Financial Services Newsletter

Estate Tax Planning for Hedge Fund and Private Equity Fund Managers

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It is clear that there continues to be considerable debate in Washington over the future of estate tax. Throughout this period of uncertainty, there is still significant value in gift and estate tax planning when the right opportunity arises. A large benefit of estate planning involves asset protection and proper use of trusts, but maintaining flexibility is key.

With the use of proper advanced planning strategies, hedge fund and private equity partners possess unique opportunities to reduce gift, estate and generation skipping transfer tax liability. This planning can provide the family — over multiple generations — with the asset protection needed to protect it from creditors and tort, contract and divorce claims. This can benefit surviving spouses, children, grandchildren, and potentially more distant lineal descendants.

Backdrop

Planning with interests in private equity and hedge funds is generally attractive because there is an opportunity to transfer a portion of a partner's share of his/her carried interest, which has potential for significant appreciation. However, because of Internal Revenue Code (IRC) Section 2701, one cannot transfer just the carry alone. Generally, the Fund managers must transfer a proportionate share of all equity interests in their Fund to perfect the transfer as being a gift. This is known as transferring a "***vertical slice."*** IRC Section 2701 provides the guidelines in determining the value of intra-family transfers of these fund interests.

Whether a general partner has an existing fund or is contemplating a new launch, valuations for carried interest can be remarkably low at this point in time. Depending on the fund's investment strategy, holdings and risk profile, initially there is generally a high degree of uncertainty regarding the achievability of the hedge fund's or private equity's goals, capital raising and performance. This is the cornerstone of this strategy.

Importance of the Valuation

Until the fund launches and commences its trading, and without committed capital from outside investors, the fund has little value from a gift tax perspective. With fairly low interest rates, coupled with high confidence in the markets, it is the ideal time to revisit estate planning strategies. In order to support this gifting, an independent valuation professional must assess the discounted value of the manager's limited partnership and general partnership interests. In other words, an independent valuation is needed. The valuation is also needed to achieve proper gift tax disclosure.

Transfer tax optimization depends on several factors including:

- Committed capital at the time of the valuation
- Nature of the fund's strategy, holdings and volatility

- Formula which governs the earning (granting) of the carried interest
- Whether there is any seed capital from an institutional investor
- Investor lock-ups
- Management and incentive fees, hurdle rates, high watermarks and withdrawal provisions

Complicated Laws

In addition to a valuation report, an attorney that has experience in this niche area should be utilized as transfers of carried interests are subject to complex estate and gift tax laws. Once the transfer takes place there are several sophisticated planning tools available to capture the interests in the funds such as family limited partnerships and a wide array of multi-generational trusts. It is also important to note that a gift tax return must be filed adequately disclosing the transaction with a qualified appraisal attached.

Dual Focus: Minimize Taxes and Protect Assets

Fund managers are positioned to utilize powerful advanced planning techniques to minimize current and future estate tax because of the low interest rate environment and potential for low valuations and to maximize asset protection. Anytime wealth transfer is considered, the impact of the current tax environment must be evaluated.

By crystallizing your goals and objectives, analyzing your hedge fund and/or private equity fund business, coupled with proper planning and advisory, you can minimize your taxes and achieve asset protection too.

Contact Us

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