

The logo for Morgan Stanley Private Wealth Management, featuring the company name in a white serif font on a dark blue background. The background of the slide is a dark blue gradient with a large, light blue, triangular shape pointing downwards from the top right corner.

Morgan Stanley

PRIVATE WEALTH MANAGEMENT

Estate Planning for Investment Fund Principals

Wealth and Estate Planning Strategists

2023

Estate Planning for Investment Fund Principals

BASIC ESTATE TAX PLANNING

- Minimize potential estate tax exposure: 40% (top rate) federal gift and estate tax
- Gift and estate tax exemption
 - In 2023, \$12.92MM per person (\$25.84MM per married couple) exemption from federal gift and estate tax
 - State estate tax?

MAXIMIZE EXEMPTION

- Gift early
- Transfer assets with relatively low current value and significant appreciation potential
- Value of interests in closely held entities may be eligible for valuation discounts for lack of marketability and lack of control

Estate Planning for Investment Fund Principals

WHY IS ESTATE PLANNING WITH INVESTMENT FUND INTERESTS MORE COMPLEX THAN TRADITIONAL PLANNING?

- Capital and profits interests in private investment funds are complex assets that require particular attention and expertise
- Specific federal gift tax and income tax laws must be addressed in conjunction with any plan
- Securities laws restrict ownership in private investments

Estate Planning for Investment Fund Principals

HOW MORGAN STANLEY PRIVATE WEALTH ADVISORS CAN HELP:

- Work with a client's independent tax advisor to:
 - ❑ Analyze structure of funds to navigate the intersection of the estate, gift and income tax rules
 - ❑ Review gift tax valuation issues under IRC Section 2701 (the so-called "vertical slice" rule)
 - ❑ Address income tax issues relating to transfer of profits interests
 - ❑ Address vesting issues
 - ❑ Discuss planning techniques appropriate for different types of investment funds
 - ❑ Coordinate with appraisers to determine valuation
 - ❑ Navigate securities law issues relating to investment restrictions for private funds

IRC Section 2701

SECTION 2701 OF THE INTERNAL REVENUE CODE (“IRC” OR THE “CODE”)

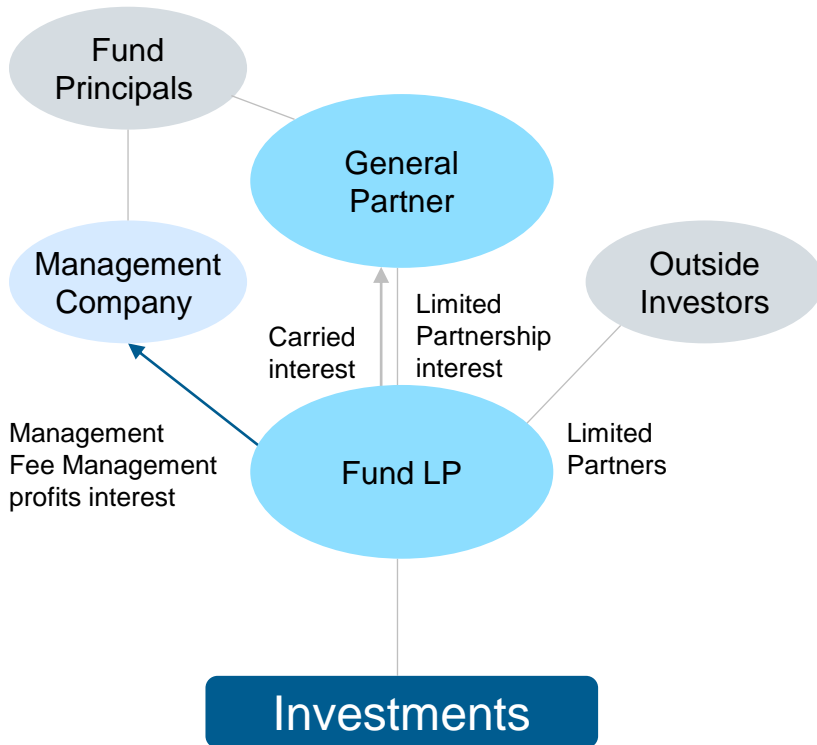
- Designed to address potentially abusive estate planning transactions with closely held family owned businesses
- Directs a specific gift tax valuation process for equity interests in an entity transferred to members of the family, where the transferor and/or certain family members retain certain interests in the entity
- May require fund principals to transfer a proportionate share of all equity interests in the fund if deemed to be controlled by the principal and/or the principal’s family. (According to the statute, “control” means holding of at least 50 percent of the vote or value of the stock of a corporation, at least 50 percent of the capital or profits interest in a partnership, or in the case of a limited partnership, holding any interest as a general partner)
- Failure to address may result in punitive federal gift tax consequences

VERTICAL SLICE

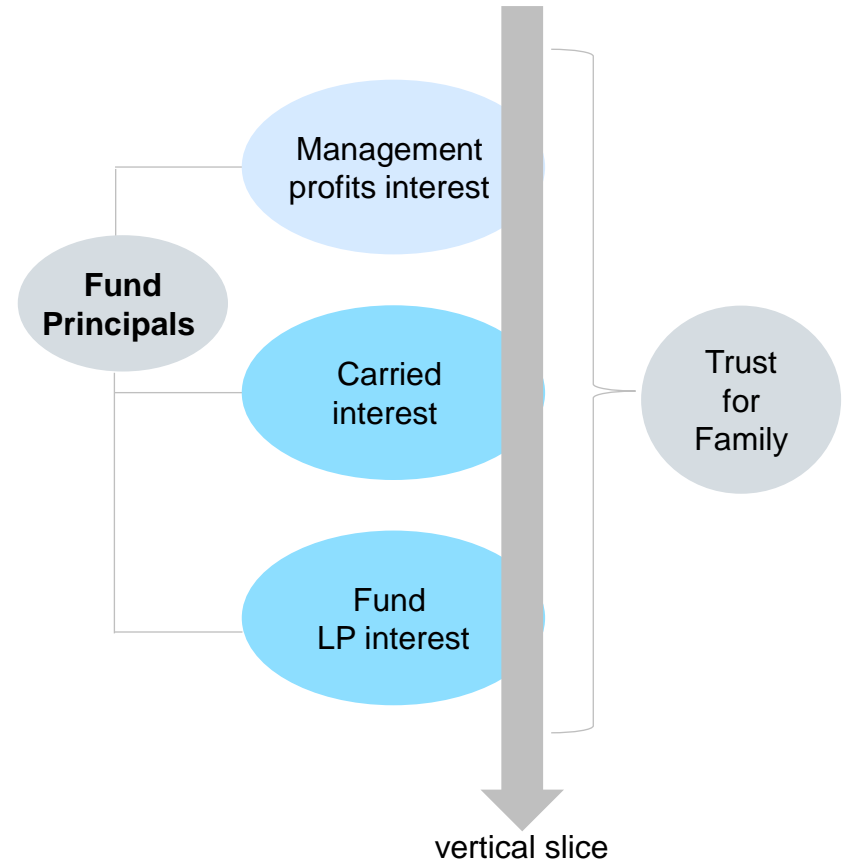
- An exception to Section 2701
- Requires that principals transfer a proportionate share (“vertical slice”) of all equity interests in a fund (such as capital investment interests, carried interests and any other profits interests)

IRC Section 2701

COMMON FUND STRUCTURE



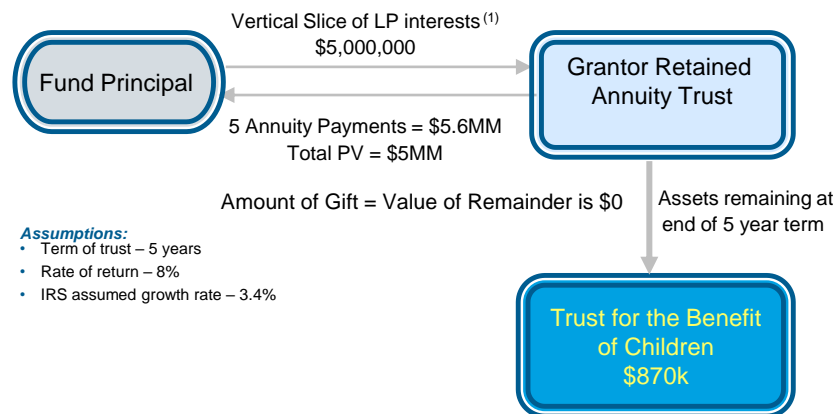
VERTICAL SLICE



Transfer Techniques

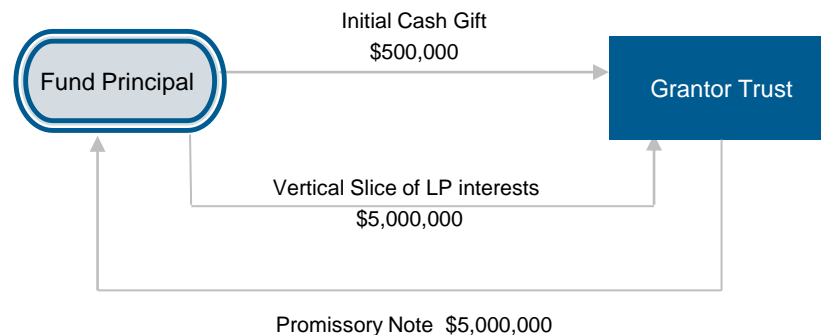
GRAT

- Requires annual annuity payments
- Payments in kind require annual appraisals and may dilute success of the GRAT
- Mortality risk



SALE TO GRANTOR TRUST

- Typically requires seed gift prior to sale
- Installment note may be designed with flexibility to match cash flow
- Only initial appraisal needed if cash flow is sufficient to cover note payments



1. Multiple LP interests can be combined into a family entity to facilitate gifting.

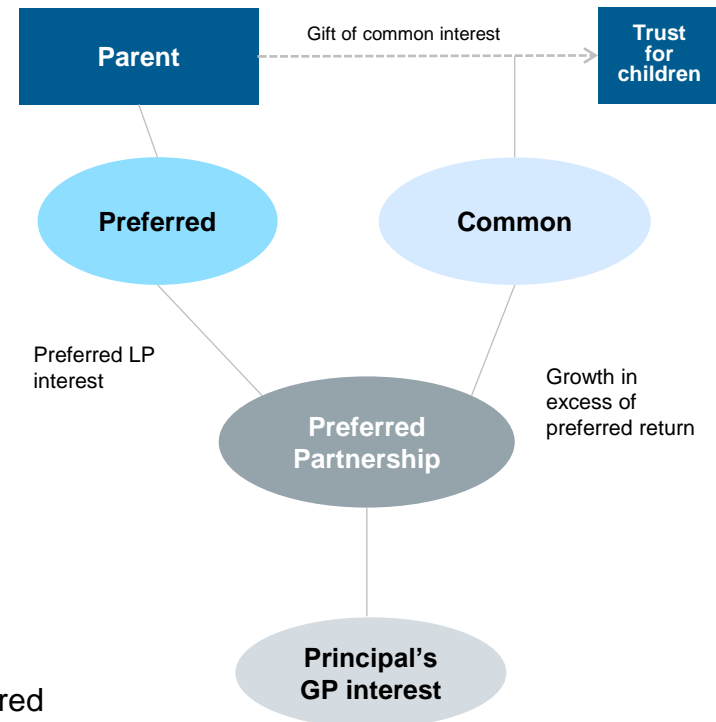
Alternatives to Vertical Slice Planning

PARTNERSHIP FREEZE

- Transferor retains a preferred interest with an annual preferred, fixed, cumulative return; payment of preferred may be deferred for up to four years
- Transfer of “common” interest to younger generation
 - Value must be at least 10% of entity value
 - Entitled to residual value after preferred return

DERIVATIVE ON CARRIED INTEREST

- Principal sells or gifts a derivative based on value of carried interest
- Appraisal needed to establish initial value of the option
- Section 2701 should not apply because no equity interest is transferred
- Principal may need to preserve carry distributions



Estate Planning for Investment Fund Principals

INCOME TAX ISSUES:

- Three-year holding period for capital gains tax treatment of profits interest
 - Gifting interests subject to vesting schedule
 - Income recognition upon disposition of profits interest

Estate Planning for Investment Fund Principals

SECURITIES LAW ISSUES:

- Does the recipient of gift/transfer qualify?
 - Accredited investor
 - Qualified purchaser

Appendix & Disclosure

This presentation was designed to illustrate the financial impact of a particular planning decision. The slides herein do not constitute a recommendation.

Caution: Many estate techniques share the common risk of the loss of control of the assets once the gift of the assets is complete.

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