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Estate Planning Strategies for Private Equity Fund Managers

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A manager of a private equity fund is uniquely positioned to take advantage of leveraged gifting opportunities to shift wealth to younger family members at a minimal gift tax cost. The fund manager will usually hold an interest in the fund's general partner, which in turn holds a "carried interest" in the fund—generally a 20 percent allocation of residual investment gains after prior allocations and distributions specified in the fund agreement. In a successful fund, the value of the fund manager's interest in the general partner can literally "explode" tens, if not hundreds, of times over the values in the early stages of the fund. Prior to this explosion in value, if the fund entity's governing instruments so allow, the fund manager can transfer interests in the fund's general partner to trusts or entities established for the benefit of family members to shift substantial wealth *before it has been created* out of his taxable estate and thereby provide for his descendants for generations to follow.

The keys to a successful wealth transfer plan in this context are to have a thorough understanding of the fund's complex economic arrangement and to manage the transfer tax (as well as the income tax) risks and opportunities associated with using the selected wealth transfer planning technique. As is the norm for lifetime transfers, a greater amount of wealth can be transferred to one's descendants at a low gift tax cost if one is willing to start early, when the gift tax value of the carried interests is relatively low.

This article is intended to serve as a guide to the wealth transfer planning opportunities and common carried interest planning techniques that are available to fund managers of private equity funds, and the tax risks that need to be managed in developing and implementing the wealth transfer plan. This article will first address some of the unique features of the private equity fund agreement and the various classes of equity interests that the fund manager will acquire through an ownership stake in the fund's general partner and certain affiliated entities. This article will next address some of the common carried interest planning techniques, including gifts, installment sales to grantor trusts, grantor retained annuity trusts (GRATs) and planning involving business entities. Finally, this article will consider some of the risks that

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must be assessed in structuring and implementing wealth transfer strategies involving carried interests. These risks include: (a) valuation risk (b) the risk of deemed gifts under the special valuation rules contained in Section 2701 of the Internal Revenue Code (c) certain other gift tax risks, including the risk of incomplete gifts upon the transfer of unvested interests in the fund's general partner and (d) income tax risks.

I. The Private Equity Fund Agreement

Private equity funds are investment vehicles that pool capital for investment in privately owned businesses. Although the type of fund may vary,[1] the predominate characteristic is that an investor in a private equity fund has no liquidity in the short term. Rather, investors achieve liquidity in stages as the fund disposes of its portfolio investments for cash or marketable securities and distributes the proceeds.[2]

Because a private equity fund is a privately negotiated contract among multiple participants, any given fund agreement or fund structure will therefore depart from market "norms" as necessary to reflect the specific objectives of its participants.[3] The following discussion attempts to generalize certain significant aspects of the fund structure that will influence the selection and implementation of an appropriate estate planning strategy.

The Fund

Typically, the sponsor of a direct investment fund organizes the fund[4] as a limited partnership, a limited liability company (LLC) or other form of pass-through entity for US tax purposes. The fund has a fixed life, generally seven to ten years. Upon formation, the fund solicits capital commitments from prospective investors and calls on these commitments in stages as it identifies investment candidates or otherwise as necessary to fund management fees and other expenses. Once the fund reaches a targeted level of commitments, the fund manager closes the fund to other investors. As compensation, the fund pays a periodic management fee to the fund manager equal to a fixed percentage of the total capital commitments. Once the fund reaches full investment, the base for computing the management fee shifts to "invested capital," and therefore declines as the fund disposes of investments.[5] During the "investment period," the fund invests the committed capital in portfolio companies. Distributions to investors occur as the fund either sells those investments or converts them to marketable securities. The general partner will participate in those distributions based upon its "carry percentage," which usually conveys a fixed percentage of gains over losses on fund investments, computed on an aggregate basis.[6]

The General Partner

The general partner of a private equity fund is usually a passive entity that engages in no business activity, serving as a pure holding company for the carried interest. The sponsor organizes the general partner of a fund as a pass-through entity for tax purposes. It usually contributes nominal capital to the fund (e.g., one percent of the aggregate commitments), often through an affiliated entity, for which it receives the same return as an investor (the "subscription capital" or "co-investment"). The general partner also receives a special allocation of investment gains, commonly described as a "carried interest" but occasionally as a "promote," an "override," an "incentive allocation," or a "profits

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interest." The sponsor usually sets the carry percentage at 20 percent, although this may vary from fund to fund.[7] For federal income tax purposes, the sponsor will structure the carry as a partnership allocation to pass through the character of income at the fund level to the general partner and its members, and to avoid separate entity level taxes.[8]

The Fund Manager

The fund manager manages the fund on behalf of its investors. On occasion, it provides services not only to the fund, but also to the portfolio company investees of the fund. As compensation, the fund manager receives a periodic management fee. To avoid entity-level taxes on the management fee, the sponsor usually structures the fund manager as a separate LLC or other pass-through entity.[9]

Commitments and Funding

Unlike investors in hedge funds, investors in private equity funds do not invest their entire capital commitment at once. Instead, they *commit* to invest a fixed amount of capital in stages, commonly referred to as the "investment period."[10] The general partner calls on these commitments over time, usually to fund investments but occasionally to pay management fees or other fund-level expenses.[11]

The investors usually insist that the fund sponsor fund a small percentage of the total investments of the fund, often one percent, which is frequently accomplished by creating a separate entity for that purpose. The investors require the minimum commitment to discourage excessive risk-taking by the general partner. The underlying assumption is that with its own money at risk, the general partner will be less inclined to exploit the option value inherent in the carried interest in an effort to realize a speculative gain.[12]

When the general partner calls capital, each investor must contribute its pro rata share. In practice, however, the process can be more complex because some investors will not fund in lockstep with the other investors. The "investment period" terminates after a fixed period, usually five to seven years. After the investment period, the general partner ordinarily may not call any remaining unfunded commitments.[13]

The Distribution Waterfall

The "distribution waterfall" is the economic agreement that governs the distribution of sales proceeds by the fund, whether in the form of cash or marketable securities that a fund may receive after a portfolio company has an initial public offering. Every fund distributes investment proceeds to its investors pursuant to an established set of priorities. The first priority is "invested capital," whether attributable to investment in fund portfolio investments or an allocable portion of the management fee. In most cases, the second priority is a "preferred" or "hurdle" return on that capital. If the fund provides a hurdle return, the third priority is a "catch up" distribution to the general partner. The fund then distributes any remaining proceeds, which represent residual investment gains, to the investors and the general partner with respect to its carried interest.[14]

The Carried Interest

The "carried interest" in a fund refers to the general partner's allocation of residual investment gains (usually set at 20 percent) after the prior allocations and distributions specified in the fund agreement. The general partner does not "earn" its carry until aggregate gains exceed aggregate losses. If the fund provides for a hurdle return, the aggregate gains must exceed the aggregate

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losses by more than the hurdle return.[15]

Despite this uncertainty, funds that distribute to investors and the general partner on an "investment-by-investment basis"[16] or a "realized aggregation basis"[17] (as opposed to a "full aggregation basis"[18]) allow current distributions to the general partner. This may produce excess distributions to the general partner during periods that precede liquidation of the fund. The effect of these provisions can be to reward the general partner for accelerating the sale of gain investments and deferring the sale of loss investments. To prevent this result and achieve full aggregation of gains and losses, most funds impose a "clawback" obligation on the general partner.[19]

The Clawback

To reconcile the aggregate nature of the carry with the market practice of distributing proceeds on an "investment-by-investment" or "realized aggregation" basis, most funds impose a "clawback" obligation. Assuming that the fund has properly allocated profit and loss, a general partner who contributes no capital to the fund should have a negative capital account at liquidation equal to its unearned distributions. In funds that provide for a clawback, therefore, the general partner and its members must restore those distributions, which the fund will then redistribute to the investors. In most funds, the fund agreement reduces the maximum clawback by taxes imposed (or deemed imposed) on the unearned distributions.[20]

Special Issues for Members of the General Partner

The general partner will grant an interest in the carry to its members.[21] Unlike the carry in the underlying fund, however, the interest in the general partner usually bears some form of vesting restriction. In addition, in many cases, the general partner will grant variable sharing ratios in the underlying carry to reflect the relative involvement of its employees in sourcing, negotiating and/or managing specific investments of the fund.[22]

Bifurcation Between General Partner and Fund Manager; Waiver of Management Fees

If the investment management activities of the general partner would otherwise be subject to state or local income taxes, the sponsor may choose to split the general partner and the fund manager into two separate entities, one to hold the carried interest and the other to manage the fund. The fund manager will often waive its management fees and instead receive a priority allocation on distributions.[23] This can have the effect of converting ordinary income (subject to tax at a 35 percent federal income tax rate) into capital gains (taxed at a 15 percent federal rate).[24]

II. Carried Interest Planning Techniques

A. Gifts to Irrevocable Grantor Trusts

The carried interests that fund managers hold through the general partner are ideal candidates for a lifetime gifting program — in particular, to irrevocable trusts that are structured as grantor trusts for federal income tax purposes. Let's assume that a fund manager wishes to transfer a portion of the carried interest that he or she holds through the fund's general partner to a trust that has been established for the fund manager's descendants.[25] In the early stages of a fund, the following factors may significantly reduce the federal gift tax value of the carried interest to be transferred to the trust:

1. There is uncertainty as to the subsequent capital appreciation of the

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portfolio companies that are held by the fund, and whether their return on investment will exceed the hurdle or preferred return on the capital under the fund's governing documents. As discussed earlier in this article, the carried interest is a partnership allocation (usually 20 percent) of the fund's residual investment gains. Accordingly, depending upon how the fund is structured, the fund may not make any distributions on account of the carried interest (other than tax distributions) until the hurdle or preferred return has been surmounted. This should significantly reduce the gift tax value of the carried interest transferred.

2. The carried interest may be subject to a clawback—which, as discussed above, is an obligation to restore certain excess distributions that have been made to the general partner over the course of the fund.

3. Interests in the general partner may themselves be subject to vesting restrictions and a vesting schedule.

4. Interests in the general partner should be entitled to discounts as warranted to reflect their lack of marketability and their status as a minority (i.e., non-controlling) interest.

Looking at these circumstances, the client's appraiser may determine that what the fund manager has transferred to the trust has a relatively low fair market value, say, of $100,000—and let's assume that this is the value that the fund manager would report on a gift tax return (provided that I.R.C. § 2701 does not apply, or has been adequately planned for, as later discussed in this article).

Now let's fast forward seven or eight years when the fund is ready to liquidate, and what the fund manager has transferred to the trust has grown in value to $5 million. In effect, what the fund manager has done is transfer $5 million out of his or her taxable estate at a gift tax value of only $100,000 due to the success of the fund—a leverage factor of 50 times the gift tax value of the property transferred to the trust.

The gift of carried interests would have accomplished the following:

1. Gifts remove gifted property and post-gift appreciation and income from the transfer tax system.[26] If properly structured, the full value of the property transferred to the irrevocable grantor trust (including the subsequent appreciation in the value of, and the income generated by, such property following the date of transfer) is excluded from the donor's gross estate for estate tax purposes.

2. The income generated by such property would remain taxed to the donor (the fund manager) due to grantor trust status, effectively allowing for the tax-free build-up of wealth within the trust outside of the fund manager's taxable estate.

B. Installment Sales to Irrevocable Grantor Trusts

One possible disadvantage of making *gifts* of carried interests is that, to the extent that they are not covered by the gift tax annual exclusion,[27] they cut into the fund manager's lifetime $1 million gift tax exemption, or may even generate gift tax if the lifetime exemption amount has been exceeded. In order to "reduce pressure" on the $1 million gift tax exemption and provide further leverage, the

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fund manager may instead wish to consider a sale of carried interests to an irrevocable grantor trust.

A sale transaction would involve a fund manager's sale of interests in the general partner, which holds the carried interest to an irrevocable grantor trust in exchange for the trustee's promissory note. To provide additional leverage, this can be structured as a balloon note with interest payable annually but with no payments of principal due until the note matures. This has the important benefit of reducing the use of the donor's lifetime gift tax exemption. An initial gift of "seed money" to the trust[28] of about ten percent to 15 percent of the amount of the transfer is generally recommended so that the IRS respects the promissory note as debt.[29]

As a result of grantor trust status (i) the sale transaction will not be a taxable event (ii) tax-advantageous profits interest treatment will be maintained and (iii) interest income on the trustee's promissory note will be disregarded for federal income tax purposes.[30] The full value of the trust would be excluded from the donor/fund manager's estate for estate tax purposes, although the outstanding principal amount of the trustee's promissory note (if any) at the time of the donor's death would generally be included in the donor's estate for estate tax purposes. The growth in the value of the carried interests above the interest rate on the trustee's promissory note (as determined under I.R.C. §§ 1274(d) and 7872) effectively transfers wealth to the trust free of transfer tax. Moreover, the income generated by such property would remain taxed to the fund manager for income tax purposes, allowing for the tax-free build-up of wealth within the trust outside of the fund manager's taxable estate.

C. Grantor Retained Annuity Trusts

A grantor retained annuity trust (a GRAT) can provide an excellent planning opportunity to transfer the growth potential of carried interests above the monthly IRS benchmark interest rate[31] without paying any gift or estate taxes. The GRAT is essentially simple: The fund manager (the "grantor") transfers property to an irrevocable trust (the GRAT) for a specified number of years, retaining the right to receive an annuity (a fixed amount payable not less frequently than annually). The annuity would be payable to the grantor's estate should the grantor die before the expiration of the GRAT term. Upon termination of the GRAT, the trust assets are paid to the remainder beneficiaries named by the grantor—typically an irrevocable grantor trust established for the benefit of the grantor's descendants and possibly also the grantor's spouse.[32]

The tax benefit of the GRAT therefore arises if the investments held in the GRAT (e.g., the carried interests) *outperform* the assumed interest rate used in the gift tax calculations. In such event there is a tax-free transfer to the extent of that extra performance from grantor to remaindermen.

A GRAT will often be structured to set the actuarial value of the retained annuity interest that is payable to the grantor (or to the grantor's estate if the grantor dies before the end of the annuity term) approximately equal to the gift tax value of the property transferred to the GRAT. By adjusting the duration of the GRAT, the payout of the annuity and other provisions (for example, the annuity can increase by up to 20 percent from year to

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year), the grantor may be able to create a GRAT where the gift tax value of the retained annuity interest is almost equal to the initial value of the carried interest transferred to the GRAT. In this manner, the grantor makes only a very small taxable gift upon creation of the GRAT. Because the amount of the taxable gift is very small, if the particular fund is not a great success and the carried interest transferred to the GRAT fails to appreciate in value in excess of the Section 7520 rate, the grantor will have lost little.[33]

The foregoing notwithstanding, the following should be carefully considered by the planner in advising a fund manager whether to use GRATs instead of gifts or sales to grantor trusts as an estate planning vehicle for carried interests:

First, the grantor generally must survive the term of the GRAT for the planning to be fully effective. If the grantor dies during the term of the GRAT, the IRS now takes the position that a portion of the GRAT will be included under Section 2036 in the grantor's gross estate for estate tax purposes.[34]

Second, there can be a potential liquidity crunch because a single funding of a GRAT is required due to the prohibition on additions to a GRAT after the GRAT has been established.[35] Accordingly, sufficient assets must be contributed to the GRAT all at once to fund the annuity payments to the grantor, as well as any capital commitments that will need to be made (importantly, however, the need to satisfy capital commitments can be avoided if the subscription or coinvestment interest is held through a separate entity). Further, the GRAT regulations prohibit the use of a note, other debt instrument, option or similar financial arrangement, either directly or indirectly, to pay the annuity amount due to the grantor.[36] This could require the carried interest to be returned to the grantor to help fund the annuity, which substantially reduces the leverage that can be achieved by using a GRAT. It therefore will generally be advisable to use longer-term GRATs for carried interests (e.g., five, seven or even ten years if the fund is expected to last that long) than would otherwise be employed for GRATs funded with marketable securities (for which a two-year term is often the norm).

One technique that has been suggested to help protect against this liquidity crunch is for the grantor to retain at the outset the right to revoke the GRAT. If such right were retained, there would not be a completed gift to the GRAT for gift tax purposes until the moment that the right to revoke is released or otherwise lapses.[37] This could be timed so that the "cord would not be cut" to create the GRAT for federal gift tax purposes until shortly before a liquidity event occurs (such as a sale or initial public offering of the fund's portfolio companies, to be followed by a distribution of sales proceeds or marketable securities upstream) that would both generate a substantial increase in the value of the assets held by the GRAT and provide liquidity to fund the annuity payments.[38]

Third, gifts or sales to grantor trusts may be better techniques to transfer wealth to grandchildren because the estate tax inclusion period (ETIP) rule generally prevents the grantor from allocating generation-skipping transfer (GST) tax[39] exemption to a GRAT until the GRAT term ends.[40] Thus, with a GRAT, the leveraging opportunity that is available for the gift tax is not available for the GST tax.

D. Use of Business Entities Including Family Limited Partnerships

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Family limited partnerships and limited liability companies are alternative arrangements for transferring assets to family members or to trusts. Instead of creating beneficial interests in a trust for the purpose of transferring assets, a fund manager may establish a family limited partnership or a limited liability company together with other family members and transfer carried interests to it.

A family limited partnership (FLP),[41] if properly structured and administered,[42] can provide significant tax and nontax benefits to senior and junior family members in appropriate circumstances[43] The transfer tax savings are attributable to discounts in the value of limited partnership interests or limited liability company membership interests, that are transferred to junior family members or to trusts (generally, wholly grantor trusts) established for their benefit. These valuation discounts reflect the relative lack of marketability and lack of control associated with such interests.

Where, however, the decedent (whether expressly or by implied agreement as demonstrated through a course of dealings) has retained too much control over the FLP's operations (particularly with respect to the ability to direct entity distributions), or has retained the possession or enjoyment of, or the right to the income from, the entity's property, the property transferred to the FLP may be subject to inclusion in the decedent's gross estate under Section 2036 of the Internal Revenue Code. Depending upon the circumstances, this can cause the client to be *worse off* than if had he or she had done nothing due to a potential disparity in estate tax values for gross estate and marital deduction purposes and the potential loss of (or limitation upon) a step-up in basis for both the FLP interests and the underlying FLP property.[44]

In many cases, the fund manager will not be willing to part with the degree of control necessary to ensure that a FLP strategy will be successful. Accordingly, given the substantial risks that FLP planning may present, it will often be advisable that the fund manager instead consider the gift, sale or GRAT strategies discussed earlier in this article.[45]

III. Risk Considerations to Address in Structure

A. Valuation Risk

The general rule of valuation for estate and gift tax purposes is "fair market value." Fair market value is defined as "the price at which... 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."[46]

Possible valuation approaches for carried interests may include the following:

- Speculative/liquidation value (based solely on the extent of contributed capital to the general partner—which may be zero where a separate entity is used to hold the fund manager's subscription interest)[47]
- Net asset value and option pricing models[48]
- Projected discounted cash flow models based on prior fund and industry performance[49]

The IRS may challenge the valuation assumptions made or the methodology used. Thus, there is a premium placed on estate planning techniques that permit a "self-correcting revaluation formula" to

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prevent adverse gift tax consequences if the IRS challenges the valuation.[50]

Defined value clauses may be used to reduce the valuation risk associated with gifts or sales to grantor trusts. Such a clause may provide, for example, that the amount of the transfer to the trust is X dollars as finally determined for federal gift tax purposes. Any amount in excess of X dollars as so finally determined could then pour over to one or more additional trusts (one of which could be structured as an incomplete gift trust) to reduce gift tax exposure.[51]

GRATs, in turn, offer a very easy solution to valuation risk because the Section 2702 regulations expressly require the amount of the grantor's retained annuity to be increased to take into account any IRS adjustment to the value of the property transferred to the GRAT.[52] This effectively eliminates any exposure to a material increase in the amount of the taxable gift due to a contested valuation.[53]

B. Risk of Deemed Gifts Under Section 2701

The complex rules of Section 2701 need to be considered in estate planning for carried interests. Section 2701 applies special valuation rules to determine the value for gift tax purposes of certain interests in corporations and partnerships that are transferred to members of the transferor's family. Under Section 2701, a "subtraction method" is employed to value the transferred junior equity interest, which is arrived at by subtracting the value of all family-held senior equity interests from the value of all family-held interests in the entity as determined immediately before the transfer. Significantly, for purposes of this computation, an "applicable retained interest" (which may consist of either an "extraordinary payment right" or a distribution right in a controlled entity other than a "qualified payment right") is generally valued at zero for gift tax purposes.[54] The upshot of this is that it could produce an unpleasant "gift tax surprise" whereby the full value of the family-held interests in an entity may be subject to gift tax without any offset to reflect the value of retained senior equity interests. This gift tax surprise could also occur upon an arm's-length sale to a family member for full and adequate consideration.[55]

Even if it is ultimately determined not to apply, Section 2701 is always of concern in estate planning for carried interests because the carried interest represents a "junior" class of equity, as it entitles the holder to a portion of *residual* investment gains. In contrast, the following classes of equity that are typically held, directly or indirectly, by the fund manager would be considered "senior" to the carried interest because they are preferred as to distributions or allocations:

- The fund manager's interest in any co-investment or subscription capital
- The fund manager's interest in any partnership allocation in lieu of management fees
- The fund manager's interest attributable to the general partner's catch-up allocations on any hurdle return before the carried interest becomes entitled to distributions (other than tax distributions)

The special valuation rules only apply if one of the following rights (referred to as an "applicable retained interest")[56] is retained by the transferor or applicable family members[57] immediately after the transaction:[58]

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1. A liquidation, put, call or conversion right (which are referred to as "extraordinary payment rights" in the regulations)[59]

2. A distribution right, but only if the transferor and applicable members of the transferor's family control the corporation or partnership (referred to as a "controlled entity" in the regulations)[60]

Importantly, a "controlled entity" is a corporation or partnership controlled immediately before the transfer by the transferor, applicable family members and any lineal descendants of the parents of the transferor or the transferor's spouse.[61] In the case of a corporation, control means holding at least 50 percent of the total voting power or total fair market value of the equity interests in the corporation.[62] In the case of a partnership (including a limited partnership), control means holding at least 50 percent of either the capital interests or the profits interests in the partnership.[63] In addition, in the case of a limited partnership, control also means holding any interest as a general partner.[64]

Attribution rules can cause an individual to be treated as holding an equity interest where the interest is held indirectly through a corporation, partnership, estate, trust or other entity. If an individual holds an equity interest in more than one capacity, the interest is treated as held in the manner that attributes the largest total ownership of the equity interest to the individual.[65]

As a practical matter, Section 2701 usually will *not* apply to transfers of carried interests held through the fund's general partner unless the fund manager and his family, taking into account Section 2701's attribution rules, hold or are deemed to hold a general partnership interest in the fund.[66] First, provided that there does not exist at least 50 percent deemed family ownership of the fund's general partner (or of any general partner of an entity that is serving as the fund's general partner), the transfer clearly will not involve a "controlled entity" for purposes of Section 2701.[67] This is illustrated by Private Letter Ruling 9639054,[68] in which the IRS determined that a controlled entity did not exist for purposes of Section 2701 where a corporation that served as the sole general partner of a limited partnership was 37 percent owned by family members upon applying the attribution rules under the Section 2701 regulations.[69]

Second, a fund with substantial outside investors will usually not confer any "extraordinary payment rights" for purposes of Section 2701. An extraordinary payment right is any put, call or conversion right, any right to compel liquidation or any similar right, the exercise or non-exercise of which affects the value of the transferred interest.[70] A call right includes any warrant, option or other right to acquire one or more equity interests.[71] These rights confer upon the transferor discretion over whether to receive the payments or otherwise benefit from these rights. In contrast, certain rights are not considered extraordinary payment rights and therefore will not be valued at zero under Section 2701. Specifically, mandatory payment rights,[72] liquidation participation rights (unless the transferor, members of the transferor's family or applicable family members have the *ability to compel liquidation*),[73] rights to guaranteed payments of a fixed amount under I.R.C. § 707(c), and non-lapsing conversion rights[74] are valued under normal valuation rules because they are not

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considered extraordinary payments.[75] These rights effectively give the transferor no discretion over whether to receive the payments or otherwise benefit from these rights and therefore the policy reason for applying Section 2701 to these rights (i.e., to prevent a disguised gift) does not exist.[76] Although due diligence suggests that the planner review the fund's governing legal instruments (including those of the entity that is serving as the fund's general partner), the fund entities—as a product of arm's-length negotiations—usually will not confer any extraordinary payment rights under Section 2701.[77] Accordingly, assuming that there is less than 50 percent deemed ownership of the fund's general partner (including less than 50 percent deemed ownership of any general partner of an entity that is serving as the fund's general partner), Section 2701 will usually not pose a problem in estate planning for carried interests.

How should the estate planner proceed where there is family control of the fund's general partner? There are safe harbors set forth in the Section 2701 regulations that may be employed to protect against the risk of a Section 2701 gift tax surprise. Chief among these safe harbor techniques is the so-called "vertical slice" exception.[78] Under this exception, Section 2701 will not apply where there is a transfer of equity interests to the extent the transfer proportionately reduces each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer.[79] For example, Section 2701 would not apply if the fund manager owns 50 percent of each class of equity in the LLC general partner and other affiliated entities (including in parallel funds established for tax exempt and foreign investors), and transfers a portion of each class of equity, thereby reducing each interest held by the fund manager and any applicable family members in the aggregate by ten percent.[80]

Finally, the application of Section 2701 is by no means a death knell as far as estate planning is concerned. First, certain of the cumulative preferred interests that are retained by the fund manager or applicable family members may constitute "qualified payments"—which *are* given value for purposes of Section 2701.[81] In addition, even if a preferred interest does not meet the definition of a qualified payment because it is not cumulative, the fund manager may elect to treat it for federal gift tax purposes as though it were a *qualified payment*.[82] Further, particularly in the early stages of a fund, the value of the applicable retained interests (to which Section 2701 would ascribe a zero value) may be sufficiently low so that the amount of the deemed transfer attributable to these interests would be manageable (i.e., within lifetime gift tax exemption limits).[83]

C. Incomplete Gift Risk for Transfers of Unvested Interests in the Fund's General Partner and Other Gift Tax Issues

As earlier discussed, in contrast to the carried interests that are held by the fund's general partner, a fund manager's interest *in* the general partner will often be subject to a vesting schedule. Commentators have noted the risk that the IRS may argue that a transfer of a fund manager's *unvested* interest in the fund's general partner to a trust established for descendants does not constitute a completed gift for federal gift tax purposes. The concern here is that the gift may not become complete for federal gift tax purposes until the interest transferred becomes fully

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vested. At that point, the gift tax value of the interest transferred may have significantly increased, thereby exposing the fund manager to substantial gift tax exposure.[84] The basis for this concern is Revenue Ruling 98-21,[85] which addressed the gratuitous transfer of *nonstatutory stock options*. In that Ruling, the IRS concluded that the transfer to a family member, for no consideration, of a nonstatutory stock option is not a completed gift for gift tax purposes until the *later of* (i) the transfer or (ii) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor.[86]

There are significant reasons why the IRS's analysis in the context of unvested compensatory stock options should not apply to gifts or other transfers of unvested partnership or membership interests in the fund's general partner. Importantly, there can be little doubt that a fund manager who holds a membership interest in a limited liability company that is the fund's general partner holds a substantial property interest. Even prior to vesting, he or she will be entitled to allocations and distributions from the fund's general partner, and may be able to exercise certain voting and management rights conferred under the entity's governing instruments.[87] Nevertheless, until the IRS confirms by ruling that the reasoning of Rev. Rul. 98-21 does not apply to the transfer of unvested equity interests in the fund's general partner, it may be appropriate depending upon the circumstances to prioritize the interests to be transferred for estate planning purposes so that fully vested interests are transferred first, followed by transfers of the unvested interests that will be first in line to vest.[88] By structuring the transaction in this manner, the risk (if any) posed by an unwarranted extension of Rev. Rul. 98-21 can be minimized.[89]

In addition, depending upon how the fund is structured, gift tax exposure could also result from the fund manager's waiver of its management fees where the fund manager has transferred its *subscription interest* to a trust established for the benefit of family members. As discussed earlier in this article, in order to convert ordinary income to capital gains, it is relatively common for the fund manager to waive its management fee in exchange for receiving a priority allocation in the fund's distribution waterfall. If, instead of this approach, the fund manager were to receive an offset against subsequent capital contributions on its subscription interest in exchange for its fee waiver after having previously transferred the subscription interest to a family trust, the IRS could contend that the fee waiver constitutes a disguised gift by the fund manager to the trust beneficiaries.[90] It may be possible to mitigate the gift tax consequences of the IRS's position by including *Crummey* powers of withdrawal in the trust instrument.[91]

D. Income Tax Risk

Finally, pursuant to Revenue Ruling 85-13,[92] grantor trusts can be employed to avoid income tax consequences upon the transfer of carried interests to a trust established for family members. By using an "intentionally defective grantor trust" (IDGT), the transfer will be complete and out of the fund manager's taxable estate for estate, gift and GST tax purposes, but disregarded for income tax purposes.[93] There are two corollaries to this:

First, transactions between the grantor trust and the trust owner are ignored for income tax purposes. Therefore, the fund manager's sale of appreciated property to the trust will not subject the fund

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manager (or the trust) to capital gains tax. In addition, interest on the trustee's promissory note is ignored for income tax purposes. Moreover, the transfer of a carried interest to a grantor trust will not compromise the favorable income tax treatment that profits interests enjoy.[94]

Second, all trust income (including capital gains) is taxable to the fund manager until grantor trust status is terminated. As discussed earlier in this article, this allows gifts to the trust to be further leveraged by the fund manager's payment of income taxes. Further, the fund manager's payment of income taxes attributable to the trust will not constitute an additional gift for federal gift tax purposes because the fund manager is discharging his own legal obligation.[95] *This effectively provides tax-free compounding of the assets in the trust.*[96]

Conclusion

In sum, the high growth potential of the carried interests that the fund manager holds through the fund's general partner makes these interests ideal candidates for wealth transfer planning. This article has discussed some of the estate planning techniques that may be best suited for carried interests, with the primary strategies being gifts to grantor trusts, installment sales to grantor trusts and grantor retained annuity trusts. Against this backdrop, the planner must be vigilant to protect the fund manager against valuation risks upon IRS audit and the possible application of Section 2701, particularly where the fund manager and his or her family has at least 50 percent deemed ownership of the fund's general partner (or of any entity that is serving as the general partner of the fund's general partner) or possesses certain "extraordinary payment rights." Finally, a careful analysis of the entity agreements is at all times warranted to understand the precise character of the interests to be transferred. Indeed, the estate planner should ideally be consulted in the early stages of a fund to maximize the extraordinary opportunities for wealth transfer planning that carried interests present.

Endnotes

1 The "private equity" umbrella encompasses a wide range of fund structures, including (1) venture capital funds, (2) leveraged buyout funds, (3) mezzanine funds, (4) distressed securities funds, (5) angel funds, (6) real estate funds, and (7) geographically targeted funds. For an excellent summary of certain of these fund types and discussion of private equity investments from the investor's and a trustee's point of view, *see* Douglas Moore, *Private Equity Comes of Age*, Trusts & Estates 28, at 34 (April 2006).

2 *See* Andrew W. Needham and Anita Beth Adams, *Private Equity Funds*, 735 T.M., at A-1 (2005). This is an outstanding resource on the income tax issues presented by private equity funds.

3 *See* Needham and Adams, *supra* note 2, at A-2.

4 In addition to a "direct investment fund" (which is described in the text), a private equity fund may also be structured as a "fund of funds," "parallel fund" or "hybrid fund." A "fund of funds" is an entity formed for the sole purpose of investing in other private equity funds. A "parallel fund" is formed to serve the special tax objectives of tax exempt and foreign investors. A "hybrid fund" is a fund that merges two or more of the basic prototypes within a single entity. *See id.* at A-3 – A-4.

5 *See id.* at A-3. In many cases, the fee percentage itself drops to a lower rate after the fund has invested the entire commitment. The fund pays the management fee either from contributed capital or from the proceeds of sale of its portfolio investments. *See id.*

6 *See id.* at A-3.

7 *See id.* In some funds, the carry percentage may even increase over time as the fund achieves benchmark returns on invested capital. *See id.*

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8 *See id.* Although many general partners operate as independent entities, some share affiliations with commercial or investment banks and others operate as the venture capital arm of a public company. *See id.*

9 *See id.* The sponsor bifurcates the fund manager and the general partner into separate entities to minimize local taxes and to facilitate the creation of separate interests in discrete income streams. *See id.*

10 *See id.* at A-7. The sponsor targets a level of aggregate commitments to reflect the desired size of the fund. If the fund does not receive sufficient commitments at the first closing, the sponsor may hold one or more additional closings before closing the fund to new investors. *See id.*

11 *See id.*

12 *See id.*

13 *See id.* This prohibition does not apply, however, to outstanding calls to invest in a portfolio company effective as of the termination of the investment period or to "follow on" investments. A "follow on" investment is an investment in a portfolio company in which the fund is already a shareholder. *See id.*

14 *See id.*

15 *See id.* at A-9.

16 Funds that distribute proceeds "investment-by-investment" reimburse capital and expenses allocable only to investments that have been sold by the fund. In a fund that follows this methodology, the general partner will participate in any sales proceeds in excess thereof even if the fund has realized an aggregate loss on previously sold investments. If the fund provides for a preferred or hurdle return, the general partner will not participate in distributions (other than tax distributions) until the fund achieves that return as well. Because this methodology allows the general partner to participate in sales proceeds even if the fund has yet to realize a net gain, most funds that follow this methodology impose a "clawback" when the fund liquidates. *See id.*

17 If a fund aggregates gains and losses on realized investments, the fund first distributes sales proceeds to reimburse capital and expenses allocable to the investment and then to reimburse unrecovered losses on prior sales (and, in some cases, built-in losses on retained investments). The general partner will therefore participate in distributions (other than tax distributions) only when current gains exceed the aggregate excess of losses over gains on previously sold investments. In funds that provide for a preferred or hurdle return, the general partner will not participate in distributions (other than tax distributions) until the net gains also exceed the preferred or hurdle return. Most funds that follow this methodology will impose a "clawback" when the fund liquidates. *See id.*

18 In a fund that provides for "full aggregation," the general partner will receive carry distributions (other than tax distributions) only after the fund reimburses all invested capital, not merely capital allocable to previously sold investments. In funds that provide for a preferred or hurdle return, the general partner will not participate in distributions (other than tax distributions) until the net gains also exceed the preferred or hurdle return. In a fund that adopts this methodology, the general partner may not participate in distributions (other than tax distributions) until late in the life of the fund, even if the fund realizes substantial gains. *See id.*

19 *See id.*

20 *See id.* at A-9 – A-10. Regardless of the distribution methodology (i.e*.,* investment-by-investment, realized aggregation or full aggregation), the members of the general partner will bear tax on their allocable share of the investment gains as the fund sells its investments. To address this concern, nearly every fund agreement will provide for a tax distribution that overrides the general distribution priorities. *See id.* at A-10 – A-11.

21 *See id.* at A-18. As is the case with the interest in the carry that the general partner holds in the underlying fund, this is typically structured as a profits interest to avoid current income tax consequences (as discussed later in this article) and to upstream the benefit of the capital gains preference. *See id.* at A-18 – A-19.

22 *See id.* at A-18 – A-21.

23 Alternatively, this may be structured as an offset against subsequent capital contributions that the fund manager would have to make in respect of its subscription interest in the fund.

24 *See id.* at A-22 – A-24.

25 The fund manager can serve as the investment trustee of the trust, perhaps with a trusted family friend or advisor serving as co-trustee responsible for distribution decisions. The fund manager can have the power to remove and replace the co-trustee so long as the successor

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trustee that would hold the distribution power is neither the fund manager nor a related or subordinate party in respect of the fund manager within the meaning of Section 672(c) of the Internal Revenue Code. *See* Rev. Rul. 95-58, 1995-2 C.B. 191. In addition to providing professional asset management, trusts can provide asset protection for trust beneficiaries, including protection from creditors and spouses in the event of divorce. Moreover, trusts can provide significant gift and income tax planning flexibility. Further, grantor trust treatment can cause a trust to be disregarded for income tax purposes, although out of the fund manager's estate for estate tax purposes. This allows a tax-free build up of wealth outside of the fund manager's taxable estate.

26 Not all gifts generate gift tax. The first $1 million of taxable gifts by a US citizen or resident will not generate any gift tax (this amount can be doubled to $2 million by gift splitting with one's spouse). In addition, there is a $12,000 per donee annual exclusion for gifts of present interests (this can be doubled to $24,000 per donee by gift splitting with one's spouse). The gift tax annual exclusion can be utilized for gifts in trust by using "Crummey" powers of withdrawal. *See Crummey v. Comm'r,* 397 F.2d 82 (9th Cir. 1968). Further exclusions from gift tax apply to direct payments of medical and educational expenses under I.R.C. § 2503(e).

27 *See* I.R.C. § 2503(b).

28 The amount of the taxable gift may be reduced (or potentially even eliminated) by using *Crummey* powers of withdrawal.

29 *See* Kevin Matz, *Special Concerns in FLP Planning Where Both Spouses Are Living*, 34 Estate Planning 16, at 24 (Jan. 2007); *see also* Michael D. Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?*, 32 Univ. of Miami Philip E. Heckerling Inst. on Est. Pl. ¶ 1507.1, at 15-32 (1998) (indicating that 10 percent pre-funding of the irrevocable trust should be adequate); Byrle M. Abbin, *[S]he Loves Me*, *[S]he Loves Me Not—Responding to Succession Planning Needs Through a Three-Dimensional Analysis of Considerations to be Applied in Selection from the Cafeteria of Techniques*, 31 Univ. of Miami Philip E. Heckerling Inst. on Est. Pl. ¶ 1300.1, at 13-9 (1997) (also suggesting that 10 percent pre-funding of an irrevocable trust should be adequate).

30 Rev. Rul. 85-13, 1985-1 C.B. 184. Certain aspects of grantor trust treatment (including the significance of maintaining profits interest status on certain transfers in trust of the fund manager's interests in the general partner) are discussed later in this article.

31 *See* I.R.C. § 7520.

32 In essence, the grantor creates a GRAT to transfer its *remainder* at termination. This transfer of the GRAT remainder is a taxable gift that is deemed to occur upon creation of the GRAT. The remainder is valued for gift tax purposes by subtracting the annuity retained by the grantor (and the grantor's estate) from the gross value of the property transferred to the GRAT. The Internal Revenue Service ("IRS") requires that the value of the retained annuity be calculated on an actuarial basis using an assumed interest rate published by the IRS that is in effect for the month that the GRAT is funded. *See* I.R.C. § 7520.

33 It can often be advantageous to establish multiple GRATs, each of which would be funded with a separate asset (or class of assets) to "capture" the growth above the benchmark IRS interest rate of one or more assets without having their successful performance offset by underperforming assets. This technique (known as "serial GRATs") is consistent with the theme that the GRAT is best suited for assets expected to substantially outperform the Section 7520 rate in effect for the month that the GRAT is established. Accordingly, if there is more than one fund in which the fund manager holds an interest in the general partner, the fund manager should consider establishing multiple GRATs, so that the failure to achieve returns on assets transferred to a particular GRAT in excess of the Section 7520 rate (i.e., underperformance) will not offset successful performance on another GRAT.

34 *See* Prop. Treas. Reg. § 20.2036-1(c)(2) (the portion of the GRAT that is includible in the decedent's gross estate for federal estate tax purposes is that portion of the trust corpus necessary to yield the decedent's retained annuity, taking into account the Section 7520 rate in effect at the date of death). It is imperative that the GRAT contain appropriate contingent provisions to utilize fully the federal estate tax marital deduction, if applicable. This may be done by requiring that, following the grantor's death

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survived by a spouse, the trustee shall pay annually to the holder of the annuity interest (e.g., the trustee of the QTIP trust pursuant to the grantor's estate plan) the *greater of* the amount of the GRAT annuity or the income of the GRAT.

35 *See* Treas. Reg. § 25.2702-3(b)(5); Moore, *supra* note 1, at 33.

36 *See* Treas. Reg. § 25.2702-3(d)(6).

37 *See* Treas. Reg. § 25.2702-1(c)(1).

38 *See* Edward M. Manigault and Milford B. Hatcher, Jr., *GRATs and GST Planning—Potential Pitfall and Possible Planning Opportunity*, Probate and Property 28, at 30 (Nov./Dec. 2006).

39 The GST tax generally applies to transfers that "skip" a generation, such as from a grandparent to or for the benefit of a grandchild. Very generally, its purpose is to ensure that transfer taxes will not "skip" a generation by bypassing the child's generation in favor of dispositions to grandchildren.

40 *See* I.R.C. § 2642(f); Manigault and Hatcher, *supra* note 38, at 31-33.

41 References to "family limited partnerships" are intended to include both limited partnerships and limited liability companies (as well as other similar entities) in which family members hold the partnership or membership interests.

42 *See* Matz, *supra* note 29, at 18-20.

43 There should generally be a substantial nontax purpose for establishing a FLP. This can include any of the following: (1) asset protection; (2) a joint investment vehicle for partners or members; (3) the centralized and active management of assets; (4) facilitating an investment strategy that expressly permits the retention of portfolios that are heavily concentrated in particular assets or classes of assets; (5) facilitating the establishment of a voting block through the pooling of partners' or members' voting securities of a particular issuer; (6) facilitating the raising of capital from third parties; and (7) providing a mechanism to ensure the submission to arbitration of any intra-family disputes subject to strict confidentiality provisions. *See* Matz, *supra* note 29, at 18.

44 *See* Matz, *supra* note 29, at 22 (discussing the implications of *Estate of Bongard v. Comm'r,* 124 T.C. 95 (US Tax Ct. 2005)).

45 Other strategies that may be considered beyond the scope of this article include charitable planning (including with charitable remainder trusts—which can provide a tax-free method for diversifying the fund manager's holdings—and testamentary charitable lead annuity trusts), life insurance planning and private annuities.

46 Treas. Reg. § 25.2512-1.

47 The IRS would almost certainly be inclined to challenge a valuation based on this approach.

48 In Revenue Procedure 98-34, the IRS set forth a methodology to value for gift, estate and GST tax purposes certain nonpublicly traded compensatory stock options on stock that, on the valuation date, is publicly traded on an established securities market. The Revenue Procedure provides that taxpayers may determine the value of such compensatory stock options for transfer tax purposes by using a generally recognized option pricing model (for example, the Black-Scholes model or an accepted version of the binomial model) that takes into account as of the valuation date the following factors: (1) the exercise price of the option; (2) the expected life of the option; (3) the current trading price of the underlying stock; (4) the expected volatility of the underlying stock; (5) the expected dividends on the underlying stock; and (6) the risk-free interest rate over the remaining option term. *See* Rev. Proc. 98-34, 1998-18 I.R.B.15, 1998-1 C.B. 983.
Rev. Proc. 98-34, however, does not purport to apply to partnership allocations such as carried interests—rather, it only applies to noncompensatory stock options where the underlying stock is publicly traded on an established securities market. Accordingly, its relevance would appear to be limited except by way of analogy.

49 *See* Frank W. Dubreuil, *Wealth Transfer Planning for General Partners of Venture Capital and Private Equity Funds*, at 6 (Oct. 2004).

50 This also argues in favor of obtaining a professional appraisal that can be attached to the gift tax return to help satisfy the adequate disclosure regulations so that the gift tax statute of limitations can begin to run on the transfer. *See* Treas. Regs. §§ 301.6501(e) (special adequate disclosure rules for transfers subject to Sections 2701 and 2702 of the Internal Revenue Code), 301.6501(f) (adequate disclosure rules for transfers other than those subject to Sections 2701 and 2702).

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51 *See* Jonathan G. Blattmachr and Diana S.C. Zeydel, *GRATs vs. Installment Sales to IDGTs: Which is the Panacea or are They Both Pandemics?*, 41 Univ. of Miami Philip E. Heckerling Inst. on Est.Pl. , at 1-45 n.85 (2007).

52 *See* Treas. Reg. § 25.2702-3(b)(2).

53 *See also* Blattmachr and Zeydel, *supra* note 51, at 1-17 (suggesting that the IRS may attempt to scrutinize GRATs for which the annuity payments have not been timely made within the 105-day grace period under Treas. Reg. § 25.2702-3(b)(4) and claim that such improperly administered GRATs are *void ab initio*, resulting in immediate gift tax consequences on the full value of the property transferred to the GRAT).

54 *See* I.R.C. § 2701(a)(3)(A); Treas. Reg. § 25.2701-2(a)(1), (2).

55 *See* Treas. Reg. § 25.2701-1(b)(1).

56 I.R.C. § 2701(a)(1), (b)(1).

57 An "applicable family member" is the transferor's spouse, an ancestor of the transferor or the transferor's spouse, or the spouse of any such ancestor. Applicable family members are in the same generation as or above the generation of the transferor. I.R.C. § 2701(e)(2); Treas. Reg. § 25.2701-1(d)(2).

58 There are several exceptions to the application of Section 2701. Among other things, these rules do not apply if: (1) the transferred interests are publicly traded on an established securities market; (2) the applicable retained interest is of the same class of equity as the transferred interest; (3) the applicable retained interest is of a class that is proportional to the class of the transferred interest, without regard to certain nonlapsing differences in voting rights (or, for a partnership, nonlapsing differences with respect to management rights and limitations on liability); (4) where the transfer proportionately reduces each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer (this is sometimes referred to as the "vertical slice exception"); or (5) the retained interest constitutes a right to a guaranteed payment of a fixed amount under I.R.C. § 707(c). *See* Louis A. Mezzullo, *Transfers of Interests in Family Entities under Chapter 14: Sections 2701, 2703 and 2704*, 835-3rd T.M. A-7 – A-9 (2005).

59 Treas. Reg. § 25.2701-2(b)(2).

60 Treas. Reg. § 25.2701-2(b)(5).

61 I.R.C. § 2701(b)(2)(C); Treas. Reg. § 25.2701-2(b)(5)(i).

62 Treas. Reg. § 25.2701-2(b)(5)(ii)(A). Equity interests that carry only the right to vote on liquidation, merger or a similar event are not considered to have voting rights. A voting right is considered held by any individual to the extent that the individual, either alone or in conjunction with any person, is entitled to exercise (or direct the exercise of) the right. Voting rights held in a fiduciary capacity are not considered held by the fiduciary, but instead are considered held by each beneficial owner of the interest and by each individual who is a permissible recipient of the income from the interest. A voting right does not include a right to vote that is subject to a contingency that has not occurred unless the contingency may be controlled by the individual holding the right. *See* Treas. Reg. § 25.2701-2(b)(5)(ii)(B).

63 *See* Treas. Reg. § 25.2701-2(b)(5)(iii). A "capital interest" is "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." Rev. Proc. 93-27, 1993-2 C.B. 343. A "profits interest" is any interest in a partnership *other than* a "capital interest." *Id.* A right to a guaranteed payment under I.R.C. § 707(c) is disregarded for purposes of determining whether a person holds an interest in the profits or capital in the partnership. *See* Treas. Reg. § 25.2701-2(b)(5)(iii).

64 *See* I.R.C. § 2701(b)(2)(B)(ii); Treas. Reg. § 25.2701-2(b)(5)(iii). It is not entirely clear how these rules would apply to a limited liability company (LLC), although it would *see*m likely that a member-managed LLC would be treated as a general partnership and that a manager-managed LLC would be treated as a limited partnership with the manager-members treated as general partners. *See* Mezzullo, *supra* note 58, at A-5; Lawrence M. Lipoff, *Estate Planning with Interests in Private Investment Partnerships—Advanced Planning Issues: Chapter 14 of the Internal Revenue* Code, 45 No. 1 Tax Management Memo., at 5-6 (Jan. 12, 2004).

65 *See* Treas. Reg. § 25.2701-6(a)(1); Lipoff, *supra* note 64, at 5-6.

66 It is assumed for purposes of this analysis that more than 50 percent of the fund's capital and profits interests (including for any parallel funds) is attributable to non-family members. Thus,

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the focal point of this analysis is on deemed family ownership of the fund's general partner.

67 In contrast, if, after applying the attribution rules, there is at least 50 percent ownership of the fund's general partner (or of an entity that serves as the general partner of the fund's general partner), the footing to avoid Section 2701 without resort to exceptions (such as the "vertical slice" exception, discussed *infra*) would appear to be less certain. A strong argument can nevertheless be made that deemed family ownership of interests in the fund's general partner constituting less than 100 percent ownership thereof (or less than 100 percent ownership of a general partner of the entity that is serving as the fund's general partner) is insufficient to meet the definition of control under Section 2701. Indeed, any other construction conflates holding an interest ***in*** the general partner with holding an interest ***as*** a general partner. The author, however, is not aware of any rulings addressing this issue, so this position would appear to carry some degree of audit risk if Section 2701 were not otherwise planned for.

68 PLR 9639054 (Sep. 27, 1996).

69 In determining whether a limited partnership was a controlled entity for purposes of the Section 2701 regulations, the Service took into account interests in the corporation general partner (which was the sole owner of a general partnership interest) that were held immediately before the transfer by the following persons: the transferor, the transferor's children, the transferor's children's partnership, the transferor's sibling, the sibling's children and the sibling's children's partnership. Consistent with the Section 2701 regulations, the Service did *not* take into account interests in the general partner that were held by the sibling's spouse, the transferor's cousin, the cousin's spouse, and the cousin's children's partnership. *See* PLR 9639054(Sep. 27, 1996).

70 *See* I.R.C. § 2701(c)(2)(A); Treas. Reg. § 25.2701-2(b)(2).

71 *See* Treas. Reg. § 25.2701-2(b)(2).

72 A mandatory payment right is a right to a required payment at a specific time of a specific amount. For example, a mandatory redemption right in a preferred partnership interest that requires such interest be redeemed at its fixed par value on a date certain is a mandatory payment right. A right to receive a specific amount on the death of the holder is a mandatory payment right. *See* Treas. Reg. § 25.2701-2(b)(4)(i).

73 A liquidation participation right is a right to participate in a liquidating distribution. *See* Treas. Reg. § 25.2701-2(b)(4)(ii).

74 In the case of a corporation, a non-lapsing conversion right is a non-lapsing right to convert an equity interest into a fixed number or a fixed percentage of shares of the same class (or into an interest that would be of the same class but for nonlapsing differences in voting rights). The conversion right must be entitled to proportionate adjustments for changes in the equity ownership of the corporation and to adjustments for unpaid amounts. Consequently, the value of such a right will increase or decrease as the value of the transferred interest increases or decreases. *See* Treas. Reg. § 25.2701-2(b)(4)(iv)(A).

A partner's non-lapsing right is a non-lapsing right to convert his or her equity interest into a specified interest (other than an interest represented by a fixed dollar amount) of the same class (or into an interest that would be of the same class but for non-lapsing differences in management rights or limitations on liability). The conversion right must be entitled to proportionate adjustments for changes in the equity ownership of the partnership and to adjustments for unpaid payments. Consequently, the value of such a right will increase or decrease as the value of the transferred interest increases or decreases. *See* Treas. Reg. § 25.2701-2(b)(4)(iv)(B).

75 *See* Treas. Reg. § 25.2701-2(b)(4).

76 *See* Mezzullo, *supra* note 58, at A-8.

77 Section 2701 could, however, apply if the governing instrument of the fund's general partner conferred upon the fund manager, acting together with applicable family members, the *ability to compel the liquidation* of the general partner.

78 *See* Ivan Taback and Jay D. Waxenberg, *Estate Planning for Private Equity Fund Managers*, 94, at 95-96 (Dow Jones Private Equity Analyst Conference 2006); Mark M. Christopher, *Estate Planning for Venture Capitalists*, 5-6 (Oct. 2004).

79 *See* Treas. Reg. § 25.2701-1(c)(4).

80 *See id.* This result may obtain even if the transfer does not proportionately reduce the fund manager's direct interest in each class. Rather, the testing is done by aggregating the interests of the fund manager and applicable

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family members, taking into account Section 2701's attribution rules. *See id.*

81 *See* I.R.C. § 2701(a)(3)(A); Treas. Reg. §§ 25.2701-2(a)(2), 25.2701-2(b)(6); *see also* Richard L. Dees, *Using a Partnership to Freeze the Value of Pre-IPO Shares*, 33 Univ. of Miami Philip E. Heckerling Inst. on Est. Pl. ¶ 1103.4, at 11-55 (1999) (addressing Section 2701 issues in the context of preferred partnership freezes with qualified payments). The failure to pay qualified payments in a timely manner may increase the value for gift and estate tax purposes of a transfer of an applicable retained interest that confers a qualified payment right. The increase applies when a taxable event occurs. A taxable event occurs when the transferor or an applicable family member either transfers an applicable retained interest conferring a qualified payment right or dies holding such a right. *See* I.R.C. § 2701(d)(1); Treas. Reg. § 25.2701-4(b)(1). The Code gives a grace period under which any qualified payment made within four years of its due date will be treated as having been made on the due date. *See* I.R.C. § 2701(d)(2)(A), (C). Accordingly, in order to avoid additional gift or estate tax as a result of a taxable event under Section 2701, dividends on the cumulative preferred stock must be paid within four years of their due date.

82 *See* I.R.C. § 2701(c)(3)(C)(ii); Treas. Reg. § 25.2701-2(c)(2).

83 *See* Mezzullo, *supra* note 58, at A-20.

84 *See* Taback and Waxenberg, *supra* note 78, at 96; Christopher, *supra* note 78, at 6-7.

85 Rev. Rul. 98-21, 1998-18 I.R.B. 7, 1998-1 C.B. 975.

86 According to the IRS, until the employee performs the services that cause the nonstatutory stock option to vest, "the rights that [the employee] possesses in the stock option have not acquired the character of enforceable property rights susceptible of transfer for federal gift tax purposes." Rev. Rul. 98-21, 1998-18 I.R.B. 7, 1998-1 C.B. 975. Thus, the employee "can make a gift of the stock option to [the transferee] for federal gift tax purposes only after [the employee] has completed the additional required services because only upon completion of the services does the right to exercise the option become binding and enforceable." *Id.* In the event the option were to become exercisable in stages, each portion of the option that becomes exercisable at a different time is treated as a separate option for the purpose of applying this analysis. *See id.* In the event that the donee is a skip person (within the meaning of I.R.C. § 2613(a)), the generation-skipping transfer tax would apply at the same time as the gift tax. *See id.*

87 *See* Taback and Waxenberg, *supra* note 78, at 96; Christopher, *supra* note 78, at 6-7.

88 *See* Taback and Waxenberg, *supra* note 78, at 96; Christopher, *supra* note 78, at 6-7.

89 The trade off to be balanced here is that unvested interests would presumably hold a sharply reduced value for gift tax purposes precisely because of this uncertainty of vesting.

90 *See* Taback and Waxenberg, *supra* note 78, at 96-97; Christopher, *supra* note 78, at 7-8.

91 *See* Taback and Waxenberg, *supra* note 78, at 97; Christopher, *supra* note 78, at 8.

92 Rev. Rul. 85-13, 1985-1 C.B. 184.

93 An intentionally defective grantor trust is created when one of the so-called "grantor trust" provisions set forth in I.R.C. §§ 671-679 is "violated." These provisions are designed to ensure that the income earned on the trust assets is taxed to the virtual owner. The grantor trust rules can also be used effectively as "switches;" when activated, they cause the income to be taxed to the grantor, even if he does not actually receive income pursuant to the terms of the trust. For example, grantor trust status may be triggered if the trust agreement provides that any person acting in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity, may exercise the power to reacquire the trust corpus by substituting other property of an equivalent value. *See* I.R.C. § 675(4)(C). In addition, grantor trust treatment may be obtained if a person (usually an "independent trustee" who does not have any beneficial interest in a trust and is not a "related or subordinate party" to any person having a beneficial interest in the trust) who is a "nonadverse party" in respect of the trust, acting without the approval or consent of any "adverse party" in respect of the trust, has the power to add charitable beneficiaries while the grantor is living. *See* I.R.C. §§ 674(a), 674(b)(5), 674(c). It is possible to provide the trustee with a

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release mechanism in the trust instrument to "switch" grantor trust treatment on and off from year to year, thereby permitting flexibility in income tax planning.

94 In Rev. Proc. 93-27, 1993-2 C.B. 343, the IRS set forth its position that the receipt of a profits interest for services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner is *not* a taxable event. The revenue procedure defines a "profits interest" in the negative as any interest in a partnership *other than* a "capital interest." A "capital interest" is "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." *Id.* The tax-free treatment of profits interests was later extended by the IRS to include receipt of a profits interest in a partnership even if such interest was subject to a substantial risk of forfeiture. *See* Rev. Proc. 2001-43, 2001-34 I.R.B. 191. These rules may, however, be in a state of flux as the IRS has proposed to apply the substantial risk of forfeiture provisions of Section 83 to all transfers of partnership interests for services, without maintaining any distinction between capital and profits interests. *See* Prop. Reg. § 1.704-1(b)(4)(xii) (2005); *see also* Notice 2005-43, 2005-24 I.R.B. 1221, which contains a proposed revenue procedure that would obsolete Rev. Proc. 93-27 and Rev. Proc. 2001-43.
Significantly, as it relates to the issues that are the principal focus of this article, the safe harbor for tax-free treatment of profits interests under Rev. Proc. 93-27 does not apply, among other exceptions, where a partner disposes of a profits interest within two years of its receipt. *See* Rev. Proc. 93-27, § 4.02(2). This is where grantor trust treatment saves the day because, pursuant to Rev. Rul. 85-13, a sale or other disposition of a profits interest by a partner to a wholly grantor trust would be disregarded for income tax purposes, and therefore should not result in the loss of tax-free profits interest treatment even if such transfer were to occur within two years of receipt of the profits interest.

95 *See Rev*. Rul. 2004-64, 2004-27 I.R.B. 7.

96 There should not be any income tax liability at death if the fund manager dies while the promissory note is outstanding. *See* Jonathan G. Blattmachr, Mitchell M. Gans and Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, Jnl. of Tax'n 149 (Sep. 2002) (gain will not be recognized at the death of the grantor if the note received in the installment sale of appreciated property is outstanding at death).

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