ROCKEFELLER
GLOBAL FAMILY OFFICE

JULY 2024

Preserving Prosperity
Planning with Carried Interest

Rockefeller Insights

Optimizing Estate Tax Planning with Private Equity Carried Interest

With the current gift and estate tax regime of 2017 set to sunset to historical norms[1] on January 1, 2026, renewed emphasis and attention has been placed on generational wealth transfer. Heightened exemption levels allow a unique opportunity to shift greater amounts of additional wealth to future generations through various strategies and types of trust vehicles. For individuals with private equity carried interest components on their balance sheet, proper planning with respect to the transfer of these types of interests is integral to achieving the goal of preserving a family's wealth by minimizing estate and gift taxes.

The ownership of carried interest rights provides unique wealth transfer opportunities as carried interest is speculative in nature, thereby allowing the potential to leverage gifts through low valuations on an asset that is expected to exponentially appreciate in many cases. However, Internal Revenue Code Section 2701 ("Section 2701") complicates planning with carried interest for private equity fund managers as Section 2701 can result in unintended gift tax consequences if special attention is not paid to navigating the Section's intricacies when transferring these interests to family members or trusts for their benefit. This Rockefeller Insight looks to explore a typical private equity fund structure, the complications arising from Section 2701, the vertical slice exception to Section 2701, and various strategies to effectively transfer carried interest ownership.

[1]The federal gift, estate, and Generation Skipping Transfer Tax (GSTT) exemptions were temporarily doubled from $5 million to $10 million, indexed by inflation, by the Tax Cuts and Jobs Act of 2017 (TCJA).

TRANSFER TAX LAW OVERVIEW

The TCJA effectively doubled the lifetime gift and estate tax exemption, as well as the generation-skipping transfer tax ("GSTT") exemption, that had historically been in effect prior to the law's passage. For tax year 2024, the lifetime gift, estate, and GSTT exemption amounts are $13,610,000 per individual ($27,220,000 per married couple) and these amounts will be increased for inflation through 2025. Any individual that exceeds their allowable exemption amounts is taxed federally at 40% on the excess amount.[2] Barring affirmative congressional action, on January 1, 2026, the inflation-adjusted exemption amounts are projected to reduce to approximately $7,000,000 per individual ($14,000,000 per married couple) with the estate, gift, and GSTT tax rates remaining at 40%.

Given the impending changes to the gift, estate, and GSTT exemption amounts, it is an opportune time for families to revisit their estate planning to implement wealth transfer strategies to shift assets to future generations. The increased exemption amounts are a use it or lose it opportunity and the Internal Revenue Service ("IRS") has formally published Regulations that mandates an "anti-clawback" rule in which completed gifts made by a taxpayer in a time period in which the exemption was higher than at date of death are honored.[3] While no one can predict exactly what the exemption amounts will be over the next several years as political landscapes change, it is advisable for individuals with wealth to utilize the current increased exemption amounts given under current law.

PRIVATE EQUITY VS. HEDGE FUNDS

Private equity and hedge funds are alternative investment vehicles that aim to generate returns for their investors. The two main differences are their investment focus and liquidity, though they can also differ in terms of risk profile, regulation, and fee structure.

Private Equity

Private equity firms typically invest in private companies by acquiring a controlling stake or by making a significant investment. The fund's investors commit capital and subsequently fund this commitment in periodic contributions during the fund's investment period. Thus, businesses are bought, improved over time (typically a 5–10-year timeframe), hopefully sold for a profit, and the proceeds distributed back to fund investors. Private equity funds generally have a longer investment horizon and are illiquid in nature. This makes sense. Why? It takes time for fund managers to implement their strategies, nurture the investment away from the public markets, and ultimately unlock the value of a private company. Therefore, investors are heavily constrained from selling their equity.

Hedge Funds

Hedge funds invest in a wide range of assets, including stocks, bonds, commodities, currencies, and derivatives. They aim to generate high returns as quickly as possible for their investors regardless of the market conditions by using various strategies, including long/short equity, global macro, event-driven, and arbitrage strategies. Hedge funds generally invest in the public markets and therefore are often more liquid compared to private equity funds. Investors can typically redeem their investments periodically (usually monthly or quarterly), although there may be lock-up periods or restrictions on withdrawals.

[2] State death taxes may also be imposed. Eleven (11) states impose an estate tax: Connecticut, Hawaii, Illinois, Maine, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, and Washington. The District of Columbia imposes an estate tax as well. Five (5) states have an inheritance tax: Iowa, Kentucky, Nebraska, New Jersey, and Pennsylvania. Maryland imposes both an inheritance and estate tax.

[3] IRS Final Regulation Sec. 20.2010-1(c)

KEY PLAYERS AND PRIVATE EQUITY FUND STRUCTURE

Key Players

A private equity fund is typically structured as a limited partnership ("LP"). The general partner of the LP is usually structured as a limited liability company (the "GP LLC"), with the fund manager(s) being the members (owners) and managers (operators) of the GP LLC. Through this structure, the fund managers/sponsors/GPs (hereinafter referred to as "fund manager") control the private equity fund via their control of the GP LLC.

Limited partners of the private equity fund are the investors that put up the great majority of the capital to fund the investments of the fund in exchange for a capital interest in the fund.

Investors are usually pension plans, family offices, fund of funds, sovereign wealth funds, and potentially wealthy individuals that qualify as accredited investors.[4] Often, the fund managers also invest their own capital in the fund, either through the GP LLC, or in the fund directly as limited partners, so that they have a capital interest in the fund, are subject to the same capital calls as the outside investors, and have "skin in the game." (A fund manager's investment in the fund through the GP LLC or in the fund directly, is hereafter referred to as a "fund manager's LP capital interest.")

Structure

Funds usually utilize limited partnerships and limited liability companies ("LLCs") taxed as partnerships because of two primary advantages to investors:

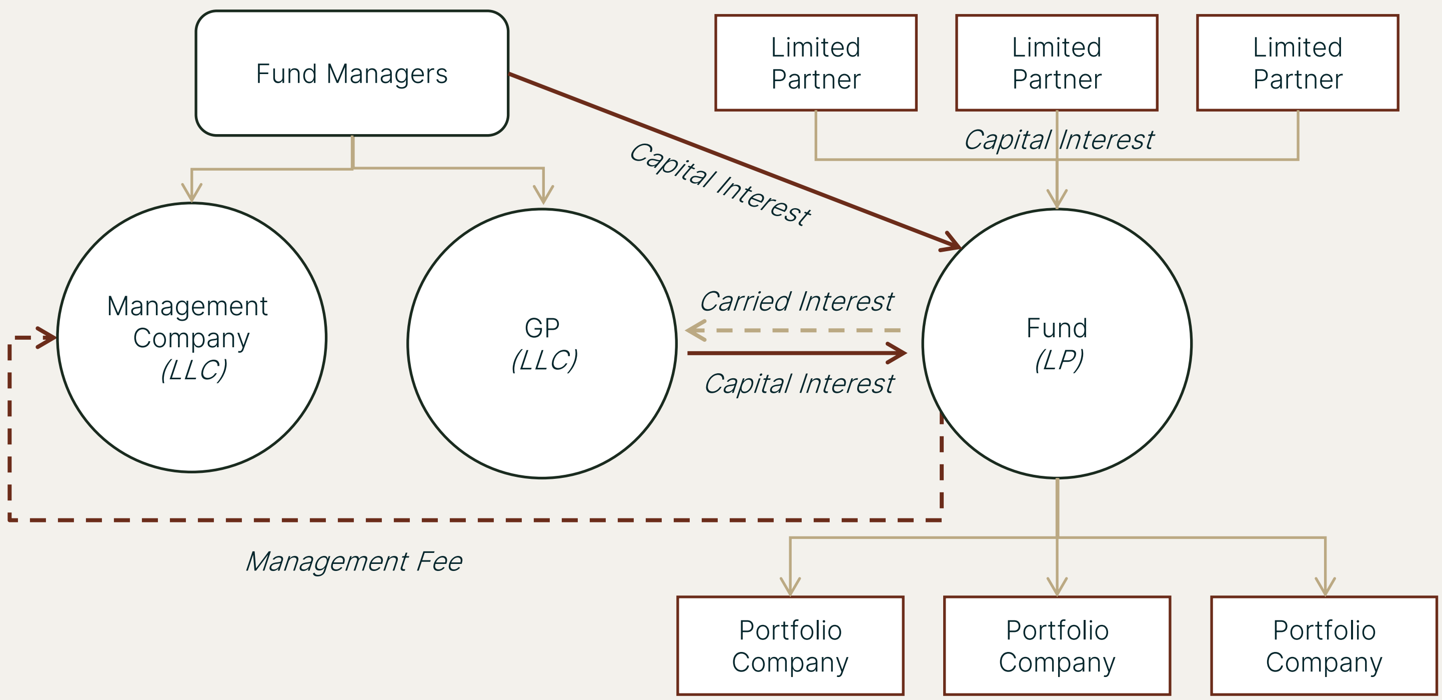
- Limited Liability – Should there be a lawsuit, the investor is only out the capital they committed to the fund. They are generally shielded from personal liability.
- Taxes – They are pass-through/flow-through entities for federal income tax purposes. This means there is no entity level tax (like a C-Corp), rather, the limited partnership's/LLC's income, credits, deductions, or losses pass through to the owners/members/investors and are reported on their individual income tax returns at their own individual income tax rates.

[4]Individuals qualify as an accredited investor if net worth is over $1 million (individually or together with spouse), excluding primary residence, or income is over $200,000 (individually) or $300,000 (with spouse) in each of the prior two years, and reasonably expect the same for the current year. – U.S. Securities and Exchange Commission.

KEY PLAYERS AND PRIVATE EQUITY FUND STRUCTURE (CONTINUED)

There is often a second LLC set up that serves as the management company for the fund that is owned by the fund managers. While limited partners and the GP LLC have a capital interest in the fund, the management company generally does not have a capital interest in the fund but acts under a formalized contract with the fund to provide operational services to the fund. As compensation for its services, the management company is typically paid a fee equal to 2% of the assets under management. Occasionally, the fund managers, as the owners of the management company LLC, will enter into a fee waiver agreement in which they relinquish their 2% compensation for managing the fund in exchange for a credit towards their LP capital interest capital call requirements.

Common Fund Structure



KEY FUND DOCUMENTS

While a comprehensive overview of all relevant private equity fund documents is beyond the scope of this Insight, it's important to have a definitional understanding of three (3) key documents – the limited partnership agreement, private placement memorandum, and subscription agreement. These documents outline much of the structure, terms, and conditions of the fund.

Limited Partnership Agreement

This is perhaps the most important document in the private equity fund formation process. It outlines the terms and conditions of the partnership between the general partner and the limited partners. It covers various aspects such as capital commitment requirements, management fees, carried interests, the distribution waterfall, governance rights, and other operational and governance matters.

Private Placement Memorandum ("PPM")

This document, also commonly referred to as the offering memorandum, is the key offering and disclosure document that provides detailed information about the fund to prospective investors (i.e., limited partners). It typically includes the investment strategy, the background and track record of the fund managers, the terms of the offering, risks involved, and other relevant information. The PPM is used to solicit investment from accredited investors.

Subscription Agreement

Otherwise known as the "Subdoc," the subscription agreement is the core agreement for the fund that sets forth all of the relevant terms and provisions as it relates to the limited partners' investment in the fund.

Through the subscription process, the investors subscribe to become limited partners and the general partner then makes the final decision as to the investor's acceptance to become a limited partner. Subscription agreements are generally covered by SEC Rules 506(b) and 506(c) of Regulation D. The stipulations define the method of conducting an offering and the amount of material information that companies are required to disclose to investors.[5] The terms set forth in the subscription agreement are important to understand before engaging in wealth transfer with equity ownership in the fund.

CARRIED INTEREST

In addition to a fund manager's LP capital interest in the fund, a fund manager also generally receives an economic interest in the fund through the GP LLC called a carried interest or a performance fee in exchange for providing services to the fund via the GP LLC. (A fund manager's economic interest in the fund through the GP LLC is hereafter referred to as a "carried interest" or "carry.") The carried interest is commonly structured as a 20% allocation of the fund's future profits above a certain hurdle rate.

The value of a carried interest is calculated based on a percentage of gains generated from the investment portfolio within the fund. A successful fund will accumulate a sizeable return over its lifecycle and make distributions amongst the GP, LLC and the limited partners in relation to those returns.

[5]U.S. Securities and Exchange Commission. "Private Placements-Rule 506(b)."

CARRIED INTEREST (CONTINUED)

The type of partner, whether the GP LLC or a limited partner, as well as the type of interest held by the partner, whether an LP capital interest or a carried interest, will dictate the priority in which such partner will receive distributions as fund investments are liquidated. The distribution formula is often referred to as the profit waterfall, which is in place to ensure that partners who invested capital into the fund have both recouped their investment and earned a return before any carried interest owned by a fund manager is paid out. As such, the capital interests of the limited partners (including a fund manager's LP capital interest) are actually the senior equity interest in the fund as they must be paid first.

The initial pool of profits is allocated to all partners who invested capital in the fund (including a fund manager's LP capital interest) up to the amount of each respective partner's investment as a return of capital. Secondly, capital interest holders (including fund manager's LP capital interest) receive a contractually agreed upon preferred rate of return, which is usually 7%-9%. The third waterfall step is usually the catch-up that is favorable to the fund managers holding carried interests as it provides them with a certain percentage of the amount distributed to the capital interest holder limited partners in the previous step. Lastly, the residuary profits are generally divided 80% to the capital interest holder limited partners (including a fund manager's LP capital interest) and 20% to the carried interest holder fund managers. The catch-up and residuary steps represent the carried interest allocated to the fund managers.

Common Profit Waterfall

Return of Capital	• 100% of distributions to LP capital interest holders until they achieve a full return of invested capital.
Preferred Return	• LP capital interest holders receive a contractually agreed upon preferred rate of return. • Rate of return is usually 7%-9%.
Catch Up	• 100% of distributions to GP until it is "caught up" to 20% of profits.
Residuary Profits	• 80% of remaining profits to LPs. • 20% of remaining profits to GPs.

CARRIED INTEREST (CONTINUED)

American vs. European Waterfall

It is important for both the GP LLC and limited partners to understand whether the fund makes distributions based on the American or European waterfall structure. The American waterfall distribution structure is favorable for fund managers while limited partners would generally prefer the waterfall to be the European variation. The American structure makes distributions according to the profit waterfall on a deal-by-deal basis which could allow for a fund manager to receive carry before a limited partner is fully paid back.

Alternatively, the European structure looks to the fund's investments as a whole, ensuring that the limited partners (including a fund manager's LP capital interest) are completely paid back before the fund manager receives their incentive carried interest compensation.

	European Waterfall	American Waterfall
Distribution Timing	Aggregate fund level	Deal by deal
Carried Interest Distribution Timing	After investors receive 100% of invested capital and preferred return	Before investors receive 100% of invested capital and preferred return
Contributions	Returned in full before GP distributed	Returned for realized investments and pro rata expense contribution
Preferred Return	Calculated based on all contributions and returned in full	Calculated and returned for realized investments and pro rata portion of expense contribution
Benefits	Investor	Manager

CARRIED INTEREST VALUATION

Carried interest is viewed as a significant source of incentive compensation for the fund managers to maximize the long-term profits of the fund, and they generally enjoy the benefit of the preferential income tax rates associated with long-term capital gains on their carried interest payments. In addition, due to the speculative nature of a return on the carried interest they receive, as well as accounting for the potential for exponential financial appreciation from its low initial value, carried interest is an ideal asset for fund managers to utilize for wealth transfer purposes.

A fundamental tenet of estate and gift tax planning is to obtain a low valuation on an asset that is to be transferred out of the donor's estate before significant appreciation takes place. Once a completed gift is made with an asset for wealth transfer purposes, any future appreciation escapes the wealth transfer regime for the donor entirely.[6] This concept of an estate reduction and freeze is why using carried interest for estate and gift tax planning is a valuable technique that many fund managers wish to take advantage of.

In order to transfer carried interest for estate and gift tax planning purposes, it is necessary to obtain a qualified appraisal of the interest to properly evaluate and structure the transfer. A qualified appraisal is also necessary to substantiate the fair market value (FMV) of the carried interest for gift tax purposes, as well as to start the 3-year statute of limitations the IRS has to audit the gift tax value of the carry. The gift tax value of a fund manager's carried interest may be low as it represents unearned profits,

[6] IRC 26 CFR §2512(a).

CARRIED INTEREST VALUATION (CONTINUED)

especially in the earlier stages of a fund's lifecycle. However, while the gift tax value may be low, the carried interest has the potential to be worth substantially more over the lifetime of the fund. The described discrepancy in current value versus potential future value further showcases the need for a qualified appraiser to determine the FMV, as well as why carried interest may be a prime asset to consider for wealth transfer planning.

Carried interest, like all other gifts, must be valued at their FMV, meaning that the interest must be valued "at the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[7] Therefore, while a fund manager may make the argument that their carry is worth nothing, that cannot be the case based on the willing buyer and willing seller methodology as the fund manager would never be willing to part with the carry for nothing as he/she understands the potential for significant appreciation.

Therefore, in order for an appraiser to be able to justify a value that could withstand audit by the IRS, the fund must be far enough along to provide legitimate and justifiable predictions about its structure, including: current value of committed capital; expected value of future committed capital; formula that governs the granting of carried interest; investor lockups; management and incentive fees, hurdle rates, high watermarks and withdrawal provisions.[8] For optimal transfer tax efficiency, the timing of fund creation and the timing of the valuation must be integrated so that the appraiser has enough information to work with, but that it is early enough in the fund timeline to create the speculation necessary to justify a lower gift tax valuation.

Once the FMV of the carried interest is established, the appraiser will be able to assess any applicable and appropriate gift tax valuation discounts for purposes such as lack of control, illiquidity, lack of marketability, etc. Taking advantage of justifiable and appropriate discounts further accelerates the impact of the wealth transfer.

IMPLICATIONS OF INTERNAL REVENUE CODE SECTION 2701 ON TRANSFERRING CARRIED INTEREST

With an understanding that the main goal of successful wealth transfer is to move assets when they have a low value before they significantly appreciate, it is often the desire of a fund manager to gift his or her carried interest to an irrevocable trust for spouse and/or descendants. Based on the fundamentals of estate planning, a fund manager who owns both an LP capital interest and a carried interest, would prefer to transfer the carry and keep the LP capital interest as this allows the shifting of the growthier asset at a lower gift tax value while keeping the piece of the fund that currently has higher value. However, the existence of Section 2701 impedes the fund manager's ability to do this in a gift tax efficient manner.

[7]IRC 26 CFR §20.2031-1(b).
[8]See generally Bruce A. Geyer, Carried Interest: Reducing the Risk of Audit, Prac. Tax Strategies (July 2014).

IMPLICATIONS OF INTERNAL REVENUE CODE SECTION 2701 ON TRANSFERRING CARRIED INTEREST (CONTINUED)

Under Section 2701, if a fund manager were to transfer his or her carry in a specific fund while retaining his or her LP capital interest in that same fund, the fund manager could be deemed from a gift tax valuation perspective to have made a transfer equal to the value of his or her entire ownership interest in the fund (LP capital interests and carried interests), which could result in a much larger transfer than anticipated and potentially result in the fund manager having to pay gift tax to the IRS.

Section 2701 was originally put into place as an effort by the IRS to thwart the abuse of value manipulation when transferring business interests to younger generations. Value manipulation was generally accomplished by the transferor retaining an interest that conferred some benefit upon them that they had control over. Given the similarities between a private family business and a private equity/hedge fund structure, fund managers are often pulled into the net of Section 2701 and must plan accordingly.

At its most basic level, Section 2701 will apply and restrict the transfer-tax efficiency of a **"transfer"** of an interest in a privately-held entity to a **"member of the transferor's family"** if the transferor, or an **"applicable family member,"** maintains an **"applicable retained interest"** in the entity immediately after the transfer.[9]

If it is found that a transfer is subject to Section 2701, the result is an increase in the value of the transfer. The value of the adjusted transfer is determined using the "subtraction method," meaning that the transfer tax value will be calculated by subtracting the value of all equity interests in the entity held by the transferor (and applicable family members) immediately after the transfer from the aggregate value of all equity interests in the entity held by the transferor (and applicable family members) immediately before the transfer.[10]

If the interest retained by the transferor (or applicable family member) is an "applicable retained interest," then the value of the of the "applicable retained interest" for transfer tax purposes is zero ($0). This results in the transfer tax value being significantly higher than expected as the transferor is treated for transfer tax purposes as transferring not only the actual transferred interest, but all "applicable retained interests" as well.

It is important to understand the definitions of the relevant terminology in Section 2701 to be able to properly identify whether the Section is applicable to an anticipated transfer of an equity interest:

- Section 2701 is only applicable when an interest is transferred to **"a member of the transferor's family"** which is defined as "(a) the transferor's spouse, (b) a lineal descendant of the transferor or the transferor's spouse and (c) the spouse of any lineal descendant of the transferor or his or her spouse."[11] For purposes of determining whether an interest is transferred to "a member of the transferor's family," attribution rules are applied to account for interests held indirectly through a trust, partnership, corporation or other entity.[12]

[9] 26 CFR §25.2701-1(a).
[10] 26 CFR §25.2701-1(a)(3).
[11] I.R.C. §2701(e)(1).
[12] I.R.C. §2701(e)(3).

IMPLICATIONS OF INTERNAL REVENUE CODE SECTION 2701 ON TRANSFERRING CARRIED INTEREST (CONTINUED)

- Section 2701 is only applicable if the transferor or an **"applicable family member"** holds a retained interest after the transfer. **"Applicable family member"** is defined as "(a) the transferor's spouse, (b) an ancestor of the transferor or of the transferor's spouse and, (c) the spouse of any ancestor of the transferor or of the transferor's spouse."[13] Just like above, attribution rules are applied in the context of an "applicable family member" to account for interests held indirectly through a trust, partnership, corporation, or other entity.[14]
- Section 2701 is only applicable if the retained interest held by the transferor (or applicable family member) after the transfer is classified as an **"applicable retained interest."** An **"applicable retained interest"** is defined as "any interest in an entity with respect to which there is (a) a distribution right, but only if, immediately before the transfer ... the transferor and applicable family members[15] hold ... **'control of the entity,'** or (b) a liquidation, put, call, or conversion right."[16]
- For purposes of Section 2701, **"control of the entity"** in the partnership context is defined as holding at least 50% of either the capital interest or the profits interest. In addition, specifically for limited partnerships, **"control of the entity"** means holding any interest in the limited partnership "as a general partner." As a result, in the case of a fund manager with a carry interest and an LP capital interest in a fund, the LP capital interest could qualify as an "applicable retained interest" for purposes of applying Section 2701.[17] Attribution rules will also apply to determine whether an entity is "controlled."
- Section 2701 uses a broad definition of **"transfer,"** which includes not only gifts of fund interests outright or in trust, but also sales of interests for full and adequate consideration, including those to irrevocable grantor trusts.[18]

In the scenario described above where a fund manager transfers his or her carried interest to an irrevocable trust vehicle for the benefit of "members of his or her family," but retains his or her LP capital interest, the transfer could trigger adverse transfer tax treatment due to Section 2701. To the extent the retained LP capital interest is appropriately deemed an "applicable retained interest," the subtraction method of valuation would apply potentially creating a scenario where the adjusted transfer tax value of the transferred carried interest would be the value of the manager's (and Applicable Family Member's) entire interest in the fund (LP capital interests and carried interests).

To illustrate, assume the fund manager has an LP capital interest valued at $10,000,000 and a carried interest in the same fund valued at $500,000.

If the fund manager gifts just the carried interest and the retained LP capital interest qualifies as an

[13] I.R.C. §2701(e)(2).
[14] I.R.C. §2701(e)(3).
[15] "Applicable family member" for purposes of determining whether an entity is controlled under Code § 2701(b) is defined in I.R.C § 2701(b)(1)(2)(C) to include any lineal descendant of any parent of the transferor or the transferor's spouse. In other words, for this purpose only, the term "applicable family member" includes junior generation family members.
[16] I.R.C. §2701(b).
[17] While certainly a nuanced area of the tax code, in many circumstances practitioners take the position that a fund manager will be treated as controlling a fund if the fund manager owns any equity interest in the general partner of the fund, even if the general partner is organized as an LLC.
[18] 26 CFR §25.2701-1(b).

IMPLICATIONS OF INTERNAL REVENUE CODE SECTION 2701 ON TRANSFERRING CARRIED INTEREST (CONTINUED)

"applicable retained interest," the value of the adjusted taxable gift would be deemed to be $10,500,000. When applying the subtraction method, the IRS would first value the fund manager's entire interest in the fund prior to the transfer, $10,500,000, and then subtract from that value the fund manager's interest in the fund immediately after the transfer. However, for purposes of the calculation, the "applicable retained interest," the $10,000,000 LP capital interest retained after the transfer, would be assigned a zero ($0) value. The resultant calculation would be $10,500,000 minus zero ($0) which equals a total adjusted gift of $10,500,000 despite the manager still retaining an LP capital interest in the fund with a fair market value of $10,000,000.

THE VERTICAL SLICE PLANNING EXCEPTION TO SECTION 2701

A "safe harbor" exception to the complex set of rules set forth by Section 2701 is the transfer of equity interests through "vertical slice" planning. Treasury Regulation § 25.2701-1(c)(4) states:

"Section 2701 does not apply to a transfer by an individual to a member of the individual's family of equity interests to the extent the transfer by that individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer."

Simply stated, if a fund manager transfers a proportional interest (a "vertical slice") of each class of interest held by him/her (and all applicable family members) in the fund (LP capital interests and carried interests), not just the carried interest, then you avoid triggering the potentially punitive valuation rules of Section 2701.[19]

The idea behind this concept is that there is no ability to shift value among classes because the fund manager still holds an equal percentage in each class of equity.

While this is not as big of the proverbial home run as the fund manager being able to transfer only his or her carried interest, the transfer of equity interests utilizing vertical slice planning can still significantly minimize estate taxes for younger generations while limiting the risk of adverse transfer tax consequences based on Section 2701. It should be noted that the LP capital interests are generally valued significantly higher than the carry, which will result in a higher transfer tax valuation associated with the vertical slice transfer when compared to a theoretical transfer of just the carry.

When attempting to utilize the vertical slice exception to Section 2701, it is important to be mindful of fund interests owned by "applicable family members" as well due to the technical requirements of Section 2701. For example, a fund manager may make a vertical slice transfer of a percentage of some or all of his or her interests in the fund entities to trusts for his or her children. If the fund manager's parent (or the fund manager's spouse's parent) continues to own an LP capital interest in the fund, then the rules of Section 2701 could still be implicated. This is

[19]Most practitioners take the stance that a fund manager does not need to transfer their ownership of the management company entity in order to remain compliant with the vertical slice planning rules as the ownership of the management company is generally not an equity interest in the fund. However, care should be given if there are fee waiver and/or offset agreements in place as the IRS could conclude that the management company/fee waiver represents an equity interest in the fund making the management company also subject to Section 2701 and required to be included in any vertical slice planning.

THE VERTICAL SLICE PLANNING EXCEPTION TO SECTION 2701 (CONTINUED)

because the fund manager, as the transferor, has made a transfer of interest (albeit an attempted vertical slice transfer as to his or her interests); however, the fund manager's parent, who is an "applicable family member," has continued to retain an LP capital interest in the fund, which would be the retention of a distribution right of a controlled entity and, therefore, an "applicable retained interest," subject to the zero valuation rule.

ACHIEVING VERTICALITY- THE HOLDING ENTITY APPROACH

Often, with vertical slice planning, a fund manager will transfer all their fund equity interests (LP capital interests and carried interests) to an LLC with a single class of equity (the "vertical slice holding entity LLC"). This approach creates the vertical slice safe harbor and makes transferability of interests easier in that you are only interacting with the fund one time to initially transfer the fund interests to the vertical slice holding entity LLC, as subsequent transfers would be of interests in the vertical slice holding entity LLC, rather than interests in the fund entities, and would not require additional fund approval.

Thereafter, the fund manager would make a transfer of an interest in the vertical slice holding entity LLC; often to an irrevocable trust vehicle. By placing the ownership of all fund equity interests within the vertical slice holding entity LLC, a transfer of a vertical slice may be achieved in a more streamlined fashion by way of a simple transfer of an ownership interest in the holding entity. In addition, going forward, this will ensure that the same proportional ownership is maintained.

Further, transfers in the future could be achieved by making additional transfers of interests in the vertical slice holding entity LLC. The creation of the vertical slice holding entity LLC could also result in additional transfer tax valuation discounts when transferring the interests of the vertical slice holding entity LLC to the irrevocable trust vehicle.

A word of caution, however. If the fund manager retains an interest in the vertical slice holding entity LLC, it is often prudent to draft the LLC operating agreement carefully to ensure that the irrevocable trust is not includible in the fund manager's taxable estate. For instance, the LLC operating agreement may allow the fund manager to make investment decisions on behalf of the entity, but in some way limit his or her ability to direct distributions from the LLC or cause the entity's dissolution.

Additional Considerations to Note

- Before making a transfer of any equity ownership interest in a fund, it is imperative that the fund manager ensures that transfers are permissible per the fund's governing documents.
- Revenue Ruling 98-21 states the transfer of unvested stock options is not a completed gift for estate tax purposes until the options become vested.[21] Often a fund agreement includes a requirement that the fund manager maintain employment with the fund in order for the manager's carried interest to vest.

  Some practitioners argue that this revenue ruling should not apply with respect to carried interest as it is an equity interest and not a property interest like stock options, but it is generally a best practice not to transfer unvested carried interests.

ACHIEVING VERTICALITY- THE HOLDING ENTITY APPROACH (CONTINUED)

Management companies often enter into a fee waiver agreement to waive the ordinary income earned by a fund manager for managing the fund and instead compensate the fund manager with a credit towards the capital commitment requirements for their LP capital interest. This offset arrangement must be analyzed before a transfer to ensure that the arrangement would not be viewed by the IRS as additional gifts with respect to future capital calls. Such an arrangement could also result in the IRS concluding that the management company/fee waiver represents an equity interest in the fund, making the management company also subject to Section 2701 and required to be included in any vertical slice planning.

- LP interests that are transferred to an irrevocable trust(s) may still be subject to capital call agreements. As such, the fund manager will be required to either gift additional funds, if possible, or loan the assets to the trust(s) holding the equity if liquidity is not available within the trust.

ESTATE PLANNING TECHNIQUES

Private equity fund managers are in a unique position to benefit from the heightened lifetime gift exemption in order to reduce the potential estate tax liability for their beneficiaries. Once a fund manager structures a transfer in a manner that doesn't run afoul of the Section 2701 valuation rules, the strategies that can be utilized to shift the equity ownership are the same strategies that are frequently discussed when analyzing wealth transfer opportunities with other assets.

Additionally, if a fund manager is philanthropically inclined, there are other strategies that this Insight does not address that the manager can employ, such as a charitable lead annuity trust ("CLAT") or a charitable remainder unitrust ("CRUT"), to transfer their carried interest while potentially providing their beneficiaries with access to the donated interests.

Gift or Sale to an Intentionally Defective Grantor Trust ("IDGT")

An IDGT is an irrevocable trust that is created for the benefit of an individual's heirs.[22] A gift to an IDGT is considered a completed gift for estate tax purposes, but it is considered "defective" for income tax purposes due to the grantor's retention of certain powers over the trust, and/or because of the relationship of certain beneficiaries of the trust to the grantor, and/or other provisions of trust.[23] The fact that the transfer is defective for income tax purposes means that the trust is not a separate tax paying entity, thus the trust's income and deductions are taxable to the grantor and transactions that occur between the grantor and the trust are not recognized or taxable.[24] The fact that the transfer is a completed gift for estate tax purposes means that the IDGT is a separate entity for estate and gift tax purposes,

[21]Revenue Ruling 98-21.

[22]An IDGT can be set up to benefit a client's spouse through a Spousal Lifetime Access Trust ("SLAT"). A SLAT will name the current beneficiary of the trust as the grantor's spouse. Therefore, while the clients are married and assuming that the beneficiary spouse does not predecease the grantor spouse, the grantor spouse will have indirect access to the funds within the trust through the beneficiary spouse.

[23]Retained powers that make a trust defective for income tax purposes include: a reversionary interest of more than 5% of the trust property or income; the power to revoke the trust and/or return the trust's corpus/principle to the grantor; the power to distribute income to the grantor or grantor's spouse; power over the beneficial interests in the trust; and administrative powers over the trust allowing the grantor to benefit.

[24]The requirement to satisfy the taxes from the grantor's taxable estate allows the trust to grow without distributions for income taxes. The payment of the taxes is essentially a "gift tax-free" annual gift to the trust.

ESTATE PLANNING TECHNIQUES (CONTINUED)

therefore the assets (and any subsequent appreciation) will not be includable in the grantor's estate at his or her death.

A gift to an IDGT utilizes the grantor's lifetime gift exemption and removes the asset and any subsequent appreciation completely from the grantor's estate.

Alternatively, a transfer can also be structured as a sale or loan to the IDGT. In this situation, the only gift that will be made would be a seed gift to the trust, which is usually 10% of the total value of the assets sold or loaned to the trust.[25] The trust would issue a promissory note to the grantor with interest charged at the then current appropriate IRS prescribed interest rate (the "applicable federal rate" of "AFR") in effect at the time of the sale or loan and provide the applicable repayment terms.

Intentionally Defective Grantor Trust ("IDGT") (Continued)

In a sale or loan situation, the value of the note owed by the trust at the time of the grantor's death is includable in the grantor's estate, but the asset value is "frozen" at the time of sale or loan and any future appreciation will not be includable in the grantor's estate. The success of a sale or loan strategy is dependent upon the growth of the asset(s) sold/loaned to the IDGT exceeding the AFR, as well as any applicable valuation discounts that are determined when the asset(s) is appraised prior to the transfer to the IDGT.

Since the vertical slice safe harbor requires that a proportionate amount of a fund manager's LP capital interest also be transferred along with their carried interest, the fund manager may not have enough lifetime gift exemption to accomplish the transfer without incurring a gift tax. However, it is still possible to accomplish the transfer by structuring it as a part-gift, that fully utilizes the fund manager's remaining lifetime gift exemption, and a part-sale, for some or all the remaining interest.

Grantor Retained Annuity Trust ("GRAT")

A GRAT is an irrevocable trust in which a grantor contributes assets while retaining the right to receive payments equal to the asset value plus the IRS prescribed interest rate of return in effect at the time of the contribution to the GRAT (the "7520 Rate"). At the expiration of the term, any remaining asset value, which is usually equal to the appreciation less interest accrued at the 7520 Rate, is passed to the beneficiary(ies). If the asset does not appreciate more than the 7520 rate and/or the grantor passes away during the trust term, the GRAT is considered failed, and the transferred asset(s) is includible in the grantor's estate.

This strategy uses little to no lifetime gift tax exemption and it enables an individual to freeze their estate by shifting the appreciation to their heirs. GRATs are a popular tactic when planning with private equity ownership interests since the equity is the type of asset that is expected to substantially appreciate in value.[26] Due to the fact that this strategy can be implemented without using lifetime

[25]A seed gift to the trust is often necessary to substantiate a proper arms'-length debtor/creditor relationship between the trust and the grantor. Alternatively, a grantor or another trust that has the same beneficiaries may guarantee the loan in order to avoid making the seed gift due to lack of liquidity or lack of remaining lifetime exemption.

[26]It is important to take into account distribution needs. If the asset does not have enough liquidity for the mandated distribution, the fund may be forced to liquidate assets to raise funds or distribute assets in-kind.

ESTATE PLANNING TECHNIQUES (CONTINUED)

gift exemption, it is often utilized by a fund manager if the qualified appraisal valuation is an amount that is prohibitive from gifting or selling the asset to an irrevocable trust or if the manager has no remaining lifetime gift exemption.

Beneficiary Defective Irrevocable Trust ("BDIT")

A BDIT, or often referred to as an Internal Revenue Code Section 678 trust, is an irrevocable trust vehicle that would allow the fund manager to maintain access to the trust assets without the inclusion of the asset in his or her taxable estate. A BDIT grants the beneficiary asset protection over the assets in the trust and "freezes" the value of the assets sold to the trust in exchange for a promissory note for estate and gift tax purposes. This makes a BDIT an attractive strategy, particularly for a fund manager that may not be married, have children, and/or have remaining lifetime gift exemption.

The initial creation of a BDIT is done through a third party, which is typically a family member, who contributes cash (usually $5,000) to the trust. The trust creator relinquishes all powers and controls over the trust that would otherwise cause the trust to be taxable to them from an income tax perspective or included in their estate. Section 678 of the Internal Revenue Code provides that if the beneficiary retains certain powers and controls over the trust, the trust will be considered a grantor trust to the beneficiary.

Similar to the IDGT described above, since the BDIT is now considered a grantor trust to the fund manager as beneficiary (as opposed to the trust creator in the IDGT strategy), the BDIT's income and deductions are taxable to the beneficiary, and there are no income tax implications to the beneficiary when engaging in transactions with the trust. Therefore, the beneficiary can "freeze" the value of assets that are expected to appreciate by selling or loaning them to the trust in exchange for a promissory note at the then current AFR rate. This transaction does not utilize any of the beneficiary's lifetime gift exemption and all appreciation of the asset above the AFR rate will be outside of the transfer tax regime. Another advantage of the BDIT being a grantor trust is that the beneficiary will be responsible for the income taxes associated with the sold/loaned assets, which will further reduce the beneficiary's taxable estate. Finally, there is also an opportunity to utilize leverage with discounts when selling assets to the trust.

In contrast to an IDGT, a BDIT gives the fund manager access to the funds as the trust document would allow for distributions to the fund manager beneficiary in an independent trustee's discretion. The beneficiary would also have the ability to gain liquidity, if needed, by calling the principal back on their promissory note for any reason. The beneficiary can serve as an investment advisor to the trust or remain in a managerial position within the company.

When using this strategy with fund managers, there may be the opportunity to avoid the application of Section 2701 altogether, allowing the fund manager to sell just his or her carried interest to the BDIT. If this is to be accomplished, it is important to ensure that the fund manager is the sole beneficiary of the trust during his or her lifetime and that any default remainder beneficiaries named in the BDIT are not "members of the transferor's family" as defined in Section 2701.

ESTATE PLANNING TECHNIQUES (CONTINUED)

Instead, the fund manager beneficiary will be granted a broad limited power of appointment that could be exercised at his or her death to appoint BDIT assets to the members of his or her family. Under this structure, no "member of the transferor's family" should be considered to own any equity interest held by the trust for purposes of Section 2701. This could allow the fund manager beneficiary to sell just his or her carried interest directly to the BDIT without invoking Section 2701 and without requiring the transfer of a vertical slice of all of his or her fund interests. The use of BDITs as a wealth transfer strategy, especially when structured to avoid the application of Section 2701, is complex and some practitioners are still wary about the legitimacy of them. It is important to work with an attorney who is well versed in the strategy so that they are able to identify potential issues.

ADDITIONAL PLANNING STRATEGIES

There are additional planning strategies that have been implemented to avoid the application of Section 2701 when making a transfer of carried interest. However, these strategies are not as common as traditional vertical slice planning.

Derivative Contracts

Planning with derivative contracts is a newer technique. Simply stated, a fund manager would sell an option to an IDGT to receive an amount that exceeds the carried interest's return, often over a specific hurdle rate, by a certain date.

The derivative would be tied to the carried interest's performance. The trust, per contractual agreement with the fund manager, would purchase a right to receive, at a predetermined future date, a payment directly tied to the carried interest value at that date. By using a derivative contract, the fund manager retains his or her LP capital interest and carried interest. The retention of all economic interests in the fund makes this an attractive strategy as it avoids potential pitfalls related to planning with carried interest and Section 2701.

Risks associated with transferring interests with a vesting schedule are also avoided by using this strategy. However, the risks related to valuation and the consequences of the IDGT potentially underpaying for the option may be riskier and more complex than the tried-and-true technique of transferring a vertical slice of equity ownership.

Side by Side Direct Investments in Portfolio Companies

Fund Managers sometimes look to make side by side investments instead of utilizing the vertical slice exception when they have significant capital invested in the fund, meaning that the potential transfer tax implications of transferring a vertical slice, including their LP capital interest, is too high. A fund manager may be able to limit this exposure by investing capital directly in portfolio companies on a side-by-side basis, as opposed to investing in the fund as a whole through their LP capital interest. The fund manager could then do wealth transfer planning with his or her direct ownership in a portfolio company, if permitted.

CONCLUSION

Utilizing carried interest in a private equity fund for wealth transfer purposes can result in a significant shift of wealth to future generations. However, this strategy does not come without complications due to the penal and complex valuation rules under Internal Revenue Code Section 2701, and potentially having to navigate and comply with the vertical slice safe harbor and the many nuanced attribution rules associated with it.

In addition, potential risks and pitfalls exist when valuing fund interests in general, and these are further amplified when planning with carried interests due to their speculative nature. It is extremely important to work with your trusted professionals and Private Advisors to review a fund's ownership structure and a fund manager's various ownership interests in the fund, before engaging in any wealth transfer with the carried interests.

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- Lack of liquidity in that there may be no secondary market for a fund;
- Volatility of returns;
- Restrictions on transferring interests in a fund;
- Potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- Absence of information regarding valuations and pricing;
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RCMID-1428079438-5850