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GIFTING CARRIED INTERESTS: VALUATION & PLANNING PITFALLS – EXPERIENCE FROM THE TRENCHES

BY: HUGH WOODSIDE, ASA, CFA, MANAGING DIRECTOR

Over nearly 15 years of direct involvement in the valuation of private equity fund and real estate fund carried interests for gift tax purposes, experience has taught me that there are a wide range of considerations to ensure that the planning, execution and valuation process goes smoothly from the client's perspective. Many of these considerations involve planning and communication with all parties early in the process, and other considerations are directly connected with the valuation. All of them can have an impact on the process and the client's experience.

Carried Interests, Carry Points & the Vertical Slice: An Overview of Key Concepts

Carried Interest: In the context of private equity and private real estate funds, a carried interest is the right to share in prospective future profits of the fund. These rights are typically granted to the fund's general partner entity ("GPE") pursuant to the terms of the fund's governing documents. Within the GPE, carried interest is typically allocated to the members based on carry points or a carry percentage, which are discussed further below.

Carried interest is typically the most junior tranche of the fund's equity structure, to be realized only if future profits are significant enough to first satisfy returns of capital and a minimum internal rate of return ("IRR") to the investors. This is managed through a waterfall structure detailed in the fund's governing documents. A typical limited partner ("LP") capital waterfall, in which the GPE would receive a carried interest of 20%, might look something like this:

1. LPs in the fund would first receive a pro rata return of capital contributions to the fund;
2. LPs would receive an allocation of profits such that they received investment returns equal to an IRR-based hurdle rate on contributed capital (frequently 8%);
3. The GPE would receive a "catch-up" distribution of profits until it had received 20% of the profits distributed under steps two and three; and
4. Remaining profits, if any, would be allocated 20% to the GPE and 80% pro rata to the LPs.

Carry Points: The right to receive carried interest can be expressed in terms of a carried interest percentage or carry points. When expressed as a percentage, the GPE is typically entitled to receive 100% of the carried interest generated by the fund. In this case, if a member of the GPE has a 20% carried interest percentage, the member would be entitled to receive 20% of the carried interest cash flows received by the GPE. When expressed as points, there are typically 100 carry points in total. A member having 20 carry points would also be entitled to receive 20% of the carried interest cash flows received by the GPE.

Membership in the GPE typically includes two components: (1) a capital interest percentage, which is equal to the capital commitment of the individual member divided by the aggregate capital commitments to the GPE; and (2) a carried interest percentage or carry points, depending on the terminology utilized by the fund. There is no requirement that an individual member's capital percentage and carried interest percentage be the same. In fact, they are often different.

Vertical Slice: In order to avoid potential issues under Section 2701 of the Internal Revenue Code, a generally accepted technique utilized by many practitioners is the transfer of a "vertical slice." A vertical slice is a pro rata percentage of an individual's entire interest in a private equity or real estate fund. This would generally include an interest in the GPE, as well as any limited partnership interest that the individual owns directly in the fund itself.

A possible alternative to the use of a vertical slice is a carry derivative. The structure of the prospective transaction, and whether or not a vertical slice or carry derivative is more appropriate, is typically based on the recommendation of the client's estate planning counsel, and considers a wide range of factors specific to the client's situation.

Build a Team Early

Key initial players of the planning team typically include the client, his or her accountant, and the estate planning attorney. Often, valuation experts only become part of the process once a gift has been completed. In general, I advocate that the valuation expert should be involved early in the planning process, and prior to the time that the gift is completed. This is particularly important in the context of gifting carried interests, given the technical and structural nuances associated with these gifts, and an experienced valuation expert can add value in structuring the transaction. Given the unique nature of carried interest transfers, fund counsel is also a key part of the team. Having drafted the fund documents, they are uniquely positioned to offer insight into how the fund works and often have a knowledge base that estate planning attorneys new to these transfers do not have. Another key individual to identify early in the process is the primary contact at the fund. While this is often initially the client, it is frequently the CFO who winds up quarterbacking the process. Everyone wins when the full team is assembled early in the process and communicates often throughout.

How to Structure the Engagement

Valuation engagements for carried interests most often start with a single client and attorney. One of my first questions for the prospective client is always, "Do any of your partners also need a valuation?" Often, the answer is "yes." In that situation, it is frequently true that multiple planning attorneys and advisers are involved (the number of advisers seems to grow exponentially with the number of clients!). When this happens, I most often suggest that we be engaged by the fund (or the management company) directly, instead of by the individual client or their estate planning attorney. The engagement can be structured so that there are multiple users of the reports, and often the reports are tailored to individual partners. This process helps to ensure consistency across the valuations that individual partners are using to support their estate planning activities and helps to reduce the "per user" costs for the report – a win-win for the clients.

Gifting at Inception – How Early is too Early?

Executing a gifting transaction involving carried interests at "time zero" is attractive. Assuming that no capital has been called prior to the transaction, the "capital" component of the interest generally has $0 value, and the carried interest component would be at its lowest value due to the high degree of performance risk (there is generally significant risk at inception associated with identifying attractive investment opportunities and ultimately realizing future gains on a fund-wide basis). But how early is too early? Answers to the following questions may help provide guidance for certain situations.

1. **Have critical documents been executed in "final" form?** I would characterize the fund agreement, offering memorandum and the GPE agreement as critical documents, because they define the rights of the GPE relative to the fund, and the rights of the individual members of the GPE. Of course, the offering memorandum provides critical information about the new fund. A few years ago, we were engaged in May to value gifts associated with transactions that were completed in January. An agreement for the GPE was executed prior to the gifting transactions, but it was a generic four-page placeholder agreement that did not remotely resemble the final GPE agreement. Simply put, while there was an implicit agreement among the members of the GPE as to what the final terms would be based on prior funds, it had not been properly documented in the GPE agreement. Had there not been a term sheet which was agreed upon by the members of the GPE that reflected the expected final terms of the GPE agreement, it would not have been possible to consider those terms in the valuation process. Issues of this nature can be avoided through timely communication between members of the advisory team.

2. **Is the interest being transferred clearly NOT subject to dilution?** It is common for carry points to be assigned to employees who become members of the GPE sometime after the inception of the fund, or for carry points to be reassigned within the GPE with the addition of a new partner. If the carry points associated with the interest to be transferred are subject to potential future dilution, the fair market value ("FMV") of the interest may be overstated if the prospective dilution is not properly accounted for. There are multiple ways to address this, which include: (1) specifically accounting for the dilution in the determination of FMV; (2) including a smaller percentage interest (lower number of carry points) in the transfer such that the potential future dilution would not impact the interest; or (3) executing an agreement that all prospective dilution will be borne by the interest retained by the donor. Not long ago, we were informed that a transfer was completed shortly before a dilutive event that occurred near formation. Following the dilutive event, the transferee owned a smaller interest in the GPE than he purportedly transferred just days before. This highlights the real-time flux of events and the critical need for the advisory team to be fully informed throughout the process.

3. **Has the fund raised substantially its entire target committed capital amount?** This is the most common question we get around timing. If there is a $500 million target for committed capital and only $200 million has been committed through the initial close, should a gifting transaction be completed at the initial close? Great question. How confident is the fund that it will close on the entire $500 million? The answer may be different for a fund in a new fund family, versus the seventh or eighth fund in a successful family of funds. While uncertainty increases risk and theoretically reduces value, assuming an aggregate committed capital amount that turns out to be too high is counterproductive. However, it is generally still best to complete the transaction before any capital has been called. This is a nuanced decision and the right answer will vary from fund to fund, but it is a good conversation to have prior to the gifting transactions to help ensure that the goals are accomplished.

   Alternatively, risk may also exist if the assumptions in the valuation are overly conservative regarding the capital raise. For example, there would be a meaningful impact on value if management communicated that the target capital raise for a fund would be capped at $500 million at the time a transaction was completed, and it was ultimately closed at $750 million or $1 billion. While that would be great for the fund, it could result in a meaningful increase in audit risk if the client's gift tax return was selected for audit.

Identity of the Transferee

While the identity of the transferee falls outside the context of the FMV definition and does not directly impact value, it does raise practical questions in connection with the transfer. The most significant concern is the transferee's ability to fund the capital calls associated with the capital interest component of the vertical slice. One option is to execute a formal loan agreement between the transferor and the transferee, with the borrowed funds to be used to fund the capital calls. A second option is to contribute the vertical slice to a "wrapper" entity, such as a limited partnership or LLC, or to a trust which has sufficient liquid assets to fund the future capital commitments. Liquid assets can be contributed to the newly-formed trust or entity to fund the capital calls, or a loan agreement can be put in place as described above.

The use of a wrapper entity may create valuation issues if not owned 100% by transferor prior to the contribution of a vertical slice, or if gifts of non-controlling interests in the wrapper entity will be made. This is particularly true if the wrapper entity owned other illiquid assets prior to the contribution of the vertical slice. If a wrapper entity is utilized in the transfer, discounts for lack of control and marketability at the entity level should be considered and applied as appropriate.

The Impact of Co-investment Vehicles

Over time, fund structures have evolved such that a meaningful component of the client's capital commitment to the fund may be invested through a parallel, or co-invest, vehicle. The structure of the co-invest vehicle may not only impact the valuation analysis, but it also will impact the composition of the vertical slice transfer. If the co-invest vehicle is effectively a feeder vehicle for the fund itself (i.e., capital invested through the co-invest vehicle is contributed to the fund itself, and the fund invests in the portfolio companies), it would likely be included in the vertical slice analysis and may also be responsible for its share of fund expenses (thereby increasing the expected IRRs of the other partner classes).

However, if the co-invest vehicle invests directly into the underlying portfolio companies side-by-side with the fund, it generally is not considered a part of the fund itself and would likely be excluded from the vertical slice transfer. Moreover, an investment management entity associated with the fund is generally not included in the vertical slice transfer.

It's in the Details – the Importance of Communication throughout the Process

A key part of the valuation process with carried interests is to ensure that all members of the team are on the same page with respect to what the fund agreement and the GPE agreement actually say. Across fund types, there are numerous variations on the priority of distributions—i.e., who gets what, and when? In venture funds, there is often a pro rata return of capital to all partners directly followed by a carried interest allocation to the general partner and all other profits to the limited partners. In later stage private equity and real estate funds, the return of capital is often followed by the payment of a preferred return, a "catch-up" to the GPE, and then allocation of the carried interest. There may also be multiple hurdle rates, with increasing carried interest allocations to the GPE based on the achievement of increasing IRR targets on LP capital. There are also several potential variations in the fund documents regarding when carried interest is earned, and which investors' capital is subject to the waterfall. Terms of the GPE agreement may also further impact the manner in which cash flows received from the fund are allocated to members of the GPE.

These are all meaningful considerations that directly impact the value of the carried interest cash flows at inception. Incorrect modeling could result in an over-allocation of value to the carried interest, which is problematic on many levels. I find that it is critically important to review the fund model with the fund's management (typically the client/clients and the fund's CFO) prior to communicating estimates of value to the client. It gives the client an opportunity to "kick the tires" and challenge the assumptions used to build the valuation model—and they appreciate being involved! Importantly, it also gives the planning team an opportunity to incorporate feedback into the process before the conclusions of value have been discussed.

It's Not Worth $0! (i.e., Difficult Conversations & Planning Considerations)

Yes, I still encounter new clients who know that the value of the carried interest for *income tax purposes* at inception is $0 because no profits have been earned as of the date such interest is received by the client, and thus believe that the value is $0 for gift tax purposes as well. While prospective clients clearly understand that the carried interest is an option on performance of the fund and that it has value at inception, they may still think that it has a $0 value for gift tax reporting purposes. This is not the case. Unfortunately, this situation can lead to some difficult conversations, which are best had at the outset of the engagement. These conversations can be particularly tough if the client has made prior carried interest gifts and just assumed that the gifts had no value, and will become more complicated if the client didn't file gift tax returns for the earlier transfers. Having an "eyes wide open" conversation with the client is important to help them understand the risks associated with each of the options they have to address these situations. Such conversations should occur sooner rather than later in the planning process. This is the ultimate example of a situation in which the planning team can work together to help a client identify the best path forward in a difficult situation.

It's a Wrap!

This is a sample of some of the more significant issues that we have encountered over the years. In each case, we've worked with the planning team and the client to identify the best possible solution, and to put processes in place to avoid future issues. Our team includes multiple Managing Directors, Managers and Valuation Consultants with experience in this space. We look forward to bringing that experience to your next engagement.

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Hugh Woodside is a Managing Director at Empire Valuation Consultants, where he has worked since 2000. He is an Accredited Senior Appraiser (ASA) of the American Society of Appraisers and a Chartered Financial Analyst (CFA). Hugh has been involved in a wide range of carried interest valuations over a period of nearly 15 years, including private equity and real estate funds ranging in size from $250 million to over $2 billion.

Hugh H. Woodside, ASA, CFA | Managing Director
hwoodside@empireval.com

777 Canal View Blvd., Suite 200
Rochester, NY 14623
585.794.5720

One International Place, Suite 1400
Boston, MA 02110
617.535.7785

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