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The Choreography of Planning for Private Equity Principals

By any measure, the "private equity" industry has grown multi-fold over the past two decades. According to McKinsey & Company, private equity fundraising in 2021 reached an annual record high of $1.2 trillion. At the same time, private equity assets under management reached an all-time high of $9.8 trillion.

Enter the private equity fund manager ("PE manager") who stands to be rewarded mightily if the underlying fund investments do well. Generally speaking (very generally since the old norms of private equity seem to change almost daily), PE managers will hold two types of equity interests in their proprietary funds.

- **"Limited partner interests,"** which are partnership equity interests bought and paid for by the PE manager, and which generally place the PE manager in the same position as other investors in the private equity fund.
- **"Carried interests,"** which are partnership equity interests (structured as "profits interests" for income tax purposes) received by the PE manager as incentive equity (and not purchased). By some estimates, carried interests comprise upwards of 90% of total PE manager compensation at the most senior levels.
- **"Management fees"** are not equity interests at all, but instead a right held by the private equity fund's management entity(ies) (which trickle down to the PE manager) to earn an ongoing fee paid by the private equity fund. The management fee is typically calculated as a small percentage (1% or 2%) of the private equity fund's committed capital and is intended to cover the PE manager's expenses and provide a basic level of compensation.

PE managers face a variety of financial planning, tax planning and estate planning challenges. Sounds like the perfect Choreo client! In this article, let's take a high-level look at the planning issues faced by PE managers. In future content on this subject, we'll take deeper dive into these issues.

FINANCIAL PLANNING

Choreo advisors can provide significant value to a PE manager's cash management and investment construct.

- **Cash management:** PE managers face significant cash management issues, especially early on in their careers. A PE manager with one or two successful fund liquidations under her belt may have used these funds to create a lifestyle that outstrips her regular income, rendering the PE manager cash poor until the next liquidity event. PE managers also need to be aware of, and in close communication with, their advisors on cash needs for expected tax liabilities, estimated tax payments, and investments/capital calls in private equity investments. This is an ongoing quarterly and annual planning need.
- **Credit lines:** To avoid disturbing underlying investments, PE managers may want to use asset-backed credit lines. Managing debt load and debt service thus becomes extremely important, especially as interest rates rise.
- **Investment planning:** Like other business owners who are highly concentrated into a single or small number of equity interests, PE managers need a holistic approach to investment management to provide balance to their overall investment picture.

- **D&O insurance:** PE managers will usually serve on the boards of some number of underlying portfolio companies. As a result, they should ask questions about relevant D&O and umbrella insurance carried by the portfolio company and/or private equity sponsor.

INCOME TAX PLANNING

Choreo advisors can assist PE managers to plan for, understand and model the income they stand to receive from investments. In this context, understanding the character of the income expected to be received (ordinary versus long-term capital gain) and potential opportunities to expand more beneficial forms of income are vital planning points.

- **Carried interest income character:** Under the Tax Cuts and Jobs Act, beginning in 2018, carried interests became subject to Section 1061 of the Internal Revenue Code. In general, and ignoring a number of complicating factors, Section 1061 requires a three-year holding period before a PE manager's carried interest distributions will qualify for preferential long-term capital gains rates. Carried interest distributions not meeting the requirements of IRC 1061 are taxed at ordinary income tax rates. This is a departure from the one-year holding period that is typically required for long-term capital gain treatment outside of the private equity world. The IRS released final regulations under Section 1061 in January, 2021, answering a number of lingering questions about the taxability of carried interests in a host of circumstances.
- **Carry waivers:** Some private equity funds feature carry waivers, allowing PE managers to waive their rights to receive current carried interest payments that would be taxed as ordinary income under Section 1061. Instead, PE managers who opt for a carry waiver wait for later payments from the private equity fund that will be taxed as long-term capital gain under Section 1061. The IRS has indicated it is aware of carry waivers and that it may view and test such waivers similarly to management fee waivers, discussed next.
- **Management fee waivers:** Some private equity funds feature management fee waivers, allowing PE managers to waive their right to management fees in exchange for additional carried interests. The incentive to do this is clear – management fees represent ordinary income, while carried interest distributions, if they meet the requirements of IRC 1061, are long-term capital gain. Moreover, if the private equity fund is successful, the PE manager should receive more overall compensation from the carried interest than the management fee.

In 2015, the IRS issued proposed regulations under Section 707 of the Internal Revenue Code on management fee waivers (those regulations have not been finalized). The proposed regulations set forth a six-factor test to determine if management fee waivers should be respected as designed or taxed as constructively received income. The issue generally comes down to the likelihood that the management fee waiver will result in carried interest income. The higher the likelihood, the less "entrepreneurial risk" of the management fee waiver and, therefore, the more likely IRS would recharacterize the management fee waiver as constructively received income.

ESTATE PLANNING

Choreo advisors can bridge a tremendous gap between the PE manager's intention to engage in estate planning and the reality of getting it done. While estate planning attorneys will inevitably prepare the relevant estate documents, advisors are best positioned to provide the critical path in terms of which interests to gift and how that gifting affects the client's overall financial and tax plan.

- **Gifts of carried interests under IRC 1061:** Final regulations under IRC 1061 confirmed that a gift of carried interest does not accelerate inherent gain at the time of the gift. There was some question on this emanating from the previously published proposed regulations under Section 1061 (which would have represented a significant departure in the typical non-recognition character of a gift). The same principle applies to other non-recognition transactions, like partnership contributions, which are a vital part of advanced estate planning for PE managers. Of course, even if gifted or otherwise transferred in a non-recognition transaction, Section 1061 still applies to determine the ultimate

character of distributions emanating from the carried interest.

- **Vesting:** Revenue Ruling 98-21, which addressed the gifting of non-statutory stock options ("NSO"), concluded that the gift of an NSO is not a completed gift for gift tax purposes until the later of (1) the gift, or (2) the time when the gifted NSOs are vested. Traditionally, the PE manager's carried interest will be subject to a vesting requirement. As a result, the IRS could argue that the PE manager's gift of a carried interest does not constitute a completed gift until that portion of the interest is fully vested. There are some countervailing arguments to this position in that while an unvested NSO is not entitled to any economic rights, an unvested carried interest entitles its holder to allocations and distributions right away, subject to the terms of the operating agreement.
- **IRC Section 2701 and vertical slice planning:** Section 2701 of the Internal Revenue Code was enacted in the 1990s to combat preferred stock and preferred partnership freeze transactions. In those transactions, the senior generation was able to modify the equity structure of a family-owned and controlled company to "pack" essentially all of the current company value into a "senior" preferred equity interest. At the same time, all future growth in value of the company would accrue to a "junior" common equity interest. The common equity interest would then be gifted at low value and effectively freeze the value of the preferred interest in the hands of the senior generation. In these situations, Section 2701 effectively ignored the value of the gifted "junior" common stock interest and instead deemed the value of the gift to be equal to the retained "senior" preferred interest. This is a highly problematic result for the transferor, as the "senior" preferred interest would represent the entire value of the company (likely well in excess of applicable gift tax exemption amounts).

  Practitioners fear the application of Section 2701 to gifts of Carried Interests. This fear is founded in the fact that most PE managers who gift Carried Interests will also retain a Limited Partner Interest in the same fund. This effectively emulates the same "senior" interest / "junior" interest arrangement which Section 2701 was designed to combat. While there are arguments that Section 2701 should not apply in many cases, a common planning method to avoid Section 2701 while gifting Carried Interests is the "Vertical Slice" approach. To fall within this exception, the transferor must gift a proportionate amount of each equity class (both the Carried Interest and Limited Partner Interest) in the private equity fund. For example, the PE manager could gift 1% of both the Carried Interest and the Limited Partner Interest and meet the Vertical Slice exception.

  Family LLCs and LPs become useful mechanisms for engaging in the Vertical Slice. For example, a PE manager might contribute all of her Carried Interests and Limited Partner Interests into a Family LLC and then gift a percentage interest in the Family LLC to a gift trust.
- **Documentation burden:** Sophisticated private equity subscription documents now number in page count at over 100! This is independent of the offering memorandum or private placement memorandum and relevant LP or operating agreement. A new set of subscription documents is often requested even for gratuitous transfers that clearly meet estate planning exceptions to transfer limitation within fund governing documents. Advisors can provide significant value in easing this extensive paperwork burden for clients.

Let's talk. If you're working with or are a private equity principal, Choreo can help. Please reach out with any questions or to discuss how we can make your planning as smooth as possible.
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