

Planning for Fund Principals



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WITHERS

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— Planning for Fund Principals

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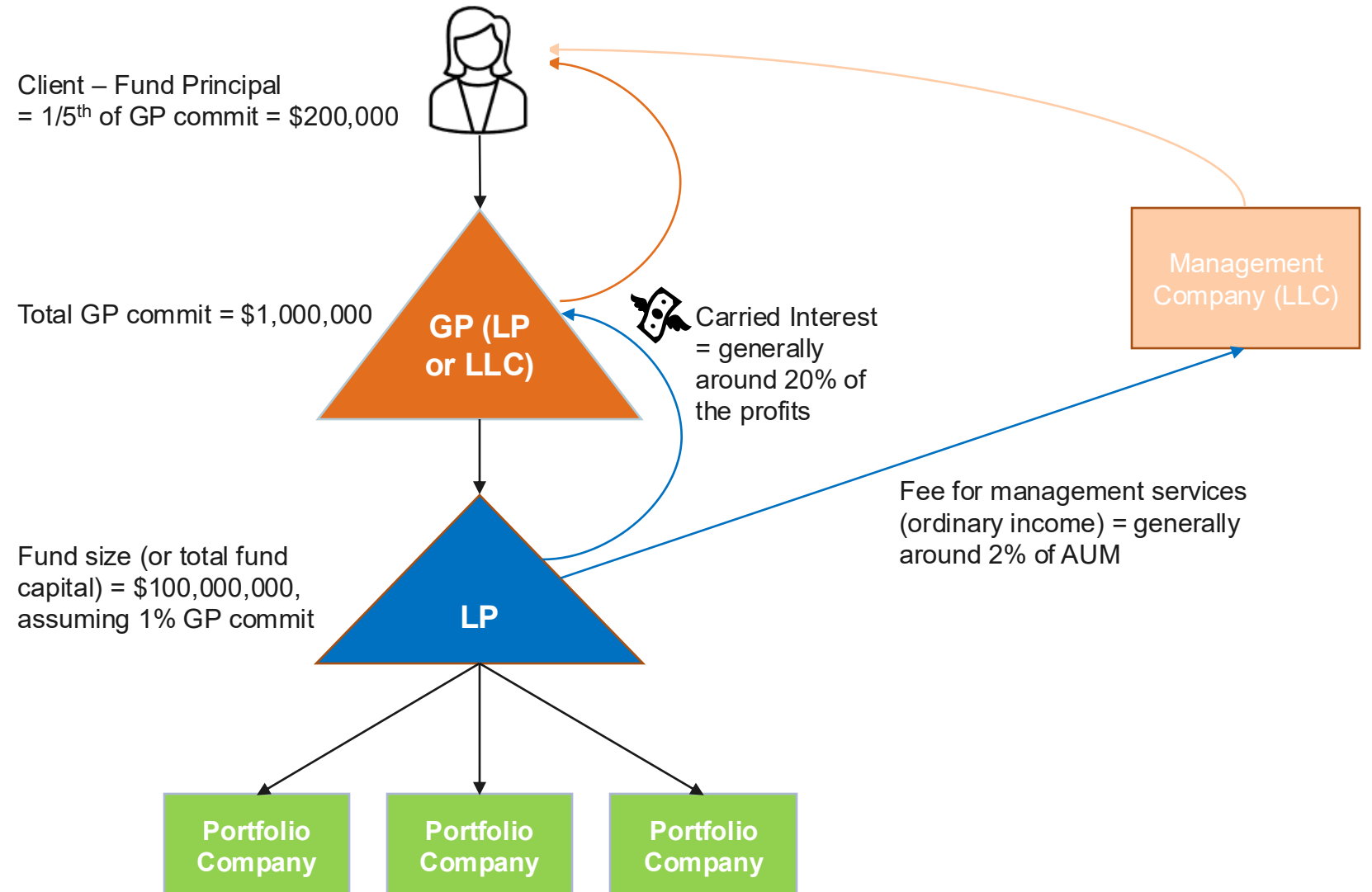
Agenda

- Overview of fund structures
- Introduction to carried interest planning
- Checkpoint 1: Transferability
- Introduction to Chapter 14 and Vertical Slice Planning
- Fund Structures and Effect on Vertical Slice
- Checkpoint 2: Proportionate Share in All Equity Interests
- Alternative to Vertical Slice: Derivative Planning
- Checkpoint 3: Choice of Strategy
- Trust Structure & Income Tax Considerations
- Checklist

Overview of Fund Structures

- Funds for our purposes = venture capital, private equity, hedge funds
 - *Most descriptions here are more typical of venture capital funds*
- Funds are generally structured as limited partnerships – with limited partners (usually investors) and the general partner (“**GP**”)
 - GP is usually itself a partnership that is owned by the “**fund principals**” i.e., the individuals ultimately managing the fund and making the investment decisions
- Carry vs. Capital
 - Refers to the types of interest
 - **Capital interest** – what you get when you put money into the fund; predominantly owned by limited partners who are generally third party investors, however the GP also has a capital interest (usually 1% or less)
 - **Carried interest (aka “carry”)** – type of profit interest; generally owned by the general partner of a fund
 - Profit distributions - typically provide that **after expenses and return of capital (and if applicable, a preferred return)**, the GP gets a “**first bite**” of the profits in form of the carry (typically around 20%) and the remaining profits (remaining 80%) are then distributed among all partners proportional to their capital, and this is the GP’s “**second bite**”
 - Carry can work on a ‘whole fund’ basis or a ‘deal-by-deal’ basis

Typical VC Structure



Introduction to Carried Interest Planning

- Carry is more speculative, especially early stages of any fund when there are no profits yet (i.e., it is not “in the money”) – maximizes upside for gifts
 - But note, it is not -0- value either (even if no profit has yet been earned)! Proper third party valuation is very important.
- Speculative assets have valuation discounting – further, since is it an interest in the GP of the fund, it will be subject to restrictions on sale etc. which leads to greater discount for lack of marketability. In addition, most fund principals will own a minority interest in the GP, which leads to discount for lack of control.
- Long term capital gains treatment (if held for 3+ years)
- What about management company interests?
 - In the basic form they give rise to ordinary income, usually taxable where the fund is located (vs. carry that gives rise to capital gains, and can be made taxable to where the trust is located)
 - Potential assignment of income issues

Checkpoint 1: Transferability

- Do the fund agreements allow transfers to the type of trust you are contemplating?
 - There are usually allowances for “estate planning” but they come in all shapes and sizes
 - Some might require the transferor to retain control in some manner – which can be a Section 2036 issue
 - Sometimes manager consent is required – it can take time and extend the period for planning
 - Unauthorized transfers are generally void; if fund refuses to recognize transfer, your client will not be very happy...
- Are the interests vested?
 - Simply put, you cannot gift what you do not own
 - Transfer of unvested interests can result in a future gift (at a much higher value, and potentially triggering a good deal of gift tax)

Application of Chapter 14 Rules to Funds

- Why? Because of Chapter 14 (IRC Sections 2701-2704)
- Perhaps the most convoluted part of the code...
- Essentially enacted to counteract wealth transfer using closely held entities with “senior” and “junior” interests such as a preferred interest vs. common interest
 - Elder generation would retain the “senior” interest and transfer the “junior” interest at a steep discount to younger generation
 - Abusive transactions would have illusory preferences, e.g., a preferred coupon that was never going to be enforced

‘Vertical Slice’ Exception to Ch 14

- IRC Section 2701 & Treas. Reg. 25.2701-1(c) exception
 - The special valuation rules (which can cause the “senior” retained interest to be valued at -0-) do not apply if there is a proportionate transfer of each class of equity held by the transferor to a family member (limited to spouses, lineal descendants and spouses of lineal descendants)
 - “Vertical slice” is a shorthand to describe a proportionate share of each class of equity
 - This includes interests that may be attributed to the transferor by virtue of being owned by certain related persons (spouse, ancestor (transferor or spouse), spouse of ancestor). For example, if the fund principal owns GP interests in a fund where his in laws also owned LP interests, the in-laws interests would be attributed to the transferor and could be treated as a “senior” retained interest
- Key for vertical slice – clear understanding of each type of equity interest owned by the transferor and certain applicable family members
- Biggest downside for vertical slice – valuation
- Second biggest downside – need for cash to make future capital calls

Fund Structure Effect On Planning with Vertical Slice

- Maturity of fund (need to make future capital calls)
- Hedge Funds vs. Venture Capital/ Private Equity Funds
 - Hedge funds may be structured such that the carry and the limited partnership interests share in different proportions of the profit, therefore, it may be argued that one is not “senior” or “junior” to the other
 - Carry can be “in the money” much sooner – affects valuation discounts
- Management Fee Waivers
 - Waive management fee in exchange for additional ‘profits interest’
 - Can also be used to offset GP capital commitment
- Ownership of Fund Interests by Other Family Members
- Common GP of Multiple Funds
 - ‘Vertical slice’ will require proportional transfer of capital in each fund

Checkpoint 2: Proportionate Share in All Equity Interests

- Have you identified all the types of interests owned directly, indirectly, or attributed to the transferor fund principal?
 - Creating an LLC to hold all of the transferor's interests in the fund could be a solution for indirect and indirectly owned interests
 - However, it does not solve for attribution
- Have you obtained an independent qualified appraisal?
 - And reviewed any valuation report to ensure that the identified interests reflect your understanding of the structure

Alternative to Vertical Slice – Derivative Planning

- Fund principal retains the fund interests but sells a derivative to a trust, which entitles the trust to future payments on the carry (usually above a hurdle rate)
 - Gift cash to grantor trust, which purchases the derivative contract
 - Fund principal pays trust upon maturity of the contract
 - All capital calls made by the fund principal, no need for cash gifts to trust
- Ideal for mature funds or when fund principal does not have much gift exemption remaining
- Pros/ Cons compared to vertical slice
 - Exception under Ch. 14 not as clear cut
 - Better control over cash flow
 - Much lower valuation
 - Drafting derivative contract is trickier

Checkpoint 3: Choice of Strategy

- How much gift exemption does the client have remaining?
- Have you considered liquidity requirements for capital calls?
- How sophisticated/ risk averse is the client?

Trust Structure & Other Income Tax Considerations

- Grantor vs. Non-grantor
 - Non-grantor trusts make more sense if there is potential for layering state income tax planning, and when the interest will be funded via a gift
 - Derivative planning usually done with grantor trust because it involves a sale of the contract
 - Key - understanding underlying fund assets – potential for QSBS planning in case of VC fund interests and non-grantor trusts
 - Must consider fund restrictions. For example, if the fund requires the transferor to be a trustee or other fiduciary, and the transferor is California resident, it will undercut state income tax planning (and the case for a non-grantor trust)
- Assignment of income issues
 - Lurking issue in many fund structures – closely related to vesting
 - Issue is whether the value of the interest derives from the fund principal's work, i.e., whether capital is the income producing factor

Carry Planning Checklist

- ☐ Determine in which entities in the fund structure the individual (or spouse, parents, children etc.) owns interests
- ☐ Collect all relevant fund operating agreements/ limited partnership agreements
- ☐ Review fund documents and determine vesting status, restrictions on transfers of interests, and procedural steps for allowable transfers
- ☐ Assess fund interest for valuation discount and upside
- ☐ Determine choice of planning technique
- ☐ Determine exact interest in fund(s) to be gifted
- ☐ Communicate with fund counsel to determine nature of assignment/ gift agreements etc.
- ☐ Trust and ancillary document drafting and finalization
- ☐ Trust funding
- ☐ Update books records of fund

Speaker bio: Naomita Yadav

Naomita is a partner in the private client and tax team at the international law firm, Withers. She has a diverse and well-rounded tax background, including experience in both income tax and estate and gift tax matters, which makes her particularly suited for families with existing complex trust structures. She also has experience with cross-border families as well as nuances of visa designations and the interplay with tax laws. Interestingly, her own family is situated in three continents.

Naomita advises families with generational wealth in the context of changing circumstances and passage of time such as multi-generation wealth planning for family members who are beneficiaries of trusts settled by prior generations. This particular mix of experiences and knowledge enables Naomita to act as a proficient adviser for the globally mobile high net worth family.

Education

Yale University, *cum laude*, B.S.

University of Michigan, M.B.A.

University of Michigan Law School, *cum laude*, J.D.

Recent activities

'How to Fix a Broken Trust' CalCPA Conference – July 2025, speaker

'Planning for Fund Principals' Nevada Trust Conference – April 2025, speaker

'State Income Tax and Trust Planning' Nevada Trust Conference – April 30, 2024, speaker

'Leaving California' 2024 USC Tax Institute – January 23, 2024, speaker



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