

## VALUATION ISSUES FROM GIFTING CARRIED INTERESTS

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A private equity fund is typically set up to invest in a variety of private equity investments over a time horizon, often ten years. During a fund's investment period, interests in the fund experience negative cash flows as the fund calls capital to build its investment portfolio. As the portfolio matures, the investments are harvested and distributions are paid to investors.

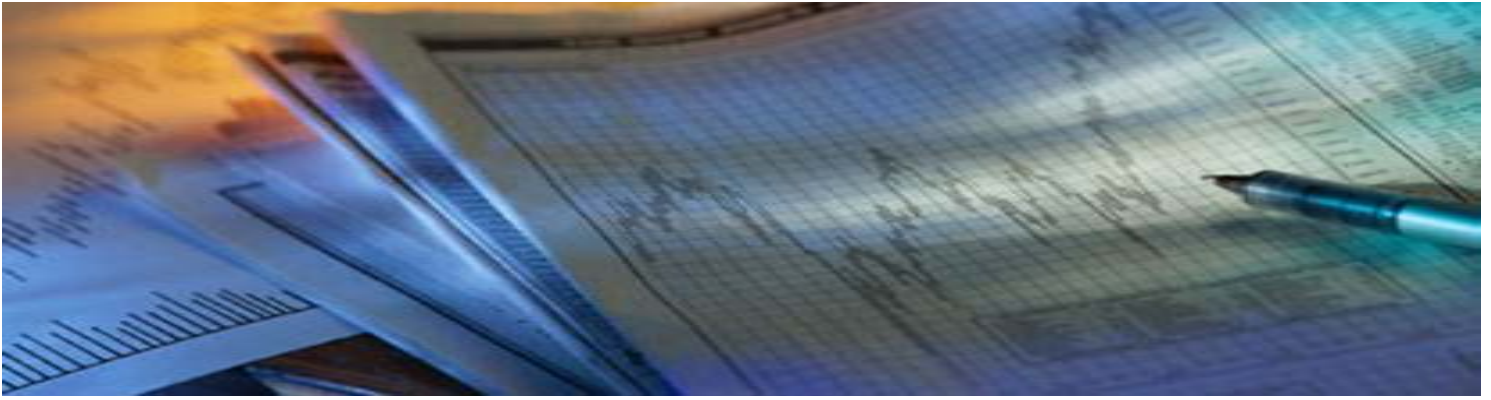
Gifts of non-controlling member interests in the fund's general partnership (GP) entity during the fund's early years has been an attractive estate planning tool because of the discounting of future cash flows, and applicable discounts for lack of control and lack of marketability. However, principals of the GP-donor should be aware of unexpected consequences that come from the unfunded capital obligations for future capital calls to be made by the fund. If plans are not made in advance of capital calls relating to a gifted membership interest, the donor may be in the position of funding a future capital call via additional gifts to the donee(s). The future cash transfer(s) may be an additional gift, with no consideration for any discounts for lack of control or lack of marketability applicable to the cash provided to meet the capital call.

### **Self-Funding Holding Company**

One way to handle unfunded capital calls when gifts have been made is to place the interest into a "wrapper entity" (i.e. a limited partnership or limited liability company) which has other investments that have sufficient liquidity or produce the cash flow necessary to meet the future capital calls of the fund. This allows for an interest in the wrapper entity to be gifted, with appropriate discounts for lack of control and marketability considered for both the pro-rata membership interest and the wrapper entity without causing the recipient of the gift to have to manually fund the capital commitment.

### **Formal Loan Agreement**

Another approach is to have a loan agreement with the donee in conjunction with the gift. The loan is established to provide the cash funding (either in a lump sum at inception or as needed) for future capital calls. The funding may be necessary if the donee does not have the financial ability to meet future capital calls. In many instances, the loan's interest rate can be set at the term-appropriate AFR. The appreciation of the gifted interest is there by transferred to the donee, less the cost of the loan. Discounts for lack of control and marketability are considered for the pro-rata membership interest.



An interest in a GP entity will be valued differently based on the manner in which future capital call obligations are financed, whether by future cash gift from the giftor, a self-funded wrapper entity holding the interest, or a formal loan agreement for financing future capital calls.

Proper understanding of unfunded obligations will allow for better planning and eliminate unintended tax consequences when gifting GP interests in private equity funds.

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#### ABOUT THE AUTHOR



David Thompson, CFA, is a Manager in the Rochester, NY office of Empire Valuation Consultants. He has broad business valuation experience, specializing in the valuation of the carried interest since 2006.

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