

## Estate Planning

### Simple Goals in a Complex World: Estate Planning for Hedge Fund Interests

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In our experience, most well-to-do individuals and their families share simple financial goals: to increase wealth by realizing satisfactory rates of return on their assets and to manage and pass on wealth in a tax-efficient manner. Hedge fund investing is one way to address the first objective. Intelligent estate planning is one way to address the second.

This article will provide a brief introduction to estate planning considerations for hedge fund managers and hedge fund interests. We will first describe some fundamental concepts of sophisticated estate planning, and the typical structure of a hedge fund investment. We will then discuss certain approaches to estate planning with both a new hedge fund investment and an existing hedge fund investment. The goal is to give the reader an understanding of the family planning and tax savings results that can be achieved with this kind of estate planning.

#### *Estate Planning Fundamentals*

As of this writing, repeal of the estate tax is increasingly unlikely. The estate tax is expected to stay at or near the current 45% rate with a \$3.5 million estate and generation-skipping tax ("GST") exemption. Besides achieving family goals, estate planning in general focuses on reducing exposure to these taxes in several ways, including (1) the best use of an individual's \$1 million lifetime gift tax exemption, (2) structuring the ownership of assets so that future

appreciation accrues to the individual's family but is outside of the individual's taxable estate, and (3) where available, transferring assets out of the individual's name with the use of valuation discounts. Hedge fund interests, which are generally expected to appreciate significantly in value over the long-term, can be ideal assets for estate planning.

Most domestic hedge funds are structured as limited partnerships. A typical structure involves a one percent (1%) general partner entity – often a limited liability company ("LLC") – that sometimes is owned or controlled by the fund manager. The entity earns what is known as the "carried interest," or "carry," which is a right to be allocated 20% of the profits of the fund. The limited partnership interests, representing in the aggregate 99% of the hedge fund, are owned by the investors. In addition, the fund manager creates a management company (usually an LLC) which contracts with the fund to manage its investments in return for a two percent (2%) management fee. When working with hedge fund investors, estate planners focus on the investors' limited partnership interests in the fund. When working with fund managers, estate planners work with the general partner interest (including the carry), the management company (and its two percent fee) and any additional limited partnership investment that the manager has in the fund.

### *Planning with a New Fund Investment*

The inception of a hedge fund or fund investment is an ideal time to implement estate planning. Using intra-family gifts, loans or sales, the investment can be structured so that future appreciation is outside of the individual's estate. The following examples illustrate just a few ways this might be accomplished.

#### *Example 1 – Structuring a Fund Manager's Interest at Inception*

Dad is a hedge fund manager starting a new fund. At the fund's inception, Mom creates a new irrevocable trust for the benefit of Dad, Son and Daughter. The trust is a grantor trust as to Mom for income tax purposes. Dad is the trustee of the trust.

Mom makes a gift to the trust of \$1 million in cash, which is gift tax free due to the application of Mom's \$1 million lifetime gift tax exemption. Mom applies \$1 million of her GST exemption to the gift so that the trust is fully GST-exempt.

The trust then uses the \$1 million to purchase a 90% interest in the entity which will be the general partner of the fund. This entitles the trust to 90% of the earnings of the general partner, including the general partner's carried interest. Moreover, since the trust is a grantor trust, the tax on any income generated by the trust will be paid by Mom, allowing the trust assets to grow income tax free. If in five years the general partner entity is worth \$10 million (including the carried interest which may have been paid out or reinvested in the fund), 90% of this increase in value will be outside of Mom and Dad's taxable estates, saving over \$4 million in estate tax.

#### *Example 2 – Gift and Loan*

Dad, who is a hedge fund investor, creates a new irrevocable trust for the benefit of Mom, Son and Daughter. The trust is a grantor trust as to Dad for income tax purposes, and also is intended to be GST-exempt. Dad loans \$5 million to the trust. In return, the trust issues a nine year promissory note bearing 2.75% interest (or the current mid-term AFR issued by the IRS). The trust uses the loan to purchase a limited partnership interest in the fund.

Dad also makes a gift to the trust of a limited partnership interest in the fund having a value equal to his \$1 million gift tax exemption. The gift may be subject to a valuation discount because the interest is nonmarketable and noncontrolling. Assuming for purposes of this example that the discount is determined to be 25%, Dad's gift represents \$1.33 million of underlying value in the fund's assets. Following these steps, Dad will have transferred \$6.33 million in value out of his taxable estate (\$5 million of cash and \$1.33 million of a hedge fund interest), and will retain a \$5 million note receivable. The note receivable (which will never increase in value) and the 2.75% interest on the loan will be included in Dad's taxable estate, but all of the appreciation of the hedge fund, and earnings on the appreciation, in excess of this will accrue estate tax free in the trust outside of Dad's taxable estate.

### *Planning for Existing Funds*

In determining the best way to transfer an interest in an existing hedge fund, once the individual's applicable exclusion has been exhausted, a GRAT should be considered.

A GRAT is a type of irrevocable trust that is expressly permitted under the Internal Revenue Code. The grantor contributes assets to the trust, but retains the right to receive a series of annuity payments from the trust for a term of years (often two or three years). At the end of the term of years, any assets remaining in the trust generally pass to another trust for the benefit of the grantor's family.

The gift tax consequences of the GRAT are determined by (1) the value of the property contributed to the GRAT, (2) the value of the grantor's retained right to annuity payments, and (3) the IRS-prescribed interest rate. Generally speaking, if the value of the grantor's retained annuity is equal to (or slightly less than) the value of the assets contributed to the GRAT, then there is no significant gift at the time of the GRAT's creation. This is often called a "zeroed-out GRAT." If the GRAT's assets appreciate at a rate greater than the IRS-prescribed interest rate or "hurdle rate" (currently 3.2%), then the excess appreciation passes to the GRAT's remainder beneficiaries gift and estate tax free, and the GRAT is successful. Furthermore, if any discounts (such as for lack of marketability or lack of control of an entity) are applicable to the assets transferred to the GRAT, then the tax benefits of the transaction may be improved.

### *Code §2701 and the Vertical Slice*

One issue that can arise in a fund manager's planning for an existing fund is the potential application of Internal Revenue Code ("Code") §2701. In general terms, Code §2701 can apply when a person makes a gift of a "junior" or "common" interest in a partnership or corporation and retains a "senior" or "preferred" interest. If it applies, the rule treats the donor's retained interest as having a value of zero, making the taxable gift of the "junior" or "common" interest much larger.

There is no specific precedent applying Code §2701 to transfers of interests in hedge funds. However, it could be argued that Code §2701 applies if the donor makes a gift of a portion of the carried interest, but retains an investment in the fund. In this analogy, the gift of the carried interest would be a "junior" or "common" interest and the retained investment in the fund would be a "senior" or "preferred" interest. To avoid this potential risk, it is generally recommended that hedge fund managers transfer a "vertical slice," or a proportionate amount of all of the interests that they own in an existing fund. The donee of the gift will thus have a pro rata share of all the same interests that the donor has. Note that this issue does not arise if the donee owns the interest at the inception of the fund, as in Example 1 above.

### *Vesting*

Another potential issue is vesting. A fund manager's interest in the GP's carried interest may be subject to a vesting schedule. This raises the question as to whether the fund manager can make an effective transfer of an unvested interest for gift and estate tax purposes. The IRS has not issued guidance on this issue. Moreover, in the context of stock options, the IRS position is that unvested stock options cannot be effectively gifted prior to vesting. See Revenue Ruling 98-21. However, an unvested interest in the GP's carried interest arguably is materially different than an unvested stock option because the unvested partnership interest often carries significant economic rights despite the vesting schedule (such as the right to vote and receive distributions). Thus, while not free from risk, it may be reasonable to transfer such an unvested interest for gift and estate tax purposes, which can achieve substantial tax savings.

### *Example 3 – GRAT*

- Ownership of the fund. Dad owns a 90% interest in ABC Fund, LLC, which is the 1% general partner of ABC Fund, LP, the actual hedge fund. Pursuant to the limited partnership agreement for the fund, ABC Fund, LLC earns the 20% carried interest. Dad also owns a 90% interest in ABC Fund Management Co., LLC, which has a contract to act as the investment manager of ABC Fund, LP and earns a two percent (2%) management fee.
- GRAT. Dad creates a new, two year zeroed-out GRAT, funding it with (1) 50% of his interest in ABC Fund, LLC and (2) 50% of his interest in ABC Fund Management Co., LLC. Pursuant to the GRAT's terms, Dad retains the right to receive an annuity payment from the GRAT (paid annually) for the next two years. The annuity payment is set at a payout rate so that the value of Dad's annuity is just about equal to the value of the property Dad gifted to the GRAT.
- Gift valuation. An appraiser determines that Dad's interest in ABC Fund, LLC is worth \$18 million, and Dad's interest in ABC Fund Management Co., LLC is worth \$2 million, taking into account valuation discounts due to lack of control and lack of marketability. Dad's gift of 50% of his interests in these entities therefore is valued at \$10 million (\$20 million x 50%). The trust is structured so that Dad receives an annuity equal to \$5.3 million per year for two years. This in turn makes the value of Dad's gift to the trust equal to \$1,000.
- Vertical slice. Because Dad has contributed a pro rata share of all of his interests in ABC Fund, he should not have an issue under Code §2701.
- Vesting. We have assumed that Dad's interests are fully vested.
- Investment performance and annuity payment. For each of the GRAT's two years, it is entitled to 50% of (1) the management fees earned by the management company, (2) the earnings attributable to the one percent (1%) GP interest of ABC Fund, LLC and (3) the carried interest. Distributions of cash to fund the GRAT's annuity obligation may reduce the GRAT's capital account balance in ABC Fund Management Co., LLC or in ABC Fund, LLC, but should not reduce its right to its pro rata share of the management fees or carried interest. If the investments increase in value, all appreciation exceeding the annuity amounts paid to Dad will pass tax free to the GRAT's remainder beneficiaries. On the other hand, if the investments decline in value, the GRAT will not be able to make its annuity payments in full, and Dad will receive back all of the GRAT's assets through the annuity payments.

These examples, of course, are for illustration purposes and do not present all of the issues and potential risks in these types of transactions (including, for example, qualifying the trust as an "accredited investor" for securities law purposes, and appraisal and reporting requirements). But they do demonstrate how hedge fund managers and investors can realize significant transfer tax savings through estate planning with hedge fund investments. Individuals in this position should work with a team of competent advisors to accomplish their goals.

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