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Estate Planning for the Private Equity Fund Manager

By Alan S. Halperin, Esq.

The last issue of Private Investment Forum described the challenges and opportunities facing the private equity (or hedge) fund manager wishing to pursue estate planning. That discussion focused on strategies designed to transfer a portion of the fund manager's carried interest, when a low value (for gift tax purposes) may be justified. While the tax laws create some roadblocks, we described a solution involving a family limited partnership. In this issue, we build on those principles and describe additional estate planning techniques.

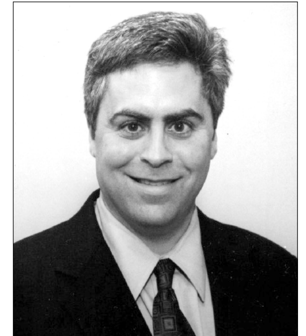
Valuation Discounts

The family limited partnership itself may permit leveraging of the tax exemption. This is so because the family limited partnership will depress the value of the transferred interest for gift tax purposes. The limited partnership interests likely will be cloaked with restrictions, such as prohibitions from withdrawing from the partnership and limitations on transfers. Those restrictions, when coupled with lack of control, could lead to handsome valuation discounts for estate planning purposes.

Grantor Trusts

To enhance the estate planning further, the fund manager may transfer limited partnership interests to a grantor trust for income (but not estate) tax purposes. In that case, the grantor (and not the trust or its beneficiaries) would pay the income tax generated by the trust, even if the income is distributed to the beneficiaries. This result provides a planning opportunity.

The trust property may grow unencumbered by the income tax. The fund manager's estate, in turn, will decline by the income tax payments. These income tax payments, under current law, should not be viewed as additional transfers subject to gift tax.



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Estate Freezes

An estate freeze is a planning technique designed to fix the value of a particular asset (for gift and estate tax purposes) at its current value, so that the future appreciation (beyond some stated return) passes to, or on behalf of, family members without an estate or gift tax.

If Section 2701* did not present a roadblock, the transfer of a carried interest, with the capital investment being retained, would be an estate freeze: the transferred interest would carry out a disproportionate share of the future appreciation, while freezing the estate at the value of the capital investment (and the growth on that capital). While Section 2701 might prevent an estate freeze via a direct transfer of the carried interest, a similar economic result could be achieved with a trust.

Sale To Income Tax Grantor Trust

The income tax grantor trust (described earlier) could purchase a limited partnership interest in the family partnership in exchange for the trust's promissory note. The purchase price would be the current fair market value of the limited partnership interest, taking into account appropriate discounts for lack of marketability and lack of control. All appreciation from the discounted value (beyond the

*Section 2701 was discussed in the first installment of this two-part series. Part one may be viewed at www.mkllp.com.

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ESTATE PLANNING...

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interest on the note) would escape a transfer tax. In effect, the value of this interest (for estate tax purposes) would be frozen at the face amount of the note plus interest on the note. The sale should not be a taxable event for income tax purposes because of the trust's grantor trust status. (However, for technical tax reasons, the sale may give rise to a remote issue as to whether the carried interest is subject to ordinary income tax.) Furthermore, so long as the fair market value of the transferred interest (after taking into account valuation discounts) equals the face amount on the note, the sale should not be a gift (provided there is adequate interest on the note). The interest payments to the fund manager on the promissory note will not be taxable income; nor will the interest payments be deductible from the trust.

Grantor Retained Annuity Trust

Another strategy would be for the fund manager to create a grantor retained annuity trust, or GRAT. Under a GRAT, the fund manager would transfer a limited partnership interest in the family partnership to a trust, while retaining a right to receive an annuity for a stated number of years. At the termination of the trust term, the trust principal remaining after satisfying the annuity payments would pass to, or on behalf of, the family members without further transfer tax.

This estate planning technique freezes the value of the transferred property - the limited partnership interest - at the economic value of the retained annuity interest. If the property appreciates at a rate higher than the assumed rate of return, that excess will inure to the benefit of the next generation free of estate or gift tax.

The taxable portion of the transfer, for gift tax purposes, would be the full value of the transferred property less the value of the retained interest. It is recommended that the GRAT be structured so that the value of the annuity interest approximates the value of the transferred assets, resulting in a zero or near zero gift.

The IRS's position, based on a Treasury Regulation, is that the gift cannot be valued at zero (because the actuarial possibility that the grantor might die prior to the expiration of the trust term must be taken into account). However, the IRS's position was rejected in a recent Tax Court case.

Comparing The GRAT To A Sale

The GRAT is similar to the sale to an income tax grantor trust. In both cases, the estate is frozen (with respect to the transferred interest), with all appreciation (beyond some rate of return) inuring to the benefit of the family without transfer tax.

With a GRAT, the fund manager receives annuity payments with a present value equal to the fair market value of the transferred interest. With a sale, he or she receives interest and principal payments on the promissory note with a current value equal to the transferred property. The sale, in many instances, will be the preferred technique.

The major hurdle with a GRAT is that it requires that the annuity payments be made every year and that the payment in any one year cannot exceed 120% of the payment in the preceding year. The GRAT structure therefore is somewhat inflexible, particularly when there is little or no cash flow in the early years.

In-kind distributions, in satisfaction of the annuity flow, are permitted. These distributions would not give rise to a taxable event. However, they would require annual appraisals, increasing the cost of the estate planning technique. (This consideration may be more of a hindrance for transfers involving private equity funds than those involving hedge funds.

In the latter case, the investments are usually marked to market, simplifying the valuation process.) In-kind distributions further would lead to the grantor's receipt of an interest with high appreciation potential. To deal with this latter point, the fund manager could re-GRAT the interest received in satisfaction of the annuity payment.

Another strategy might be to extend the GRAT term, thereby reducing the annuity payment to be made in any one year. The annuity amounts further could be laddered so that the earlier annuity obligations are more manageable (provided that an annuity in any one year is no more than 120% of the annuity in the prior year). But a longer trust term increases the possibility that the grantor might die during the trust term.

As explained below, that event would undermine the GRAT, as the trust property would be tossed back into the estate. The fund manager also might fund the GRAT with sufficient liquidity to pay the first few annuity obligations until a liquefying event (such as a sale of a portfolio company) occurs. By comparison, the note is far more flexible. It could be structured so that only interest payments are to be made in early years.

There are other factors tipping the scale in favor of a sale over a GRAT. For example, the interest charged on the

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promissory note (in respect of a sale) generally will be lower than the discount rate used to discount the value on the GRAT annuity payments. The lower rate for the note will lead to less funds being returned to the fund manager, and therefore more for the ultimate beneficiaries.

In addition, with a GRAT, the grantor must survive the trust term for the plan to be effective. By comparison, there is no survivorship requirement for the sale to be an effective planning tool. Nevertheless, it is recommended that the note be paid in full prior to death in order to remove (or at least dim) the spotlight from shining on the transaction during an estate tax audit.

"The uncertain future of the estate tax should not stop proactive planning for private equity fund mangers."

The GRAT further is not effective for making gifts to grandchildren. By comparison, a sale generally is unencumbered by those restraints. The GRAT, on the other hand, has considerable appeal, particularly where valuing in-kind distributions will not be problematic (which may be the case with hedge funds, as opposed to private equity funds).

A GRAT, with an annuity formula - such as a fixed percentage of the initial fair market value - minimizes the adverse gift tax consequences that may result from an IRS audit adjustment. No such protection is afforded to someone selling assets to an income grantor trust at a fixed price. With a sale, any upward adjustment in value (assuming a fixed purchase price) will result in a taxable gift. The GRAT, unlike the sale to an income tax grantor trust, has statutory approval.

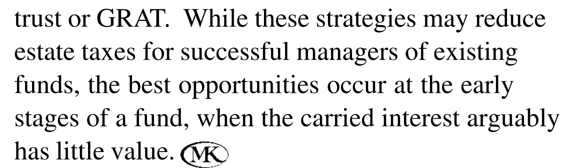
The IRS may challenge the sale as an ineffective end-around the GRAT rules. A successful IRS attack on that theory would have adverse gift and estate tax consequences. To reduce (or eliminate) that risk, the manager could fund the income tax grantor trust with assets in addition to those transferred in the sale. However, that additional funding will require a taxable gift, unless an existing income tax grantor trust already has sufficient assets. Those additional assets will be at risk if the asset acquired in exchange for the promissory note declines in value.

With a GRAT, by comparison, if the value of the transferred interest declines, the fund manager (from a tax perspective) is not harmed, because little or no gift is made in the GRAT transfer.

Conclusion

The uncertain future of the estate tax should not stop proactive planning for private equity fund mangers. Otherwise, opportunities will be lost. The uncertainty, however, does affect planning in that it encourages the use of those techniques which give rise to the payment of no (or little) gift tax.

One effective technique calls for the use of a family limited partnership, perhaps in conjunction with a sale to an income tax grantor trust or GRAT. While these strategies may reduce estate taxes for successful managers of existing funds, the best opportunities occur at the early stages of a fund, when the carried interest arguably has little value.



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