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Carried Interest and Estate Planning: The Second in a Two Part Series

The "carried interest" in a private equity or venture capital fund can be a particularly attractive subject of lifetime wealth transfer planning. Such an interest consists of the holder's right to receive allocations of future partnership income or gain without regard to his or her proportionate share of current or committed partnership capital. The structure of the carried interest, and the uncertainties surrounding future fund performance, generally justify a relatively modest valuation. Therein lies the estate planning opportunity.

Valuation

The carried interest in a fund is typically gifted or otherwise transferred by means of the assignment of a non-managing, member interest in the general partner ("GP") of the fund that is entitled to the carried interest. Values of carried interests in the early life of the fund are low because neither exceptional performance nor above average investment returns from shortened holding periods is assumed. While the fund could also underperform over its life, disappointing returns are not posited at the fund's inception. The required rate of return of an investor in the non-managing, member interest in the GP factors in the uncertainty of the projected cash flows and the possibility of mediocre fund performance.

Non-managing, member interests in the GP are generally valued through a discounted cash flow analysis or option model (as discussed in the first article of this series). Since such interests do not have control of the GP or of the underlying fund and are usually subject to transfer restrictions, discounts for lack of control and marketability are applied to them. Control discounts for GP interests can be calculated using the implied price to NAV multiples of LP interest transactions in similar funds, which typically are sold at a discount to NAV. The marketability discount can be determined through a comparison of GP interests to empirical studies of private placements of securities restricted under Rule 144 or through options based models such as the Black-Scholes Put Model, Asian Put Model, and Finnerty's Put Model.

Valuation discounts should also apply with respect to the family entities used to implement the estate planning. If the GP interests are first contributed to a family limited partnership ("FLP") or family limited liability company ("FLLC"), then control and marketability discounts are warranted for interests in the FLP/FLLC. Such interests do not have any control over the FLP/FLLC's asset management or distribution policies and there is no secondary market for them. Control discounts for FLP/FLLC interests can be calculated using price to NAV multiples of closed-end funds, while marketability discounts can be calculated using similar methodologies to those applied to the GP interest. Marketability discounts for FLP/FLLC are generally lower than discounts for the GP interests since GP interests tend to have a higher volatility than FLP/FLLCs, which often hold less volatile assets such as marketable securities, real estate, or collectibles.

The Capital Interest vs. the Carried Interest

Regardless of the estate planning strategy employed, a key consideration is the interests that are gifted or transferred. Fund investors often expect the fund principals to commit substantial capital to fund investments so as to better align the interests of the fund principals and investors. Such investments are usually made through the general partner entity, the fund itself, directly in portfolio companies, or through a "side-by-side" fund in which the principals are the sole participants and the side-by-side fund is required to invest in the same portfolio companies as the primary fund. The capital interest is less attractive for estate planning transfers since, compared to a carried interest, it has a relatively high present value (the actual cash amount invested) and relatively low return potential.

The valuation of capital interests and carried interests involves evaluating the risks of both interests. Capital interests are generally less risky, since holders have a claim on the initial value of fund investments, whereas carried interests derive their value from appreciation of fund assets above a certain hurdle amount. Returns associated with carried interests also tend to be much more volatile when compared to capital interests. At the beginning stages of the fund's life, the intrinsic value of the carried interest is zero, before increasing as the fund's investments become profitable.

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Due to the riskier nature of the carried interest, rates used to discount projected cash distributions will be higher than the expected returns of the capital interests. Depending on the distribution waterfall of the fund, carried interest can also be paid out at a later date than the capital interest. As a result, each dollar of expected payout will be discounted at a higher required rate of return and over a longer holding period, resulting in a lower value for the carried interest's cash flows. The low initial carried interest value means that holders of the carried interest benefit from transferring the interest during the earliest stage of a fund's life. Once a fund's investments achieve success, become profitable, and there is a positive carried interest allocation, the value of the carried interest will increase significantly.

"VERTICAL SLICE"

For that reason it would be preferable to commit only the carried interest to estate planning transfers and to retain the capital interest. However, if IRC Section 2701 ("Section 2701") applies to the transfer of the carried interest, the interest transferred (the "junior interest"), will be valued (under the "subtraction method") by subtracting the value of the interest retained (the "capital" or "senior interest") from the combined value of junior and senior interests. In determining the value of the senior interest to be subtracted, some or all of the rights of the senior interest may be valued at $0, with the result that the senior interest retained will be treated as in effect having also been transferred, thereby increasing the size of the gift.

Under Section 2701, a "distribution right" (which would include a capital interest in an entity "controlled" by a transferor) does not include a right to distributions with respect to any interest which is junior to the rights of the transferred interest. The Regulations provide that the exception applies to "[a]ny right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest." The Regulations further provide that a proportionate transfer of all classes of equity interests held by the transferor and all applicable family members is not subject to Section 2701. That "proportionate transfer" exception can be particularly important for carried interest transfer planning purposes. Section 2701 should not apply to the transfer of a percentage interest in the GP as long as the transfer includes a proportionate share of both the capital and the carried interest held or deemed held by the principal (transferor) through the general partner (i.e., a so-called "vertical slice" of the general partner is transferred).

If Section 2701 does not apply, both the capital and carried interests in the fund can be valued discretely for estate planning purposes. The expected future cash flows and capital calls attendant to the senior interests can be identified and modeled at the appropriate risk adjusted rate that also factors in the characteristics specific to minority interests in the capital interest, including lack of control and marketability features. The anticipated timing of the future cash inflows and outflows, present valued at the required rate of return of an investor in the senior interest, determines its fair market value.

In a similar manner, the carried interest can be valued directly by modeling the general partner's expected cash inflows from distributions (returns on and of capital plus proceeds available to the general partner from the liquidation of fund assets), and outflows from obligations (capital commitments) and allocated charges (management fees and other operating expenses) over the life of the fund, and determining their present value using a required rate of return specific to the characteristics and risks of the non-managing, member minority interest in the carrried interest.

The direct valuation of the capital and carried interests establishes the basis of the fair market value, separately, of each of the individual interests. By this means, the senior interest's value is not attributed to the junior interest. Further, while the junior interest has the potential for significant appreciation, the extreme uncertainty of the fundamental drivers of its potential future value combined with the uncertainty of the degree of success of as yet unidentified companies that will eventually comprise the fund's investment portfolio, require that the carried interest's purchase at the fund's inception be made, to some extent, on blind faith. The required rate of return should reflect the riskiness of blind faith future cash flows allocable to the carried interest's non-managing, members.

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