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Point of View

BOOM IN TRUSTS PASSING CARRIED INTEREST TO HEIRS

Arden Dale of The Wall Street Journal writes about the latest boom in trusts by members of the private equity community passing their carried interest to their heirs. This latest boom has actually been the “Go to Strategy”, that M3 has utilized with their PE clients since 1997.

The illiquidity and enormous potential for appreciation of private equity fund carried interest of our clients created both the need and the opportunity to pursue sophisticated estate planning. In the event of the premature death of a member, their estate may be faced with a liquidity gap for their taxable estate, and over the long term the carried interest can produce significant valuations subject to estate transfer costs.

The solution utilized by M3 and their team of advisors consisted of setting up family LLC’s controlled by the PE member, and gifting or selling the LP interest at a discounted value to a defective trust for the benefit of their heirs. These can even be structured where the member can be the income tax payer on the growth of the carried interest while trust compounds income tax free.

Freeze, Discount and Leverage, are the prefect trifecta for an effect estate arrangement that transfers the future value of carried interest outside of the members taxable estate while providing access to the funds if ever needed by the family.

M3 Wealth Advisors LLC | Two Newton Executive Park | 2227 Washington Street, Suite 202 | Newton, MA 02462 | 781-371-2672 | M3WealthAdvisors.com

WEALTH ADVISER

Boom in Trusts Passing Carried Interest to Heirs

By ARDEN DALE CONNECT

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A new generation of principals in their 30s and 40s at private-equity firms and hedge funds are making their first estate plans, creating a boom in trusts that give their heirs a lucrative slice of the investments they oversee.

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Under this strategy recommended by industry peers and financial advisers, heirs get the right to collect a share of carried interest, a form of compensation that rewards an investment manager for enhancing performance. It could potentially save a lot in federal gift and estate taxes.

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What makes carried interest a popular gifting vehicle is that it typically has a relatively low value initially due to its speculative nature. But, as a hedge fund's returns grow, so does that value of the carried interest.

Dan Schrauth, a wealth adviser in the San Francisco office of J.P. Morgan Private Bank, calls carried-interest planning the "go-to strategy" when working with clients at hedge funds as well private-equity and venture-capital firms.

"It's where you start the conversation," said Mr. Schrauth, who brings it up with every one of his client in this niche.

Recently, he introduced the idea to the partner of a Silicon Valley venture-capital firm. The man, in his early 40s, wants to get started on an estate plan that includes gifts to his heirs. He liked the idea of a trust that would hold carried interest from a new fund he plans to raise soon. The client will start modestly, transferring a small percentage of his carried interest.

Carried interest lets the general partner of a private investment fund share its profits. Often, the general partner is a partnership itself, owned by investment managers. It may contribute 1% to 5% of initial capital for the fund. It also manages the fund's assets and gets an standardized annual management fee of 2% of the assets, as well as carried interest.

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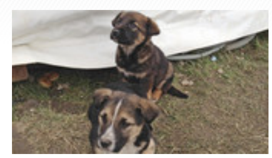

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Carried interest typically equals 20% of a fund's profits over a set rate of return. Individual partners in the general partnership, not the partnership itself, pay taxes on these profits. On average, carried interest accounts for about one third of the payments that private-equity general partners get while management fees make up the rest, according to the Tax Policy Center.

Various kinds of trusts are suitable to use for the carried-interest strategy. Some tax attorneys use versions of grantor retained annuity trusts, and others like a strategy known as a sale to a defective grantor trust. Both are widely employed to reduce or eliminate federal gift or estate taxes on gifts to heirs.

The goal is to find an asset that's likely to increase sharply in value, and pass the appreciation on it to heirs with no tax due. Carried interest, like real estate, art, partnership interests and other assets, has to be valued by a professional before it goes into a trust.

"If it explodes in value, you've hit a home run," said Tye Klooster, an attorney and partner at Katten Muchin Rosenman in Chicago who specializes in carried-interest transfers. A trust set up at the outset when a fund is new is more likely to succeed, because of the carried interest's low value, he said.

However, caution is required when making a carried-interest transfer. The Internal Revenue Code includes various provisions which could trip up the planning, Mr. Klooster pointed out.

Tax planners make use of what they call the "vertical slice" exception to Section 2701 of the tax code--which spells out how to value partnership interests in trusts--to transfer a derivative tied to the performance of the carried interest. The derivative planning allows growth on the carried interest to be passed along without actually transferring the interest itself.

Vertical-slice planning is one of the more straightforward forms of carried-interest planning, said Christine Quigley, an attorney in the Chicago office of law firm Holland & Knight. It tends to be more attractive to younger principals who are doing significant planning for the first time, for that reason, she said.

Ms. Quigley said the term "vertical slice" is used because the strategy essentially involves taking a slice out of each class of ownership or interest that a principal has in a fund. It gives away a proportional share of each of those interests.

Given their financial sophistication, adviser Joseph W. Spada's clients in this niche often know a little bit about the strategy when they come to him.

"They have heard about this because their peers have done it, and we sit down, say 'what are your goals?' and explain how these work," said Mr. Spada, a senior principal at Summit Financial Resources Inc. in Parsippany, N.J., which manages around $3.5 billion.

He recently talked with one client, a private-equity partner worth about $70 million, about creating a trust to gift carried interest in a new fund to his children. A gift of $1 million to the trust now could be worth as much as $10 million in seven years, according to estimates.

Write to Arden Dale at arden.dale@wsj.com

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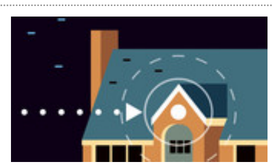

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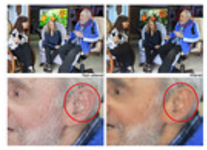

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