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INTERNAL REVENUE CODE SECTION 2701 AND CARRIED INTEREST PLANNING—THE BASICS

By Genevieve M. Larson, Esq. and Kenneth A. Pun, Esq.***

A key component of wealth transfer planning is understanding the value—current and future—of an asset. That value is considered in deciding what to gift, when to gift, and what planning vehicle to use when gifting. Internal Revenue Code Section 2701 is a technical section that focuses on the value of intra-family transfers of interests in privately-held corporations or partnerships. Section 2701 can be a trap for the unwary transferor who does not take into account its provision when analyzing the value of a sale, gift, or exchange for adequate consideration.

If Section 2701 is applicable to a transfer, special valuation rules apply that differ from the standard test for fair market value under the willing buyer-willing seller rule.[1] The effect of Section 2701 can greatly increase the value of a gift and, therefore, may result in a significant and unexpected transfer tax liability.

This article is designed to provide a basic understanding of Section 2701 to guide planners in determining whether Section 2701 applies to a particular transfer. It then provides guidance on techniques to avoid the application of Section 2701 generally, and for planning with funds and carried interests in particular. Finally, the article considers how these planning techniques can be used in conjunction with other more common estate planning techniques when planning with carried interests.

I. BASIC CONCEPTS

Before addressing the technical terms of Section 2701, it is important to understand certain basic definitions of funds and carried interests. This section reviews those basic factors, and then discusses why carried interests can be an important part of a client's wealth transfer planning.

A. Definitions—Funds and Carried Interest

1. Funds, Generally

An investment fund, generally speaking, is a pooled investment vehicle in which multiple parties participate and one party manages the investments. The term may refer to one of several vehicles including mutual funds, exchange traded funds, real estate investment trusts, hedge funds, and private equity funds. This article will focus on hedge funds and private equity funds (collectively referred to as "funds"), both of which are private investment vehicles.

a. Hedge Funds

A hedge fund is an alternative investment fund that typically has a high minimum investment threshold and is open only to accredited investors.[2] Hedge funds usually have a wide range of investments, including stocks, options, bonds, commodities, derivatives, and/or most any other investment the fund manager believes will yield a significant return. Hedge funds are typically structured as a master-feeder fund. Investors contribute capital in a lump sum to a pass-through entity, such as a limited partnership ("LP") or limited liability company ("LLC") (the feeder entity), that in turn contributes the capital to an entity in which the underlying investments are held (the master fund entity). In return, the investor receives a capital interest in the LP or LLC (the feeder entity). The fund manager or the general partner of the master fund entity generally receives a fee for managing the investments held by the fund (typically 1-4% of the fund's capital or net asset value), as well as an interest that is tied to the success of the underlying investment assets (typically 20% of the profits, often referred to as a "carried interest," as discussed below).

b. Private Equity Funds

A private equity fund is an alternative investment vehicle that invests primarily in privately held companies or portfolio companies. Unlike hedge funds, investors in private equity funds contribute capital periodically as capital needs arise. The additional capital contributions generally are made in accordance with capital commitments agreed to at the inception of the fund. Private equity funds are often structured as LPs, with the investors contributing capital in exchange for LP interests and the fund manager contributing a relatively small amount of capital and serving as the general partner, typically through a pass-through entity such as an LLC. The fund manager or general partner often receives LP interests commensurate with his, her, or its contribution to the LP, compensation for the management of the underlying investments in the form of a management fee paid to a separate management company, and also some form of a profits or carried interest.

c. Carried Interest

As indicated above for both hedge funds and private equity funds, the individual or entity managing the underlying investments of the fund—the general partner or fund manager—receives an incentive payment to ensure the manager's interest is aligned with the investors contributing capital to the fund. The incentive payment goes by many names: the promote interest, incentive allocation, performance fee, or profits interest. For purposes of this article, such interest is referred to as the "carried interest." The carried interest is the manager's profit interest in the fund (which does not correlate to the manager's capital contribution to the fund). For example, a manager may be obligated to contribute 1% of the fund's total capital, but may be entitled to receive 20% of the profits as the holder of 20% of the carried interest.

2. *Carried Interest—an Ideal Asset for Wealth Transfer Planning*

Gift, estate, and generation-skipping transfer taxes (collectively referred to as "transfer taxes") are based on the value of the property transferred at the time of the transfer.[3] As such, there is a substantial benefit to transferring assets that have a depressed or low value at the time of transfer but are likely to increase in value over time. For example, if a transferor makes a completed transfer of property valued at $1 million to a trust for the benefit of the transferor's children, such transfer is treated as a gift and must be reported for gift tax purposes. The gift tax is calculated using the date of transfer value, or the $1 million value. If the same property subsequently increases in value to $10 million, the additional $9 million of growth in the children's trust will not be subject to any additional transfer taxes with respect to the original transferor.

Wealth transfer planning is most successful when the value of the transferred asset is low at the time of the transfer and the post-transfer appreciation is expected to be high. Carried interests fit both of these hallmarks. Because a fund's success is uncertain at its inception, the value of a carried interest is depressed in the early stages of the fund. As a result, there is a significant inherent potential for future appreciation with carried interest. The combination of the initial low value and the potential for appreciation makes carried interest an ideal asset for wealth transfer planning.

II. INTERNAL REVENUE CODE SECTION 2701

Chapter 14 of the Internal Revenue Code contains numerous gift and estate tax provisions designed to reduce or eliminate the benefit of certain types of transactions or arrangements entered into between family members. Section 2701 and the sections that follow were enacted to prevent perceived valuation manipulation in transactions between family members.

The classic transaction that garnered the ire of the IRS pre-Section 2701 involved a transferor owning two classes of equity interests in an entity (e.g., common and preferred). These two classes of equity interest would have differing rights associated with each class. The preferred interest would have several discretionary rights (e.g., the right to compel liquidation of the entity, the right to require the entity to purchase the interest, the right to purchase additional interest in the entity, etc.).[4] These discretionary rights would artificially increase the value of the preferred interest. Correspondingly, the value of the common interest would be depressed since it would be adversely impacted by the exercise of the preferred rights. The transferor would ordinarily transfer the common interest and retain the preferred interest. The impact of the preferred rights on the common interest resulted in a lower gift tax value for the transferred common interest in the entity. The transferor then would decline to exercise the discretionary rights of the preferred interest, allowing the common interest to grow in value as though the preferred interest rights did not exist. This election not to exercise the discretionary rights associated with the preferred interest achieved a shift in value without incurring a gift tax.

Congress responded to this perceived abuse by enacting Section 2701. Section 2701 sets out special valuation rules intended to curtail valuation manipulation with intra-family transfers of entity interests. Under certain circumstances, it attempts to ascribe a portion (or even all) of the value of the retained preferred interest to the value of the transferred common interest. In short, the value of the transferred common interest is inflated. The result is a larger gift tax value than anticipated.

A. Basic Rule

Any Section 2701 analysis depends upon an understanding of its key terms. While Section 2701 has a broader application than many believe is necessary and the definitions of the key terms are not always intuitive, it helps to keep in mind the intent of Section 2701: to prevent valuation manipulation in intra-family transfers of equity interests in an entity where the senior generation retains certain preferred rights that are discretionary in nature. Section 2701 is implicated where a transferor makes a "transfer" of an "equity interest" in an entity to a "member of the family," and the transferor and/or

"applicable family members" retain an "applicable retained interest" in that entity.[5]

B. Impact of Rule

As detailed below, when Section 2701 applies, the value of the transferred interest for gift tax purposes may far exceed the value that is actually transferred. The deemed gift provisions of Section 2701 artificially increase the value of the transferred interest for gift tax purposes.

In the fund context, the transferor of a carried interest likely will be deemed to also have gifted the transferor's capital interest or LP interest in the fund when Section 2701 applies. This additional deemed gift increases the value of the gift, and may be particularly problematic where the transferor has contributed a substantial amount into the LP interest. This outcome arises under the rules of Section 2701 despite the fact that the transferor actually only transferred the carried interest and not any LP interest.

C. Definitions

1. *Transfer*

Generally, the event triggering the application of Section 2701 is a transfer. The term "transfer" is broadly defined in Section 2701 and goes beyond what would be considered a gift for gift tax purposes.[6] For example, under the Treasury Regulations ("Regulations") for Section 2701, a transfer may include a capital contribution to a new or existing entity, a redemption, a recapitalization or other change in the capital structure of an entity, a transfer for full and adequate consideration, or a termination of an indirect holding in an entity.[7]

In the context of a fund, the gift, sale, or exchange for full and adequate consideration of a carried interest or LP interest squarely falls within the definition of "transfer" in Section 2701 and triggers the application of its provisions. For purposes of this article, the terms "transfer" and "gift" will be used interchangeably, despite the broader definition of transfer in Section 2701.

2. *Equity Interest*

While Section 2701 only refers to an interest, the Regulations add the word "equity" but fail to expressly define an "equity interest" despite its relevance in the interpretation and application of the Section and the Regulations. The term "equity interest" and its meaning must be inferred from the definition provided under the minimum valuation rules of the Section.[8] This specific rule defines equity interest as stock or any interest as a partner.[9] It seems clear that direct ownership of a partnership interest is an equity interest, whether as a general or limited partner (this also would include a membership interest in an LLC). By contrast, a management fee payable to a management company is generally not an equity interest. Rather, it is compensation for services. Likewise, debt is not an equity interest unless it can be converted to stock or a partnership interest.

The inference as to the meaning of an equity interest continues, as the Section differentiates between the types of equity interest as either senior or junior (subordinate). A senior equity interest is an equity interest in an entity that has a right to distributions of income or capital that is preferred as compared to the rights of the junior interest.[10] By contrast, a junior equity interest (or subordinate interest) is an interest in an entity where there is a senior equity interest that has some form of preference.[11] For example, with a typical fund structure in mind, a carried interest would be the junior equity interest since it only entitles the holder to a right to a share of profits after payment to all investors (or LPs). The LP interest would be the senior equity interest since it has distribution preference over the carried interest by means of a priority for return of capital invested and often a preferred return component. However, without a more elaborate definition in the Code or Regulations, and given the complexity of many fund structures, it is often difficult to determine whether an interest in a fund truly constitutes an "equity interest" and whether a particular interest constitutes a "senior equity interest" or a "junior equity interest" for purposes of Section 2701.

3. *Member of the Family and Applicable Family Member*

The terms "member of the family" and "applicable family member" have separate definitions under Section 2701, but the definitions intersect. Specifically, the transferor and the transferor's spouse are included in both definitions. However, the term "applicable family member" generally refers to relatives from prior generations while the term "member of the family" generally refers to members of subsequent generations. "Applicable family member" is defined to include the transferor, the transferor's spouse, an ancestor of the transferor or the transferor's spouse, or a spouse of such ancestor.[12] By contrast, "member of the family" includes the transferor, the transferor's spouse, a descendant of the transferor, or the spouse of such descendant.[13]

4. Applicable Retained Interest

As described above, the perceived abuse that Section 2701 was enacted to prevent is the retention of discretionary preferred rights in an entity by a transferor in order to decrease the gift value of a transferred equity interest. The term "applicable retained interest" generally refers to those types of discretionary rights retained by senior generation family members under Section 2701, which are disregarded or valued at zero for valuation purposes.[14]

Applicable retained interests fall into two categories: (i) extraordinary payment rights and (ii) distribution rights.[15]

a. Extraordinary Payment Rights

Extraordinary payment rights include the right to liquidate the entity, buy or sell equity interests to or from the underlying entity, convert one form of equity into another, or any similar right, the exercise or non-exercise of which affects the value of the transferor's interest.[16] These rights generally will only be an extraordinary payment right when the holder of such right has the discretion as to whether (or when) to exercise it. Generally speaking, these are rights that would permit a holder to benefit while reducing the underlying value of the entity.

An extraordinary payment right does not include the following: (i) a right that must be exercised at a particular time and in a particular amount (*e.g.*, mandatory payment right or liquidation participation rights) or (ii) a non-lapsing right to convert the transferor's interest into a fixed number of shares of the same class as the transferred interest.[17] The nature of each of these powers prevents manipulation of the value of the transferred interests, eliminating the need to disregard them in the valuation process.

b. Distribution Rights

To the extent a transferor and applicable family members (senior generation) control an entity, distribution rights (*e.g.*, dividends) that they can trigger through control of the entity will be scrutinized because the exercise or non-exercise of these powers to compel a distribution impacts the valuation of the entity. Unlike extraordinary payment rights held by the holder individually, distribution rights are held by the entity itself. When a transferor and applicable family members control an entity, they can manipulate the value of the entity by the majority's exercise or non-exercise of distributions. The assumption is that a family-controlled entity will not make distributions to senior family members, notwithstanding their entitlement, in order to maintain and grow the value of the entity for the benefit of the junior family members.

Distribution rights are defined as any right to receive distributions from an entity other than: (i) a right to receive distributions with respect to any interest that is of the same class as, or a class that is subordinate to, the transferred interest, (ii) an extraordinary payment right and the exceptions thereto, or (iii) any right to receive a fixed guaranteed payment as described in Section 707(c) (guaranteed payments to a partner for services or the use of capital without regard to the income of the partnership).[18] Like the listed exceptions to extraordinary payment rights, these excepted rights do not affect the value of the underlying entity.

i. Control Requirement

While extraordinary payment rights are always applicable retained interests because holders have the right to exercise discretion with respect to such rights, distribution rights are only "applicable retained interests" to the extent "control" of the entity is held immediately before the transfer by the transferor, applicable family members, and lineal descendants of the parents of the transferor or the transferor's spouse.[19] For these purposes, "control" means:

> In the case of a corporation, at least 50% of the total voting power or total fair market value of the equity interest in the corporation.[20]
>
> In the case of any partnership, at least 50% of the capital or profit interest in a partnership (except any right to a guaranteed payment of a fixed amount under Section 707(c)), or any equity interest as a general partner of an LP.[21]

As noted above, funds are generally structured as LPs. If a fund manager holds an interest in the fund *as a* general partner, a fund manager will be treated as controlling a fund. If the general partnership is organized as an LLC, the fund manager generally will hold an ownership interest in the LLC which gives the fund manager an interest *in the* general partner of the fund. Notwithstanding this technical point, a conservative approach is that the fund manager will be treated as controlling a fund even if the fund manager only holds a membership/ownership interest in the LLC which is the general partner.

Planners should be aware of the various attribution rules under Section 2701, which address equity interests held indirectly by entities, such as partnerships, corporations and

LLCs and trusts.[22] However, a full discussion of such rules are beyond the scope of this article.

ii. Exception—Qualified Payment Rights

The Regulations create further carve-outs from the Section 2701 zero valuation rules for a distribution right, provided it is a "qualified payment right."[23] Generally, qualified payment rights are required payments, eliminating the perceived abuse by removing the ability for controlling applicable family members to allow such rights to lapse. A qualified payment right is a distribution that is any of the following:

> A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate;
>
> Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount; or
>
> Any distribution right for which an election has been made to treat the distribution right as a qualified payment.[24]

iii. Qualified Payment Right Election

Importantly, senior generation members may, in limited situations, elect to treat a retained distribution right as a qualified payment right on a properly filed gift tax return, thereby avoiding zero valuation treatment with respect to the interest.[25] Such an election is irrevocable. The election assumes that a fixed payment will be made to the holder of the equity interest on a specified date. Despite the specified date in the election, there is some flexibility in when the qualified payment is actually made, as the Regulations permit a four-year grace period from the due date.[26] Further, the qualified payment may be satisfied with a debt obligation, provided the term of the debt does not exceed four years and the debt obligation bears compound interest from the due date of the fixed payment at an appropriate rate.[27] To make a proper and effective election, the transferor must comply with onerous technical requirements to prevent adverse gift and estate tax implications.

If payments are not made as provided in the election, the holder's subsequent taxable gifts or taxable estate will, upon the occurrence of a taxable event (*e.g.*, the transfer of the equity interest with the qualified payment right), be increased by an amount determined under the Regulations[28]and the individual will be personally liable for any increase in tax attributable thereto.[29]

Again, the election is a limited form of relief for retained distribution rights only. Thus, if a fund manager transfers a carried interest and a small portion of the LP interest to a trust for children, and retains a significant portion of the LP interest that has a distribution right (such as right to preferred non-cumulative dividends on the retained LP interest only, assuming no other rights associated with the LP interest), then if the transferring fund manager fails to elect into a qualified payment right, the gift value will be increased by the fund manager's retained LP interest (as under the subtraction method, the retained LP interest will be valued at zero). In contrast, if an election is made for the retained LP interest to be a qualified payment right, and the fund manager agrees to fixed determinable dividend payments, then the retained LP interest will be valued using traditional valuation principles which reduces what would otherwise be the deemed value of the gift.

5. Recap of Rights that are Neither Extraordinary Payment Rights nor Distribution Rights[30]

As set out above, certain rights may be retained by applicable family members that do not fall into the definition of an extraordinary payment right or distribution right, and therefore are not "applicable retained interests" that trigger the application of the special valuation rules of Section 2701. These rights are as follows:

- Mandatory payment right, which is a right to receive a required payment of a specific amount at a specific time;
- Liquidation participation right, which is a right to participate in a liquidating distribution (as compared to a right to compel liquidation which would be an extraordinary payment right);
- Guaranteed payment right, which is a right to a guaranteed payment of a fixed amount without any contingencies under Section 707(c); or
- Non-lapsing conversion right, which is a right to convert an equity interest into a specific number or percentage of shares or interest.

The above stated rights do not allow the manipulation of value of intra-family entity interests as they are fixed or prescribed, and therefore Section 2701 is not triggered.

6. Statutory and Regulatory Exceptions to Section 2701

Again, Section 2701 is intended to prevent the manipulation of value of the equity interests in transactions between family members. The risk of manipulation can occur when: (i) senior family members retain discretionary rights the exercise or non-exercise of which impacts the gift tax value of equity interests transferred to junior family members or (ii) where applicable family members control an entity to a degree that allows manipulation of the value of equity interests. Therefore, under circumstances where value manipulation is not possible, Section 2701 does not apply. These circumstances expressly include the following:

- If there are readily available market quotations on an established securities market for either the transferred interest or the retained interest[31] (given that funds are private investment vehicles, it is unlikely this exception will apply to interests transferred by fund principals or managers);
- If the rights pertaining to the retained interest and the transferred interest are the same (the "same class" exclusion), except for non-lapsing differences in voting rights (or for partnerships, non-lapsing differences with respect to management and limitations on liability);[32] or
- If the transfer results in a proportionate reduction of each class of equity held by the transferor and applicable family members immediately before the transfer (commonly referred to as the "vertical slice" approach, more thoroughly set out below).[33]

III. PLANNING TO AVOID SECTION 2701 SPECIAL VALUATION RULES

If, using the above road map of the defined terms of Section 2701, a determination is made that a fund principal's or manager's proposed transfer of a carried interest will result in the application of Section 2701, a planner is left with two options: (i) find a solution to avoid Section 2701 or (ii) understand the valuation effect on the transfer under the special valuation rules of Section 2701.

As to the second option, the effect of Section 2701 is a deemed gift of the total value of the transferor's fund interest held immediately before the transfer, rather than the value of the fund interest *actually* transferred to family members. This is often a very undesirable outcome for the client, and one that the planner will seek to avoid. Therefore, carried interest planning usually focuses on avoiding Section 2701. The remainder of this article is an overview of planning techniques that use various safe harbor exceptions in Section 2701 to avoid its application.

A. Vertical Slice Planning

Section 2701 will not apply if a transferor (and all applicable family members) transfer a proportionate amount of each class of equity interest they own.[34] "Vertical slice" planning, as it has come to be called, is one of the most common approaches to planning with carried interests. It is a low risk plan that falls under the statutory safe harbor of Section 2701 and is relatively straightforward to implement.

In the fund context, a transfer of a transferor's equity interests in a fund that proportionately reduces all of his or her equity interests in the fund (including attributed interests under the attribution rules[35]) falls under the vertical slice exception. For example, if a transferor owns a carried interest and an LP interest, then to fit within the vertical slice exception, the transferor needs to transfer a proportionate share of each equity interest, namely a proportionate share of the carried interest and the interest in the LP (including the related obligation to contribute capital). Where the transferor has reduced every equity interest in the entity on a pro-rata basis, the ability to manipulate the value of the transferred interest by the transferor, through discretionary rights or otherwise, does not exist. Rather, the transferor and transferee will share proportionally in the future growth or decline in value of the fund.

A common method of utilizing the vertical slice exception is for the transferor to create a holding company and transfer proportionate interests (or even all interests) in the fund to the holding company. The transferor then transfers interests in the holding company, rather than the underlying discrete equity interests in the fund. Since the holding company owns all of the transferor's fund interest (or proportionate interests), a subsequent gift of an interest in the holding company would be a vertical slice, reducing proportionately all equity interests in the fund (carried and LP interest). This technique has two additional benefits: it minimizes the actual transfers of fund interests, which often require extensive documentation and approvals at the fund level; and it maintains privacy, as the fund is only privy to the holding company and not to any underlying planning that the transferor may undertake at the holding company level.

Vertical slice planning, however, can be restrictive. A transferor may have significant capital invested in the fund, thereby increasing the gift value upon transfer through

vertical slice planning. The transferor may be reluctant to pass along the significant obligations associated with the transfer of an LP interest and its required capital commitment to children, making vertical slice planning suboptimal. In such circumstances, there are other alternative solutions.

B. Family Holding Entities

An alternative to vertical slice planning is using a family holding entity structured to avoid the application of Section 2701 and its special valuation rules. This planning option requires the entity to be structured to take advantage of one of two safe harbors under Section 2701: (i) the same class exception,[36] in concert with the mandatory payment right exception,[37] or (ii) the qualified payment right exception.[38] Each is further discussed below.

Under both of the described planning options, the fund principal or manager (or transferor) creates a family holding entity into which all equity interests in the fund are contributed.

1. Mandatory Payment Right Holding Entity

After the creation and capitalization of the entity with fund equity interests, the entity issues two classes of equity interests, a common interest and a preferred interest. The preferred interest holder is entitled to a payment of a sum certain on a specified date, known as a mandatory payment right, while the common interest holder retains all the upside beyond the amount required to be paid to the preferred interest holder.

By way of example, a transferor funds a mandatory payment-right-holding entity with all of the transferor's equity interests in a fund (both carried interests and LP interests) and in return, the transferor receives both common and preferred interests in the holding entity. The preferred interest has a mandatory redemption right at par value within five years of issuance. The transferor then gifts some of the common interest in the entity to a trust for the benefit of the transferor's children while retaining all of the preferred interests in the entity. Despite the transferor retaining a portion of the common interest and all of the preferred interests, the gift to the children's trust should not trigger Section 2701 because the retained common interest is within the same class exception of Section 2701. The same class exception provides that the special valuation rules of Section 2701 are not applicable if the retained equity interest is of the same class as the transferred equity interest. In this example, the common interest is the same class as what is retained by the transferor and what is gifted to the trust. This is not the case for the preferred interest retained by the transferor. However, since the equity right associated with the preferred interest is neither an extraordinary payment right nor a distribution right as defined above, Section 2701 also would not apply to the preferred interest. Rather, the equity right associated with the preferred interest constitutes a mandatory payment right (namely, a right to receive a payment required to be made at a specific time for a specific amount).[39]

Section 2701 should not apply to the above example, since neither the retained common interest nor the retained preferred interest would fall within the definition of an applicable retained interest.

2. Qualified Payment Right Holding Entity

Another approach involves the same basic family holding entity and structure as discussed above, except the retained preferred interest has a qualified payment right rather than a mandatory payment right. Recall that a qualified payment right is a right to a distribution payable on a periodic basis, at least annually, and determined at a fixed rate[40] (*e.g.*, a cumulative distribution paid annually). In this case, the retained preferred interest would typically be subject to Section 2701 as a distribution right, but because the distribution right is structured as a qualified payment right, it is not subject to the harsh zero-value valuation rule of Section 2701.

An estate planner also must contend with the limitation known as the minimum value rule[41] if using this approach. Section 2701 provides that the value of the junior equity interest (in this case the common interest) cannot be less than its pro-rata portion of 10% of the sum of the (i) total value of all equity interests and (ii) the total amount of indebtedness owed to the transferor and all applicable family members. Thus, although the zero-value valuation rule of Section 2701 is not applicable, the value of the gift of a junior equity interest made by the transferor could be deemed to be greater than the fair market value of the interests transferred because of the minimum value rule of Section 2701. To avoid the minimum value rule, the planner must ensure that the qualified payment right is sufficient and not overstated or inflated in an effort to reduce the value of the common interest.

C. Irrevocable Trusts

Other non-vertical planning options have evolved that rely either on the use of irrevocable trusts combined with the various ownership attribution and ordering rules in Section 2701, or providing benefits to people other than the transferor's descendants.

1. Parallel Trusts and Incomplete Gifts

This technique involves the creation of two irrevocable trusts, each for the benefit of members of the transferor's family. One of the trusts is a grantor trust for income tax purposes and structured so that transfers to the trust are completed gifts for gift tax purposes. The other trust is a nongrantor trust for income tax purposes and structured so that the transfers to the trust are incomplete gifts for gift tax purposes.

The transferor transfers his or her carried interest to the completed gift trust, and concurrently, a proportionate amount of capital interest (or LP interest) to the incomplete gift trust. With respect to the transfer to the completed gift trust, if properly structured, ownership of the carried interest (subordinate interest) is attributable to the transferor's descendants[42] as beneficiaries of the trust, as opposed to the transferor, even though he or she is the grantor of the trust for income tax purposes. This attribution of ownership to the beneficiaries occurs because ownership by members of the family has priority over ownership of a grantor of a grantor trust under the order rules applicable to subordinate equity interests in Section 2701. With respect to the incomplete gift trust, so long as the trust is a nongrantor trust, ownership of the interest is attributable to the beneficiaries.[43] Thus, the transferor is not deemed to hold an LP interest (or an applicable retained interest by virtue of the equity interest of the LP interest) in the fund after the transfer since such transfer was to a nongrantor trust. Because the transferor is not attributed beneficial ownership in either trust and, most importantly, is not attributed beneficial ownership in the incomplete gift trust, the transferor would not have an applicable retained interest and, therefore, Section 2701 should not apply to either transfer for valuation purposes.

This technique solves some of the suboptimal planning that is inherent in vertical slice planning. Through the use of this parallel trust structure, the transferor can make a gift of only his or her carried interest and avoid paying any current potentially large gift tax on the LP interest.

2. Trust for the Benefit of Others

Another irrevocable trust technique involves an irrevocable trust created for the benefit of the transferor's parent, sibling, or even a non-family member. The terms of the trust would provide the beneficiary with a lifetime or testamentary limited power of appointment with a limited class of appointees. The terms of the trust would further give the trustee of the trust the power to make discretionary distributions to the beneficiary.

As stated above, Section 2701 only applies to a gift to a "member of the family" of the transferor. Recall that "member of the family" does not include the transferor's ancestors or descendants of ancestors, but rather includes the transferor's spouse and the transferor's descendants. Since the beneficiary would not have a legal entitlement to the trust assets and the power of appointment is a limited power of appointment rather than a general power of appointment, the exercise of which should not constitute a taxable gift, Section 2701 should not apply. The Section 2701 definition of "transfer" specifically excludes a transfer that is a result of a shift of rights occurring upon the release, exercise, or lapse of a power other than a general power of appointment, and provided that such release, exercise, or lapse would not otherwise constitute a gift.[44]

In this case, the transferor could transfer their carried interest to such a trust without triggering the application of Section 2701 or being forced to also transfer their LP interest (as would be the case with vertical slice planning). The practical downside to this approach is that the beneficiary controls the ultimate recipient of the transferor's carried interest which may not align with the transferor's wealth transfer goals.

D. Other Planning Considerations

While carried interest planning has unique considerations that may not apply to planning with other assets (namely, the special valuation rules of Section 2701), other rules and considerations generally related to wealth transfer planning also apply.

1. Section 2036

As noted above, a family holding company can be an efficient way to address or avoid Section 2701 special valuation issues when planning with funds and carried interests. However, such holding companies are not immune to challenges posed by the IRS under Section 2036. The Service has had some success arguing that transferors who fund family limited partnerships ("FLP") (which collectively refers to intra-family LLC or LP) have an implied understanding with the other owners of the FLP that the transferor would retain the use and enjoyment of the property until the transferor's death, causing the property to be includible in the transferor's estate.[45] Similarly, where a transferor, whether alone or in conjunction with another person, has the right to designate who shall possess or enjoy assets, or the income from assets, such assets will remain includible in the transferor's estate.[46]

While the typical FLP challenged by the Service involves an entity formed for different reasons than vertical slice planning or the holding entities contemplated by this article, a

planner creating an entity for those purposes should consider Section 2036 and its corresponding case law.

2. Vesting and Control

Section 2701 is triggered when there is a transfer of an interest. Generally, a transfer is an essential element of a gift. A planner must ensure that a transfer is deemed to be a completed gift in order to shift the gifted asset out of the estate of the transferor (except of course in the parallel irrevocable trust structure described above). A transferor may not retain control over the asset transferred and should have the present authority to transfer the asset. In planning with carried interests, it may be that the transferor is not fully vested[47] in the carried interest. Further, the transferor may be a principal of the fund, and thereby retain too much control over the equity interests (*e.g.*, such as the ability to control the allocation of a fund's carried interest percentages on an annual basis). In both cases, there is a risk that any gift of such carried interest may be deemed incomplete, regardless of the special valuation rules of Section 2701.

3. Valuation

It is common for principals or managers of funds who are considering planning with carried interests to insist that their fund interests at the start-up stages have very little or no value. This is a fiction that exists with start-up businesses across industries. However, this expectation does not survive the regulatory inquiry of what the fair market value would be between a willing buyer and a willing seller, with neither under any compulsion to transact.[48]

As such, it is important to hire a third-party appraiser to value the transferred interests for transfer tax purposes. An appraiser who is experienced in valuing carried interests will be able to model out different outcomes for the entity, determine relevant discount factors, and (where applicable) consider data on comparable transactions when establishing the value of the interest.

4. Gifting Strategies Using Common Estate Planning Vehicles

An understanding of the special valuation rules of Section 2701 is meant to highlight the challenges of planning with carried interest but not deter planning. Carried interests are good candidates for wealth transfer planning. A carried interest often has a great potential for appreciation in the future, but at the same time has characteristics that support a low transfer tax value, at least at the inception of the fund. While one or more of the specialized planning techniques described above likely will be required (*e.g.*, vertical slice planning, family holding entities, and specialized irrevocable trust structures), these specialized carried interest planning techniques may still be used in conjunction with more common estate planning techniques. These include the vehicles and techniques discussed below, namely "Dynasty Trusts," Grantor Retained Annuity Trusts ("GRATs"), and Sales to Intentionally Defective Grantor Trusts ("IDGTs").

a. Gifts to a Dynasty Trust

A straightforward and simple approach to planning with a carried interest using the vertical slice approach is for the transferor to make a gift of proportionate shares of the transferor's carried interest and LP interest to an existing or newly created irrevocable trust for the benefit of the transferor's family. While this technique may result in gift tax payable upon the transfer or likely at least the use of a portion (or all) of the transferor's transfer tax exemption, it still allows for the future appreciation on the gifted assets to accrue outside the transferor's estate. The trust may be structured to survive multiple generations while still providing discretionary access to the assets, allowing the appreciation to benefit the family for years to come. In the fund-planning context in which significant appreciation is anticipated, a dynasty trust may often be an appropriate wealth transfer vehicle to pair with the carried interest planning techniques discussed above.

b. GRAT

Similarly, GRATs (grantor retained annuity trusts) are useful estate planning vehicles to pair with carried interest planning. A GRAT generally is considered to be one of the safest planning techniques available because it is approved by statute.[49] A transferor creates a GRAT by transferring an asset into an irrevocable trust and retaining the right to an annuity interest for either a fixed term of years, or for the shorter of a fixed term of years and the grantor's life. The value of the remainder interest is deemed to be a gift upon the creation of the GRAT. However, the timing and amount of the payments and the number of years selected for the term of the trust can be structured to minimize or even eliminate nearly all of the value of the gift. At the end of the annuity term, the assets that remain in the GRAT pass to the remainder beneficiary without further gift taxes. The value of grantor retained annuity interest is calculated based on the Section 7520 rate (which remains historically low), and to the extent the investment produces a return greater than the applicable Section 7520 rate, that excess return passes free of gift or estate tax.

In the fund-planning context, the highly speculative nature of carried interests coupled with the potential for appreciation in a short time frame may make a GRAT an appropriate and attractive wealth transfer vehicle for carried interest planning. However, a GRAT is required to make regular annuity payments, so a fund that does not have liquidity or regular cash flow may not be the best asset to transfer to a GRAT. Further, funds often have capital calls. If the interests contributed to the GRAT do not generate a cash flow that significantly exceeds the annuity payment, the GRAT may not be able to make the capital contributions required by the fund interest. One possible solution for both issues is for the transferor to include cash with the transfer of the fund interest at the inception of the GRAT.

There also are income tax benefits with a GRAT. A GRAT is considered a grantor trust for income tax purposes because the transferor retains the right to receive both income and trust principal to satisfy the required annuity payments. This means the transferor/grantor will be subject to tax on the income produced by the GRAT assets as well as any capital gains on a sale during the term of the GRAT. The transferor's payment of tax on trust income is effectively a tax-free gift of the income taxes that are attributable to GRAT assets, and serves to allow the GRAT to grow for the benefit of the remainder beneficiaries.

c. Sale to an Intentionally Defective Grantor Trust

An additional wealth transfer technique effective in a low interest rate environment is a sale to an intentionally defective grantor trust. As mentioned above in connection with GRAT planning, a grantor trust is a trust that contains certain provisions that result in the grantor being considered the owner of trust assets for federal income tax purposes but not for transfer tax purposes. As such, for income tax purposes, a sale between a grantor and a grantor trust will not result in any capital gain or loss, as the trust is ignored for federal income tax purposes.

In the fund-planning context, the transferor could sell the carried interest and LP interest (using the vertical slice approach) to an irrevocable grantor trust structured to benefit the transferor's descendants, potentially even a dynasty trust. In return, the transferor would receive a promissory note[50] that would pay interest at no less than the applicable federal rate to avoid making an unintended gift to the trust. If the fund interests grow in value beyond the principal and interest rate of the note, the transferor has shifted wealth to the next generation with minimal to no gift tax liability. However, unlike GRATs, there is no statutory prescription for intentionally defective grantor trusts and this vehicle may involve more risk and exposure on an audit than a GRAT.

IV. CONCLUSION

Given the inherent characteristics of funds and carried interests, these assets are often very effective to use in wealth transfer planning. However, planners need to know and understand the rules and implications of Section 2701 before undertaking these planning techniques. The failure to consider Section 2701 when planning with fund and carried interests likely will have considerable adverse and unintended transfer tax consequences.

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1 Treas. Reg. section 25.2512-1.

2 *See* 17 CFR, sections 230.501-230.508 (2008).

3 *See* IRC, section 2031, subd. (a); IRC, section 2512 (a); IRC, section 2624(a).

4 *See* 136 Cong. Rec. S15629, S15679 (daily ed. Oct. 18, 1990) (informal Senate Finance Committee report on the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508).

5 Treas. Reg. section 25.2701-1(a)(1).

6 Treas. Reg. section 25.2701-1(b)(1).

7 Treas. Reg. section 25.2701-1(b)(2).

8 IRC, section 2701(a)(4)(B).

9 IRC, section 2701(a)(4)(B)(ii).

10 Treas. Reg. section 25.2701-3(a)(2)(ii).

11 Treas. Reg. section 25.2701-3(a)(2)(iii).

12 IRC, section 2701(e)(2); Treas. Reg. section 25.2701-1(d)(2).

13 IRC, section 2701(e)(1); Treas. Reg. section 25.2701-1(d)(1).

14 IRC, section 2701(a)(3)(A).

15 IRC, section 2701(b)(1).

16 IRC, section 2701(c)(2)(A).

17 IRC, section 2701(c)(2)(B)-(C).

18 IRC, section 2701(c)(1)(B).

19 Treas. Reg. section 25.2701-2 (b)(5); s*ee also* IRC, section 2701(b)(1)(A), which includes the transferor and applicable family members, but not the broad class of lineal descendants (including siblings of the transferor and transferor's spouse, who are otherwise not included in the definition of either applicable family member or member of the family) included in this Treasury Regulation definition. Query whether the Treasury Regulation is a valid interpretation of the Code.

20 IRC, section 2701(b)(2)(A); Treas. Reg. section 25.2701-2(b)(5)(ii).

21 IRC, section 2701(b)(2)(B); Treas. Reg. section 25.2701-2(b)(5)(iii).

22 Treas. Reg. section 25.2701-6.

23 Treas. Reg. section 25.2701-2(a)(2).

24 Treas. Reg. section 25.2701-2(b)(6).

25 Treas. Reg. section 25.2701-2(c)(2).

26 Treas. Reg. section 25.2701-4(c)(5).

27 *Ibid.*

28 *See* Treas. Reg. section 25.2701-4(c), which describes how the increase is to be determined.

29 Treas. Reg. section 25.2701-2(c)(5).

30 *See* Treas. Reg. section 25.2701-2(a)(3) (Note if the transferor or applicable family member has one or more extraordinary payment rights with respect to an applicable retained interest and the interest also confers a qualified payment right, the value of all of these rights is determined assuming that each extraordinary payment right is exercised in a manner that results in the lowest value being determined for all of the rights.).

31 IRC, section 2701(a)(2)(A); Treas. Reg. section 25.2701-1(c)(1)(2).

32 IRC, section 2701(a)(2)(B); Treas. Reg. section 25.2701-1(c)(3).

33 IRC, section 2701(a)(2)(C); Treas. Reg. section 25.2701-1(c)(4).

34 *Ibid.*

35 Treas. Reg. section 25.2701-6 (Attribution rules apply with respect to equity interests indirectly owned by way of entities such as LPs, corporations, limited liability companies, and trusts.).

36 Treas. Reg. section 25.2701-1(c)(3).

37 Treas. Reg. section 25.2701-2(b)(4)(i).

38 Treas. Reg. section 25.2701-1(a)(2)(ii).

39 Treas. Reg. section 25-2701-2(b)(4)(i).

40 While the qualified payment right holding entity is structured to avoid the application of the zero-value rule of Section 2701, a deemed gift may, nevertheless, occur under general gift tax principles if the payment right associated with the preferred interest is set at a rate below the rate that would be used in an arm's length transaction.

41 *See* IRC, section 2701, subd.(a)(4); Treas. Reg. section 25.2701-3(c)(1).

42 *See* Treas. Reg. section 25.2701-6(a)(4)(i).

43 The multiple attribution rules should not be triggered with respect to the trust and the transfer of a senior equity interest so long as the trust is non-grantor.

44 Treas. Reg. section 25.2701-1(b)(3)(iii).

45 *E.g., Estate of Bigelow v. Commissioner* (9th Cir. 2007) 503 F.3d 955; *Estate of Malkin v. Commissioner* (2009) 98 T.C.M. (CCH) 57.

46 IRC, section 2036(a)(2).

47 *See* Rev. Rul. 98-21 (Some practitioners analogize a carried interest to a non-statutory stock option and take the position that the transfer of carried interest before vesting is an incomplete gift.).

48 Treas. Reg. section 25.2512-1.

49 IRC, section 2702.

50 *See Karmazin v. Commissioner* (Feb. 10, 2013) TC Docket No. 2127-03; *Estate of Woelbing v. Commissioner* (Mar. 25, 2016) T.C. Docket No. 30261-13 and (Mar. 28, 2016) T.C. Docket No. 30260-13.

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