

## Estate Planning for Transfers of Hedge Fund and Private Equity Interests

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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# Estate Planning for Transfers of Hedge Fund and Private Equity Fund Interests

Marc J. Bloostein

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# Hedge Funds

- Hedge funds are pooled investment vehicles
  - Investors are institutions and wealthy individuals
  - High minimums and investor qualification requirements
  - No set investment period
  - Typically accept new investments and permit redemptions
- There are all kinds of hedge funds
  - Various assets, e.g., public equities, distressed debt
  - Various strategies, e.g., long/short, arbitrage, derivatives
- Compensation
  - Management fees
  - Percentage of profits

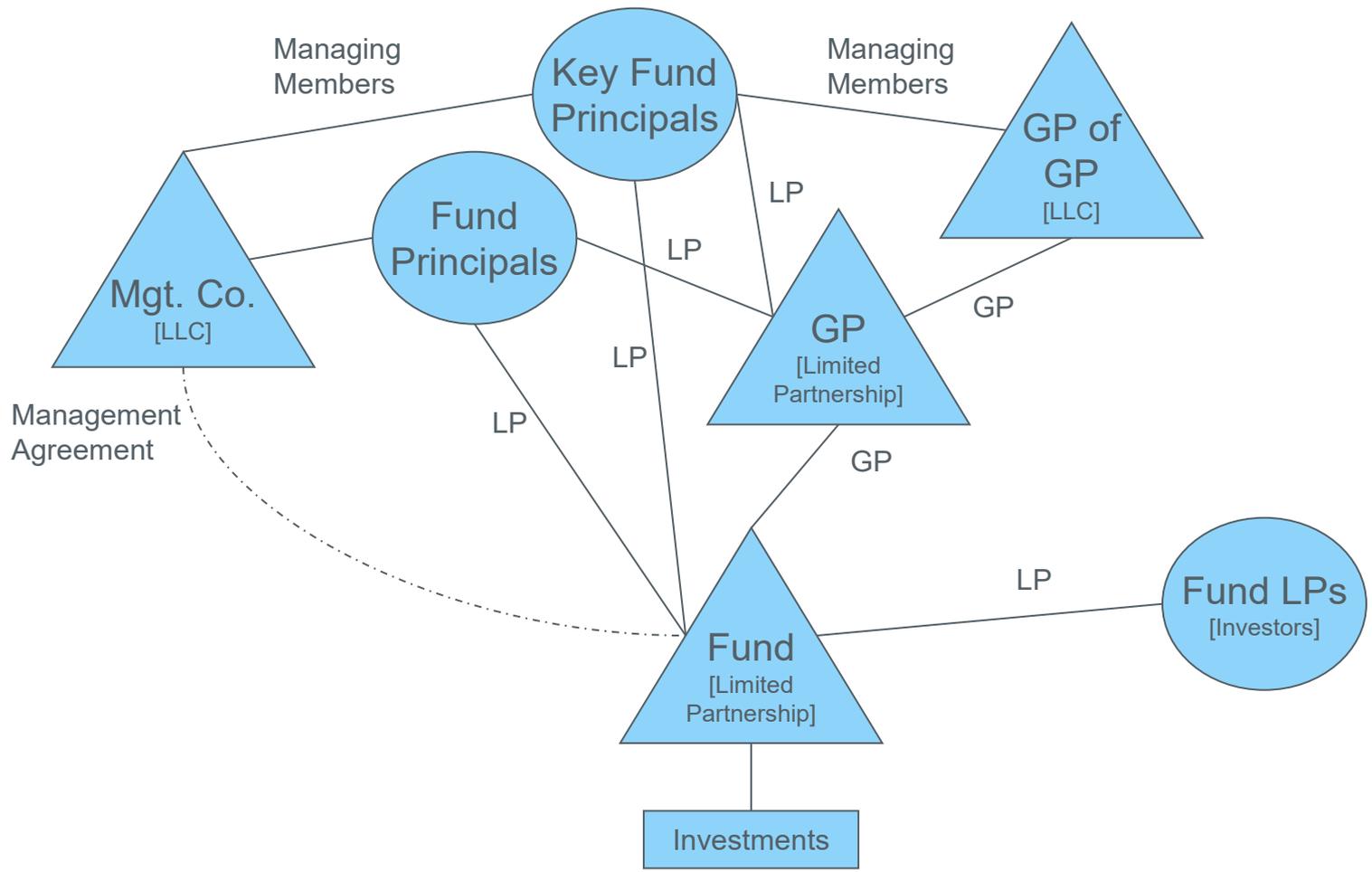
# Private Equity Funds

- Private equity funds are also pooled investment vehicles
  - Investors are institutions and wealthy individuals
  - High minimums and investor qualification requirements
  - Up-front capital commitments called over time
  - No liquidity until an investment is sold
- There are all kinds of PE funds
  - Various investment stages, e.g., buy-out, venture capital
  - Various industries, target sizes, geographic focus, etc.
- Compensation
  - Management Fees
  - Percentage of profits

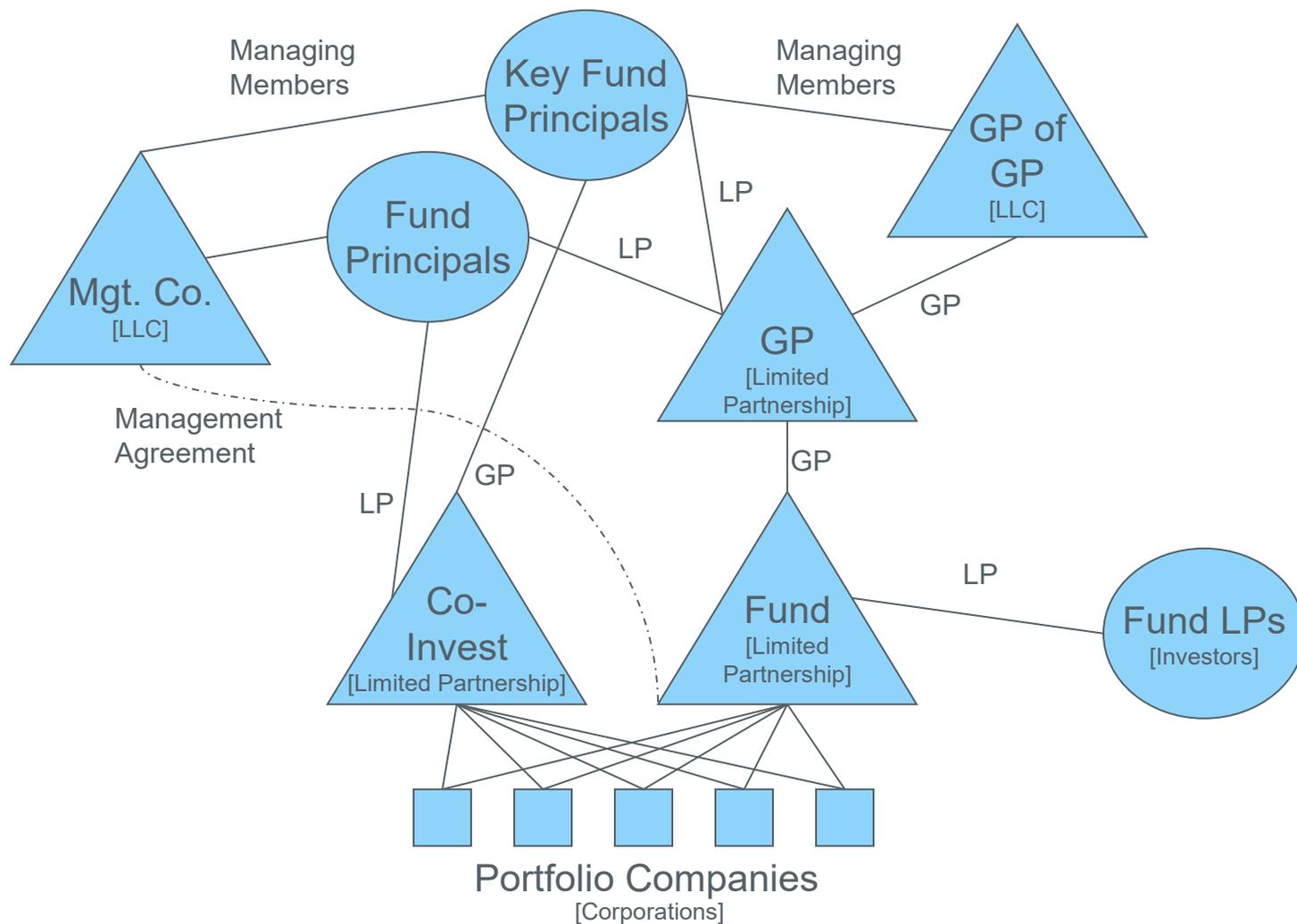
# Key Terminology

- “Firm”; “Sponsor”
- “Fund”
  - “Fund Limited Partnership”
  - “Fund GP”
  - “Fund LPs”
- “Management Company”
- “Fund Principal”
- “Carried Interest”, “Carry”, “Performance Fee”, “Override”
- “Management Fees”
- “Fee Waiver”

# Typical Hedge Fund Structure



# Typical PE Fund Structure



# Hedge Fund Economics

- Annual management fee (+-2%)
- Performance fee (carried interest) paid annually (or sometimes quarterly)—
  - Profits allocated—
    - +-80% to LPs
    - +-20% to GP (this is the GP's “carried interest”)
    - May be a hurdle
    - May be high water mark
- GP's performance fee generally remains invested in the fund

# 1 2 PE Fund Economics

- Annual management fee (+-2%)
- When each investment is sold—
  - GP and LPs receive back contributed capital
  - GP and LPs receive a hurdle return (7-10%/year)
  - Remaining profits allocated
    - +-80% to LPs
    - +-20% to GP (this is the GP's “carried interest”)

# 1 3 Management Fee Waiver

- Fund documents may permit waiver of fees before they accrue
  - Gives rise to an additional profits interest
    - Equals waived fees plus investment return
  - Satisfies investment commitment
- Fee waiver advantages
  - Fund Principals “invest” with pre-tax dollars
  - Distributions are generally long-term capital gain

# Principals' Fund Interests

- Interest in the Fund GP
  - Capital
  - Carry
  - Fee waiver profits interest
- Capital invested outside the Fund GP
  - Through the Fund
  - Side-by-side with the Fund
- Interest in the Management Company
- Interest in the Firm

# Estate Planning with Fund Interests

- What to transfer?
  - Carried interests are an ideal candidate for lifetime transfers
    - Low current value and high potential value
  - Other fund interests
    - It may be necessary to transfer fee waiver and capital investment (I.R.C. § 2701)
- When to transfer?
  - Best time is at outset of a new Fund
    - Likely lowest value; no invested capital to transfer
  - Possible to transfer carry later
    - Investments already made; value may be less speculative

# Transferring Carry—Completed Gift Issues

- Gift tax applies at time a gift becomes “complete”
  - The donor must give up dominion and control over the transferred interest
  - The donor must have an enforceable property right in the interest before he or she can transfer it
    - Rev. Rul. 98-21
      - Transfer of unvested stock option incomplete gift
- Timing of transfer is crucial because valuation could change dramatically over a relative short period of time

# Fixed Interests In Carry

- Carry percentages must be fixed at outset
  - Hedge Funds—the sharing ratio or distributive share may be fixed or may be set annually by the Key Fund Principal
  - PE—typically there is a presumed sharing ratio or distributive share to apply to each fund investment
- Future adjustments possible
  - Accretion and dilution
  - Individualized compensation-related changes
    - Increases should benefit only the Principal
    - Decreases could either affect Principal first or be shared proportionally

# Vesting

- Unvested interests may be transferred as long as they constitute enforceable property rights
  - Entitlement to 100% of current distributions
  - No requirement to return distributions on departure
- A Principal's ability to affect interests by terminating employment is OK
  - Independent legal significance
- Fund GP agreement should deal with application of vesting provisions to transferred interests

# Vesting Examples

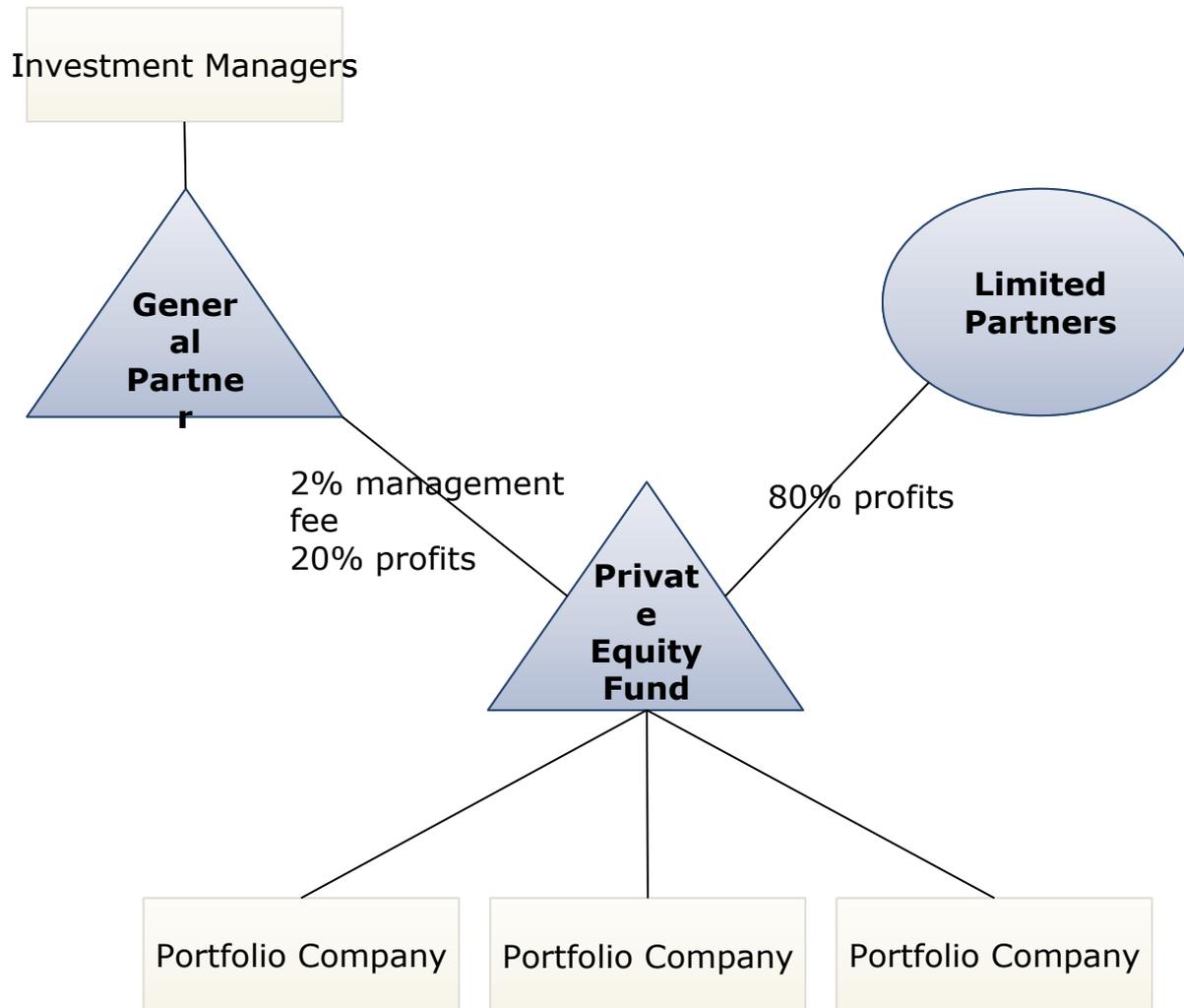
- Good
  - Partner/trust entitled to 100% of distributions while with Fund; post-departure distributions reduced to bring cumulative distributions to vested %.
- Problematic
  - Partner/trust entitled to 100% of distributions while with Fund; partner/trust required to repay distributions over vested % upon departure
  - Partner/trust entitled to current distributions only equal to current vested % and balance held in escrow
- If problematic, transfer only vested carry



# Estate Planning for Transfers of Hedge Fund and Private Equity Interests

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# Typical Private Equity Fund



# Income Tax

**Carried interest, income flowing to the general partner of a private investment fund, often is treated as capital gains for the purposes of taxation.**

- Some view this tax preference as an unfair, market-distorting loophole.
- Others argue that it is consistent with the tax treatment of other entrepreneurial income.

**Carried interest is a contractual right that entitles the general partner of an investment fund to share in the fund's profits.**

- These funds invest in a wide range of assets, including real estate, natural resources, publicly traded stocks and bonds, and private businesses.
- Hedge funds, for example, typically trade stocks, bonds, currencies, and derivatives.
- Venture capital funds invest in start-up businesses.
- And private equity funds invest in established businesses, often buying publicly traded companies and taking them private.

**Depending on the investment, the general partner's share of the profits can take a variety of forms: interest, royalties, long- or short-term capital gains, and dividends.**

- There is ongoing debate about whether partners receiving **long-term capital gains** and qualified dividends as carried interest should receive the preferential tax rates accorded to regular investors.
- The preferential tax rate is especially important for a private equity fund and its managers. A private equity fund typically uses carried interest to pass through a share of its net capital gains to its general partner which, in turn, passes the gains on to the investment managers. The managers pay a federal personal income tax on these gains at a rate of 23.8 percent (20 percent tax on net capital gains plus 3.8 percent net investment income tax).

# IRC Section 1061

## **Section 1061 of the Tax Cuts and Jobs Act (TCJA) changed the way carried interest is taxed.**

- TCJA increased the length of time a fund must hold assets for the gains that managers receive to be taxed at the 20% long-term capital gains rate.
- The law states that the fund must hold assets for more than 3 years in order for managers to pay the preferential long-term capital gains rate instead of the 37% ordinary income tax rate. Assets held between 1 and 3 years are now subject to re-characterization. Prior to enactment of this law, funds only had to hold the assets for more than 1 year to qualify for long-term capital gains.

## **Treasury Regulations**

- The Treasury Department and the IRS recently issued final regulations for the treatment of carried interest, clarifying parts of the TCJA to provide additional insight and taxpayer guidance.
- C corporations are exempt from the longer 3-year holding period.

# Overview of Federal Estate, Gift and GST Taxes

**Estate Tax** – imposed on property transferred at death

- Federal estate tax exemption: \$12,060,000
- Maximum rate: 40%

**Gift Tax** - imposed on property transferred during life

- Federal estate tax exemption: \$12,060,000
- Maximum rate: 40%

**Generation-Skipping Transfer Tax** - imposed on transfers of property to persons more than one generation removed from the transferor, as well as some trusts

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# Overview of Federal Estate, Gift and GST Taxes

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# Basis of All Transfer Taxes

## Fair Market Value

- Transfer taxes are imposed on the fair market value of property transferred
- Fair market value is defined to mean the price a willing buyer would pay to a willing seller for the property in an arm's length transaction
- For some types of property, such as securities listed on a national exchange, it is easy to establish what a willing buyer would pay to a willing seller for the property.
- For other types of property where there is no real market, such as fractional interests in real estate, it may be more difficult to fix a value.

## Valuation Discounts

- The apparent value of property is not necessarily the fair market value of the property for transfer tax purposes. The IRS has been forced to recognize valuation discounts in a number of different contexts:

Discount for lack of marketability – difficulty in sale of asset.

Discount for minority interest – lack of control.

Discount for fractional interests – owning less than 100% of property.

Discounts for restrictions on sale.



# What is the Importance of Estate Planning for Carried Interests?

**The high growth potential of carried interests, as well as of non-public stock of fund-backed companies, makes them ideal for estate planning leveraging techniques**

# Planning to Reduce Estate Taxes

## **Gift of \$12,060,000 lifetime gift tax exemption**

- Assets with low current value, and significant growth potential
- Maximize the value of the transfer but minimize the use of the gift tax exemption
- Valuation discounts

## **Installment Sale to an Intentionally Defective Grantor Trust (IDGT)**

## **Grantor Retained Annuity Trust (GRAT)**

## **Charitable Lead Annuity Trust (CLAT)**

# Grantor Retained Annuity Trust - Overview

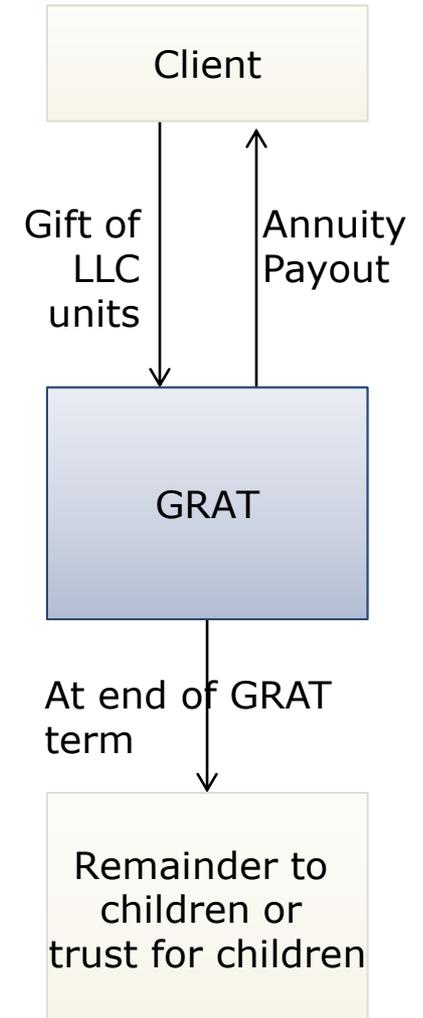
**A Grantor Retained Annuity Trust (GRAT) is an irrevocable trust designed to transfer future appreciation to individuals or trusts, typically children or other family members, in a tax-efficient manner.**

- The Grantor initially funds the GRAT with assets that are expected to appreciate. The GRAT returns to the Grantor fixed annuity payments for a fixed number of years.
- A GRAT can be structured so that there is little or no transfer tax cost. The present value of the stream of annuity payments from the GRAT is structured to be almost equal to the value of the property with which the GRAT is initially funded.
- If the assets in the GRAT appreciate at a rate that exceeds the IRS's growth rate assumption (the "7520 Rate"), all appreciation in excess of this threshold passes free of transfer tax.
- The 7520 Rate for June 2022 is 3.6%.

# Grantor Retained Annuity Trust - Illustration

## Assumptions

- Client transfers \$10 million worth of LLC units to GRAT in June 2022. The term of the GRAT is 5 years.
- Annuity payments from the GRAT to client re:
  - Year 1 \$1,511,510.14
  - Year 2 \$1,813,812.17
  - Year 3 \$2,176,574.60
  - Year 4 \$2,611,889.52
  - Year 5 \$3,134,267.86
- The payments may be made in LLC units.
- Assumed annual appreciation is 8%
- June 2022 7520 Rate is 3.6%.
- **Value of assets transferred to beneficiaries at end of 5 years is \$1,858,142**
- **Gift tax cost is almost \$0.**



# GRAT – Advantages and Disadvantages

## Advantages

- Appreciation, in excess of the 7520 rate, can be transferred at no tax cost
- Does not require any outlay of cash to be funded
- Set up and administration costs can be relatively modest depending upon assets used to fund trust
- Gain on any sale of assets during the term of the GRAT is taxable to the grantor, providing further income tax leveraging of the gift

## Disadvantages

- To receive the intended benefits from a GRAT, the Grantor must survive the term
- If the property in the GRAT does not appreciate in excess of the 7520 rate, there will be little or no property in the GRAT at the end of the term
- Inefficient for GST exemption
- Depending upon the characteristics of the assets gifted, a valuation of those assets may be required

# Sale to IDGT - Overview

**A Sale to an Intentionally Defective Grantor Trust (IDGT) is designed to transfer future appreciation to trusts for lower generation, typically family members, in a tax-efficient manner**

- The Grantor sells assets to the IDGT in exchange for an interest-bearing note\*
- If the assets sold to the IDGT appreciate in value at a rate in excess of the AFR, appreciation in excess of AFR passes free of transfer tax
- Transactions between the Grantor and the IDGT are typically ignored for income tax purposes
- No sale is deemed to occur and no part of the gain inherent in the asset becomes taxable by reason of the sale

\*IDGT should be funded prior to the sale.

It may be funded with a gift.

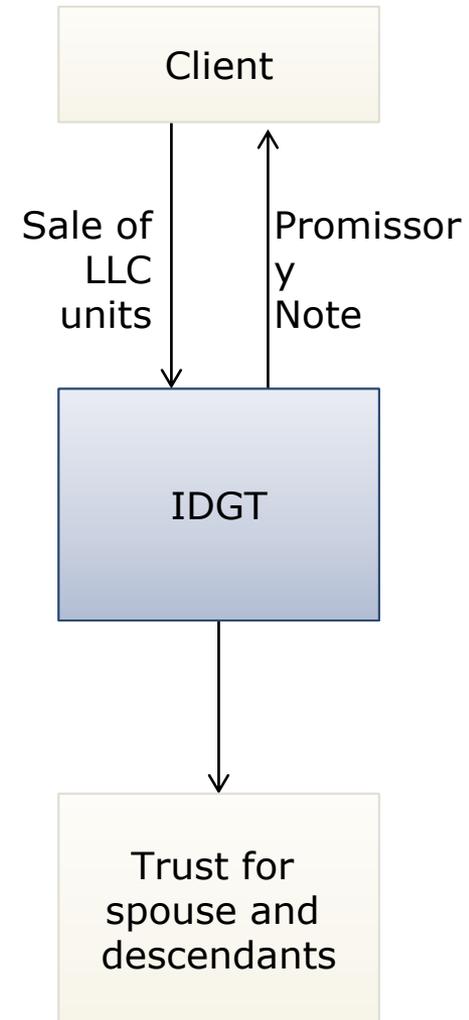
The value of the gift is typically equal to 10% of the value of the property sold.



# Sale to IDGT - Illustration

## Assumptions

- Client sells \$10 million worth of LLC units to IDGT
- IDGT gives Client 9-year promissory note, providing for 2.93% annual interest (AFR) during the term, and a balloon payment at the end of the term
- 8% annual growth rate
- Annual interest payments from IDGT to client are \$293,000
- **Value of assets transferred at end of 9 years is \$6,331,192**



# Sale to IDGT – Advantages and Disadvantages

## Advantages

- Potentially leveraging effect
- Beneficiaries can receive distributions while the note is being paid to Grantor
- Can be effective for GST planning because GST exemption can be allocated at creation
- May still be partially effective if the grantor dies during the term
- Lower interest rate hurdle than a GRAT
- Transactions between the Grantor and the IDGT are typically disregarded for income tax purposes

## Disadvantages

- There is a significant gift element
- If the Grantor dies before the note is satisfied, the balance due on the note is included in the estate. It is uncertain whether death triggers capital gains
- Depending upon the characteristics of the assets sold, a valuation of those assets may be required
- Gift tax return is not required, but is often recommended if non-marketable assets are sold to the IDGT

# Charitable Lead Annuity Trust - Overview

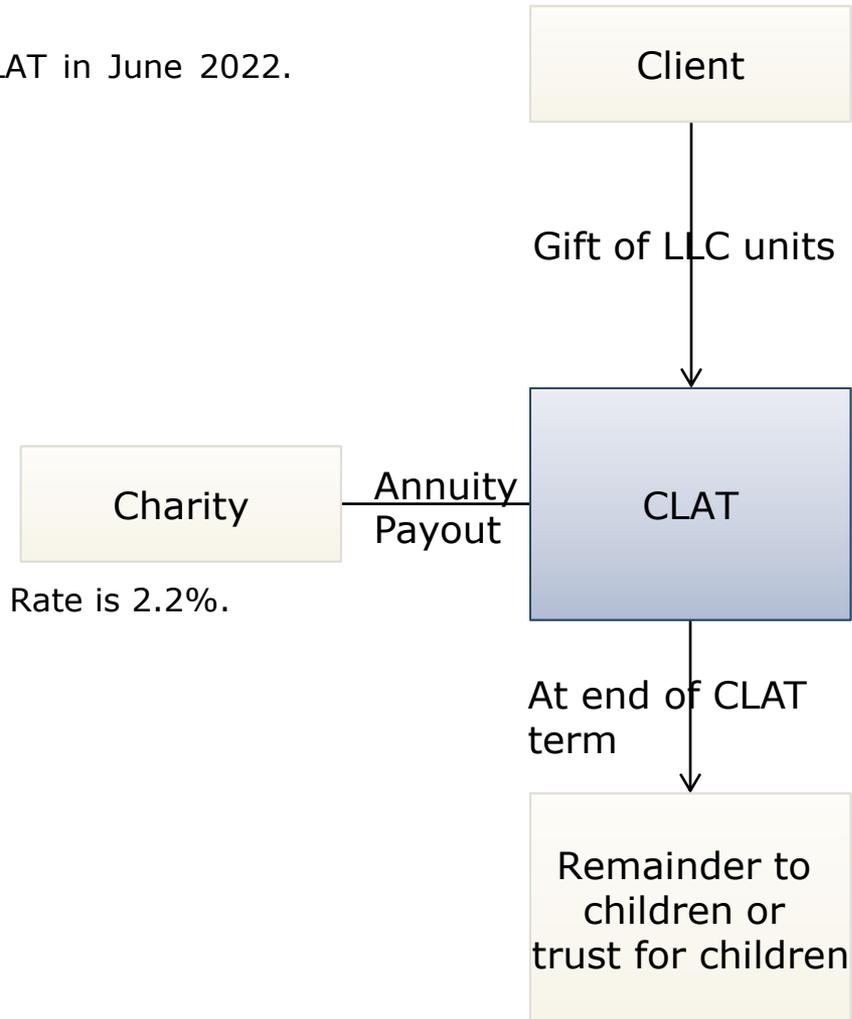
**A CLAT is an irrevocable trust designed to provide financial support to one or more charities for a period of time, with the remaining assets eventually going to family members or other beneficiaries.**

- CLATs operate for a set term, which could be the life of one or more individuals, and payments are made to one or more designated charitable beneficiaries for that time period.
- After the end of the trust term, the remainder of the trust is distributed to non-charitable beneficiaries, such as family members.
- CLATs can be funded either during the lifetime of the individual creating the trust or by will.
- It is a strategy most frequently used by the charitably inclined for estate or gift tax planning purposes.
- It can potentially provide benefits such as an income tax deductions or estate or gift tax savings on assets ultimately passed to the individuals designated as remainder beneficiaries.
- At the same time, the trust distributes regular payments to benefit a preferred charity or charities during the term of the trust.
- Grantor CLATs. The grantor can take an immediate income tax charitable deduction for the present value of the future payments that will be made to the charitable beneficiary, subject to applicable deduction limitations depending on whether the beneficiary is a public charity or a private foundation. However, this benefit should be considered in conjunction with the fact that the trust's investment income is taxable to the grantor during the trust's term.
- Non-grantor CLATs. The trust, not the grantor, is considered the owner of the trust assets. Accordingly, the grantor is not eligible to take an income tax deduction for the present value of the lead interest to charity. It is the trust itself that pays tax on its undistributed net income, and the trust is able to claim an unlimited income tax charitable deduction for its distributions to the charitable beneficiary.

# Charitable Lead Annuity Trust - Illustration

## Assumptions

- Client transfers \$10 million worth of LLC units to CLAT in June 2022. The term of the CLAT is 5 years.
- Annuity payments from the GRAT to client re:
  - Year 1 \$1,445,065.83
  - Year 2 \$1,734,079
  - Year 3 \$2,080,895
  - Year 4 \$2,497,074
  - Year 5 \$2,996,489
- Assumed annual appreciation is 8%. April 2022 7520 Rate is 2.2%.
- **Client's income tax deduction: \$10 million**
- **Benefit to Charity: \$10,753,602.83**
- **Benefit to Children: \$2,422,359.68**



# IRC Section 2701 and the “Vertical Slice”

**IRC Section 2701 may create gift tax liability where a fund manager makes a lifetime gift of an interest in a fund’s general partner to a family member and retains an interest in the same partnership that is not of the same class**

- Family member is narrowly defined – does not include nieces and nephews
- The gift tax liability would be for the value of all interests held by the fund manager – both the interests gifted and those retained
- Key: To avoid §2701, one must make a gift of a vertical slice – a proportionate amount of all interests owned by the fund manager in the general partner

# Vesting Issue

## **A fund manager's interest in the general partner's carried interest may be subject to a vesting schedule**

- This vesting schedule could be analogized to an unvested employee stock option
- A gift of these employee options is not a complete, taxable gift until the exercise of the option is no longer conditioned upon the performance of services by the employee. (Rev. Rul. 98-21)
- Thus, a gift of an unvested carried interest (which has a low value) may not be considered complete until the interest vests (when it likely has a high value)

## **Addressing the vesting issue**

- Only transfer the vested portion of a carried interest, or
- Take the position upon audit that an unvested general partner interest entitles its holder to property rights, including immediate rights to allocations and distributions, as if the interest were fully vested, thus, the analogy to employee stock options is not appropriate
- Structure the fund and general partnership agreement to minimize the risk of making an incomplete gift, i.e., do not require the fund manager to return capital account allocations or distributions made prior to resignation

# Management Fee Offset Arrangements

**This is when fund managers forego receipt of a portion of management fees in exchange for an offset against capital contributions to the fund, thereby reducing the capital contribution required of the general partner**

- The IRS may view this arrangement as a series of future gifts by the fund manager if the offset arrangement is not properly structured
- The direct link between the services provided by the manager and the reduction in the cash contribution that would otherwise be required could be viewed as an additional gift by the manager

# Reporting Transfers of Carried Interests on Gift Tax Returns

## Need to File a Gift Tax Return

- Filing a gift tax return begins the tolling of the 3-year statute of limitations
- Need for Professional Appraisers When Filing Gift Tax Returns
- Regardless of the statute of limitations, if a gift is not adequately disclosed the IRS can challenge its valuation at any time during the donor's life or at death
- Using a professional appraiser, rather than relying on a CFO's statement, can avoid this unwanted result
- Civil penalties for individuals preparing appraisals (whether or not professionals) for valuation misstatements starting at 65% or lower of determined value
- Could apply to CFO of fund who opines on value

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Thank you.

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# Estate Planning For Private Equity & Hedge Fund Principals

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June 9, 2022

**Holland & Knight**

# CARRIED INTEREST TRANSFER CONSIDERATIONS

# Agenda / Objectives

- Review IRC Section 2701 concerns:
  - Application of Section 2701 to an “applicable retained interest,”
  - Required “family control” for purposes of preferential distribution right requirement
  - Certain exceptions to IRC 2701, including the vertical slice.
- Valuation of carried interest transfers.

# IRC Section 2701

- IRC Section 2701 may create gift tax liability where a fund principal makes a lifetime gift of an interest in a fund's general partner **to a family member** (or more typically their trusts) and retains (or other family members retain) an interest in the same partnership that is not of the same class.
  - The gift tax liability would be for the value of all interests held by the fund principal – both the interests gifted and those retained.
- **EXCEPTION:**
  - To avoid Section 2701, a fund principal may make a gift of a **vertical slice** – a proportionate amount of **all** interests owned by the fund principal in the general partner.

# IRC Section 2701: Subtraction Method & Applicable Retained Interests

- Subtraction Method:

- Value of the gift is an amount equal to the entire value of what the transferor owned prior to the transfer, reduced only by certain rights the transferor retains.
- Certain retained economic interests (defined as the “Applicable Retained Interests”) are disregarded for valuation purposes.

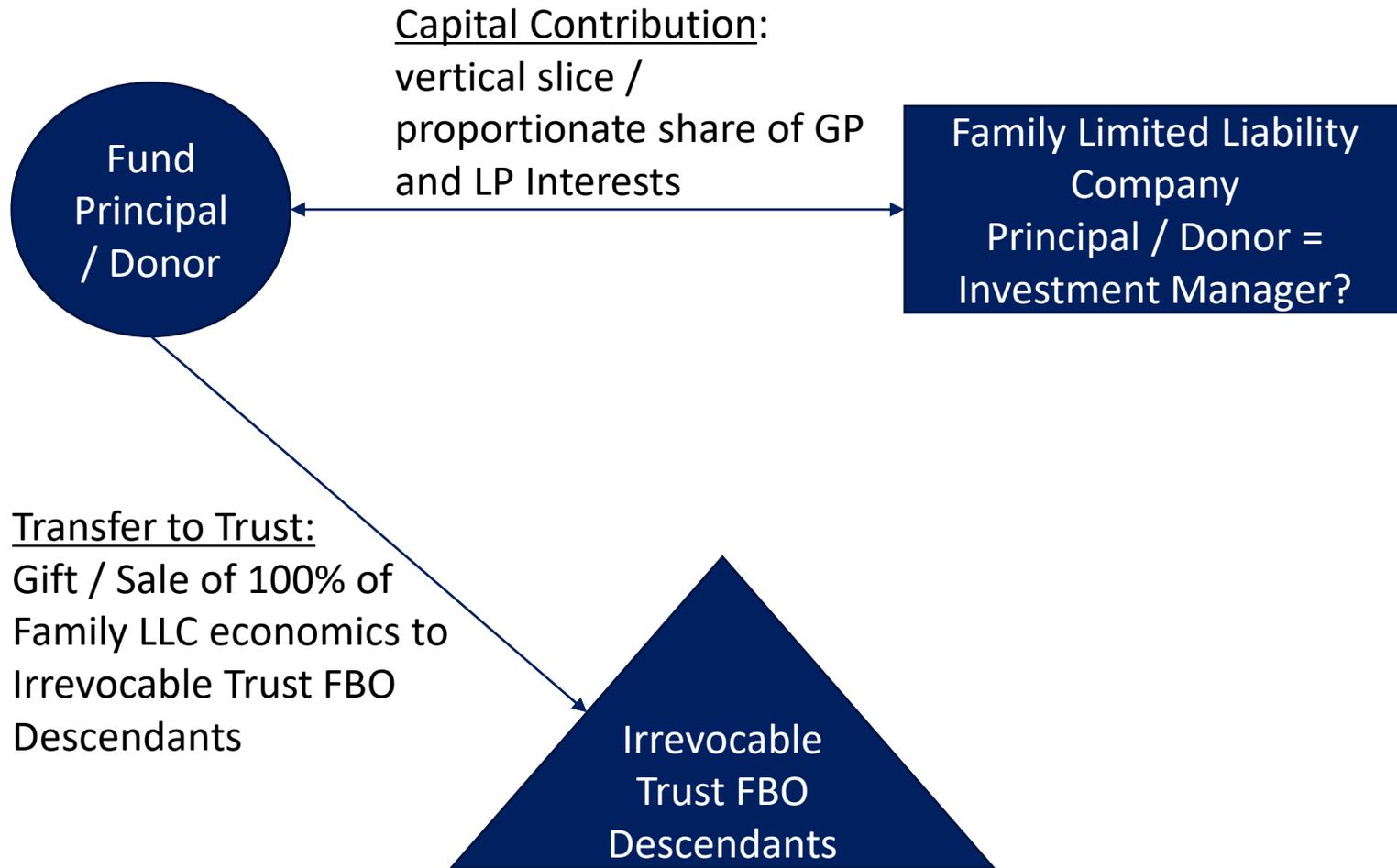
- Applicable Retained Interests

- A preferential distribution right from a family-”controlled” corporation or partnership which is not a “qualified payment.”
  - Qualified Payment = cumulative preferred dividend or cumulative preferred net cash flow distribution.
- A liquidation, put, call, or conversion right

# Vertical Slice Exception

- The vertical slice exception is a safe harbor under IRC Section 2701. It is a “proportionality” exception.
- IRC Section 2701(a)(1) shall **not** apply to any applicable retained interest if such interest is proportionately the same as the transferred interest, without regard to nonlapsing differences in voting power (or, for a partnership, nonlapsing differences with respect to management and limitations on liability). See IRC Section 2701(a)(2)(C).
- Example: PE principal wishes to transfer 25% of his GP Carried Interest to applicable family members. The vertical slice exception requires the principal to transfer a proportionate 25% LP Interest.

# LLC Wrapper For Vertical Slice Transfer



# Non-Vertical Slice Carry Transfers

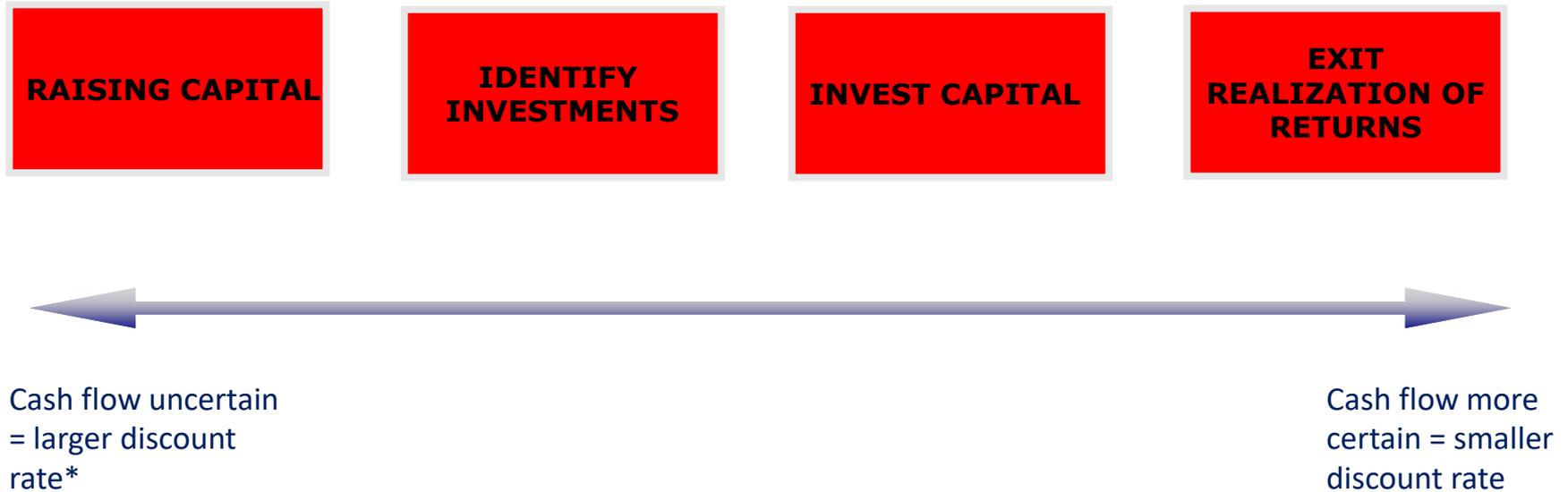
- Gift Not to “Applicable Family Member.”
  - “Applicable Family Member” = any lineal descendant of any parent of the transferor or of the transferor’s spouse.
- Side-by-Side Co-Investment Vehicle
  - Potential to segregate carried interest from co-investment interest as a mechanism to avoid application of IRC Section 2701.
  - Investment made directly in a portfolio company in lieu of through the GP or LP entities.
  - Principal may still have investments through the GP and/or LP entities, but the idea is to limit the scope of those investments to more easily facilitate a gift of the pure carried interest.

# Non-Vertical Slice Carry Transfer

- Does the principal / family have “control”?
- Section 2701 will apply to typical private equity waterfall distribution ordering.
- The Section 2701 special valuation rule will apply to a preferential distribution right if, immediately before the transfer, the transferor and applicable family members, hold “control” of the entity. See IRC 2701(b)(1)(A).
  - “Control” = (i) holding at least 50% of the capital or profits interest in the partnership, or (ii) “in the case of a limited partnership, the holding of any interest as a general partner.” See IRC 2701(b)(2)(B).
- Typically, principal would have an interest *in the general partner entity*, but would not, hold a direct interest “as a general partner.”
- Does this distinction provide sufficient safety to make a pure carry, non-vertical slice gift where the transferor and his or her family do not own 50% or more of the GP entity? See, e.g., Private Letter Ruling 9639054.

# VALUATION CONSIDERATIONS

# Factors Affecting Valuation: Timeline of Fund



\*Transfer Tax Planning at the inception of the Fund likely to provide greatest gift tax efficiency

# Determination of Value

- Carried interest most frequently valued through a discounted cash flow methodology.
  - New fund each valuation;
  - Finite fund terms; and
  - Value at inception of the fund is based on a forecast of several factors
    - Interesting to note whether prior successful performance of previous funds may impact valuation of a successor fund, i.e., track record of success.

# Minority and Marketability Discounts

- Concluded present value of the estimated future cash flows of the Fund represent an indication of value of the carried interest of the entire general partner's carry.
- Minority and Marketability Discounts can be appropriate as long as the transferred interest does not represent a "controlling interest" in the GP.
- Minority and Marketability Discounts are cumulative. Example:

Controlling, marketable value:	\$1,000,000
less: minority discount (20%):	(\$200,000)
Minority, marketable value:	\$800,000
less: marketability discount (30%):	(\$240,000)
Minority, nonmarketable value:	\$560,000*

\*Combined valuation discount = 44%



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**Brent Berselli** is a partner in Holland & Knight's Portland office and is a member of the firm's Private Wealth Services Practice Group. Mr. Berselli serves as general counsel to wealthy individuals, their families and their businesses throughout the United States to design and implement sophisticated strategies integral to family wealth planning. High-net-worth individuals, including principals of private equity, venture capital and hedge fund firms, private and public company executives, real estate developers, entrepreneurs and business owners, turn to Mr. Berselli for advice and counsel in all aspects of wealth transfer strategies, income and transfer tax planning, philanthropy and business succession.

**Family Office Entities.** Pooling family assets offers several advantages, including access to investments that would otherwise be unavailable to certain family entities and individuals, centralization of asset management decisions and the resulting reduction of overall investment fees and potential creditor protection. Mr. Berselli creates new entities to accomplish these goals and works with clients' investment advisers to ensure that appropriate investment policies are developed that focus on the overall asset mix, as well as the different investment objectives applicable to a client's taxable and nontaxable estate.

**Private Company Succession Planning.** A workable succession plan requires considerable development that often evolves over a multiyear period. Succession planning is necessarily an iterative process that requires close interaction between owners of privately held businesses and their advisors. Mr. Berselli guides business owners in designing and implementing a succession plan that balances the current and future needs of the business and the owner. Such coordination is particularly critical where an entrepreneur wants to transfer the business to the next generation but is relying on the ownership interest in the company to fund retirement.

**Pre-liquidity Event Planning.** Prior to a sale of a business or a major liquidity event, there are several wealth transfer opportunities that should be considered. Such strategies often focus on passing potential wealth to future generations in a tax-efficient manner. Mr. Berselli is often called upon to assist owners of businesses that are embarking upon such transactions to guide them in this critical pre-translation planning process.

**Wealth Planning for Private Equity, Venture Capital and Hedge Fund Principals.** The unique nature of private equity funds requires specialized planning for the principals of such funds. Implementation of any wealth transfer strategy requires careful attention to the nature of the principal's ownership interest, the fund documents and the manner of distributions. Mr. Berselli works closely with private equity fund principals to structure transfers involving their carried interests in their funds. Following such transfers, extensive additional planning opportunities are developed that are designed to maximize future wealth transfer while minimizing overall family transfer taxes.