation firm with extensive experience in private equity. Since at the time of the creation of the derivative, little, if any, of the fund assets will have been deployed, the firm must evaluate the anticipated return of the fund based on data of comparable funds of similar size and focus, as well as factor in the variability of return. This concept has not been tested by the IRS and like many novel strategies carries with it significant audit risk.

Finally, the client must consider the financial risks of the strategy. First, the fund may not perform, in which case the principal has sold an asset to his heirs that turns out to have no value, resulting in a net transfer of assets from the heirs to the principal. Second, the principal will owe the value of the derivative to the trust upon the settlement date of the derivative contract regardless of whether he has the assets or liquidity to make the payment. This problem could result from losses from other investments, separation from the fund, divorce, or clawback obligations from this or other funds. For this reason, this strategy makes sense for fund principals with substantial wealth apart from their investments in the fund. Accordingly, carried interest derivatives are often used when no other options for dealing with Section 2701 are available. ■

1. David A. Handler and Angelo F. Tiesi, "Using Derivative to 'Transfer' Carried Interests in Private Equity, LBO and Venture Capital Funds," *Venture Capital Review* Issue 17, Spring Edition 2006

CONCLUSION

With proper planning, carried interests received by the management team of a private equity fund can be ideal assets for use in estate planning. Especially when the carried interest is transferred early in the fund's life, the asset can have a very low value relative to its potential value at payout. It's this payout potential that makes it an ideal asset to be used in estate tax-reduction planning, especially when used in combination with a grantor trust allowing for that appreciation to compound on an income tax-free basis. ■

AUTHORS



ROBERT M. HEINRICH, PARTNER

HONIGMAN MILLER SCHWARTZ AND COHN LLP

Mr. Heinrich is a partner in the Trust And Estates Practice Group at Honigman Miller Schwartz and Cohn LLP. He concentrates his practice in the areas of estate planning and wealth management for high net worth individuals. Earlier in his career, he was a corporate finance partner specializing in private equity and venture capital at the law firm of Goldberg Kohn in Chicago, Illinois. He is a member of the Probate and Estate Planning Association for the State Bar of Michigan and the Financial Planning Association. Mr. Heinrich earned a J.D., magna cum laude, from the University of Michigan Law School and a bachelor's degree, with high distinction, in economics from the University of Virginia.

Contact Robert at: 248.566.8450 or rxh@honigman.com



DAWN R. JINSKY, ASSOCIATE

PLANTE MORAN

Ms. Jinsky is an associate with Plante Moran Wealth Management, a group within Plante Moran based in Southfield, Michigan that focuses on high net worth individuals. She has been with Plante Moran since 1998 and specializes in assisting clients with estate planning, business succession planning, wealth transfer, and charitable planning. Dawn is a member of the AICPA, the MACPA, and the Financial and Estate Planning Council for Southeastern Michigan.

Contact Dawn at: 248.223.3642 or dawn.jinsky@plantemoran.com

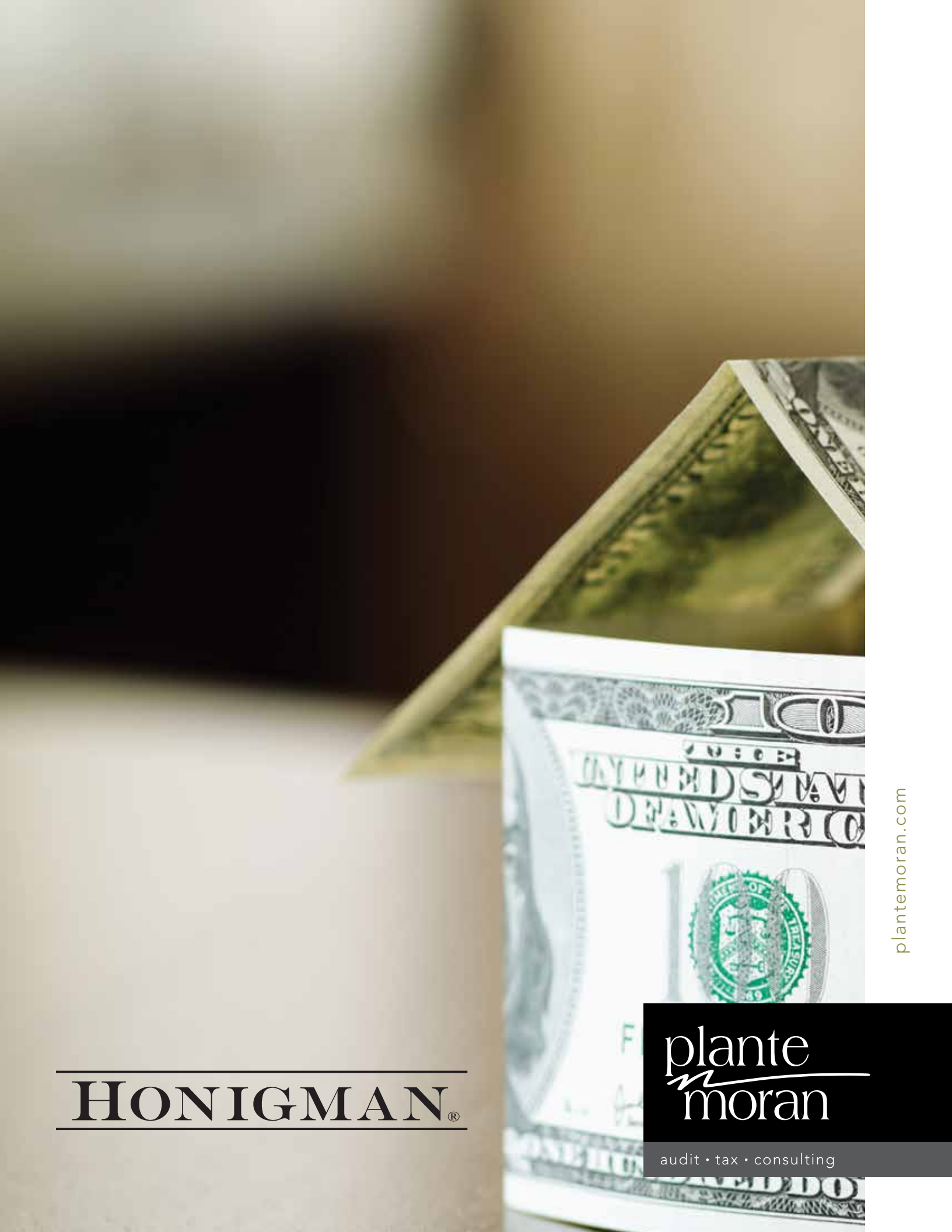


RICHARD L. LIES, CFA, ASA, ASSOCIATE

PLANTE MORAN

Mr. Lies is a principal in Plante Moran's forensic & valuation services group and is experienced in the valuation of closely-held equity securities, partnership interests, and intangible assets. He has earned the professional designation of Chartered Financial Analyst (CFA), is an Accredited Senior Appraiser (ASA) in business valuation from the American Society of Appraisers, is a member of the Chicago Estate Planning Council, and is president of the Business Valuation Association of Chicago. Rich earned his bachelor's degree BS in electrical engineering from Northwestern University and attended graduate studies at the University of Iowa, earning an MBA with a concentration in finance.

Contact Richard at: 312.980.2922 or rich.lies@plantemoran.com



HONIGMAN®

plante
m
moran
audit • tax • consulting

plantemoran.com