Demystifying Tax Planning When Using Carried Interests for Fund Managers, Promoters and Developers

by

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CHAPTER 8
NOVEMBER 6, 2025
51ST ANNUAL NOTRE DAME TAX & ESTATE PLANNING INSTITUTE

[1] Portions of these materials were initially prepared by Todd Angkatavanich for his paper in the 50th Annual Heckerling Institute on Estate Planning sponsored by the University of Miami School of Law. They are reprinted here with the permission of the Heckerling Institute.

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I. **Introduction**

Benjamin Franklin proclaimed two certainties in life: death and taxes. While investment funds cannot help with the first, they can – in the context of compensation for fund managers, promoters and developers – certainly reduce the second. Compensation for labor is generally taxed at "ordinary income" tax rates. However, an allocation of income in investment funds for providing services, often referred to or in the form of a *profits interest*, a *carried interest*, a *promote* or increased income through management fee waivers, can achieve income taxation at more favorable "capital gains" tax rates. This favorable treatment is authorized by partnership tax principles that determine the income tax character of a partner's income allocation by the character of the income earned by the investment fund.

> Take this simple example: Munn contributes $1 million in cash to an investment fund. Surv, in return for managing the investment portfolio and who does not make a capital contribution, is entitled to receive an allocation of 20% of the fund's income. On behalf of the fund, Surv purchases $1 million of stocks in public companies, later selling the shares for $1.1 million, causing the fund to realize a $100,000 long-term capital gain. Surv is allocated $20,000 of the long-term capital gain, and Munn is allocated the other $80,000 of the capital gain. In paying tax on the compensation for Surv's services at the capital gains rate rather than the ordinary income tax rate (thanks to the income characterization rules applicable to partnerships), *Surv will cut her tax bill nearly in half*.

And while death may be certain, high estate taxes on such fund interests need not be – partners can consider approaches like vertical slice planning or carry derivative agreements can transfer significant wealth tax-efficiently to the next generation.

In this paper, we focus on the economics of interests in investment funds and the income, gift and estate taxation of interests in investment funds. The term *investment fund* refers broadly to pooled capital vehicles generally organized as partnerships for federal income tax purposes. Their financial structures differ significantly and generally fall into three broad categories of income-producing activities: (1) investments in marketable securities (*e.g.*, a hedge fund), (2) long-term investments in private companies (*e.g.*, a private equity fund), and (3) investments in real estate, including debt-financed real estate (*e.g.*, a real estate debt fund). These differences drive distinct economic and tax treatment of interests in an investment fund.

Each of these three classes of investment funds requires capital to invest and individuals to provide the services to operate the fund. Thus, for each of these funds, there are generally two categories of partners: the investors who provide the startup capital, whether in cash, property or a combination thereof (the "investors"), and the partners who provide services to the fund (the "service partners"), whether prior to the fund's formation (e.g., by designing a core element of the venture or bringing the parties together by promoting the activity to investors) or as future services in operating the fund (e.g., for managing the fund's investments). One complexity of the income tax treatment is that investors derive their income from allowing the fund to use their contributed capital (taxed at capital gains rates), while service partners derive their income by contributing their labor in the form of past or future services – and though labor is normally taxed at ordinary income rates, service partners can often achieve capital gains treatment for their profits interests. Furthermore, when service partners have no capital at risk, investors frequently require that the fund structure the allocation of its income to provide themselves certain priorities upfront, with changes to the economics as capital is returned to them (the "waterfall allocations”). Finally, there can be different gift tax treatments of these various interests, depending upon how a capital interest or a profits interest is structured.

In Part II, these materials will describe how investment funds are typically financially structured between investors and service partners, using balance sheets to illustrate the impact of priority allocations and distributions among the partners. In Part III, the materials discuss the federal income tax treatment upon the formation and operation of an investment fund. In particular, the materials address the federal income tax treatment when a service partner receives an interest in future profits, the contribution property rights created by services, waterfall allocations prioritizing capital return to investors and the impact of fee waivers designed to convert ordinary income into capital gains. In Part IV, the materials address valuation issues, the impact of Code Section 2701 using “vertical slice” planning and the carry derivative alternative for investors and service partners who seek to transfer their interests to trusts for the next generation.

Overall, our objective is to provide an overview of the financial differences in how investors, fund managers, promoters and developers are compensated by the funds they create and the federal income tax treatment of such compensation. As the title of this topic is to *demystify*, we hope that this overview will be helpful.

II. The Basic Financial Structure of Fund Interests and Waterfall Allocations

Types of Fund Interests

From a federal income tax perspective, there are two types of interests one could have in an investment fund: a capital interest and a profits interest.

A capital interest is an interest in the assets of the fund which are distributable to the partner upon the partner’s withdrawal from or the liquidation of the fund;[1] put another way, a capital interest represents the share of the proceeds the partner would receive if the assets were sold at fair market value and distributed in a complete liquidation of the fund (e.g., after paying off the debts and liabilities of the fund).[2]

A profits interest, on the other hand, is any fund interest which is not a capital interest;[3] generally, a profits interest represents a right to a share of the future profits and appreciation in the assets of a fund. There are also a few different flavors of profits interest, depending on the type of fund the interest is intended to support. Relevant to fund managers, promoters and developers is the economics and taxation of:

1. A carried interest (e.g., a profits interest received in exchange for services provided to the fund; may require investors to receive a return of their initial capital and/or an internal rate of return before sharing in profits);

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1 *See* Treas. Reg. 1.704-1(e)(1)(v).

2 *See* Rev. Proc. 93-27, Section 2.01.

3 *See* Rev. Proc. 93-27, Section 2.02.

2. A promote (as used in these materials, a profits interest granted to a sponsor, typically in real estate or private equity, in return for services rendered prior to the formation of the venture, e.g., putting a deal together, acquiring initial assets or securing financing; sometimes also called an "acquisition interest");[4] and

3. A management fee waiver (e.g., the mechanism by which the administrative management fee owed to fund managers can be converted into a profits interest).

Generally, there are four ways that a partner might receive a capital interest or a profits interest in an investment fund:

- She contributes money to the fund and receives a capital interest (an investor we'll call "Munn"),

- She contributes property other than money to the fund and receives a capital interest (an investor we'll call "Prop"),

- She contributes intellectual property[5] or other service-flavored property[6] to the fund and receives a profits interest (a service partner we'll call "Ides"), or

- She performed or will perform services for the fund and receives a profits interest (a service partner we'll call "Surv").

Each of Munn, Prop, Ides or Surv could receive either a capital interest or a profits interest on account of their contributions to the fund, and over time, the nature of those interests can change as income is accumulated (causing the holder of a profits interest to also have a capital interest) or as capital interests are redeemed (causing such interest to be reduced or eliminated over time). Moreover, there are typically waterfall allocations which prioritize the return of capital to the investors from initial proceeds of the fund, with later adjustments to the economics of the split once the investors have recovered their initial investment.

Waterfall Allocations

In investment funds, the waterfall represents the order of allocations by which investors first receive back their capital, a preferred return is paid out to those investors, and the carried interest and/or promote holders then share in the profits of the fund. Below is a simple example of waterfall allocations that one might see in a private equity fund or real estate fund in which the fund managers or promoters have a 20% profits interest that pays out after a return of capital and a preferred return to the investors:

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4 We note that the term "promote" is not defined in the Code and can be used to describe a variety of profits interests in investment funds. For purposes of these materials, we restrict the term "promote" to those profits interests granted for service-flavored property contributed to the fund.

5 See *United States v. Frazell,* 335 F.2d 487, 487 (5th Cir. 1964) (nonrecognition treatment appropriate for intellectual property created prior to contribution to partnership where no obligation existed to create or contribute such property).

6 See *Stafford v. United States*, 435 F. Supp. 1036 (M.D. Ga. 1977) (contribution of a lease and loan agreement negotiated by the taxpayer constituted a contribution of property, not services, to the partnership)

1. Return of Capital. First, 100% of the profits are distributed to the investors who contributed capital to the fund until all such investors have received a return of their invested capital;

2. Preferred Return. Second, 100% of the profits are distributed to the investors who contributed capital to the fund until all such investors receive a set annual rate of return (e.g., 8%) on their invested capital;

3. Catch-Up: Third, 50% of the profits are distributed to the fund managers and/or promoters who hold the 20% profits interest (with the other 50% going to the investors who contributed capital) in order to "catch-up" those profits interests to the amount that represents 20% of the overall profits of the fund (given that no profits were distributed to such partners in the first two stages of the waterfall); and

4. 80/20 Split: Fourth, having returned capital, paid out the preferred return, and caught up the profits interest holders, the remaining profits are split according to the agreed-upon split between capital investors and the service partners.

There are numerous flavors of waterfalls. The one described above is a whole-venture waterfall whereby the gains and losses are netted at the fund level; some investment funds use deal-by-deal waterfalls, whereby the economics are managed investment by investment, and others use partner-by-partner waterfalls, which calculate the carried interest or promote at the partner level rather than at the fund level. For purposes of these materials, we'll use a whole-venture waterfall that calculates the carried interest or promote at the fund level to discuss the implications of the grant of a fund interest.

Illustrative Examples of Fund Financial Structures

To begin, let's start with a simple example of how the interests in an investment fund change over time when there is a carried interest.

Example 1 (Carried Interest):

Munn and Surv decide to form a new investment fund focused on yield-oriented investments in marketable securities. Munn agrees to contribute the initial capital of the fund ($1 million), and Surv agrees to invest the cash and manage the investment portfolio in exchange for a carried interest of 20% of the fund's income (Surv has agreed not to charge a management fee for this fund).

At the outset, Munn receives a $1 million capital interest in the fund (representing Munn's right to receive all her investment back if the fund liquidated today), as well as a profits interest with respect to 80% of the fund's income. Surv receives a profits interest with respect to 20% of the fund's income (which, because it is received in return for services she renders to the fund, is treated as a carried interest, as discussed further in Part III).

For the waterfall allocations for the profits interests, Munn and Surv agree that distributions of fund income will first be used to return Munn's initial capital contribution, with Surv receiving distributions only to pay her estimated taxes on account of her carried interest. (To reduce administrative complexity, the partnership agreement states that Surv's estimated income tax rate is 40% for purposes of these distributions.) To further incentivize Surv, Munn agrees that the split of the profits will change once she receives back her $1 million investment, with Surv then receiving 40% of the profits and Munn receiving 60%.

The initial capital accounts for the fund look like this:

Capital Accounts			
	Munn	Surv	*Notes*
Initial capital contribution:	$1,000,000	$0	
Capital Account Total:	**$1,000,000**	**$0**	

In the first year, Surv successfully invests the portfolio and achieves a 10% rate of return on her investments, generating $100,000 in income for the fund. On account of her 20% carried interest, Surv receives an allocation of $20,000, and Munn receives an $80,000 allocation with respect to her 80% profits interest. According to her 40% estimated tax rate, Surv will receive a distribution of $8,000 ($20,000 x 40% = $8,000), and the other $12,000 will be distributed to Munn to redeem a portion of Munn's capital interest. Munn therefore will receive a $92,000 distribution (e.g., $80,000 of allocated fund income on account of her profits interest, and $12,000 as a partial return of her initial capital investment, which reduces her capital interest). The capital accounts for the fund now look like this:

Capital Accounts (End of Year 1)			
	Munn	Surv	*Notes*
Initial capital contribution:	$1,000,000	$0	
Income allocation (Y1):	+ $80,000 (80%)	+ $20,000 (20%)	
Income distribution (Y1):	- $80,000	- $8,000	*Surv's tax dist.*
Redemption distribution (Y1):	- $12,000	$0	
Capital Account Total:	$988,000	$12,000	

At the end of Year 1, the fund still has $1,000,000 of assets. Now, if the fund liquidates, Munn will receive $988,000 and Surv will receive $12,000 (note that Surv already received an $8,000 distribution to pay her taxes on the $20,000 of income allocated to her, which reflects the overall deal of an 80/20 split of the fund's profits). Surv will receive a share of the fund assets upon liquidation (with respect to her $12,000 capital account) in addition to her carried interest (e.g., 20% of the profits until Munn is returned all her initial $1 million investment, which then climbs to 40% of the profits).

To continue the example, let's look at Year 2. Surv continues to invest wisely, and she achieves a 15% rate of return on the $1 million of fund investments, earning $150,000 in Year 2. After allocating 80% of the profits to Munn ($120,000) and 20% to Surv ($30,000), and after making the 40% tax distribution to Surv ($12,000 = $30,000 x 40%) and the redemption distribution to Munn ($18,000), the capital accounts now look like this:

Capital Accounts (End of Year 2)			
	Munn	Surv	*Notes*
Capital account (Start of Y2):	$988,000	$12,000	
Income allocation (Y2):	+ $120,000 (80%)	+ $30,000 (20%)	
Income distribution (Y2):	- $120,000	- $12,000	*Surv's tax dist.*
Redemption distribution (Y2):	- $18,000	$0	
Capital Account Total:	$970,000	$30,000	

At the end of Year 2, the fund still has $1,000,000 of assets. Now, if the fund liquidates, Munn will receive $970,000 and Surv will receive $30,000 (reflected in Surv's capital account climbing to $30,000). Under the economics of this deal, Surv will continue to increase her capital account, receiving no distributions of fund income until Munn has been fully redeemed (at which point, assuming no appreciation in the fund assets, Munn will have a $0 capital account and Surv will have a $1,000,000 capital account).

As this short example demonstrates, the financial structuring of the investment fund has significant impact on whether Munn or Surv own capital interests, profits/carried interests, or a mix of both. How and when these interests are granted can have significant impacts on their federal income taxation, as we discuss in Part III below.

<u>Example 2 (Promote):</u>

Ides has secured very favorable financing for a particular piece of real estate, and so Munn and Ides decide to form a new real estate investment fund wherein Munn agrees to contribute the initial capital to purchase the real estate ($1 million) and Ides agrees to contribute the favorable financing agreement in exchange for a 20% promote.

As in Example 1, Munn receives a $1 million capital interest in the fund (representing Munn's right to receive all her investment back if the fund liquidated today), as well as a profits interest with respect to 80% of the fund's income. Ides receives a promote (a profits interest) with respect to 20% of the fund's income (which, because it is received in return for prior services she rendered and is not in exchange for any further services, is not treated as a carried interest, as discussed further in Part III).

For the waterfall allocations for the profits interests, Munn and Ides agree that distributions of fund income will first be used to return Munn's initial capital contribution, with Ides receiving distributions only to pay her estimated taxes on account of her promote. (To reduce administrative complexity, the partnership agreement states that Ide's estimated income tax rate is 40% for purposes of these distributions.) As in Example 1, Munn agrees that the split of the profits will change once she receives back her $1 million investment, with Ides then receiving 40% of the profits and Munn receiving 60%.

Here, the financial structure of the fund in Example 2 is identical to the structure of the fund in Example 1, and the capital accounts for year 1 and year 2 in Example 2 will look identical to the capital accounts from Example 1. The primary difference between Surv receiving a carried interest (Example 1) and Ides receiving a promote (Example 2) is the federal income tax treatment of those interests, which we will turn to in Part III.

III. The Federal Income Tax Consequences to Grants of Fund Interests

Differentiating Between a Capital Interest and a Profits Interest

When discussing the economic structure of a partnership interest, it's most common to discuss the specific waterfall allocations – who receives how much money when – rather than the tax terms "capital interest" and "profits interest." However, it's important to understand how an interest in a partnership is classified and treated for federal income tax purposes to understand the economic effects of receiving, owning and transferring an interest in a fund.

First, Treasury Regulations define a capital interest to mean "an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership."[7] A profits interest, according to Rev. Proc. 93-27, is any interest in a partnership which is not a capital interest; the Treasury Regulations further state that "the mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership."[8]

Therefore, to the extent that an interest in a fund represents a right to receive property upon withdrawal from or liquidation of the fund, such an interest is a capital interest. All other interests (e.g., rights to future profits of the fund) are profits interests.

In this Part, we first discuss the federal income tax consequences to the grant of a capital interest, including those that vest over time. We then discuss the more favorable treatment of profits interests, with specific focus on the treatment of grants of carried interests and promotes. Finally, we discuss the treatment of management fee income and how management fee waivers can transform the character of the income received from ordinary income (taxed at the highest rates) to capital gains (taxed at favorable rates), significantly improving the economic bottom line for fund managers, promoters and developers.

a. Grant of a Capital Interest

The Economic Deal

The basic economic deal of a capital interest is the present right to share in the existing net assets of the fund, as distinguished from a profits interest, which provides rights to a share of future income and appreciation. The value of the capital interest is reflected in the partner's capital account.

The question now is the tax treatment of a grant of a capital interest to a partner. Take a partner who receives a 20% interest in an investment fund entitling her to 20% of *all allocations and distributions of the fund*, and not simply the future profits of the fund. Such a partner has received a capital interest. This is because if the fund were to terminate prior to any income being earned, the partner would still receive 20% of the net assets of the fund. In investment funds, such grants are not typical, as it results in the investors who contributed capital allocating a portion of their capital to the service partner, reducing the amount owed to them if the fund were to be liquidated. This deal, in effect, means paying the service partner before any profits are generated or any services are actually performed. However, some investment fund structures, such as those providing a vested interest in the fund, can be treated as a grant of a capital interest, and the tax treatment of such a grant is therefore important to understand.

Tax Consequences

Generally speaking, the receipt of a capital interest in exchange for property contributed to the fund is a nonrecognition transaction under Section 721(a) of the Code[9] and therefore does not result in tax to the partner receiving the interest. Thus, when (1) Munn contributes her $1 million in cash, (2) Prop

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7 Treas. Regs. 1.704-1(e)(1)(v).

8 Rev. Proc. 93-27, Section 2.02; Treas. Regs. 1.704-1(e)(1)(v).

9 All references to "the Code" refer to the Internal Revenue Code of 1986, as amended.

contributes real estate with a fair market value of $1 million, or (3) Ides contributes a pre-negotiated financing deal with a fair market value of $ 1 million, none of Munn, Prop or Ides recognizes any gain or loss on her receipt of a capital interest in the fund.

The same is not true when a capital interest is received in exchange for services, however. Under Section 83 of the Code, the grant of a capital interest in the fund in exchange for services performed for the fund causes the fair market value of such capital interest (minus any amount paid for the interest, which is typically $0 in most investment funds) to be included in the gross income of the partner in the year the interest was granted, resulting in taxation under Section 61 of the Code at the ordinary income rate applicable to the partner for that year. Thus, if Surv receives a capital interest in exchange for managing the investments of a fund, she will be taxed on the receipt of that interest in the year it is granted at high ordinary income tax rates and not the more preferable capital gains tax rates. Note that this is typically a bad deal for Surv, as structuring the deal as a profits interest instead could avoid both taxation in the year of the grant and could result in taxation at preferable capital gains tax rates. Moreover, it is also generally a bad deal for the capital investors, who are transferring a portion of their rights to their invested capital (e.g., the interest allocated to Surv) before any services are actually performed.

Example IIIA1: Grant of a Capital Interest (No Vesting):

Set-Up: Munn, Prop and Surv decide to form an investment fund. Munn contributes $1.5 million of cash, Prop contributes $1.5 million of marketable securities, and Surv contributes no initial capital but will manage the investments of the fund. Under the partnership agreement for the fund, Mann, Prop and Surv will share in the fund equally, receiving identical allocations and distributions.

Result: Because the partnership agreement does not include waterfall allocations by which Munn and Prop receive a return of their initial capital before Surv shares in the fund profits, if the partnership were to liquidate immediately after formation, Surv would receive 33% of the cash and marketable securities. She therefore has a capital interest with a fair market value of $1 million (33% of $3 million = $1 million) and **will recognize $1 million of ordinary income in the year she is granted the capital interest**. The capital accounts for the partners look like this:

Capital Accounts (Example IIIA1)			
	Munn	Prop	Surv
Initial capital contribution:	$1,500,000	$1,500,000	$0
Deemed Contribution:	$0	$0	$1,000,000
Partnership Deduction	- $500,000	- $500,000	- $0
Capital Account Total:	$1,000,000	$1,000,000	$1,000,000

To harmonize the income recognition to Surv under Section 83 of the Code with the capital account maintenance rules under Treas. Regs. Section 1.704-1(b)(2)(iv), we can use the cash purchase model to treat the grant of the capital interest in two steps. First, the fund is treated as though it paid Surv cash in the amount of the value of the capital interest ($1,000,000); second, Surv immediately contributes that $1,000,000 compensation to the fund in exchange for her capital interest. Thus, Surv has a capital interest equivalent to the income she recognized, the other partners bear dilution via the compensation deduction ($500,000 each), and any distributions upon liquidation will now align with the capital accounts, reflecting the economic deal that Munn, Prop and Surv will split all allocations and distributions from the fund equally. Using the 40% tax bracket we assumed earlier, Surv will pay income tax on the receipt of her capital interest in the amount of $400,000 (40% x $1,000,000).

<u>Example IIIA2: Grant of a Capital Interest, Subject to Vesting:</u>

<u>Set-Up</u>: The situation is the same as in Example 1, except that Surv's one-third interest in the fund is subject to vesting: she receives 50% of her interest on each anniversary of her joining the fund, with her interest fully vesting after two years. If she leaves prior to the second anniversary, she forfeits any portion of her unvested interest she has not yet received. If the fund liquidates in the first two years, her vesting is accelerated so that she is treated as receiving all one-third of her interest prior to liquidation.

<u>Result:</u> As in Example 1, Surv's interest is a capital interest because at the time it is granted to her, she has a right to a portion of the net assets of the fund upon liquidation. However, *when* does Surv receive an interest subject to vesting for tax purposes? Under Section 83 of the Code, there are two options. Under the first option, each portion of a vested interest is deemed to be received at the time each vesting period ends. Therefore, Surv would be deemed to receive a 16.67% interest on each anniversary of joining the fund (50% vested of her 33% interest = 16.67%), and she would recognize ordinary income with respect to such 16.67% interest each year. Importantly, if the value of the fund appreciates, the value of her 16.67% interest also appreciates, increasing her taxable income (subject to ordinary income tax rates) each year.

The second option is to make an election under Section 83(b) of the Code, which allows Surv to treat her entire interest subject to vesting as if she had received it all at the initial time of grant (e.g., when she joins the fund). While the grant is still treated as ordinary income, she now treats all 33% as if she had received it at the beginning of her engagement with the fund, which (hopefully) is when the value of the fund's assets is lowest. The capital accounts and tax treatment for Surv are shown below, assuming that the value of the assets grows by 10% each year and that no distributions are made to the partners:

Capital Accounts (Example IIIA2 – No Section 83(b) Election)			
	Munn	Prop	Surv
Initial capital contribution:	$1,500,000	$1,500,000	$0
End of Year 1, pre-grant (10% ROR):	$1,650,000	$1,650,000	$0
Grant to Surv (50%, End of Year 1):	N/A	N/A	$550,000
Partnership Deduction (Year 1):	- $275,000	- $275,000	- $0
Capital Account (End of Year 1):	**$1,375,000**	**$1,375,000**	**$550,000**
End of Year 2, pre-grant (10% ROR):	$1,512,500	$1,512,500	$605,000
Grant to Surv (50%, End of Year 2):	N/A	N/A	$605,000
Partnership Deduction (Year 2):	- $302,500	- $302,500	- $0
Capital Account (End of Year 2):	**$1,210,000**	**$1,210,000**	**$1,210,000**

In the scenario in which Surv did not make a Section 83(b) election, she received a capital interest valued at $550,000 at the end of Year 1 and a capital interest valued at $605,000 at the end of Year 2. Her total tax liability in the no-Section83(b) election scenario, using her assumed 40% tax rate, is thus **$462,000** (40% x $550,000 + 40% x $605,000).

Capital Accounts (Example IIIA2 – With a Section 83(b) Election)			
	Munn	Prop	Surv
Initial capital contribution:	$1,500,000	$1,500,000	$0
Deemed contribution:	$0	$0	$1,000,000
Partnership Deduction (at formation):	-$500,000	-$500,000	-$0
Capital Accounts (at formation):	$1,000,000	$1,000,000	$1,000,000
End of Year 1 (10% ROR):	$1,100,000	$1,100,000	$1,100,000
End of Year 2 (10% ROR):	$1,210,000	$1,210,000	$1,210,000
Capital Account (End of Year 2):	**$1,210,000**	**$1,210,000**	**$1,210,000**

In the scenario in which Surv does make a Section 83(b) election, she is treated as receiving her entire one-third interest at the time she joins the fund, when the interest is then valued at $1,000,000. Her total tax liability in the Section 83(b) election scenario, using her assumed 40% tax rate, is thus **$400,000** (40% x $1,000,000). She saved $62,000 by making the Section 83(b) election, paying 13.4% less tax than when she chose not to make the election. Given the possible tax consequences inherent to making grants of capital interests when the fund has appreciated assets, it is common that investment funds require those receiving vested interests to make the Section 83(b) election at the time of grant.

b. Grant of a Profits Interest

The Economic Deal

As discussed above, a profits interest in an investment fund gives the holder a right to share in the income generated by a fund's operations. As income is allocated to the partner, such amounts are reflected in the partner's capital account (giving rise to a capital interest with respect to such allocated income) or they are distributed out to the partner, which correspondingly reduce such capital account. The amounts allocated to the partner follow the mechanics of the fund's waterfall provisions, meaning that the profit which should be allocated to the partner may be delayed to a later stage in the waterfall in order to first return capital and a preferred return to the fund's investors.

The question now is the tax treatment of a grant of a profits interest to a partner. As discussed below, two of the primary advantages to a profits interest are that (1) the income allocated to the partner retains its character, allowing for some or all of the income to be taxed at rates lower than the ordinary income rates that typically apply to compensation for services and (2) the income is not recognized until there is an allocation of income to the partner, allowing for compensation to be deferred over time.

Tax Consequences

As a threshold matter, the receipt of a profits interest (whether carried interest, a promote, or another flavor of profits interest) is generally not a taxable transfer for federal income tax purposes. Rev. Proc. 93-27 provides a safe harbor in this respect – it states that "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipate of being a partner, the [IRS] will not treat the receipt of such an interest as a taxable event for the partner or partnership." However, the safe harbor does not apply if:

1. The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
2. If within two years of receipt, the partner disposes of the partnership interest; or
3. If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Section 7704(b) of the Code.

Rev. Proc. 2001-43 clarified Rev. Proc. 93-27's safe harbor by providing that the determination of whether an interest is a profits interest for purposes of the safe harbor is determined at the time the interest is granted, even if the interest is substantially nonvested for purposes of Section 83 of the Code. Thus, Rev. Proc. 2001-43 provides that taxpayers do not need to file Section 83(b) elections, as the receipt of the interest is not considered a taxable event under the safe harbor. To note, draft Treasury Regulations were released in 2005[10] which would subject profits interests to Section 83(b), and Notice 2005-43 proposed new rules by which a partner would be required to take into income the grant of a profits interest at its fair market value (though it includes a safe harbor allowing the liquidation value, which would be zero, to be used for the fair market value, which arguably could otherwise be higher if it reflected the possibility of future success of the fund). However, the proposed regulations have yet to be finalized and the procedures proposed in Notice 2005-43 have yet to be adopted, leaving the safe harbor under Rev. Proc. 93-27 intact for now. However, given the possibility that a profits interest could fall outside that safe harbor, many practitioners still recommend filing a Section 83(b) election upon receipt of a profits interest, given it has no liquidation value at the time of grant and therefore no tax would be owed even if the safe harbor did not apply. It is also common for purchasers of partnerships to request copies Section 83(b) elections for all grants of profits interests. Furthermore, the Tax Court recently held in *ES NPA Holding, LLC v. Commissioner* that the Rev. Proc. 93-27 safe harbor applies to profits interests granted through tiered partnership structures, wherein a partner receives a profits interest in one fund while providing services to another fund in the structure.[11] The case effectively extends the reach of Rev. Proc. 93-27 to the tiered partnership structures more commonly used by investment funds and reinforces the use of liquidation value in determining if a fund interest qualifies as a profits interest at the time of grant (and therefore was not a taxable event).

Importantly, pursuant to Notice 2005-1, the receipt of a profits interest does not result in deferral of compensation for purposes of Section 409A of the Code if the grant is not includible in the partner's income. This is significant, as Section 409A requires the immediate taxation of certain deferred compensation plans that do not meet its stringent election and distribution requirements, while also imposing an additional 20% penalty on such plans. While the final 409A regulations do not address the application of Section 409A of the Code to arrangements between partners and partnerships, taxpayers can continue to rely on the interaction of Notice 2005-1 and Rev. Proc. 93-27 in having comfort that Section 409A's regime does not apply to profits interests.

So, when is income included with respect to a profits interest? Income is included in the gross income of the partner holding the profits interest under Section 702 of the Code in the year in which it is allocated to such partner pursuant to the partnership agreement, and therefore not necessary in the year the partner's services were actually performed. This can result in an advantageous deferral of income. Moreover, the income allocated to a partner retains its character (e.g., capital gains), despite the profits interest itself arising as compensation for services performed for the partnership (consider that labor

[10] Treasury Reg. REG-105346-03 May 24, 2005.

[11] *ES NPA Holding, LLC v. Commissioner*, T.C. Memo. 2023-55.

income is taxed at ordinary income tax rates). The Tax Court applied this principal in *Wheeler v. Commissioner*, wherein the service partner's 25% share of the fund's realized capital gains income retained its character as capital gains when distributed to the partner.[12]

c. Grant of a Carried Interest or Promote

The Economic Deal

A carried interest (often called a "carry") is a flavor of profits interest in which fund managers or sponsors receive a share of the profits of an investment fund, but only after the investors have met certain thresholds – commonly, a return of their contributed capital, and sometimes a preferred return or hurdle. Promotes (as such term is used in these materials) are typically granted to developers, sponsors or promoters on account of significant services rendered prior to the operation of the investment fund, including on account of certain acquisitions, arranging financing, or putting together the deals which underlie the core investments the fund will manage. Promotes also commonly structured to be paid out after a return of capital and a preferred return to the investors.

The purpose of carry and promotes is to align the incentives of the fund managers with those of the investors: the managers only earn their piece once the fund has sufficiently succeeded. While fund managers may put in a small portion of the fund's capital (often called the "GP commitment") and may receive a management fee to cover administrative expenses, carried interests and promotes tie the primary means by which these service partners are compensated to the performance of the fund's investments. The typical percentage for such interests is 20%, though the actual percentage and the waterfall allocations with respect to that carry or promote can vary significantly fund to fund.

One of the most attractive features of carry and promotes is that these interests are taxed based on the character of the investment fund's underlying income (unlike a salary or bonus, which are always taxed as ordinary income). As many investment funds hold capital assets that, when sold, recognize long-term capital gains, it is typical that income from a carry or promote is taxed at long-term capital gains rates. The Tax Cuts and Jobs Act of 2017 added Section 1061 of the Code, which increased the holding period with respect to these interests (albeit with certain exceptions) from one year to three years. Thus, fund managers are typically required to hold their carried interests for at least three years in order to benefit from the beneficial tax treatment on offer through the use of these profits interests.

Tax Consequences

The grant of a carried interest or promote and the tax treatment of income with respect to those interests follows the rules for profits interests described above. However, as noted here, there is an additional hurdle for a carry or promote that qualifies as an "applicable partnership interest" (or "API") under Section 1061 of the Code. Final regulations for Section 1061 were issued January 7, 2021.[13] Generally, Section 1061 applies to APIs that are held or transferred in connection with the performance of substantial services in an applicable trade or business, unless an exception applies. An applicable trade or business is any activity which is conducted on a regular, continuous or substantial basis and which consists of raising or returning capital or investing, disposing, or developing certain assets, including

[12] *Wheeler v. Commissioner*, 37 T.C.M. 883 (1978).

[13] Treas. Reg. § 1.1061-1, T.D. 9945 (2021).

securities, real estate and cash. Thus, carried interests and promotes for fund managers, developers and promoters are typically APIs subject to the three-year holding period under Section 1061.

There are a few exceptions to the application of Section 1061 and its three-year holding period requirement. First, Section 1061 provides an exception for gain with respect to capital interests (e.g., gain earned with respect to invested capital). For this exception to apply, allocations and distributions with respect to a partner's capital interests (e.g., those of a hedge fund manager after a book-up event) must be "reasonably consistent" with the rights applicable to investors in the fund (e.g., those with 5% or more of the aggregate capital balances of the fund). The final regulations confirm that capital interests will not be ineligible for the exception solely because the partner is not charged management fees or carried interest (as the capital interests of fund managers are typically carved-out) nor on account of a partner's right to receive tax distributions as advances against future distributions. Therefore, future allocations with respect to increased capital accounts of fund managers will not be subject to the three-year holding period of Section 1061 to the extent the capital interest such capital account reflects meets the exception requirements of Section 1061.

A second key exception from the application of Section 1061 are gains with respect to Section 1231. Section 1231 gains are generally those from the sale of depreciable personal property and real property used in a trade or business and held for more than one year. This is of particular relevance to developers, promoters and fund managers in real estate funds, wherein a significant portion of the fund's underlying income may include Section 1231 gains. A carried interest or a promote in such a real estate fund can escape application of Section 1061 and thus benefit from the shorter one-year holding period generally required for long-term capital gains.

Furthermore, as discussed below, the final regulations provide that Section 1061(d), which requires taxpayers to recognize gain on transfers of interests to certain related persons, does not apply to transfers where gain is not otherwise recognized, including gifts of such interests.

Finally, there are special concerns that apply to the grant of a promote, given such interest is granted with respect to past services. As discussed above, capital interests are included in a partner's income at the time of grant, while the receipt of a profits interest is not a taxable event. However, the non-recognition safe harbor under Rev Proc. 93-27 does not apply to a profits interest which relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease. Moreover, the disguised payment rules under Section 707(a)(2)(A) should be considered to the extent the profits interest lacks entrepreneurial risk (and thus may be recategorized as a payment for services subject to ordinary income tax rates and employment taxes). In order to keep the beneficial tax treatment of a profits interest for a promote, it's important that the fund's allocation and distribution waterfall avoid early monetization of the promote and does not include predictable revenue streams so as to fall within the safe harbor of Rev. Proc. 93-27, thus maintaining its treatment as a profits interest for income tax purposes.

d. Management Fees and Fee Waivers

The Economic Deal

Fund managers typically charge a management fee to fund the ongoing operation and administration of the investment fund. Most private equity funds, hedge funds, and real estate funds charge these fees as a percentage of committed or invested capital and are generally around 1-2%

annually. The fee flows to a separate management company that is controlled by the fund manager and covers salaries and overhead for the manager's staff. These fees are generally treated like other service-based compensation: they result in ordinary income to the fund managers, and they may be a deductible business expense to the fund. Unlike carried interests and promotes, which include entrepreneurial risk and are measured by a share of the investment fund's profits, management fees are fixed and predictable.

However, fund managers have an opportunity to change that tax treatment – converting the fees' ordinary income character into long-term capital gains – by use of management fee waivers. A management fee waiver is used to waive the right to collect some or all of the manager's fixed fee in exchange for an increased share of the fund's future profits. Fund managers can thus convert their fixed fees – taxed as guaranteed ordinary income – into a profits interest that effectively increases the size of the manager's carried interest or promote percentage, taxed by the character of the fund's underlying income (e.g., generally long-term capital gains).

Tax Consequences

From a tax perspective, if the management fee waiver meets the safe harbor of Rev. Proc. 93-27 and avoids treatment as a disguised payment for services under Section 707(a)(2)(A), the fund manager will not recognize income upon the fee waiver itself (e.g., as the manager does not recognize income upon the grant of a profits interest). The increased allocations of future income from the fund will instead be taxed under the principles that apply to a profits interest, as discussed above. Importantly, the IRS has repeatedly scrutinized these arrangements, emphasizing that to avoid recharacterization, the management fee waiver must involve a significant entrepreneurial risk and not function as a guaranteed payment. The 2015 proposed regulations with respect to management fee waivers[14] identify six non-exclusive factors that indicate an arrangement may constitute a disguised payment for services for purposes of Section 707(a)(2)(A), the most important of which is the presence of significant entrepreneurial risk. The other five factors, which are all secondary to the significant entrepreneurial risk factor, include (1) the service partner holds the interest for only a short duration, (2) the service partner receives an allocation and distribution in a time frame comparable to when a non-partner would typically receive payment, (3) the service partner became a partner primarily for tax benefits not available if the compensation was received as a non-partner, (4) the value of the profits interest is small in relation to the allocation and distribution, and (5) if the arrangement provides for different allocations and distributions with respect to different services received, where the services are provided by the same person (or related persons) and the terms of the differing allocations and distributions are subject to levels of entrepreneurial risk that vary significantly. These factors all indicate that where a management fee waiver is used to convert a guaranteed payment into a right to future profits, such waiver will only be respected as a profits interest (and governed by the tax rules applicable to such interests) where significant entrepreneurial risk is at play and the other secondary factors do not suggest such waiver is a disguised payment for services. If the management fee waiver is respected, then it may be able to convert the character of the fund manager's compensation from ordinary income to long-term capital gains income (according to the underlying investments of the fund), significantly reducing the manager's tax burden.

Notably, while it was the IRS's contention that the proposed regulations reflected existing law, the text of Section 707(a)(2)(A) provided that it was subject to regulations prescribed by the Secretary, which regulations would not be effective until made final. However, the One Big Beautiful Bill Act passed

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[14] REG-115452-14.

earlier this year amended Section 707(a)(2)(A) to clarify that the provision will apply as written (i.e., it is no longer contingent on final regulations) and is therefore self-executing. Thus, the prohibition on disguised payments in Section 707(a)(2)(A) is one which any management fee waiver must carefully address in its structuring in order to achieve the beneficial tax treatment that a profits interest offers fund managers.

IV. The Federal Transfer Tax Consequences to Transferring Interests in a Fund

In this Part, we discuss the federal gift and estate tax consequences to gifting fund interests, the nuances of valuing fund interests and strategies for transferring wealth tax-efficiently. We begin by looking at general considerations for transfers of fund interests, followed by a discussion of Code Section 2701 and the vertical slice planning that many fund managers, promoters and developers grapple with when making gifts of their interests. Finally, we look at an alternative to vertical slice planning – the carry derivative agreement – as a means for transferring wealth with respect to carried interests efficiently while minimizing administrative burden.

a. General Considerations and Tax Consequences for Transferring Interests

A vested carried interest, promote or other profits interest is a valuable property right that can be transferred to others by gift during life or by bequest upon a partner's death. Generally, the best time to transfer an interest in the future profits of a fund is at the outset of the fund, when investment performance is still speculative and no gains have yet accrued with respect to such profits interest. Such a profits interest will have its lowest value for gift tax purposes at this point, requiring the least use of a partner's lifetime gift exemption (or incurring the least in gift tax). However, valuation of these interests can be tricky – the profits interest still has an option value at the outset of the fund, and a multitude of factors (e.g., prior performance by the management team, interest rate environment, nature of the fund's investments) can drive the valuation prior to recognizing any investment gain. Other issues further complicate the transfer of profits interests. It can be difficult to determine the amount to gift at the outset (given there is substantial entrepreneurial risk associated with a profits interest, it is difficult to foretell the future value of the interest). If such an interest is subject to vesting, then what was intended as a single gift could in fact result in a series of gifts that complete over time as the interest continues to vest, with subsequent gifts more valuable than earlier gifts as the fund's investments mature.

On top of this natural uncertainty as to the value of an interest comes the magic of Chapter 14 and the deemed gift rules of Section 2701. As discussed below, in the context of a typical investment fund, the transfer of a carried interest or promote without a pro rata transfer of a partner's capital interest can cause the profits interest to be valued as if all of the partner's capital interest were also transferred, causing the value of the gift for gift tax purposes to be much greater than anticipated. These materials discuss two solutions to this issue: the use of vertical slice planning and the use of carry derivatives.

b. Introduction to Section 2701

Section 2701, enacted in 1990, was designed to prevent the manipulation of valuations for certain intrafamily wealth transfers with discretionary preferred and common family partnerships. Pre-1990, parents looking to minimize the valuation of wealth transfers to their children could create a partnership (or recapitalize an existing one) with two classes of interests: a preferred interest, with various discretionary rights, and a common interest, which would be entitled to the appreciation in the partnership after the returns to the preferred interests. The value of the preferred interests could be aggressively inflated with respect to the value of the common interests by granting discretionary rights that the preferred interests could (but were not required to) exercise. Therefore, parents were able to gift the common interests to their children at very low valuations while never actually exercising some or all of the discretionary rights of the preferred interests such parents retained, thus effectuating significant wealth transfers at significant discounts.

Section 2701 sought to address this by creating a new regime for valuing gifts of interests in partnerships and corporations to family members. Section 2701 seeks to mitigate the manipulation of the value of a gifted interest (i.e., the interests transferred to a junior family member) by inflating the value of the retained interest (i.e., the interests retained by the senior family member) through the use of extraordinary payment rights or distribution rights.

The special valuation rules of Section 2701 apply any time that an individual transfers an interest in a partnership or corporation to a member of the transferor's family if, immediately after the transfer, the transferor (or any applicable family member) holds an interest in such entity that is an "applicable retained interest," or an interest in an entity that confers an "extraordinary payment right" or "distribution right." The term "member of the transferor's family" includes the transferor's spouse, the lineal descendants of the transferor and the transferor's spouse, and the spouses of such lineal descendants. The term "applicable family member" includes the transferor's spouse, the ancestors of the transferor and the transferor's spouse, and the spouses of such ancestors. Thus, Section 2701 generally applies when an interest is transferred to a family member of a younger generation than the transferor (noting that siblings, aunts, uncles, nieces and nephews are not captured by these family definitions). The term "extraordinary payment right" includes a liquidation, put, call or conversion right wherein the exercise or non-exercise of such right affects the value of the interest, and wherein the exercise of such right is discretionary. The term "distribution right" includes the right to receive distributions from an entity that is controlled (e.g., holding 50% or more of the voting power or fair market value) by the transferor and/or certain family members (including lineal descendants) immediately prior to the transfer; provided that, for limited partnerships, any interest in a limited partnership as a general partner qualifies as control. As senior family members who retain interests with extraordinary payment rights or distribution rights can simply elect not to take such payments or make such distributions, they could effectuate a significant transfer of wealth to the holders of the junior common interests (e.g., the families of their lineal descendants). The drafters behind Section 2701 were concerned with these freeze techniques which shifted growth out of the transferor's estate at minimal gift-tax cost.

Notably, Section 2701 is a labyrinth of complexity – for purposes of these materials, we highlight the general idea behind its deemed gift regime to emphasize the gift tax risks involved in transferring a portion of carry, promote or other profits interest to a partner's family. Generally, Section 2701's solution is to determine the gift tax value of the transferred interest to the junior family member using the "subtraction method," with a zero-value rule applying to the retained interest held by the senior family member. In short, the subtraction method determines the valued of the transferred interest by taking the aggregate value of all equity interests in the transferred entity held by the transferor and applicable family members prior to the transfer and subtracting out the value of all equity interests retained by the transferor and applicable family members immediately after the transfer; if the retained interest is an applicable retained interest for purposes of Section 2701, then its value for this calculation is zero. Generally, the net result is that, for purposes of the gift tax, the value of the transferred interest is equal to the value of the transferred interest *plus* the retained interest. Thus, without careful planning to avoid the application of Section 2701, making a gift of carry, a promote or another profits interest can have significant gift tax consequences which undercut a partner's goal of efficiently transferring wealth to the next generation.

c. Strategies for Handling Section 2701: Vertical Slice Planning

Section 2701 contains a useful exception to the application of its deemed gift rules: if the retained interest is proportionally the same as the transferred interest, the zero-value rule does not apply to such retained interest. Thus, the value of a fund manager's transferred profits interest will not be inflated by the value of the retained capital interest to the extent that there is a proportionate gift of the fund manager's capital interest. This approach is called the "vertical slice." Imagine that all of a fund manager's interests in an investment fund were a cake. Instead of slicing off and transferring just the icing, well-known to be the best bit of cake (e.g., the carried interest with the greatest appreciation potential), and leaving behind the spongey, less sugary part (e.g., the capital interest), a vertical slice cuts through every layer of the cake (e.g., all of a fund manager's interests in the fund) to transfer a proportionate amount of all layers to the transferee. Under the vertical slice exception, the special valuation rules of Section 2701 do not apply, and the value of the transferred interest (e.g., a portion of the fund manager's carry plus a pro rata portion of the capital interest) is simply the fair market value of what is transferred.

However, unlike cake, investment funds are not always so simple to cut up in neat proportions. Carried interests or promotes can be granted on an investment-by-investment basis, rather than at the fund level; or they could be granted annually for all investments made over the course of that year; or they could be subject to vesting, with a fund manager's portion of carry or promote growing as they continue to provide services to the fund. In these cases, the fund manager will need to make additional transfers of their interests in order to maintain the pro rata vertical slice that they crafted upon making their initial gift of interests to their family. As discussed above, management fee waivers can be used to convert guaranteed annual payments into grants of additional interests in the fund's profits. Such arrangements create new classes of interests that also must be transferred (as another layer of the vertical slice) where such rights to the fund's profits are senior to the carry or promote. And if the capital interest layer of the vertical slice is subject to future capital calls, then the fund manager needs to also ensure that the family trust to which she is typically making such gift has adequate funds to meet those capital calls when made (especially if the carry or promote will not yet have begun receiving allocations and distributions of fund income which could otherwise be used to fund such capital calls).

d. Strategies for Handling Section 2701: Carry Derivative Agreements

A second strategy to avoiding the deemed gift rules of Section 2701 is to not transfer a carry or promote at all, but to instead use a carry derivative agreement to transfer the upside value of these profits interests. A carry derivative agreement is a contract between a fund manager and an irrevocable grantor trust for the benefit of the manager's family in which the trust purchases the right to receive certain amounts in the future if the carried interest or promote which the manager holds in an investment fund hits certain performance benchmarks. In effect, the fund manager is not transferring a profits interest subject to Section 2701, but rather is transferring a separate financial instrument whose value is tied to the economic performance of such profits interest (and to which Section 2701 does not apply). Thus, a carry derivative agreement allows a fund manager to transfer the economic benefits of her carry without transferring the actual interest in the fund, avoiding not only the Section 2701 deemed gift rules but also the various complications we raised above with respect to transferring fund interests (e.g., meeting capital call requirements, future gifts based on new allocations of carry, etc).

The backbone of a carry derivative agreement is the formula which determines the value of the contract and the rights of the trust to receive amounts in the future. Generally, a carry derivative will state that, in exchange for an upfront purchase price paid to the seller (i.e., the fund manager), the purchaser of the contract (i.e., the trust) will receive payouts in the future based on certain settlement dates. These settlement dates are typically late in the fund's life (e.g., at year 6, year 8 and year 10) when the manager's carry or promote will be sharing in the fund's profits. The payouts at each settlement date may use a formula which first sums all distributions (less clawbacks) made to the fund manager with respect to his or her carry, then subtracts out a set hurdle (i.e., the amount the fund manager wants to first retain from her carry before transferring excess amounts to the trust), and then applies a set percentage (e.g., 60%, so that the fund manager retains sufficient funds with respect to the carry to pay the income taxes for the grantor trust) to arrive at the payout amount owed to the trust. The carry derivative can also include a cap, which is the maximum amount that the purchasing trust can receive under the agreement (so as to avoid overfunding the trust if the fund performs exceedingly well). These features – a hurdle, a percentage split, and a cap – are each useful levers to adjust the economics of the carry derivative agreement so as to customize it to the specific goals of a fund manager; they also each impact the value an appraiser will assign to the contract, thereby modulating the gift tax cost of the agreement (e.g., assuming the fund manager gifts the trust the cash used to enter into the agreement).

> <u>Take this simple example</u>: a carry derivative is based on a 20% carry, with a $2 million hurdle, the percentage split is 60%, and there is one settlement date at year 10 (e.g., the trust will receive 60% of the distributions with respect to the carry which exceed the first $2 million in distributions over the first 10 years of the fund). The contract is appraised at $750,000, and the trust purchases the contract from the fund manager. Over those 10 years, $15 million in distributions are made to the fund manager with respect to her 20% carry. On the settlement date, the fund manager pays the trust $7.8 million: $15 million in distributions - $2 million hurdle equals $13 million, and 60% of this $13 million is $7.8 million. Therefore, for a gift tax cost of $750,000, the fund manager was able to ultimately transfer $7.8 million to a trust for her family.

There are several key benefits to the use of a carry derivative agreement that make it more attractive than the vertical slice approach. A carry derivative agreement includes a great deal of flexibility with respect to the economics of the transfer, ensuring that a fund manager both shares in a sufficient amount of the economics (e.g., by use of the hurdle) and that a trust is not overfunded because too great an interest was transferred to the trust (e.g., by use of a cap). Because the carry derivative agreement is based on a set amount of the carry or promote, there is no adjustment for dilution due to new partners joining the investment fund or a loss of carry due to an early departure by the manager. Moreover, it avoids vesting issues completely, as no interest subject to vesting is actually transferred (but rather, a new financial instrument based on the economic performance of such interest is created). The trust is not responsible for funding any capital calls (since it does not receive any capital interest as part of the transfer, as it would when using a vertical slice approach), no additional transfers need to be made in the future if the fund manager receives additional capital or profits interests (as would be needed under a vertical slice), and the time horizon can be set (e.g., because the carry derivative is based on known settlement dates). And to be certain, a carry derivative is not without risks: the fund manager may not have the liquidity to settle the contract on account of a reduced carry due to dilution or vesting, requiring the use of a note to pay the settlement amount; the IRS could challenge the valuation of the price of the contract, possibly resulting in additional gift tax; and post-death payments can be taxable income to the trust (though resolvable by making the final settlement due at the earlier of the death of the fund manager and the last settlement date). With the right structures, a carry derivative can be more straightforward to administer and more flexible in its economics than the vertical slice approach.