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Using Derivatives to "Transfer" Carried Interests in Private Equity, LBO and Venture Capital Funds

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You are a principal in a newly formed private equity, LBO or venture capital fund (the "Fund"). You hold a capital interest and a carried interest in the Fund through an ownership interest in the Fund's general partner (the "GP"). Your carried interest has a relatively small current value because the Fund is a speculative investment, and the carried interest will only provide a return to you after the outside investors realize a certain "hurdle" rate of return (e.g., 8%). However, if the Fund's investments are successful, your carried interest could be worth hundreds of times its current value.

In the world of estate planning, it is more tax-efficient to transfer assets (via gifts or otherwise) to children and grandchildren (or trusts for their benefit) before those assets significantly increase in value. For example, giving away $1 million of stock before an IPO that increases its value to $5 million effectively transfers an additional $4 million out of your estate free of gift and estate taxes ("transfer taxes"). Similarly, transferring your carried interest is attractive because its current value is extremely low relative to its potential future value. Compared to transferring your capital interest, a gift of carried interest provides greater potential transfer tax benefits, and also avoids the complexities involved in providing cash to the recipient to fund capital calls.

Current federal tax law allows you to give away up to $12,000 per year to as many recipients as you like, plus up to $1 million in the aggregate over your lifetime without paying any gift tax. In most cases, these gift tax exemptions are sufficient to cover a gift of a carried interest in a newly formed fund. At top marginal gift and estate tax rates of 46%, a gift of your carried interest would yield transfer tax savings of 46¢ for every $1 of post-gift appreciation.

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In addition to the transfer tax benefits, transferring your carried interest provides the following additional benefits:

1. Transferring your carried interest to a trust for the benefit of your family will protect the value of the carried interest from the claims of your and your family's future creditors, including claims of spouses should a family member divorce.

2. Creating a trust fund for your children and grandchildren while you are living allows them to currently use and benefit from the trust funds, rather than having to "wait" until your death.

3. The trust can be structured as a "grantor trust," which allows the trust assets to grow free of income taxes. Rather, you would declare all of the trust's tax items on your personal income tax return and pay income taxes for the trust. This characteristic serves to further reduce your estate and, thus, your eventual estate tax liability.

Complications

However, a direct transfer of your carried interest in the Fund poses a unique set of obstacles:

First, your carried interest may be subject to a vesting schedule. That is, only a small portion is immediately vested and the remainder will vest over time. The position of the Internal Revenue Service ("IRS") as stated in a published ruling, is that a gift of a unvested stock options is not "complete" for gift tax purposes until vesting occurs. Applied to your carried interest, a gift of unvested carried interest will become effective for gift tax purposes only when and if vesting occurs. Of course, by that time, the value of your carried interest may have appreciated greatly, resulting in a large gift and possibly requiring payment of gift taxes.

Second, due to your ownership interest in the GP, you may be considered to be in "control" of the Fund for purposes of Section 2701 of the Internal Revenue Code (the "Code"). If that Code section applies and you transfer a percentage of your carried interest and retain your capital interest (considered to be a "senior" interest relative to the carried interest), the value of the gift would be equal to the value of that percentage of your carried *and* capital interests. Thus, a gift of all of your carried interest in the Fund to a trust for the benefit of your family could result in the IRS valuing that gift at the combined value of all of your carried and capital interests in the Fund. This would result in the carried interest having a gift tax value significantly greater than its actual value. Every effort should be made to avoid this draconian provision of the Code.

While you could avoid Section 2701 by transferring a proportionate amount of your carried and capital interests in the Fund, you may not want to transfer a capital interest in the Fund either due to the complexities of funding future capital calls, or simply because you want to retain your capital and the income stream it yields. Further, your capital interest has less appreciation potential than your carried interest.

Third, your carried interest is a risky investment. If the Fund is not successful, your carried interest may turn out worthless and the portion of your gift tax exemption used to transfer your carried interest would have been wasted.

Carry Derivative

In order to avoid or minimize these issues, we have developed a method to transfer all or part of the economic benefit of your carried interest in the Fund yet allow you to retain ownership of your carried interest. At the same time, the method utilizes a smaller amount of your gift tax exemptions, reducing the risk of the Fund not being successful. Although more accurately described as a derivative, we have used the term "option" to describe this method due to its option-like features.

First, it is important to recognize that your carried interest is not like stock in a family business, where it is important that your heirs actually receive the stock. Rather, the carried interest is merely a transitory investment that will produce a cash return over the next several years. Thus, transferring the carried interest itself is not necessary and merely transferring the economic return on the carried interest will suffice.

Thus, rather than directly transferring your carried interest in the Fund, you could sell a derivative tied to the performance of some or all of your carried interest to a trust for the benefit of your family. Because the derivative is cash-settled and the carried interest itself is not transferred, all of the obstacles described above are avoided.

The following steps are involved in implementing this method of wealth transfer:

Create and Fund Trust. First, you would create an irrevocable "grantor trust." A "grantor trust" is a trust all the income of which is taxable to the grantor (i.e., you). As a result, you would report on your personal income tax return all items of income, loss, deduction, and credit attributable to the trust. Perhaps you already have such a trust in existence holding insurance on your life or other assets.

You would then transfer cash in an amount sufficient to purchase the derivative from you—unless the trust already has the funds to do so. Your transfer of cash to the trust will constitute a gift that can be sheltered from gift tax through the use of your $12,000 annual exclusions and/or $1 million federal gift tax exemption. The assets in the trust would be excluded from your estate and your spouse's estate for federal estate tax purposes. The trust could also be exempt from generation-skipping tax (GST) by allocating a portion of your GST exemption to the trust, thereby excluding the assets from your children's estates and allowing the trust assets to benefit multiple generations without additional transfer taxes.

Enter into Derivative Contract with Trust. You would then enter into a derivative contract with the trust with respect to some or all of your carried interest in the Fund. Under the contract, you would be required to pay the trust, at a stated future date, an amount based on the total return on account of the carry-- i.e., the sum of the distributions you receive and the fair value of the carried interest on that future date. If desired, the contract could have a "hurdle" amount which the total return of the carry must exceed before you owe anything to the trust.

The contract would be settled upon the earlier of its expiration date (e.g., 5, 7 or 10 years) or your death. The contract should have a term long enough to capture most of the Fund's gains (realized or unrealized), evidenced either in the form of distributions or reflected in the value of the carried interest upon settlement. Thus, the contract resembles a cash-settled option on the carried interest, where the option "premium" is the amount paid by the trust for the right to a potential future payment under the contract, and the "strike price" is equal to the hurdle amount stated in the contract (which could be zero).

The trust would pay you cash for the fair market value of its rights under the contract, using the cash it received from you via gift. In order to determine that value, a professional appraiser would determine the current value of your carried interest, and from that determine the purchase price of the derivative, taking into account the hurdle amount, the volatility of the carried interest, current interest rates and the term of the contract. In general, the longer the term, the higher the purchase price. The purchase price can be reduced by increasing the hurdle amount such that the contract is "out-of-the-money" at the time of purchase. However, a higher hurdle amount will reduce the transfer tax benefits of this technique.

Settlement. Upon settlement of the contract, you would pay the trust an amount of cash equal to the value of the carried interest referenced in the agreement, plus an amount equal to the distributions by the GP on account of the carried interest (net of any clawbacks), less the hurdle amount/strike price if any. If that sum is not a positive dollar amount, you owe nothing to the trust and retain the amount paid by the trust. In either case, you would retain your carried interest.

As an example, assume that you sell a derivative contract to a grantor trust for your children with respect to all of your carried interest in the Fund, with an eight-year term and a hurdle amount (or strike price) equal to the current fair market value of the carried interest, which a professional appraiser has determined to be worth $1 million. The appraiser also determines that the appropriate price to be paid by the trust is $350,000, which the trust would pay to you for the contract.

Assume that on the settlement date in eight years, the carried interest has generated distributions totaling $5 million and is currently worth $2 million. You would owe the trust $6 million ($7 million - $1 million hurdle). Thus, the post-contract distributions and appreciation are transferred to the trust free of transfer taxes.

If the total return from the carry is less than $1 million, you would owe nothing to the trust, resulting in a $350,000 financial loss to the trust and a loss of $350,000 of your $1 million gift tax exemption. However, in that case, a direct gift of your carried interest to the trust would have resulted in a financial loss of $1 million and a loss of your entire gift tax exemption. Thus, use of the derivative can preserve more of your gift tax exemption.

The payment from you to the trust (a grantor trust) is merely an asset transfer and will have no income tax consequences. It will not result in taxable income or gain to you or the trust because a payment by a grantor to a grantor trust is treated as made by the grantor to himself, which is a non-income taxable event.

If you die before the end of the eighth year, the contract is settled as of the date of your death, requiring payment by your estate to the trust if the contract is "in-the-money." The amount owed would be a liability of your estate that should be deductible for estate tax purposes. In this case, however, the payment by your estate to the trust upon settlement will, to the extent it exceeds the trust's basis in the option, constitute a taxable capital gain to the trust because the trust ceases to be a grantor trust upon your death. Thus, some or most of the money in the trust will have been subject to income tax twice: once when received by you from the Fund and once when received by the trust in settlement of the contract after your death. However, given that current capital gain tax rates are significantly less than the estate tax rates to which the assets would otherwise be subject, this will likely be a more efficient outcome than simply terminating the contract at your death without settlement.

Benefits

By using the carry derivative contract, the complications associated with transferring your carried interest in the Fund are largely avoided. First, the fact that your carried interest is unvested is irrelevant since throughout the term of the contract, you will continue to own your carried interest. Even upon settlement of the contract, you will retain your carried interest and simply transfer cash to the trust.

Second, since you will retain both your carried and capital interests in the Fund, the provisions of Code Section 2701 should not apply. There will be no need to make a proportionate transfer of your capital interest nor gifts or loans to the trust in order to fund associated capital calls.

Third, because a derivative on the return from your carried interest is worth less than your carried interest itself, the derivative will require use of less of your gift tax exemption. Thus, in the event the Fund is unsuccessful, the carry derivative will minimize the loss of your gift tax exemption.

Fourth, the derivative will allow you to leverage your gift tax exemption and transfer a greater amount of the economic benefits of your carried interest. For example, your gift tax exemption will allow you to transfer $1 million of carried interest without gift tax. However, assuming the cost of the derivative is one-third of the value of the carry, the same $1 million exemption will allow you to transfer the economic benefits of roughly $3 million of carried interest.

Fifth, the potential gift tax due to valuation inaccuracies is reduced using the derivative. Because the derivative will have a significantly lower value than the carried interest, if the IRS argues that the value is, say, 20% greater than that determined by the appraiser, the resulting taxable gift will be significantly less than if the IRS argued that a gift of the carried interest itself was undervalued by 20%. For example, if the carried interest is worth $1 million and a derivative on the carried interest is worth $350,000, a 20% increase in the value of the carried interest results in a $200,000 taxable gift while a 20% increase in the value of the derivative results in a $70,000 taxable gift.

Lastly, the derivative can be tailored in almost any fashion to fit your personal wealth transfer objectives. The "hurdle" amount of the derivative can be set at any value to allow you to retain the first dollars produced by the carried interest (e.g., a $5 million hurdle would ensure that you receive the first $5 million produced from the carried interest). The appreciation of the carried interest over and above that amount would pass to a trust for your family. If you are concerned about over-funding the trust, the derivative could provide for a dollar cap on the trust's share of appreciation.

Risks

There are both financial and tax risks associated with the carry derivative. First, you may not have the liquidity to cash-settle the contract upon its termination either because (i) the carried interest is very valuable and significant distributions have not yet been made; (ii) you have suffered losses in your own investments; and/or (iii) you have left the Fund and lost the portion of your carried interest which was not vested, causing you to owe more to the trust than you receive (the amount of carried interest referenced in the contract is fixed, and is not dependent on the amount of carried interest you actually own). In such an event, the trustee could agree to accept other property in lieu of cash, such as a promissory note.

Second, after the contract is settled, you may have to repay to the Fund distributions previously received under the terms of the Fund's operating agreements (a clawback). In that event, the trust would not have to repay you the amounts you repaid to the Fund.

Third, as discussed above, the trust entering into the derivative contract has financial risk. The carried interest may not produce significant distributions (or perhaps any distributions) and may not appreciate in value, resulting in a financial loss the trust of the amount paid for the contract.

Lastly, the IRS could argue that, at the time the contract was entered into, the value of the contract was greater than the amount paid by the trust, resulting in a gift of the difference (and possibly gift tax due). This could occur because either the IRS does not agree with the appraised value of the carried interest referenced in the contract, or the IRS does not agree that the pricing of the contract properly reflects its value. Further, if the trust is considered to have paid an insufficient amount for the contract, your estate's liability to the trust will not be deductible under Code Section 2053 to the extent of such underpayment if you should die during the contract term. To minimize this risk, a professional appraiser should be engaged to value the carried interest and price the contract. However, as explained above, this valuation risk is less than it would be than if you transferred carried interest directly.

Conclusions

Carry derivative contracts are revolutionalizing the manner in which principals of private equity, LBO or venture capital funds transfer the wealth produced by their carried interests. Tax issues and risks are eliminated or reduced, and the contracts can be tailored to fit one's personal financial objectives. Moreover, you don't need to make additional gifts and loans to provide your trusts with funds to pay capital calls and fund managers don't need to deal with family trusts as additional partners. Overall, they are a simpler, more efficient method of wealth transfer.

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