Morgan Stanley

Estate Planning for Investment Fund Principals

Estate Planning Strategies

Wealth and Estate Planning Strategists
Family Office Resources

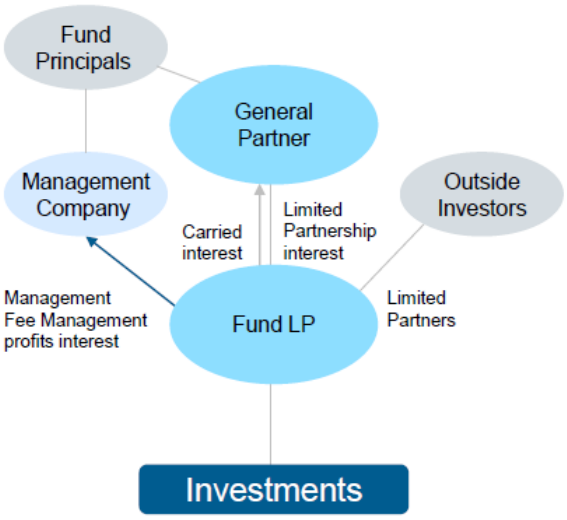
Private investment funds are attractive assets to incorporate into an estate planning gifting strategy because they are often very low value at initial creation of the fund but have a high growth potential, which can help maximize the use of a fund principal's lifetime federal gift and estate tax exclusion. They also may be, or will be, a significant portion of a fund principal's overall wealth, who may not have other assets they can gift to reduce their estate for federal estate tax purposes. Before pursuing gifting of investment fund interests, however, it's important for a fund principal to understand the particular complexities surrounding gifting fund interests, including the Internal Revenue Code section 2701 "vertical slice" requirement, income tax, and securities law restrictions. Once the complexities are addressed, there are a number of techniques available for transferring interests, including Grantor Retained Annuity Trusts, sale to an Intentionally Defective Grantor Trust, partnership freeze, and carry derivative planning.

Common Fund Structure and Interests

A private investment fund involves multiple investors pooling their capital, which is typically managed by a third party. An investment fund principal typically owns a capital interest and carried interest, and they may also have a management profits interest separate from the carried interest.

A capital interest is typically equivalent to the amount of the principal's investment into the fund. A carried interest is generally the right to share in the profits, disproportionate to the principal's capital interest, and is almost always paid to the general partner in consideration for its services. For example, a general partner may have contributed 5% of the investment capital, but receive 20% of the profits.

The following is a common fund structure:



Complexities

Internal Revenue Code Section 2701

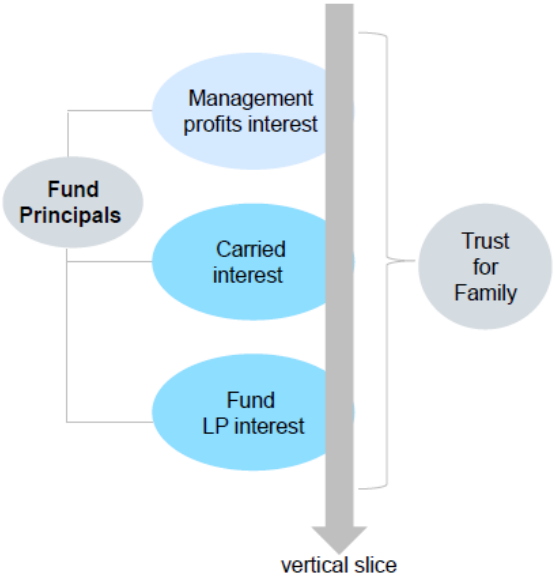
Carried interest is an attractive asset to gift, as it has potential for significant appreciation and, at least in the early stages of a fund when there is limited to no performance history to factor into a valuation, the value of the potential gift is low, compared to its potential future value.

However, Internal Revenue Code section 2701 ("Section 2701"), which was designed to address potentially abusive estate planning transactions with closely held businesses, can pose a roadblock to gifting a carried interest. Under Section 2701, when a transferor and/or certain family members retain an interest in an entity after transferring equity interests in that entity to members of the transferor's family, a special gift tax valuation applies that can deem the amount retained by the transferor to be zero, rather than the portion they purport to retain, which can cause a much larger gift for gift tax purposes than intended by the transferor.

Under Section 2701, if the principal transfers only their carried interest, and if the fund is deemed to be controlled by the principal and/or the principal's family, the punitive federal gift tax consequences may result in no deemed retained interest, resulting in a much larger gift than intended.

Vertical Slice Exception

An exception to Section 2701—referred to as a "vertical slice"—avoids punitive results by requiring fund principals to transfer a proportionate share of each class of equity interests in the fund.



There are generally two approaches to achieving a vertical slice: (1) transferring a proportionate amount of each class of interest or (2) creating a holding entity for all interests and transferring a portion of the holding entity. Transferring a proportionate amount of each class of interest achieves the vertical slice goal but can be cumbersome to coordinate. For example, if the fund structure or ownership interests later shift, there's the risk that the proportionate interests are disrupted, which could constitute a transfer for Section 2701 purposes and trigger unanticipated gift tax consequences. Additionally, it may be more difficult to achieve accredited investor and qualified purchaser status (discussed further below).

The alternative, creating a holding company like an LLC or limited partnership as a single-class entity, allows the transfer of the vertical slice of some, or all, of the fund principal's interest in each interest class to the holding company, which is then gifted. The holding company technique can simplify the initial and future transfers and maintain proportionate ownership to avoid risking future transfers that trigger Section 2701.

Non-Vertical Slice Planning

The vertical slice approach is generally considered the simplest way to avoid application of Section 2701. There are, however, alternative approaches that, when structured appropriately under Section 2701, may allow for the transfer of non-vertical interests. Please see the sections below entitled Partnership Freeze and Carry Derivative Planning.

Federal Income Tax Considerations

Under reforms made in the 2017 Tax Cuts and Jobs Act, certain profit interests (including most carried interests) must be held for more than three years in order to receive preferential long-term capital gains treatment, rather than being taxed as short-term capital gains if disposed of within three years. The legislation specifically and intentionally targeted profit interests deriving from investment funds (i.e., private equity funds and hedge funds).

As the statute specifically applies to both the taxpayer who performs the services for the fund and "other related persons" (generally defined as spouses, children, grandchildren,parents and entities that perform

services for the fund) to the taxpayer, related persons who receive a gift of a profits interest from the performing taxpayer also have a three-year holding requirement to receive long-term capital gains treatment.

If a profit interest is subject to a vesting schedule, the interest is considered received for purposes of the holding period on the date the interest is granted, not on the vesting date, in contrast with the treatment of stock interests which do not start the clock on long term capital gains treatment until the stock interest vests or an IRC section 83(b) election is made.

However, if an unvested profit interest is gifted, the gift is generally not deemed a "completed" gift until the profit interest actually vests, often at a much higher value on the later vesting date, which can cause a larger than intended gift of an often-unpredictable amount. Due to the unpredictable and possibly unlimited gift value, caution is warranted when considering gifting unvested profit interests.

Securities Law Restrictions

Securities laws can be complex and complicated, and a full review of the relevant laws is beyond the scope of this white paper. It's important for the principal's estate planning attorney and fund counsel to work together on any gifting plan to ensure the plan does not run afoul of securities laws.

An interest in a hedge fund or private equity fund is considered a security and subject to regulation[1]; however, an interest in the entity that serves as the general partner or management company may not be. A principal will want to work with their fund counsel to determine whether that interest is subject to securities restrictions.

Generally, any estate planning vehicle should be an accredited investor and a qualified purchaser. In the context of a trust, an accredited investor is defined under Regulation D Rule 501 as

- A trust whose trustee is a bank or savings and loan association (or similar financial institution) and which must control the decisions regarding the purchase of the relevant securities;
- Any trust, with total assets greater than $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person; or
- A revocable trust or a certain type of irrevocable grantor trust (a grantor retained annuity trust) whose grantor is an accredited investor.[2]

A trust is considered a qualified purchaser if:

- The trust's grantor and trustee are qualified purchasers;
- The trust's grantor and trustee are knowledgeable employees who make all the decisions with respect to the trust's investments;
- The trust owns or manages, for its own account or the accounts of other qualified purchasers at least $25,000,000 in investments, in the aggregate; or
- The trust has at least $5,000,000 in investments and was established by, or for the benefit of, two or more persons who are related as siblings, spouses, or direct descendants, spouses of such persons, estates of such persons, and charitable organizations and trusts established by or for the benefit of such persons.

Additionally, if a trust receives a fund interest as a gift from a qualified purchaser, the trust itself is treated as a qualified purchaser as long as it's not required to make additional capital contributions.

Notes:

[1] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[2] Herbert S. Wander, SEC No-Action Letter (Oct. 26, 1983).

Transfer Techniques

Timing

As with gifting strategies in general, it's often best to gift earlier rather than later in the life of a fund. Though an appraisal of a fund interest in its first few years generally must incorporate estimated performance in the valuation, there has not yet been a pattern of actual performance that must be factored into the value. This means that, for a successful fund, it's likely that the early-stage appraisal will be significantly lower than a later stage appraisal when the fund has a pattern of success.

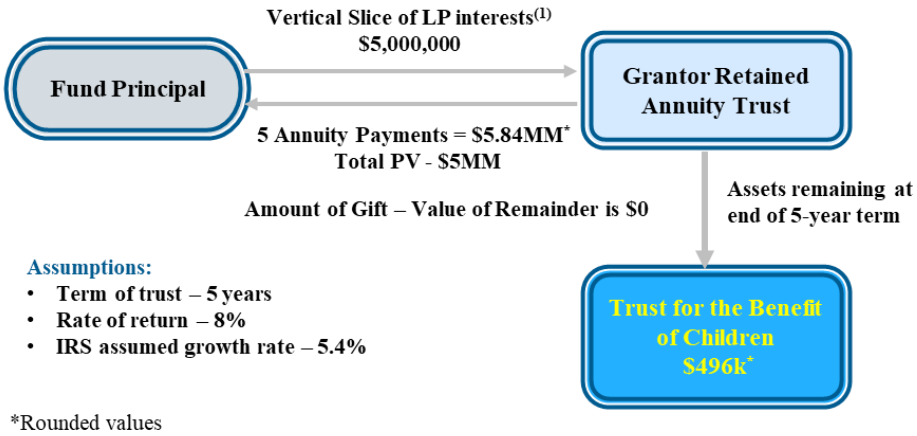
However, caution must be used in making gifts or transfers early in the fund to avoid the income tax issues discussed above, particularly when the fund principal's interests vest over time.

Grantor Retained Annuity Trust

A Grantor Retained Annuity Trust ("GRAT") is designed to move the appreciation on an asset outside of the grantor's estate, using little to none of the grantor's lifetime estate and gift tax exclusion. The original principal given to the trust comes back to the grantor with interest via annual annuity payments (valued using an IRS prescribed interest rate), and any growth above the interest rate is distributed at the end of the GRAT term to beneficiaries chosen by the grantor at the time the GRAT is created. GRATs are most often used when interest rates are low and the donor assumes that the asset transferred will appreciate more than the required interest rate. For a deeper discussion of GRATs, please see our separate white paper.

Using the GRAT technique requires an appraisal of the vertical slice at the time of contribution and, if the annuity payment is made in-kind, annual appraisals to determine the annuity payment, which may be costly, depending on the difficulty of valuing the fund's assets and the transferred share. Additionally, there is mortality risk that if the fund principal dies during the GRAT term, some or all of the GRAT assets will be included in the principal's estate for federal estate tax purposes.

Below is a diagram depicting a GRAT transaction with a $5,000,000 vertical slice initial contribution to a 5-year GRAT, with interest of 5.4% and an assumed rate of return of 8%:



*Rounded values

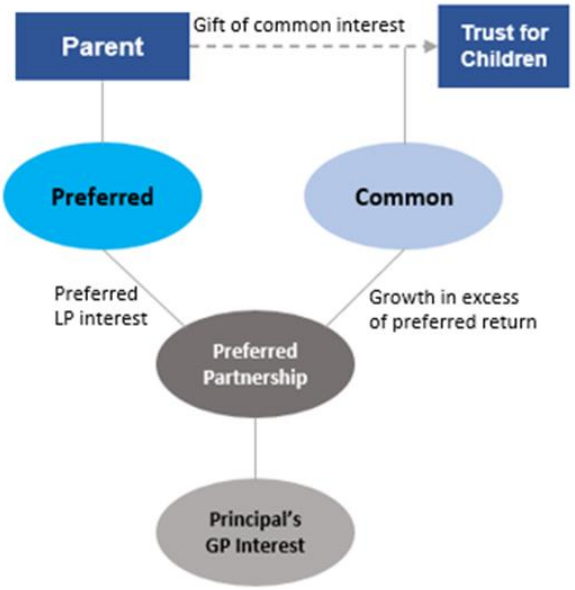
Sale to Intentionally Defective Grantor Trust

A sale to an Intentionally Defective Grantor Trust ("IDGT") is similar to a GRAT – it is an "estate freeze" technique that moves the growth of an asset outside of the grantor's estate, while retaining the original value plus interest. A grantor creates an irrevocable grantor trust, which is treated as the same taxpayer as the grantor for income tax purposes, and then sells an asset to the trust in exchange for a promissory note. Because the trust and the grantor are treated as the same taxpayer for income tax purposes, there is no income tax realization event on the sale. For a deeper discussion of sales to IDGTs and a comparison of GRATS versus sales to IDGTs, please see our separate white papers.A sale of a vertical slice to an IDGT generally requires an initial seed gift from the grantor to the IDGT, typically made in cash. If the trust's cash flow is sufficient to make the required note payments, then, generally, an appraisal is required only at the time of the sale to determine the sale value, as the cash flow avoids the need to return principal to pay the note. Additionally, the promissory note terms can be more flexible than a GRAT's required fixed annual annuity payments.

Below is a diagram depicting a sale to an IDGT transaction with a $500,000 seed gift and the sale of a $5,000,000 vertical slice interest in exchange for a promissory note:

Partnership Freeze

One alternative to vertical slice planning is the partnership freeze technique. It involves the creation of a partnership holding vehicle that has a preferred class and a common class, to which the fund principal transfers all of their interests in the fund or just their general partnership interest.



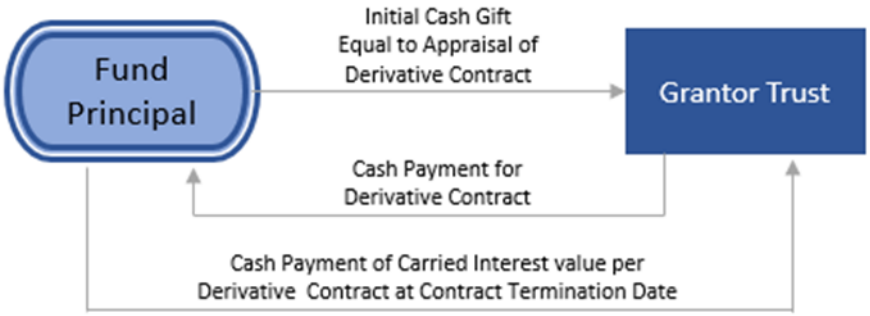
The preferred class has priority over common interests via payment of a fixed coupon and liquidation preference but does not participate in the excess growth of the partnership and is typically retained by the transferor.

The common interest receives the benefit of the appreciation of the assets above the preferred return and is typically transferred entirely to the fund principal's preferred beneficiaries. The common interest must be at least 10% of the total entity value.

Both retention of some of the common interests and all of the preferred interests fall under exceptions to Section 2701, so the retained interests may avoid the Section 2701 special valuation rules.

Carry Derivative Planning

Some of the downsides of vertical slice and partnership freeze planning—Section 2701 complexities, issues with gifting unvested interests, and limited to no control over the amount ultimately transferred—are addressed by carry derivative planning.



Carry derivative planning involves selling a derivative on the principal's carried interest to an irrevocable grantor trust in exchange for a premium. The principal first establishes an irrevocable grantor trust and gifts cash in an amount sufficient for the trust to purchase the derivative from the principal. The principal and the trust then enter into a derivative contract under which the principal is required to pay the trust, at a determined future date, an amount based on the total return of the principal's carry, which can also incorporate a requirement that the carry first must exceed a certain amount (a "hurdle") and a cap on the amount of the excess the trust is entitled to. Once an appraiser determines the value of the derivative based on the principal's carried interest and the requirements of the contract, factoring in any hurdle or ceiling, the volatility of the carried interest, the contract term, and current interest rates, the trust pays the principal for the derivative using the cash gifted by the principal to the trust. At the earlier of the end of the derivative contract term or the principal's death, the principal pays to the trust cash in the amount determined by the contract.

The value of the gift for gift tax purposes is the cash given to the trust to purchase the carry derivative, while the amount resulting from the derivative contract transfers to the trust without being subject to additional gift taxes, which can be an efficient use of the principal's available federal lifetime gift and estate tax exclusion. Additionally, because the contract does not transfer the carried interest itself, it avoids the Section 2701 complexities, and it allows transfer of value for carried interests that have not yet vested.

Similar to a sale to an IDGT because the trust purchasing the derivative is a grantor trust, the transaction is not a taxable event for income tax purposes. However, if the principal dies during the contract term, the contract value as of date of death must be paid by the principal's estate if it has a positive value. The value may be deductible by the estate as a liability on the federal estate tax return, but payment by the estate to the trust is likely to generate capital gains for the trust, to the extent the value exceeds the trust's basis in the assets, since the trust ceases to be a grantor trust as of the principal's death.

Some risks to carry derivative planning are: (1) at the termination date of the derivative contract, the principal does not have the liquidity to pay the cash settlement required; (2) the principal may be required to pay a clawback to the fund which the trust does not contribute to; and (3) the trust carries financial risk that the fund does not perform as anticipated, causing the trust a financial loss for the amount paid for the contract.