Advanced Estate Planning for Private Equity Owners

Prepared by:

Leo J. Cushing, Esq., CPA, LL.M.
Luke C. Bean, Esq., LLM
Cushing & Dolan, P.C.
375 Totten Pond Road, Suite 200
Waltham, MA 02451
Phone: 617-523-1555
Fax: 617-523-5653

lcushing@cushingdolan.com
www.cushingdolan.com

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I. Introduction & Overview

(a) Fund manager's compensation; Carried Interest Explained
(b) How is the carried interest taxed for income tax purposes?
(c) What are the estate tax consequences of the wealth from carried interest income?
(d) Can the carried interest be gifted?
(e) Protecting the carried interest from estate taxes and creditors.
(f) Valuation of the carried interest.
(g) Sale of a carried interest derivative to a domestic asset protection trust; the ultimate estate tax plan

II. Applicable Federal Tax Rates

(a) Federal Income Tax rate

(i) Ordinary Income	39.6%	(Bush era tax rates 35%)
(ii) Capital Gain Tax	20%	(Bush era tax rates 15%)

(b) Obama would like to raise capital gain taxes to 28% from 20%

(c) Does new Medicare 3.8% surtax apply to capital interest income?

(d) Federal Estate Tax Rates

(i) 40% on estates over $5,450,000
(ii) Massachusetts: up to 16% with an exemption per person of $1,000,000

(e) Federal Gift Tax Rates

40% on gifts in excess of $5,450,000

<u>PLANNING NOTE</u>:
Massachusetts has no gift tax but a gift uses up the so-called $1,000,000 exemption

(f) Federal Generation Skipping Transfer Tax Rates

(i) 40% on transfers subject to the generation skipping transfer tax with a $5,450,000 exemption

(ii) A "generation skipping transfer" is a transfer to a member of a generation at least two below that of the transferor

Example:

Father leaves assets in trust for the benefit of children and then grandchildren and more remote descendants. A distribution of property from trust to grandchildren and great-grandchildren will be subject to generation skipping transfer taxes unless exemption is allocated at the time of transfer.

III. <u>The Private Equity Owner's Carried Interest</u>

(a) A substantial amount of the private equity clients "compensation" will be in the form of a so-called Carried Interest.

(b) Try not to consider it compensation because the carried interest is taxed currently at capital gain rates (20%) rather than at ordinary income tax rates (39.6%).

<u>PLANNING NOTE</u>:
Congress would like to change the tax treatment of the Carried Interest from capital gain to ordinary income on the theory that it is compensation. The investment, together with the possibility of a clawback, is what justifies taxing the carried interest at capital gain rates rather than ordinary income because of the risk factor.

IV. <u>Typical Structure of a Carried Interest</u>

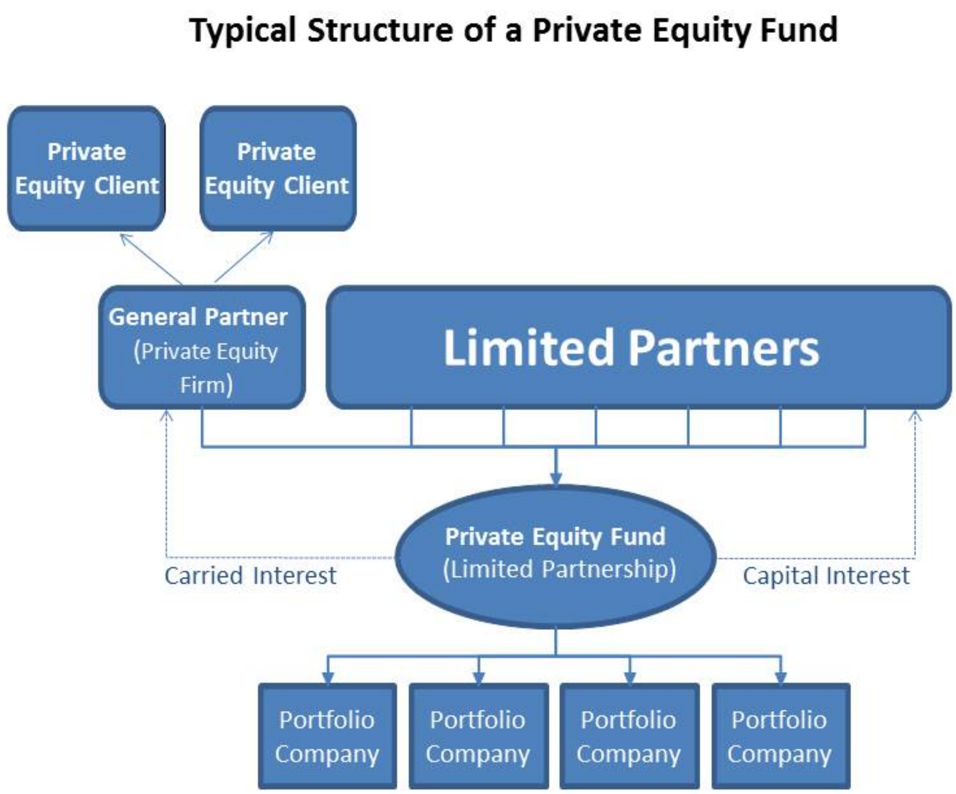
Example:

(a) Private equity client owns 50% of an LLC that will become a general partner of a limited partnership and raise funds from independent third parties to invest in various United States privately held companies ("Portfolio companies")

(b) The limited partnership (Fund) intends to raise $500,000,000 from 10 separate investors (pension funds and other wealthy investors at $50,000,000 each)

(c) In exchange for the carry interest, the general partners will invest an amount equal to 3% of the total funds raised.

V. Typical Structure of a Private Equity Fund



VI. Distributions

Distributions will be as follows:

(a) Net Proceeds attributable to the disposition of investments in the portfolio companies as well as distributions of securities in kind, together with any dividends or interest income received with respect to investments in the portfolio companies, will be distributed in the following order of priority:

(i) first, 100% to all partners in proportion to commitments until the cumulative amount distributed in respect of investments equals the aggregate of the following:

(a) capital contributions by the partners to the Fund with respect to their commitments; and

(b) a preferred return on amounts included in (a) above at the rate of 8% per annum from the date of the applicable capital contribution was due (the "Preferred Return"); and

(ii) second, 100% to the general partner until such time as the general partner has received as **carried interest**, 20% of the sum of the distributed Preferred Return; and

(iii) thereafter, 80% to all partners in proportion to commitments and 20% to the general partners as **carried interest**.

VII. Clawback Provisions

In the case of the General Partner, the General Partner will be required to restore distributions to the fund to the extent that it received cumulative distributions in excess of amounts otherwise distributable to the General Partner, but, in no event, more than the cumulative distributions received by the general partner with respect to its 20% carried interest less income taxes thereon.

VIII. Example

Assume fund raises $500,000,000 and, over a period of 5 years ("investment period"), is able to acquire a number of portfolio companies and, at the end of 5 years, has realized $1,200,000,000 in gross sales. The distribution scheme would be as follows:

1.	Sales Proceeds:	$1,200,000,000
2.	Return of Capital:	($500,000,000)
3.	Preferred Return: 8%	($200,000,000)
4.	Initial Carried Interest:	($40,000,000)
5.	Amount before Split:	$460,000,000
	20% to General Partner:	$92,000,000
	80% to Limited Partners:	$368,000,000

Summary of Carried Interest

Initial 20% Portion:	$ 40,000,000
Residuary 20% Portion:	$ 92,000,000
	$132,000,000
Your Client owns 50%:	$ 66,000,000

IX. Good News & Bad News

(a) Good News - nice pay day.

(b) Bad News - wealth will be subject to estate taxes and/or gift taxes (and this is only one of a number of deals)

(c) Computation of Estate Tax:

Total Assets:	$ 66,000,000
Less; Exemption:	$ 5,430,000
	$ 60,570,000
Estate Tax: 40%	$ 24,228,000

(d) Gifting:

Same result:

Total Assets:	$ 66,000,000
Less; Exemption:	$ 5,430,000
	$ 60,570,000
Gift Tax: 40%	$ 24,228,000

(e) Planning Ideas:

Private Equity owner needs to plan to avoid wealth transfer taxes with trust planning at the time the Funds closes well before investments are made.

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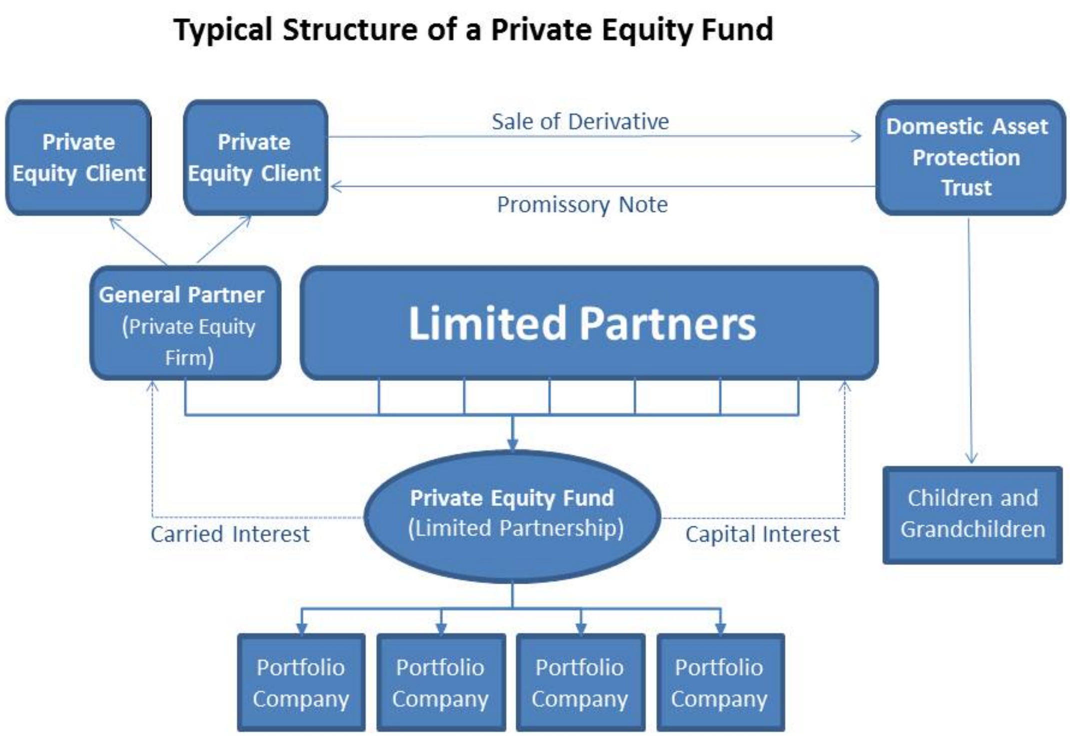
X. **Trust Planning**



(a) Revocable or Irrevocable:

(i) Revocable: No

(ii) Irrevocable: Yes

(b) Trust Jurisdiction:

(i) Massachusetts: No - Client cannot be a beneficiary of the trust

(ii) New Hampshire, Delaware, Rhode Island: Yes - these states have also adopted so-called Domestic Asset Protection Trusts where the private equity client can be a beneficiary of the trust and yet keep the asset away from estate and GST taxes and creditors.

(iii) Private Equity Investor can be a discretionary beneficiary as well as the Private Equity Investor's family.

(c) How long can trust last?

Choose a state that has repealed its Rule of Perpetuities so that the trust can last forever.

(d) What is the Rule of Perpetuities?

Go see the movie The Descendants and skip the property law course. (Only kidding!)

(e) An option contract (a/k/a derivative) is sold to the Trust

XI. <u>Trustees & Trust Protectors</u>

(a) Domestic Asset Protection Trusts require that there be a local trustee (usually a corporate trustee).

(b) All states allow the use of a "Trust Protector" which essentially allows the Private Equity investor to name his or her best friend to advise the Trustee so that the trustee has only custody of the assets.

(c) The Trust Protector makes (1) investment decisions, and (2) distribution decisions.

(d) Private Equity client can retain significant control over the Trust Protector as well as the Trustee by having the right to remove and replace the Trust Protector as well as the Trustee.

XII. <u>Income Tax Consequences</u>

(a) Grantor Trust, even though irrevocable for estate, gift and GST tax purposes, will be a grantor trust for income tax purposes (meaning it will be ignored for income tax purposes).

(b) Benefit - Any income and/or gain realized by the trust will be taxed to the grantor and not to the trust.

(c) Punitive Trust Tax Brackets are avoided:

39.6% on taxable income over $12,300

XIII. <u>Use & Valuation of a Derivative to Transfer the Carried Interest</u>

(a) Origins of the technique – a strategy designed allow the client to retain ownership of the carry while transferring the economic benefit of the carry at a lower valuation than a transfer of the carried interest outright and avoiding any potential application of IRC 2701.

(b) In the Example above, if all assumptions play out, the Carried Interest would generate about $ 66,000,000 but it is worth significantly less today because of the time value of money and risk.

(c) Appraiser will be required to compute the present value of the Carried Interest as well as the price of the derivative contract using Monte Carlo simulations.

(d) After running 10,000 Monte Carlo simulations, the appraiser determines that the current value of the option agreement is $6,000,000.

(e) The trust purchases an option from the client for $6,000,000 payable in a promissory note to acquire the carried interest to the extent the distribution exceeds a "hurdle amount" (which can be zero).

(f) In this case, at the end of the option period (lets use 5 years), the option is exercised and the trust will net $60,000,000 ($66,000,000 less $6,000,000).

(g) Wealth transfer tax savings:

Amount removed from estate	$60,000,000
Rate: 40%	$24,000,000

PLANNING NOTE:

(i) None of the estate or gift tax exemptions were used because the client "sold" the derivative for fair market value.

(ii) Sale was income tax free because the transaction was between a grantor and their grantor trust.

(iii) Assets are protected from client's creditors and can support the family forever!