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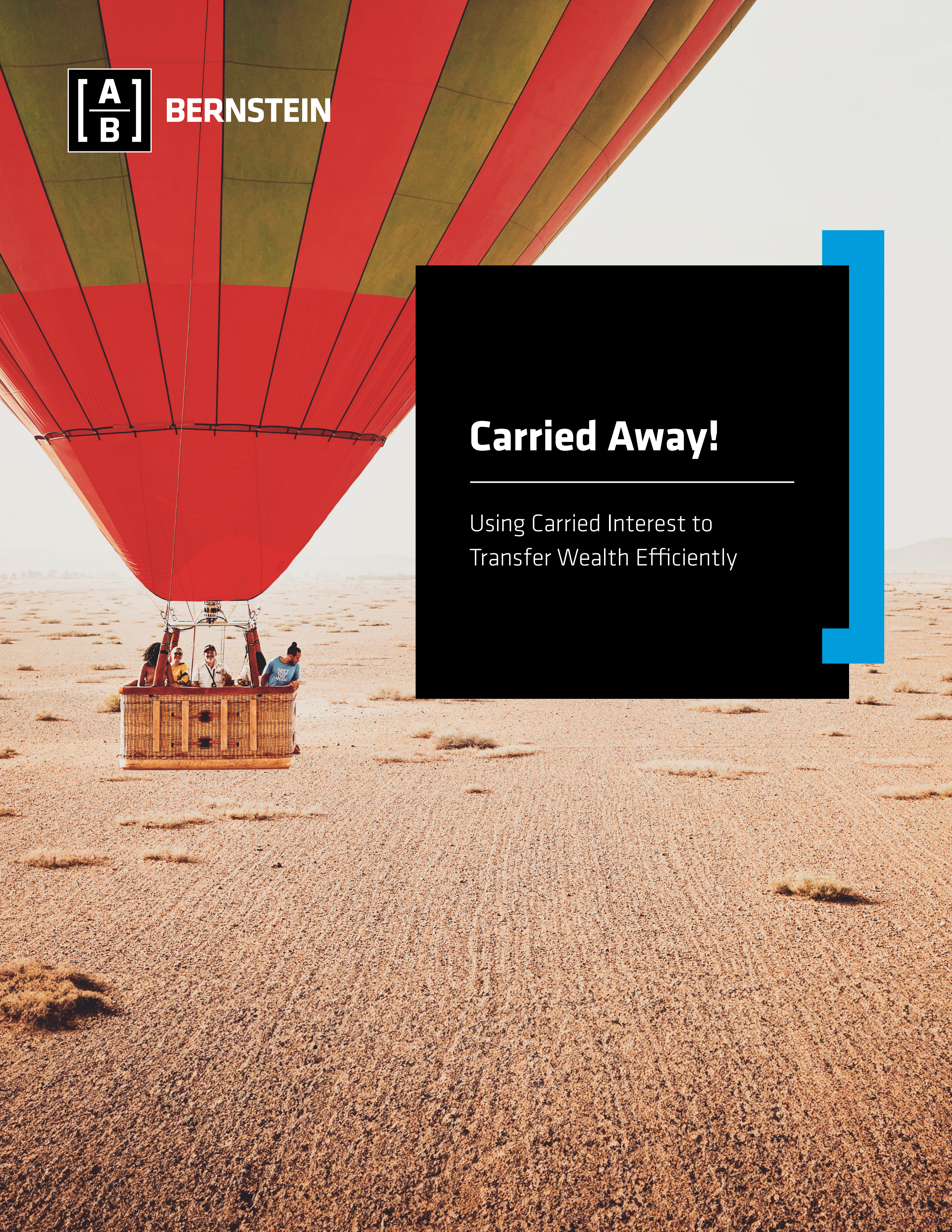

Carried Away!

Using Carried Interest to Transfer Wealth Efficiently

Utilizing Carried Interest to Transfer Wealth Efficiently

While complicated, carried interest can be an amazing asset for wealth transfer. Every fund manager who owns carried interest—and the advisors who work with them—should be aware of its potential. In this paper, we analyze the efficiency of various wealth transfer strategies for carried interest.

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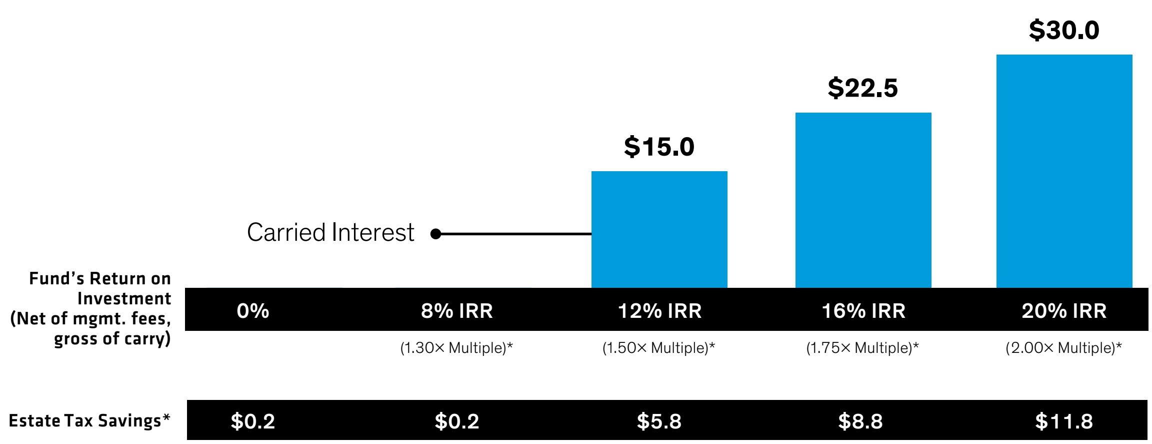
The Opportunity

Carried interest is an ideal asset for many private investment managers looking to minimize their future estate tax exposure through lifetime wealth transfer planning. Often called "carry" for short, the asset may initially be valued at only a small fraction of its ultimate worth.[1] If the carry is moved outside of the estate while the value is low—and then later explodes in value—tremendous amounts of estate taxes can be sidestepped for those with taxable estates. To illustrate, let's consider Henry:

Henry owns a general partner ("GP") interest in a $3 billion private equity fund which entitles him to 5% of the carried interest. Initially, his carry is valued at $600,000. But if the fund achieves its target 20% IRR return[2] over the next 10 years, Henry stands to receive $30 million. If he transfers that carry outside of his estate before it appreciates, we estimate that his family will likely save almost $12 million in future estate taxes (*Display 1*). This type of return opportunity is rare: to capture the equivalent amount of appreciation from $600,000 to $30 million, an asset would have to generate an annualized compound return of nearly 48% for 10 years.

DISPLAY 1: TRANSFERRING CARRIED INTEREST OUTSIDE AN ESTATE YIELDS BIG TAX SAVINGS

Future Value in 10 Years (USD Millions)



***Multiple reflects total value paid in. IRR calculation is based on variations of the cash flow model illustrated in Display 2. Estate tax savings assumes 40% estate tax on indicated values from carried interest, which further assumes other assets utilize the full remaining applicable exclusion amount. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. | **Source**: AB

1 Nevertheless, for gift and estate tax purposes carried interest is valued using a generally accepted valuation method such as discounted cash flow, options pricing, or comparable company.
2 Gross of carry, net of management fee.

Overview of Carried Interest

Carried interest is a significant source of incentive compensation for private equity, venture capital, real estate, and hedge fund managers as well as those overseeing other investment vehicles. Generally, these private investment funds are formed as partnerships with the fund's investment manager serving as general partner ("GP")[3] and outside investors as limited partners ("LPs").[4]

In exchange for their services, the fund's GP collects annual management fees and often shares in the partnership's profits through their carried interest. Carry also aligns interests between the GP and LP investors since the GP's share is typically calculated as a percentage of the fund's overall profits once they have exceeded a minimum return. In addition to their GP and carried interest, managers often acquire a capital interest funded from their own personal wealth.[5]

Upon liquidation of the partnership or its underlying investments, cash proceeds are distributed between the GPs and LPs according to the fund's partnership agreement, often referred to as a "distribution waterfall." Typically, the distribution waterfall unfolds in the following way:

1. Invested capital is returned to all investors.
2. A preferred return (often 8%) is paid to holders of capital interests.
3. The holder of the carried interest may be entitled to a catch-up distribution, which compensates for the preferred return paid to the investors. The catch-up typically stipulates that 100% of profits up to the preferred return will be allocated to the carried interest.
4. After the preferred return and the catch-up distribution, the remaining profits are split according to a predetermined ratio between the fund manager (traditionally 20%) and the investors (traditionally 80%).

Generally, carried interest has little or no intrinsic value during the early stages of an investment fund since its ultimate payout is contingent on performance. For the carried interest to have value, the fund must first generate sufficient profits to return all invested capital, plus a specified preferred return to investors.[6] However, if the fund is successful, the carried interest could become substantial later in the fund's life.

Income Tax Treatment of Carried Interest

Carried interest generally enjoys more favorable tax treatment than other forms of compensation. However, there have been many attempts to enact legislation to weaken or eliminate this preferential tax treatment.[7] Before the Tax Cuts and Jobs Act ("TCJA") of 2017, gains allocated to carried interest qualified for long-term capital gain treatment after only one year. The TCJA introduced IRC Section 1061, which recharacterizes long-term capital gains allocated to carried interest as short-term capital gains (taxed at ordinary income rates), unless the gain arises from assets held for more than three years.[8] Additional proposals have sought to lengthen this holding period to five years or eliminate long-term capital gains tax treatment altogether.

"Carried interest generally enjoys more favorable tax treatment than other forms of compensation"

3 Often the fund's GP is structured as an LLC in which the fund's investment managers control.
4 Investment fund's limited partners often consist of outside investors, including endowments, insurance companies, pension funds, and wealthy individuals meeting certain income and net worth requirements. Qualified Purchaser, see 15 U.S.C. § 80a-2(a)(51); Accredited investor, see 17 U.S.C. § 230.501(a).
5 Fund managers are often required to make substantial capital contributions to the funds they manage. It is common for new managers to acquire the necessary capital through loans from the fund's sponsor or outside sources. Alternatively, a management fee waiver may be used.
6 Including the fund manager's capital interests in the GP and/or LP. See "The General Explanations of the Administration's Revenue Proposals" each year beginning with Fiscal Year 2010 and Section 138149 of the H.R. 5376 version reported in the House on September 27, 2021.
7 IRC § 1061(a)(2). Gain realized on capital assets held for not more than three years is recharacterized as ordinary income.
8 IRC § 2701 provides special valuation rules for gifts of equity interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family.

Technical Notes on IRC Section 2701 Special Valuation Rules

Without proper planning, transferring carried interest to family members while retaining other capital interests in the entity is likely to trigger the special valuation rules under IRC Section 2701.

Generally, IRC Section 2701 applies when an interest in a corporation or partnership is transferred to or for the benefit of a transferor's spouse,[10] lineal descendants,[11] spouse of a lineal descendant,[12] or when an applicable family[13] member retains an applicable interest in the entity immediately after the transfer. An applicable retained interest involves any interest in an entity with a distribution right—but only if, immediately before the transfer, the transferor and applicable family members hold control of the entity or there is a liquidation, put, call, or conversion right.[14] Control of the entity for these purposes means holding 50% or more of the capital or profits interests or—in the case of a limited partnership—holding any interest as a general partner.[15]

Under IRC Section 2701, the gift tax value of the transferred interest is determined by the subtraction method.[16] This means the transfer value for gift tax purposes is calculated as the aggregate value of the transferor's equity ownership before the transfer, less the aggregate value of the transferor's equity immediately after the transfer.[17]

For calculation purposes, if the interest retained by the transferor is classified as an applicable retained interest, its value is considered zero. **For gift tax purposes, the zero-value rule results in the transferor being treated as transferring their entire equity interest in the entity instead of just the value of the equity interest transferred.**

The Challenge

If transferring carried interest outside of an estate is such a home run, why isn't it done more often? The answer frequently involves having to navigate the complexities of Internal Revenue Code Section 2701 ("Section 2701").[9] Special valuation rules are required, which can create wealth transfer traps for the uninitiated (see Technical Notes on IRC Section 2701 Special Valuation Rules).

Section 2701 sets special rules for valuing transfers of certain partnership interests and other entities for gift and estate tax purposes. Specifically, if a donor gives away carried interest but retains a capital interest in a partnership, Section 2701 can cause the gift to be valued as if the donor transferred their entire ownership interest. This could result in a much higher valuation then what they actually transferred.[17]

For instance, if a fund manager transfers carried interest appraised at $500,000 to their children but retains a $2 million capital interest in the partnership, the special valuation rules may value the transfer at $2.5 million for gift tax purposes, not the $500,000 value that was intended. If that were to happen, the carry would have to appreciate by $2 million before any wealth transfer could be achieved. Even worse, it could utilize $2.5 million of the transferor's lifetime gift tax exemption—with no wealth transfer to show for it—if the fund fails to perform as expected. As a result, it's crucial to consider these rules and valuation methods when planning for lifetime wealth transfer with carried interest.

When Does IRC Section 2701 Apply?	
What is transferred?	An interest in a corporation or partnership from someone with an applicable retained interest
To whom?	Spouse, lineal descendants and spouses, or an applicable family member
Who is an applicable family member?	Ancestor or spouse of the ancestor of the transferor or the transferor's spouse
What is an applicable retained interest?	Any interest with a distribution right if the transferor holds control or there is a liquidation, put, call, or conversion rights
What constitutes control?	50% or more of the capital of profits interests, or any interest as a GP

"For gift tax purposes, the zero-value rule results in the transferor being treated as transferring their entire equity interest"

9 IRC § 2701 provides special valuation rules for gifts of equity interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family.
10 IRC § 2701(e)(2)(A).
11 IRC § 2701(e)(1)(B).
12 IRC § 2701(e)(1)(C).
13 IRC § 2701(e)(2).
14 IRC § 2701(b)(1).
15 IRC § 2701(b)(2)(B).
16 Treas. Reg. § 25.2701-1(a)(2).
17 Treas. Reg. § 25.2701-3(a)(1).

The Carried Interest Planning Playbook

How do you transfer carried interest while staying compliant with the rules? Fortunately, Treasury Regulations and the Internal Revenue Code provide some "safe harbor" exceptions to Section 2701. In this piece, we model five distinct wealth transfer strategies of this nature, each designed to address the special valuation rules. After briefly summarizing each strategy, we will further quantify and explore them in the case study that follows. Further details may be found in the Appendix.

Vertical Slice Exception

Summary: Owner transfers a pro rata portion (a "vertical slice") of each class of interest held, not just the carried interest. Section 2701(a)(2)(c) provides that the special valuation rules do not apply when the owner's retained interest "is proportionally the same as the transferred interest."

Primary benefit: Simple.

Primary drawback: "Waters down" the potential wealth transfer benefit of carried interest alone.

Preferred Partnership with Qualified Payment Right

Summary: Owner establishes a new entity (e.g., a limited liability company), and transfers all interests held, or a vertical slice of each, to the new entity in exchange for preferred and common interests. Owner then transfers the common interest in the new entity to or for the benefit of family members, while retaining ownership of the preferred. If the retained preferred interest confers a "qualified payment right" on the holder within the meaning of Section IRC §2701(c)(3), then owner's transfer of the common interest should not be subject to the special valuation rules of Section 2701. Such qualified payment right is a preferred interest that provides a cumulative fixed interest payment due at least annually to its holder.

Primary benefit: Potential for greater wealth transfer than a vertical slice.

Primary drawback: Common interests must be at least 10% of the total value of all equity interests in the new entity, and the preferred coupon must be an arm's-length market rate. A qualified appraisal is needed to determine the appropriate preferred coupon rate.

Private Derivative

Summary: A private derivative is a contract that mimics some or all economic benefits of the carried interest. If that contract—rather than the carried interest itself—is transferred, then arguably, Section 2701 should not apply.

Primary benefit: Potentially all economic benefits of the carried interest may be transferred without triggering the special valuation rules.

Primary drawback: Legally untested and uncertain.

Parallel Trusts

Summary: Owner establishes two new trusts: (1) an irrevocable grantor trust to which she transfers the carried interest; and (2) an incomplete gift, non-grantor (ING) trust to which she transfers the remaining interests. If properly structured, the owner arguably does not retain any of the transferred interests, so the special valuation rules should not apply.

Primary benefit: Potentially all economic benefits of the carried interest may be transferred without triggering the special valuation rules.

Primary drawbacks: Legally untested and uncertain; potential restrictions on distributions from the ING trust to the owner.

Transfers Outside of the Owner's Immediate Family

Summary: Transfers to or for the benefit of individuals who are not married to the owner, or lineal descendants (or their spouses), are not subject to Section 2701. For example, transfers to siblings, nieces and nephews, and the owner's nonspouse partner (whether outright or in trust), are excluded.

Primary benefit: All economic benefits of the carried interest may be transferred without triggering the special valuation rules.

Primary drawback: Narrow scope, since the owner's spouse, descendants, and descendants' spouses cannot directly benefit.

Understanding the Appraisal

Why is Henry's carried interest worth $600,000? For that matter, why does it have any material value? After all, the carried interest might ultimately prove worthless if the fund fails to achieve more than an 8% IRR. Yet despite the downside risk, carried interest still has value based on its future potential.

To determine its worth, carried interest must be evaluated by a qualified appraiser, based on facts and circumstances unique to each fund. Valuations include projected cash flows for capital calls. They also account for the ultimate return of capital and profits to investors as investments are liquidated, and are often modeled on discounted cash flows based on the likelihood of success or failure. For those with a history of launching similarly successful funds, prior results factor in. In Henry's case, his fund company could point to several previously successful vintages running similar strategies.

Henry's appraisal included optimistic case projections[18] (*Display 2*), which showed that if the fund achieves its target 20% IRR, it will double invested capital and generate carried interest of $600 million for Henry and his partners. Henry's share of this would be $30 million (5%). However, these returns are several years into the future, and there is significant uncertainty surrounding them. Despite this, in the optimistic return scenario, the discounted present value of those future carried interest payments was pegged at $50 million for 100% of the carried interests of the entire fund (*Display 3, page 7*).

Cash Flow Projections

Millions USD

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Contributions to Portfolio Companies	–$600	–$750	–$600	–$600	–$450	—	—	—	—	—	–$3,000
Distributions from Portfolio Companies	—	—	$150	$435	$945	$1,200	$1,200	$900	$810	$360	$6,000
Net Annual Cash Flows	–$600	–$750	–$450	–$165	$495	$1,200	$1,200	$900	$810	$360	$3,000
Cumulative Cash Flows	**–$600**	**–$1,350**	**–$1,800**	**–$1,965**	**–$1,470**	**–$270**	**$930**	**$1,830**	**$2,640**	**$3,000**	**$3,000**
Carried Interest Projections (Fund Level)	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$186**	**$180**	**$162**	**$72**	**$600 Mil**

18 In all instances and examples for this case, IRR returns reflect fund level IRR net of management fees but gross of carry.

Display 3: Fund Level Carried Interest Projection and Valuation

Optimistic Scenario—20% IRR (net of mgmt fees, gross of carry)
Investment Assumptions (USD Millions)

Fund Size	**$3 Billion**
Multiple of Total Value Paid In	**2.0**
IRR (gross of carry, net of mgmt fees)	**Cumulative Cash Flow 20%**
Discounted Present Value of Carried Interest	**$50 Million**

> **“To determine its worth, carried interest must be evaluated by a qualified appraiser, based on facts and circumstances unique to each fund”**

The full valuation of the carried interests includes other potential scenarios as well, reflecting the chance of lower returns and longer investment return periods. Altogether, the valuation contemplated four potential scenarios including a 20% IRR, 16% IRR, 12% IRR, and 8% IRR, with each given a relative probability weighting (*Display 4*). When the present value of the carried interests were weighted and calculated, the combined total present value for all of the carry equaled $17.7 million. Additional valuation discounts were applied to Henry's 5% share for lack of marketability and control, resulting in his final valuation of $600,000.

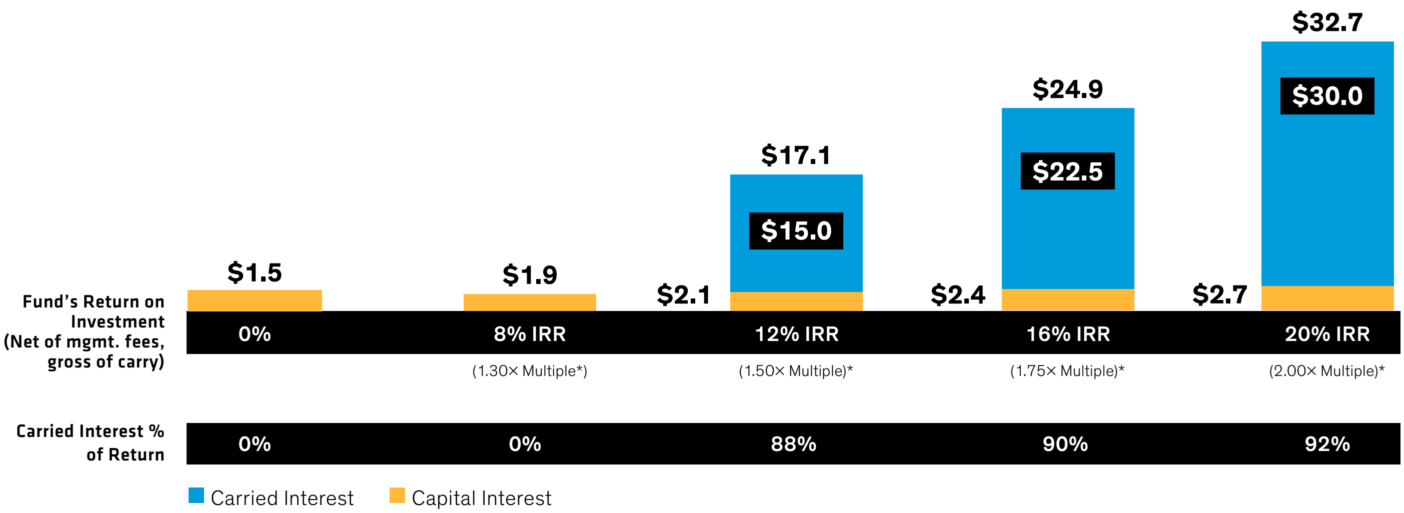
Fund Level Valuation

Carried Interest Valuation Summary (Fund Level)			
	Potential Future Value	**Discounted Cash Flow Valuation of Payout**	**Probability Weighting**
Optimistic—20% IRR*	$600,000,000	$50,000,000	20%
Base Case—16% IRR	$450,000,000	$18,100,000	40%
Conservative—12% IRR	$300,000,000	$8,400,000	20%
Breakeven—8% IRR	$0	$0	20%
Total Fund Level Carried Interest Valuation (Probability Weighted)	**$360,000,000**	**$18,920,000**	
Henry's Interests (5%)		$946,000	
Henry's Interests with applicable valuation discounts		**$600,000**	

*IRR is net of management fees, gross of carry. IRR calculation is based on variations in timing and size of the projected cash flows illustrated in Display 2.

DISPLAY 5: HENRY'S SHARE OF CAPITAL AND CARRIED INTERESTS

Future Value in 10 Years (Nominal USD Millions)



*Multiple reflects total value paid in. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. | **Source:** AB

Which Strategies Are Most Effective for Wealth Transfer?

Given the variety of strategies available, which optimally transfers wealth? To answer this question, let's revisit Henry's case. Recall that Henry is a private equity fund general partner. He invested $1.5 million of his own money in a fund that raised $3 billion of capital commitments and owns 5% of the GP capital interests and carried interests. His carried interest is valued at $600,000, reflecting significant potential future appreciation, though it could also be worthless if the fund doesn't perform. Taken together, Henry's total interests (his invested capital plus his carried interest) are valued at $2.1 million. The carried interest pays Henry 20% of all returns—including a catch-up provision, once LP investors achieve an 8% preferred return.

By its nature, carried interest is levered to the upside. While the capital interest will benefit from the fund's investment returns, the carried interest could appreciate much more rapidly once the internal rate of return exceeds 8%. Over the next 10 years, a 12% IRR would inflate the value of the carried interest to $15 million. If the fund achieves a 16% IRR, its value would balloon to $22.5 million, while at 20% it would reach $30 million. The carry drives nearly 90% of Henry's expected returns overall (*Display 5*).

When Special Valuation Rules Are at Play

To transfer this tremendous growth outside of his estate, Henry can consider a variety of strategies. But first he needs to determine if his transfers are subject to Section 2701's special valuation rules. Since he holds GP interests and wants to transfer the growth of the carried interest to trusts for his family's benefit, he is likely subject to Section 2701. To avoid the zero value rule, he can use exceptions such as the vertical slice, preferred partnership with qualified payment right, private derivative, or parallel trusts strategies. These strategies are explained in The Playbook section *(on page 5)* and detailed in the Appendix.

Vertical Slice Exception

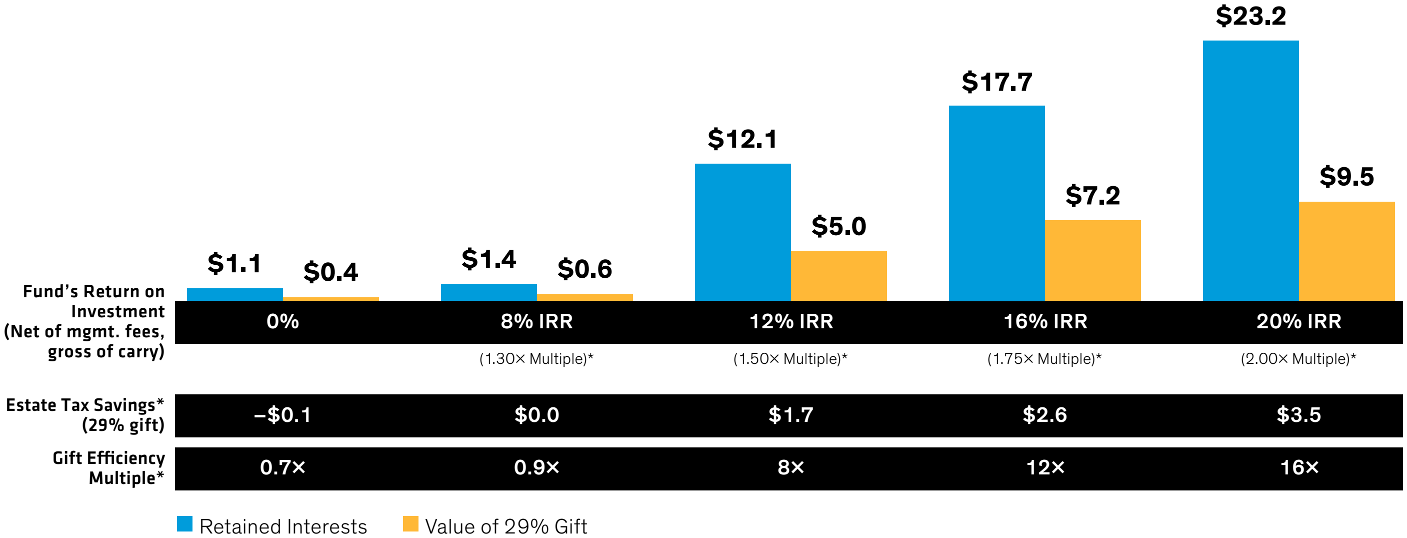
With the vertical slice method, Henry could make a gift valued at $600,000 to a trust. But that gift would not be carried interest alone. Keep in mind, Henry's total interest in the fund equates to $2.1 million (his $1.5 million capital contribution plus $600,000 of carried interest). So his gift would represent a percentage of his total stake, consisting of 71% capital interest and 29% carried interest. While this could be done with direct proportionate gifts of these interests, this pro-rata approach may be technically challenging and difficult to maintain going forward as values fluctuate.

Alternatively, Henry could first form a Family Limited Liability Company (FLLC) or a Family Limited Partnership (FLP), and then contribute all his capital and carried interests ($2.1 million). He would subsequently gift 29% of the FLLC interests to a trust for his heirs.[19] The value of the gift would equal 29% of all interests, or $600,000.[20] If the fund achieves 20% IRR over the next decade, the gift's value would swell to $9.5 million (*Display 6*). This strategy could save Henry's estate approximately $3.5 million in estate taxes in 10 years. Ultimately, the amount transferred would likely be reinvested, allowing growth to compound even further outside the estate.

DISPLAY 6: GIFT OF PRO-RATA VERTICAL SLICE—29%

Valuation of Gift is $600,000

Future Value of Gift in 10 Years, Nominal (USD Millions)



*Multiple reflects total value paid in. The Gift Efficiency Multiple is defined as the estimated future wealth transfer value divided by the appraised value of the initial gift. Estate tax savings assumes 40% estate tax on indicated values from carried interest, which further assumes other assets utilize the full remaining applicable exclusion amount. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. | **Source:** AB

19 Note that this would not be a direct gift of the underlying interests, which only change title once from Henry to the FLLC.
20 Valuation would be discounted for lack of marketability and control, but valuation discounts have been ignored to simplify the case.

While compelling, the result is substantially less efficient than solely transferring the carried interest. Recall that for a $600,000 gift (not subject to Section 2701), the carried interest alone could result in a $30 million wealth transfer if the fund delivers a 20% IRR. To bridge the gap between the two results, Henry could transfer a larger percentage of the new FLLC, but not without dramatically increasing the gift's valuation and using significantly more of his remaining lifetime gift tax exemption.

The most efficient wealth transfer strategies maximize the amount of wealth transfered while minimizing the amount of applicable gift tax exemption utilized. Efficient use of lifetime gifts is a critical component of minimizing estate taxes for large estates. To measure gift efficiency, one might consider gauging the total wealth transferred. However, this does not account for the cost of the gift—the amount of lifetime gift tax exemption utilized in the strategy. To incorporate both the cost and benefit, we have created and calculated what we will call the Gift Efficiency Multiple for each strategy. *The Gift Efficiency Multiple is defined as the estimated future wealth transfer value divided by the appraised value of the initial gift*. For example, if a 29% vertical slice is transferred and the 20% IRR is achieved, then the Gift Efficiency Multiple is 16× ($9.5 million expected transfer divided by $600,000 initial gift value). The Gift Efficiency Multiple can be a valuable metric to compare the efficiency of strategies to maximize the value of a gift.

Preferred Partnership with Qualified Payment Right

Instead of making a large gift, Henry could keep the value smaller while transferring significantly more wealth via a qualified payment right strategy. With this approach, Henry would create an FLLC with preferred and common interests and fund it with his total $2.1 million partnership interest. The preferred interest entitles Henry to a fixed annual interest payment of 8% (structured as a qualified payment right),[21] while the common interest entitles the owner to all profits exceeding this payment.[22] To accommodate the uncertain timing of future fund cash flows, the cumulative preferred interest can be structured with flexibility to allow for payments to ultimately be made up to four years after their required due date.[23]

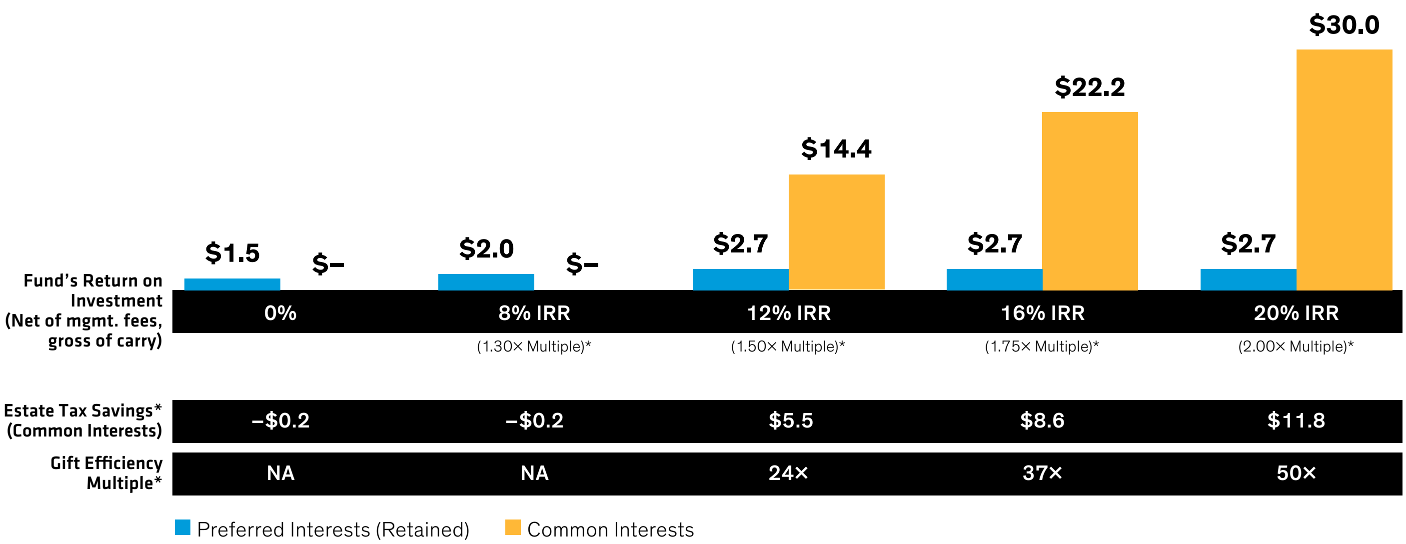
The preferred interests can be issued for any amount of the new preferred partnership, up to a limit of 90% of the partnership value. Henry structured $1.5 million of preferred interests, leaving the remaining $600,000 as common interests. He could then gift the common interests to a trust to benefit his heirs. If the fund generates a 20% IRR, we project that the value of the preferred interests would effectively be capped at $2.7 million—an 8% annual return over 10 years. The remaining value of $30 million would accrue to the common interests held in trust (*Display 7, page 12*). Overall, we'd expect this strategy to save $11.8 million in estate taxes.

21 The preferred return must be a market rate determined by a qualified appraiser.
22 IRC Sec. 2701(c)(3) and Treas. Reg. Sec § 25.2701-2(b)(6).
23 "Going Non-Vertical with Fund Interests," by N. Todd Angkatavanich and David A. Stein. November 2010, Trusts & Estates .

DISPLAY 7: PREFERRED PARTNERSHIP WITH QUALIFIED PAYMENT RIGHT

Valuation of gift is $600,000

Future Value in 10 Years, Nominal (USD Millions)



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Private Derivative

Henry could use a private derivative to achieve a similar outcome to the preferred partnership strategy. The private derivative is a contract structured to require the seller (Henry) to pay the buyer (the trust) a sum equal to the value of the carried interest at settlement. Think of it as selling a call option to the trust, where **no transfer of the carried interest itself is required**.

To execute, Henry will first need to establish an irrevocable grantor trust (IDGT) for the benefit of his children (or a spousal lifetime access trust established for the benefit of his spouse and children). Assuming the trust is not yet funded, Henry can make a seed gift to facilitate purchasing the derivative—which a qualified appraiser has valued at $500,000—from himself.[24] This strategy allows all of the appreciation from the fund's performance, net of the price paid for the derivative, to accrue to the benefit of the trust. If the fund delivers a 20% IRR, we'd project the private derivative to be worth $30 million upon settlement, transferring the same wealth as the preferred partnership strategy and saving $11.8 million in estate taxes.

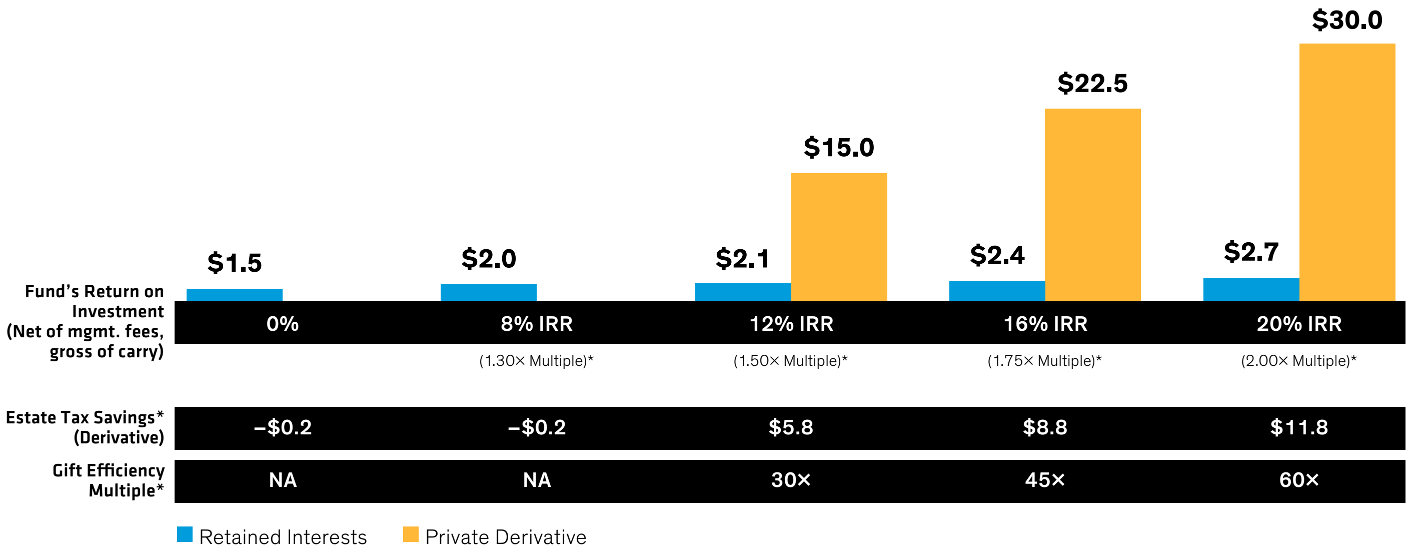
With the derivative approach, since Henry still owns the carried interest, it will be taxed to him personally regardless how much is put into the trust. Structuring the trust as a grantor trust (IDGT) is critical to the strategy's success as it avoids double taxation (by ensuring the trust doesn't pay income tax on the receipt of derivative proceeds from Henry). To further protect Henry from the potential tax liability, it's advisable to build in contract constraints—such as a hurdle and possibly a percentage split or a cap. This prevents Henry from overextending himself should the carried interest's upside result in a larger income tax bill than anticipated. Of course, the added benefit of limiting the contract is a reduction in the derivative's initial value. In fact, the ability to put parameters around the amount of wealth transferred is a unique advantage of the derivative.

24 The contract must be structured as a bona fide agreement between the two parties in which full and adequate consideration is exchanged for the future payment rights provided by the contract. See IRC § 2036(a).

DISPLAY 8: PRIVATE DERIVATIVE

Valuation of gift is $500,000

Future Value in 10 Years, Nominal (USD Millions)



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Parallel Trusts

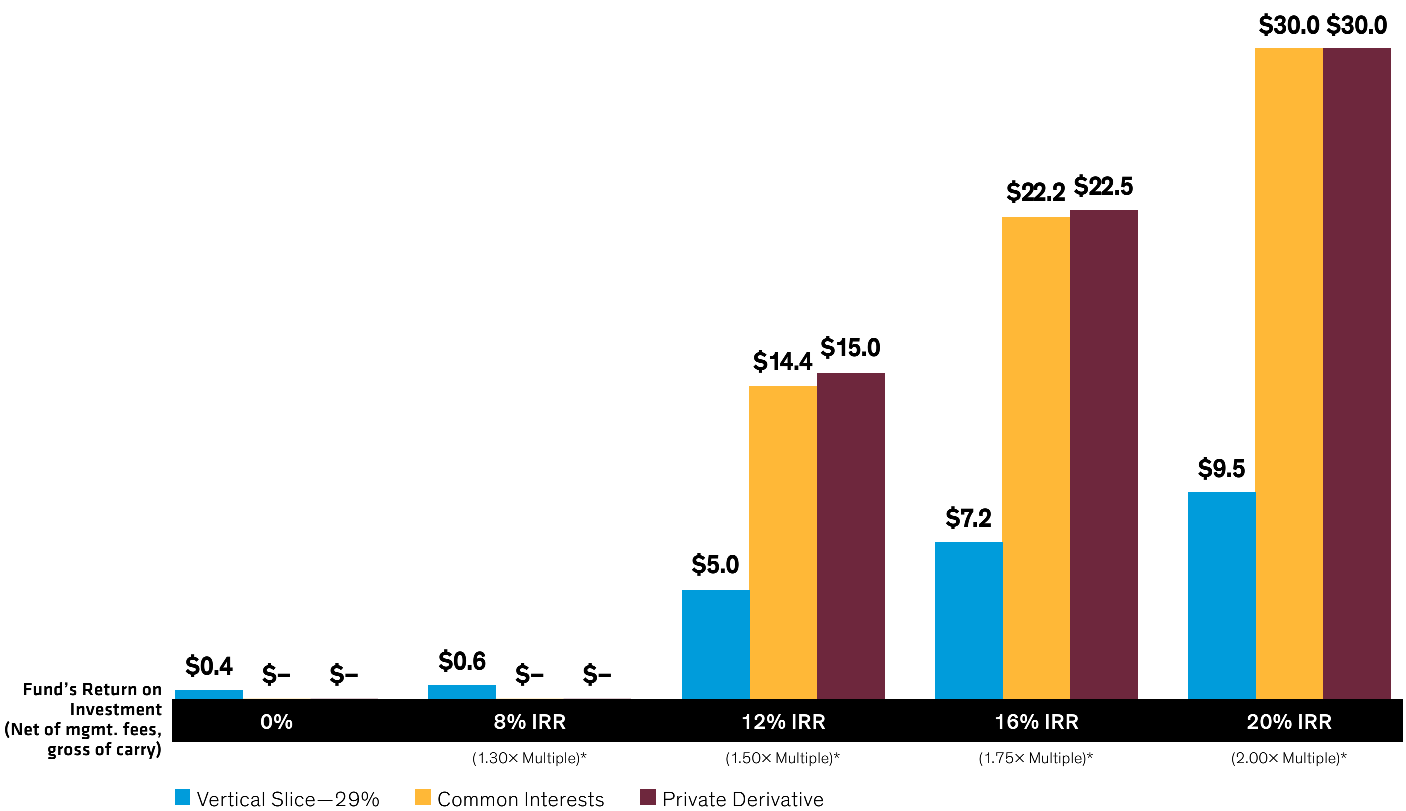
The parallel trusts strategy relies on attribution and ordering rules to avoid triggering Section 2701. Henry would establish an incomplete non-grantor trust and an irrevocable grantor trust, transferring the capital interests to the former and the carried interests to the latter as a completed gift. An incomplete non-grantor trust is an irrevocable trust that may include the grantor as a beneficiary, though a third party must be trustee and the assets are still included in the grantor's estate. An irrevocable grantor trust is for beneficiaries such as children, and assets are excluded from the estate of the grantor. Like the direct gift of carried interest, this strategy could move $30 million outside the estate and save over $11.8 million in estate taxes if the investment fund achieved 20% IRR over 10 years. However, multiple legal considerations and assumptions relative to other strategies must be considered. Notably, with the incomplete non-grantor trust, Henry's access to capital interests would be relatively limited and he would have no control.

Which Strategy Is Best?

Given the numerous ways to avoid the zero-valuation rule under Section 2701, which approach should Henry choose? Each has pros and cons. The vertical slice strategy is perhaps the most common. However, it doesn't transfer wealth as efficiently as the Preferred Partnership or Private Derivative methods. To compare apples to apples, we calculated the relative wealth transfer and Gift Efficiency Multiple for each strategy (*Display 9* and *Display 10*). Lower gift values—with equal or higher amounts of wealth transfer—result in a higher Gift Efficiency Multiple. Clearly, the preferred partnership and private derivative are both far more efficient than the vertical slice, with the derivative (60x) edging out the preferred partnership (50x) on efficiency due to the slightly lower gift value.

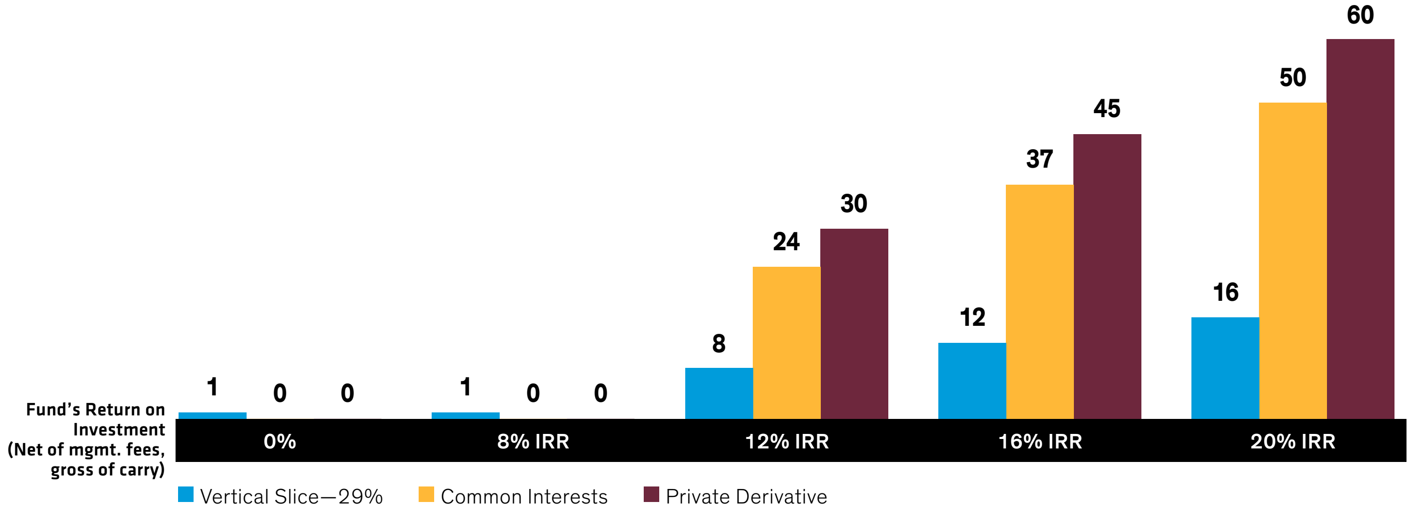
DISPLAY 9: COMPARISON OF PROJECTED WEALTH TRANSFER

Future Value of Gift in 10 Years. Nominal (USD Millions)



*Multiple reflects total value paid in. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. | **Source:** AB

DISPLAY 10: COMPARISON OF STRATEGIES—GIFT EFFICIENCY MULTIPLE*



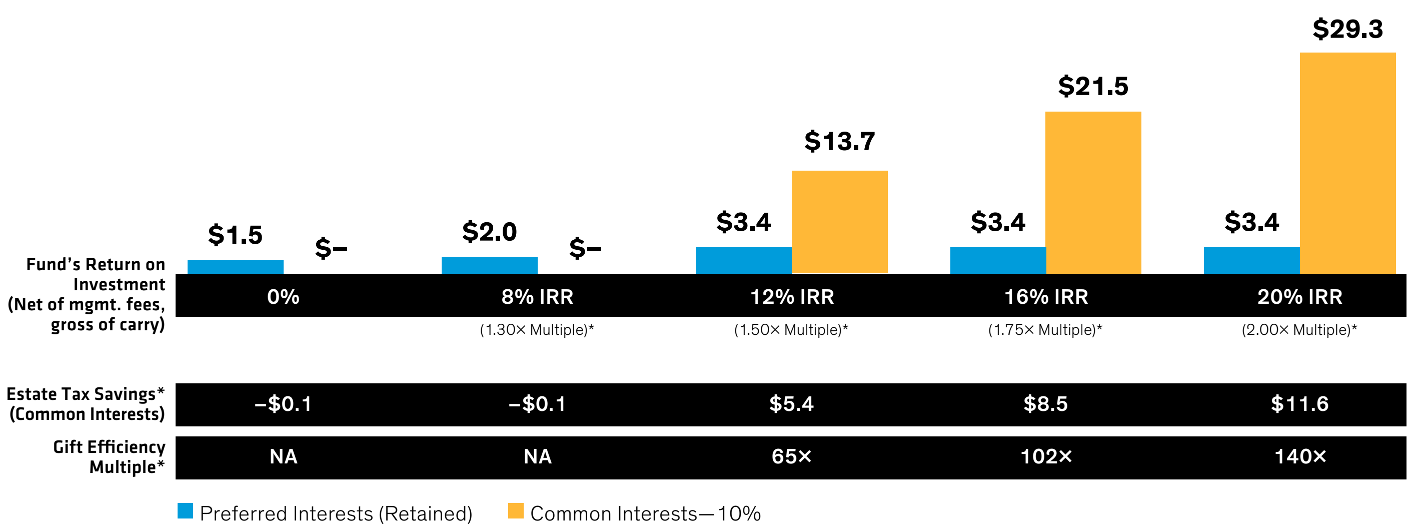
*The Gift Efficiency Multiple is defined as the estimated future wealth transfer value divided by the appraised value of the initial gift. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. | **Source:** AB

As attractive as these figures appear, their efficiency can be enhanced by further reducing the value of the gift interests as long as the gift's upside potential is not proportionately restricted. For instance, the initial value of the common interests in the preferred partnership can be reduced by structuring the preferred interests as 90% of the partnership's value. This effectively decreases the value of the common interests to $210,000, while enhancing the potential payout on the preferred interests to $3.4 million, a fixed $700,000 increase (*Display 11*). Likewise, the initial value of the derivative can be lowered by including a hurdle that requires a specified amount of return on carried interest before the derivative begins accruing value. For example, incorporating a $1 million hurdle in the contract could reduce the value of the derivative to $200,000 (*Display 12*).

DISPLAY 11: PREFERRED PARTNERSHIP WITH QUALIFIED PAYMENT RIGHT—90% PREFERRED

Valuation of gift is $210,000

Future Value of Gift in 10 Years. Nominal (USD Millions)

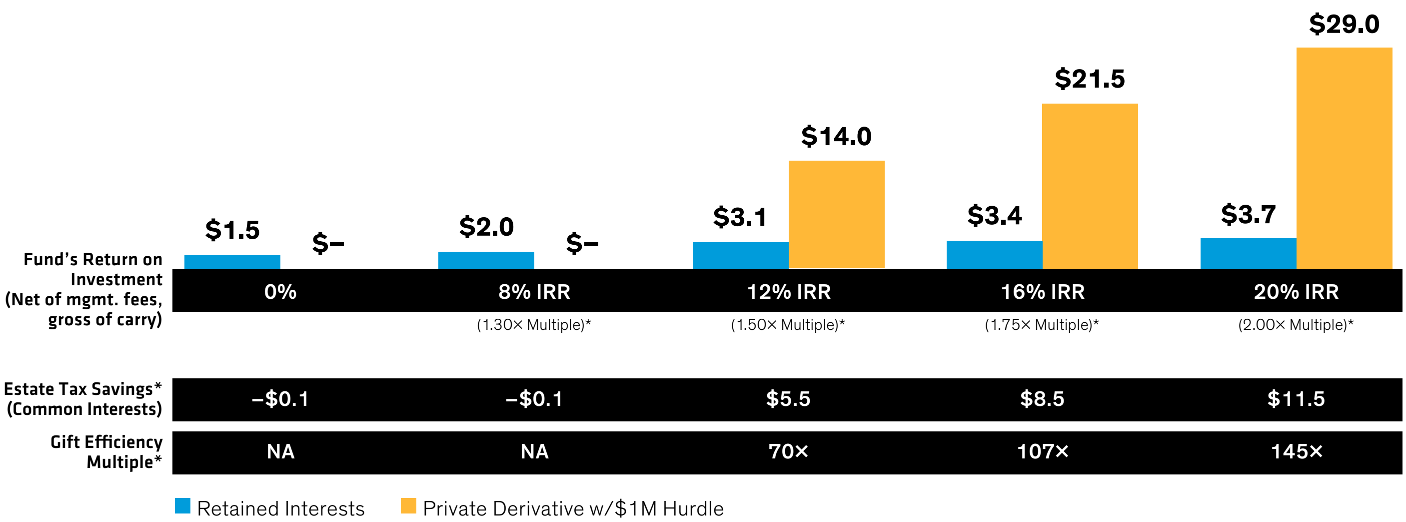


*Multiple reflects total value paid in. The Gift Efficiency Multiple is defined as the estimated future wealth transfer value divided by the appraised value of the initial gift. Estate tax savings assumes 40% estate tax on indicated values from carried interest, which further assumes other assets utilize the full remaining applicable exclusion amount. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. | **Source:** AB

DISPLAY 12: PRIVATE DERIVATIVE WITH $1 MILLION HURDLE

Valuation of gift is $200,000

Future Value of Gift in 10 Years, Nominal (USD Millions)

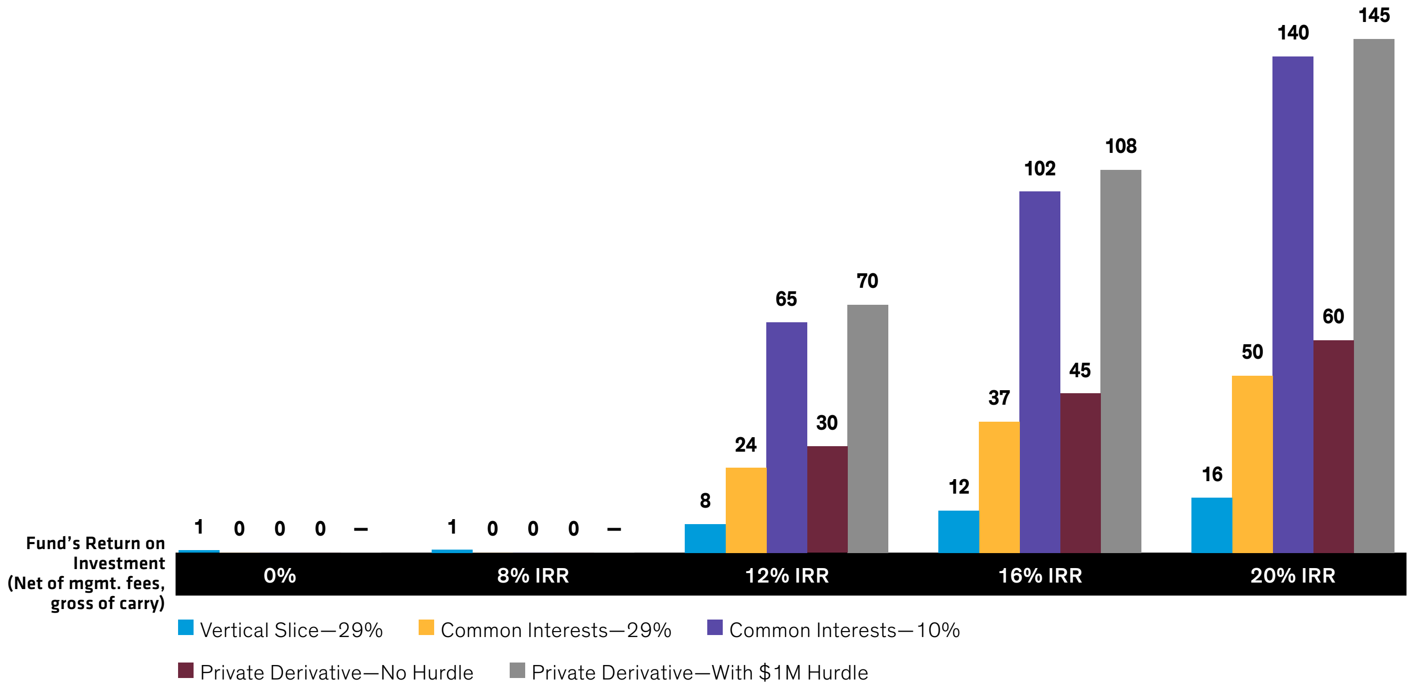


*Multiple reflects total value paid in. The Gift Efficiency Multiple is defined as the estimated future wealth transfer value divided by the appraised value of the initial gift. Estate tax savings assumes 40% estate tax on indicated values from carried interest, which further assumes other assets utilize the full remaining applicable exclusion amount. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. | **Source:** AB

A comparison of the impact of lower gift values on Gift Efficiency Multiples can be found in Display 13. While the projected future value of the gifts decline slightly, they still achieve 97% or more of the original projected outcomes—while utilizing 40% or less of the originally modeled gift value—boosting the multiples significantly.

Note that altering the gift percentage does not impact the Gift Efficiency Multiple. For example, a gift of 29% of a FLLC in the vertical slice method will have the same efficiency as a gift of 75%. Likewise, changing a gift of 75% of common interests in a preferred partnership or a derivative structured to deliver a given level of carried interest proceeds will not affect the Gift Efficiency Multiple. Although such fine-tuning will alter the value of the gift, they have a pro-rata impact on the resulting wealth transfer. Structures that offer unlimited upside while constraining the value of the gift through higher fixed hurdle returns on retained interests deliver the highest Gift Efficiency Multiple.

DISPLAY 13: COMPARISON OF STRATEGIES—GIFT EFFICIENCY MULTIPLE*



*The Gift Efficiency Multiple is defined as the estimated future wealth transfer value divided by the appraised value of the initial gift. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. | **Source:** AB

Initial Execution and Tax Concerns

Both the vertical slice and preferred partnership strategies require moving GP interests into new entities, which may be cumbersome or hampered by partnership agreements. The derivative strategy is simpler to execute since it does not require moving the GP interest but may result in double taxation under certain circumstances. To address this concern, a grantor trust must be used since transactions between a grantor and a grantor trust are disregarded for income tax purposes. However, if the grantor were to pass away or terminate the grantor trust status before contract settlement, the trust would become a non-grantor trust responsible for paying taxes on its gain. In this scenario, the trust would pay income tax on the gain realized from the the derivative, while Henry or his estate would pay income tax on the carried interest.

The other strategies are pass-through entities that hold GP interests, so they are only taxed once, regardless of ownership or grantor trust status. Additionally, keep in mind that a derivative should be structured to terminate at the earliest of a fixed date in the future, or at the grantor's death. Doing so allows the derivative to be deductible to the grantor's estate for estate tax purposes.[25] In the Appendix, we discuss further rules that apply to the derivative's structure. And, importantly, while some practitioners have been using the derivative strategy for carried interest for over 15 years, it remains untested in case law.

25 Treas. Reg. Sec. 20.2053-1(d)(4)(i); Estate of Bailly v. Commissioner, 81 T.C. 246 (1983), Estate of Graegin v. Commissioner, T.C. Memo 1988-477.

When the Special Valuation Rules Aren't a Factor

If Henry is not subject to IRC Section 2701, he could transfer the current $600,000 value of his carried interest to individual beneficiaries or trusts without applying the zero valuation rule. This removes the asset from his estate, utilizing some of his lifetime gift tax exclusion along with all future appreciation. The latter would benefit heirs and would likely be excluded from Henry's taxable estate—potentially avoiding a 40% future estate tax on all the appreciation. Assuming the fund attains a 20% return over the next 10 years, this would mean that $30 million of carried interest would reside outside the estate, saving close to $12 million of estate taxes.

Some owners who have already seen significant appreciation in their carry—or who have limited lifetime gift tax exemption remaining—may wish to avoid structuring the transfer as a gift. In that case, it may make sense to utilize wealth transfer techniques that require little to no gift tax exemption such as a grantor retained annuity trust (GRAT) or an installment sale to an intentionally defective grantor trust (IDGT). A GRAT allows a grantor to contribute assets while requiring the trustee to return all of the transferred assets plus a minimum rate of return as annuity payments over the GRAT term. At the end of the term, any remaining assets are transferred out of the estate free of gift tax. An installment sale to an IDGT is similar to a loan with a required minimum interest rate. Once the loan is paid off, then any remaining assets are effectively transferred out of the estate without gift tax. These are excellent strategies to consider when a gift is not a viable option. However, thoughtful consideration must be given to which assets will be used to make GRAT annuity payments or installment sale interest payments prior to future income realization on the carry.

For example, a 10-year GRAT may have five years of payments come back to the grantor prior to additional funds flowing into the trust as income from the carry. If the GRAT funding doesn't include other assets, then a significant amount of carry could be returned to the grantor (in the form of GRAT payments) before the carry's value is realized inside the GRAT, reducing the strategy's effectiveness. Not to mention that each GRAT annuity payment would require a valuation if paid with illiquid, non-marketable securities.

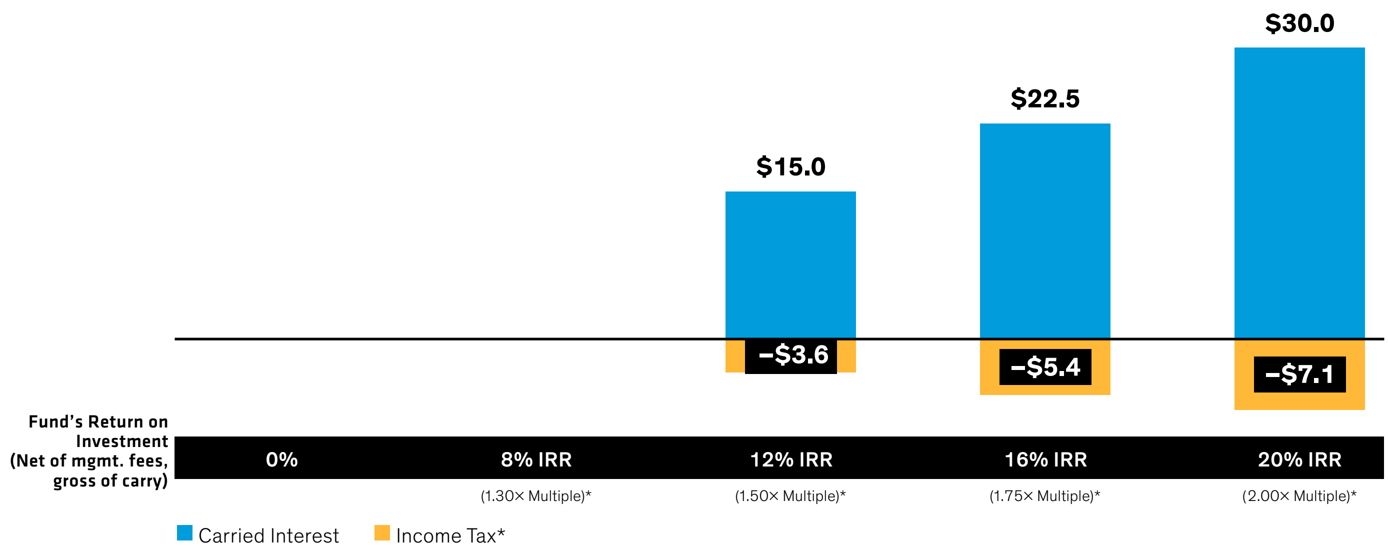
Relative to GRATs, an installment sale of carry to a IDGT may be a much easier way to avoid returning significant amounts of carry to the grantor. IDGTs may be funded with additional liquid assets to help cover several years of interest payments, avoiding the distribution of illiquid carried interests back to the grantor. In Henry's case, for instance, with carry valued at $600,000, the annual interest-only payment might total $30,000 if the applicable interest rate is 5%. To that end, a gift of $150,000 of liquid assets to an intentionally defective grantor trust—prior to an installment sale of carried interests valued at $600,000—could provide enough liquid assets to make five years of interest payments back to the grantor. This would allow the carry to remain in the trust to fully appreciate outside of the estate.

Income Tax Considerations for Wealth Transfer

If a gift of carried interest is made to an individual or a non-grantor trust, the recipient would be responsible for paying the capital gains income tax triggered by the carried interest's distribution. On the other hand, if the gift is made to an intentionally defective grantor trust (IDGT), then the grantor (Henry) would be responsible for paying the taxes on the carried interest and all income realized inside the IDGT.

DISPLAY 14: INCOME TAX LIABILITY ON TRANSFERRED ASSETS MUST BE CONSIDERED

100% of Henry's Carried Interests
Future Value of Gift in 10 Years (Nominal USD Millions)



*Multiple reflects total value paid in. Income tax reflects federal capital gains tax of 23.8%. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice.
Source: AB

While IDGTs are a mainstay of estate planning, factoring in future taxes is critical when sizing the gift. Consider that if Henry's fund achieves the 12% IRR, his carry will result in a tax bill of approximately $3.6 million (*Display 14*). Yet, if the fund generates a 20% IRR, that tax bill could reach over $7 million. How can Henry be sure that the future tax bill that he will pay on the carried interest in the grantor trust isn't more than his personally owned share of the proceeds? Generally speaking, Henry should retain an ownership stake in the carried interest at least equivalent to the future tax rate on the carried interest (i.e., 23.8% federal rate). That way, he will personally retain enough participation in the potential upside to cover the tax liabilities he will incur on behalf of the interests owned in the IDGT—no matter how well the fund performs.[26] Alternatively, he could handle the tax liability by:

(i) effectively converting the grantor trust to a non-grantor trust (a trust that pays its own taxes) before realizing the carried interest income; or

(ii) requesting reimbursement for taxes from the trust (under Revenue Ruling 2004-64).

To size the gift, Henry must calculate his core capital—the amount he conservatively needs to support lifetime spending while accounting for poor market returns, high inflation, and excess longevity. Any surplus capital beyond Henry's core capital requirement can be used to accomplish his wealth transfer objectives. Based on Henry's age, investment allocation, and future spending needs, Bernstein's forecasting determined that Henry could already secure his core capital today with his existing assets. In other words, all of his carried interest could be considered surplus capital.

26 Currently, the federal tax rate is the long-term capital gains rate (up to 23.8% federal plus state and local taxes) on carried interest held more than three years; however, the Biden administration has proposed taxing carried interest as ordinary income (up to 44.6% federal combined with other proposals).

Gift Size and Customization

To protect carried interest owners from future income tax surprises—and achieve desired wealth transfer goals—gifts must be appropriately sized. Qualified investment professionals can help quantify, forecast, and optimize strategies structured to address the following important elements and levers:

- The vertical slice strategy can be customized by selecting a percentage of assets to transfer.
- The preferred partnership strategy can be fine-tuned to provide the desired return by adjusting the amount of preferred and common interests. The value of the common may be minimized by setting the preferred interests to as much as 90% of the preferred partnership. This increases the fixed amount return to the fund manager, while decreasing the initial value of the common.
- The private derivative can be structured with a hurdle and cap to limit unintended excessive wealth transfer while allowing the owner to keep as much as desired. This optional feature offers a superior level of control and customization compared to the other strategies. Both the hurdle and the cap would effectively reduce the initial value of the derivative. However, to provide maximum wealth transfer efficiency, a hurdle without a cap would be utilized.
- Size the optimal amount of carried interest to transfer, considering future long-term taxation on the gift, future portfolio returns, and lifetime spending needs.

Charitable Strategies

Regardless of the holding period, charitable strategies can be a valuable tool for carried interest owners looking to reduce their tax bill. Recall that carried interests held less than three years are subject to short-term capital gain tax rates (ordinary tax rates as high as 40.8% for federal plus state and local tax), while interests held over three years are taxed as long-term capital gains (as high as 23.8% for federal plus state and local tax). For charitably inclined owners, the tax bill may be avoided or minimized by using certain philanthropic techniques.

Charitable gifts can be made at the partnership level—if permitted under the partnership agreement—or at the partner level through in-kind distributions. For example, a private equity fund's GP could donate shares of a portfolio company directly to charity or donor-advised fund (DAF), with each partner reporting their share of the contribution on their individual tax return.[27] Alternatively, the GP could distribute shares of a portfolio company to partners, who could then gift them directly to charity. Individual partners could also contribute partnership interests to charity. When done correctly, tax on the appreciation of the portfolio company shares or partnership interest can be avoided. At the same time, the partners should receive a charitable income tax deduction in each case, subject to certain limitations.

With that said, these strategies each have risks and drawbacks. If the partnership has debt, the gift may be subject to the bargain sale rules, which treat the release of the indebtedness resulting from the transfer to charity as a taxable event—despite the donor not receiving any cash.[28] Additionally, while the special valuation rules under Section 2701 do not apply to charitable transfers, other rules do. Specifically, the partial interest rules under Section 170 require the donor to make a gift of an undivided portion of the partnership to receive a charitable deduction.[29] In other words, for charitable gifts, a vertical slice approach may make the most sense. Finally, charities may be hesitant to accept partnership interests due to unrelated business taxable income (UBTI)—unless a sufficient cash gift is made to cover any resulting tax liability.

> **“Charitable strategies can be a valuable tool for carried interest owners looking to reduce their tax bill”**

27 IRC § 702(a)(4); Treas. Regs. § 1.702-1(a)(4).
28 Treas. Regs. § 1.1011-2(a)(3).
29 IRC § 170(f)(3).

“

Ultimately, carried interest is one of the most attractive assets to transfer outside of an estate to save significant estate taxes”

Donor-Advised Fund

Donating carried interests to a donor-advised fund before income realization provides the opportunity to accelerate a charitable deduction to the current year and avoid future taxable income, while potentially endowing future (or lifetime) charitable donations. If the interests qualify for long-term capital gains treatment, the donor's charitable deduction will be the fair market value of the interests at the time of donation. Once inside the DAF, the carried interests' profits are distributed tax-free. To maximize the deduction, the owner must have the interests appraised and donated prior to income realization. However, it's a fine line. If the interests are donated too close to income realization, the IRS may assess income tax to the original owner.

For a $1 million long-term interest donated to a DAF, the owner would receive a $1 million charitable deduction, saving up to $370,000 in federal income taxes. Once distributed, income from the carried interest is exempt from income tax, avoiding an additional $238,000 in federal tax. The owner ends up with a $1 million DAF account to direct to charities over time, effectively funded with only $392,000 net of tax benefits.

For interests under three years old, the charitable deduction is limited to the owner's cost basis—likely zero. However, for short-term interests subject to ordinary tax rates, a DAF contribution may still help avoid taxing income at a 40%+ rate. For example, a $1 million short-term interest donated to a DAF would allow the donor to direct $1 million to charities in the future while, in comparison, not making the gift to the DAF would result in only $600,000 of after-tax proceeds. Besides avoiding regular income tax, the DAF would also avoid the net investment income tax of 3.8%. Alternatively, the donor could contribute cash after receiving the $1 million pretax income, although the charitable deduction would not offset the net investment income tax and would be subject to AGI limits.

Charitable Remainder Trust (CRT)

Charitable Remainder Trusts (CRTs) help spread the tax burden from the sale of highly appreciated assets over many years. These tax-deferred charitable vehicles offer income payments to individual beneficiaries (often the grantor) for years or an entire lifetime, while the remaining assets transfer to charity at the end of the trust term.

Appreciated assets contributed to a CRT avoid immediate income taxation and defer income taxation on subsequent investment returns until distributions are made to the lifetime beneficiary. For example, a $1 million carried interest contributed to a CRT could be structured to provide a $50,000 annual payment over the beneficiary's life (5%, recalculated annually), taxed as capital gain income upon receipt. The full $1 million remains invested inside the trust, minus the distributions, and the grantor receives a partial charitable deduction for funding the trust. Without the CRT, the $1 million would be immediately reduced to $762,000 due to federal income taxes, though the owner would have full access. In contrast, the CRT beneficiary is limited to annual distributions.

Removing Carried Interest from Your Estate

For many investment fund managers, carried interest will likely become their most significant source of long-term wealth. There are several complex strategies available for those who have secured their core capital and seek ways to efficiently transfer wealth to family members while mitigating future estate taxes. These strategies, which aim to remove carried interest from an estate, require careful consultation with experienced legal, tax, and valuation professionals. You'll also need to involve investment professionals to help size and structure the appropriate parameters for any potential gift. Forecasting a gift's long-term impact in terms of potential wealth transfer, as well as income and estate tax ramifications under various scenarios, is critical to determining the optimal structure. While planning of this nature is a complex undertaking, you may ultimately transfer tens of millions of dollars with minor gift tax consequences as a result. Ultimately, carried interest is one of the most attractive assets to transfer outside of an estate to save significant estate taxes while also providing some degree of asset protection for funds held in trust.

Appendix

Vertical Slice Exception

IRC Section 2701(a)(2)(C) and the regulations thereunder offer an exception for transfers that proportionately reduce every class of equity interest held by the donor.[30] To help visualize, think of all ownership interests as a piece of cake, with the icing representing the carried interest and the cake itself representing the capital interests. The vertical slice exception is analagous to taking a full slice of the cake with every level of ownership represented. In other words, you can't only take the icing. Instead, a fund manager must transfer a proportionate amount of each class of ownership interest, which inherently includes capital interests in addition to carried interest.

To avoid the complication of maintaining pro-rata ownership percentages, a fund manager could instead transfer all her fund ownership interests to a holding company, such as a new limited liability company (LLC), with a single ownership class. The manager could then give LLC interests to desired family member or trusts. This strategy qualifies as an exception to the Section 2701 zero valuation rule when transferring interests of the same class as those retained.[31] Notably, some practitioners have expressed concern that Section 2036(a) may cause estate inclusion if the owner retains too much control over the new holding company.

Preferred Partnership—Qualified Payment Right

This strategy involves creating an LLC or other holding entity, and transferring all of the owner's fund interests, or a vertical slice of each such interest, to that entity in exchange for preferred and common interests. The owner then transfers the common interest in the new entity to or for the benefit of family members, and retains the preferred. If the retained preferred interest confers a "qualified payment right" on the holder within the meaning of Section 2701(a)(3)(B), then owner's transfer of the common should not be subject to the special valuation rules of Section 2701.

The retained preferred interest must provide a rate of return that approximates the market rate for similar securities. Typically, this rate would be higher than, say, the applicable federal rates of interest, which are tied to Treasury yields. A qualified appraiser should establish the appropriate preferred rate to ensure that it is commercially reasonable and complies with long-standing Internal Revenue Service guidance.[32] Any growth beyond the preferred return will inure to the holders of the common interests. Section 2701(a)(4) stipulates that the common interest must be worth at least 10% of the entity's total equity value.

Private Derivative

When properly structured, a private derivative contract can transfer some or all economic benefits of a carried interest, without dilution, to a fund manager's family.[33] Unlike most other strategies, private derivatives do not necessitate the physical transfer of the carried interest, arguably eliminating any Section 2701 implications. In this context, the private derivative is similar to a call option that captures future appreciation of the ownership interest.

Typically, the contract would be between the fund manager and a new or existing irrevocable grantor trust for family members. The contract terms require the fund manager to pay the trust at a future date based on the carried interest's fair market value and possibly the distribution amounts received before the settlement date. In exchange, the trust pays the fund manager an amount equal to the contract's present value of payment rights. A qualified appraiser determines the present value of the contract's right to future payment, which depends on the hurdle amount, fund volatility, interest rates, and contract term.

In structuring the contract, the fund manager can include a hurdle and cap to control the amount of wealth transferred. A hurdle only requires the manager to pay the trust if and when the carried interest exceeds a certain total return. A cap limits the total payment amount that the manager must make to the trust.

Further, the contract's term generally expires on a fixed date or the fund manager's death, whichever occurs first. If the contact expires due to the grantor's death, the contractual payment obligation is a liability of the decedent's estate. For such a liability to be deductible for estate tax purposes, it must either be limited to an amount actually paid by the estate or ascertainable with reasonable certainty.[34] The contract must be a bona fide agreement between two parties in which full and adequate consideration is exchanged for the future payment rights provided therein. Double income taxation may result if the irrevocable grantor trust becomes a non-grantor trust before the settlement date of the contract. For example, if the trust becomes a non-grantor trust due to the grantor's death, income taxation occurs

30 Treas. Reg. § 25.2701-1(c)(4).
31 IRC § 2701(a)(2)(B), Treas. Reg. §25.2701-1(c)(3).
32 Rev. Rul. 83-120, 1983-2 C.B. 170.
33 See David A. Handler, "Naked Derivatives and Other Exotic Wealth Transfers," 50th Ann. Heckerling Inst. on Est. Plan. (2016).
34 Treas. Reg. § 20.2053-1(d)(4)(i); Estate of Bailly v. Commissioner, 81 T.C. 246 (1983); Estate of Graegin v. Commissioner, T.C. Memo 1988-477.

not only on the carried interest but also on the payment between the deceased grantor's estate and the non-grantor trust.

Section 2703 generally requires that, for purposes of determining the value of certain property for transfer tax purposes, any option, agreement, or other right to acquire or use the property at a price less than its fair market value will be disregarded. If applied to a derivative in this context, the risk is that the difference between the contract price paid by the trust and the value of the carried interest at settlement will be treated as a gift.

Parallel Trusts

In this strategy, the fund manager establishes two new trusts: (i) an irrevocable grantor trust to which she transfers the carried interest; and (ii) an incomplete gift, non-grantor (ING) trust to which she transfers the balance of her interests. If properly structured, the owner arguably does not retain any of the transferred interests, so the special valuation rules of Section 2701 should not apply.[35]

Transfers Outside the Owner's Immediate Family

Transfers to or for the benefit of individuals who are not married to the owner, or who are not lineal descendants (or their spouses) of the owner, are not subject to Section 2701. Thus, for example, transfers to siblings, nieces and nephews, and the owner's nonspouse partner, whether outright or in trust, are excluded. Thus, a fund manager can avoid Section 2701 by transferring the carried interest to a trust, potentially including a grantor retained annuity trust (GRAT) established for the benefit of one or more of these individuals, since the carried interest is not deemed to have been transferred to a member of the owner's family.

35 See Treas. Reg. § 25.2701-6. Under the Section 2701 attribution rules, both the carried interest in the irrevocable grantor trust and the interests in the ING trust should be attributed to family members, not the fund manager, even though the interests in the ING trust may be subject to estate tax upon the manager's death. And since the fund manager does not hold an applicable retained interest immediately after the transfer, the special valuation rules of Section 2701 should not apply.

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