Estate Planning for Private Fund Principals

COVID-19 Crisis Considerations

Market Conditions

- **Since early March, markets have experienced tremendous stress due to the COVID-19 outbreak in the U.S.**
  - Selling has occurred across all asset classes; panic selling.
  - The environment has been characterized by significant investment losses in a short period of time, historically high price volatility in equity and fixed income markets, deleveraging of portfolios, margin calls, and a liquidity crunch as most investors try to raise cash.
  - Numerous industries in the U.S. have been effectively shuttered by federal, state and local government orders. The hospitality, restaurant, travel & leisure industries have been impacted dramatically, among others.

What Does This Mean for Fund Managers?

- **Hedge Funds**
  - We are getting our first indications of how bad the carnage has been in March; some of the largest hedge fund managers have reported drawdowns and/or year-to-date losses up to 25%.
  - We will likely soon find out about funds that “blew up” and have shuttered.
  - Redemptions across the industry are likely; investors will pull capital as early as March 31, 2020 from the most liquid funds.
  - Some funds may face the difficult decision to use “Gate” provisions to prevent a messy unwind.

What Does This Mean for Fund Managers?

- **Private Equity Funds**
  - Liquidity is at a premium; fundraising will be more difficult; 2015-2019 vintage funds are likely to see significant declines in portfolio values.
  - March 31, 2020 quarterly valuation marks are likely to be significantly lower for the large majority of LP capital accounts versus 12/31/19.
  - Exiting investments will be more difficult; holding periods will increase for existing investments; IRRs have been reduced and will be challenged going forward.
  - For new funds (2019, 2020, 2021 vintages), the opportunity set is likely to be more attractive than it has been at any point since 2009.
  - Funds with dry powder will be in a favorable position for the foreseeable future.

What Does This Mean for Fund Managers?

- **Opportunities**
  - There are always winners and losers in the public market space.
  - Firms that preserved capital the best and/or generated profits during this period will be in a superior fundraising position over the next 2-3 years.
  - Distressed debt and special situations funds are already being formed by the large firms to capitalize on dislocations, mispricings, depressed asset values.
  - Private equity firms with dry powder stand to see unique opportunities to purchase assets at low or distressed valuations, or participate in restructurings or turnarounds.
- **Gifts/Sales today could be very powerful.**
  - Valuations are depressed because uncertainty/risk is very high.
  - Transferred assets could have tremendous upside pending conditions improve.
  - Carried interests could have "homerun" potential for those fund managers that are able to buy at opportunistic/distressed prices.

What Does This Mean for the Valuations of Alternative Asset Management Firms?

- **Generally speaking, the values of asset management firms are down significantly.**
  - A significant correlation exists between AUM and firm value; lower AUM = lower firm value and vice versa.
  - Many hedge funds will be hit by the double whammy of negative returns and subsequent redemptions, leading to large declines in AUM.
  - Carried interests (for investments made pre-crisis) are in significant jeopardy for all alternative asset management firms.
    - Many hedge funds will need to make significant gains to reach previous high water marks (e.g., a 43% gain is needed to recoup losses from a 30% drawdown).
    - Many private equity funds will see their portfolios fall below the 8% hurdle required prior to allocating carried interest. Carried interest will be delayed or in complete jeopardy in many existing funds.

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Publicly Traded Alternative Asset Managers

Ticker	Firm Name	Stock Price Changes (as of 3/27/20) 1-Year	3-Month	1-Month
NYSE:APO	Apollo Global Management, Inc.	27.1%	-26.2%	-16.2%
NYSE:ARES	Ares Management Corporation	28.4%	-14.7%	-16.1%
LSE:ASHM	Ashmore Group PLC	-14.6%	-31.7%	-26.7%
NasdaqGS:HLNE	Hamilton Lane Incorporated	29.7%	-9.1%	-13.6%
NYSE:KKR	KKR & Co. Inc.	5.8%	-15.8%	-14.9%
LSE:EMG	Man Group plc	-5.2%	-21.9%	-14.4%
SWX:PGHN	Partners Group Holding AG	-5.4%	-25.7%	-23.4%
AIM:POLR	Polar Capital Holdings plc	-33.3%	-37.5%	-32.0%
NYSE:SCU	Sculptor Capital Management, Inc.	-11.1%	-32.6%	-38.2%
TSX:SII	Sprott Inc.	-27.8%	-25.3%	-25.3%
NYSE:BX	The Blackstone Group Inc.	33.9%	-17.9%	-13.5%
NASDAQGS:CG	The Carlyle Group Inc.	24.9%	-27.2%	-21.2%
	Median	**0.3%**	**-25.5%**	**-18.7%**
	Interquartile Mean	**6.0%**	**-24.1%**	**-19.5%**
	Median - Large U.S. Firms	**27.1%**	**-17.9%**	**-16.1%**
	S&P 500 Index	-9.4%	-21.5%	-14.8%
	The Financial Select Sector SPDR Fund	-17.3%	-31.7%	-23.1%

What About Discounts?

- **Closed-End Fund Discounts spiked during March to as high as 25% for equity-based funds.**
  - These fund discounts are widely used to support discounts for lack of control when valuing privately held family limited partnerships and other closely held investment companies.
- **Discounts for Lack of Marketability are correlated to volatility.**
  - We have seen a spike in volatility across equity and fixed income markets; higher volatility means higher discounts for illiquid assets.
  - During crisis periods, when liquidity is at a premium, it may be impossible to sell an illiquid asset…or the bids may be at a steep discount to the pre-crisis value.

Wealth Planning Considerations for Fund Principals

- It is a good time to consult your estate planning advisers to ensure you have your affairs in order.
- There were already plenty of good reasons to consider planning in 2020:
  - Temporarily higher federal estate/gift tax exclusion amounts provide opportunity to move assets out of your estate (scheduled to sunset 1/1/26).
  - Election year considerations – a change in administration and/or the makeup of Congress could cause an acceleration in the sunset to as early as 1/1/21 (assumes a future law is made retroactive to 1/1/21).
- Now…given the significant declines in asset values almost across the board, there could be opportunity to move assets out of your estate at a much lower valuation than would have been available earlier in the year.

What Has Happened to the Value of Privately Held Companies?

- **Many aspects of valuing a private held company involve a relative valuation exercise:**
  - Pick comparable public companies (i.e., companies either in the same industry and/or selling the same product/service).
  - Select valuation multiples based on a relative quantitative and qualitative analysis (i.e., should the private company be valued at the same multiple as the public companies given its size, margins, growth rates, etc., or should the multiple be higher or lower?).
  - If public company multiples have declined 25%+, then the starting point for the multiple selection for the private company has dropped.
  - It is a misconception that private company valuations are insulated from public market volatility; just because you can't observe valuation changes daily doesn't mean the valuations are unaffected by the broader financial markets.
- **Industry Differentials**
  - Like always, the environment differs from industry to industry. Today, while many industries are suffering greatly, there are some industries that are critical to making and delivering essential products and services (e.g., grocery stores, pharmacies, utilities, hospitals), and some industries that are positioned to take advantage of changing lifestyles and new sources of demand (e.g., pharmaceutical and biotech firms, technology companies providing cloud-based services, cybersecurity, delivery services, hospital/medical suppliers).

Valuation Considerations

- **Most corporate financial projections for 2020 were made pre-crisis and are now obsolete.**
  - Firms should be doing new forecasts and projecting what impact the crisis might have on cash flows.
- **Treasury rates have plummeted and equity risk premia have spiked.**
  - The net effect should be greater risk inherent in equity investments generally.
  - There is also greater risk in many parts of fixed income as default risk has increased and many issuers may have difficulty meeting short-term cash obligations.
  - For those firms with significant debt, this is a particularly risky time. This added risk on account of leverage must be addressed in determining the proper equity risk premium.
- **Discounts**
  - Discounts for lack of control for investment partnerships increased meaningfully in March as evidenced by the trading of closed-end funds.
  - Discounts for lack of marketability have increased; volatility has spiked and is positively correlated to discounts; illiquid assets are unattractive generally during a crisis where liquidity is at a premium.
- **CARES Act**
  - Some industries stand to gain government assistance to "bridge" the gap while their business is shut down.
- **Pension Plans**
  - We may see a spike in underfunded pension plans and/or significant increases in pension plan deficits.

Normal Considerations for Fund Managers

- The Playbook for Private Equity & Hedge Fund Managers.
- Implications of Chapter 14 of the IRC.
- Vertical and Non-Vertical Approaches (including derivatives).
- “But my client says his carry is worthless!!”
- Planning Nuggets.

Playbook

- **Hedge Fund Principals**
  - The benefits of planning at launch.
  - Some now, some later.
  - How early is too early?
- **Private Equity Principals**
  - Common to do planning with GP Carry Points as each new fund is formed.
  - Management fee waiver.

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Key Hurdle – IRC Chapter 14

- Section 2701 of Chapter 14: enacted in 1990 to curb perceived taxpayer abuses of preferred partnerships (senior-junior structures.
- Unintended consequence: the large majority of estate planners believe that Fund Principals would run afoul of Chapter 14 if they just transfer/gift carry.
- Common advice is to use the "vertical slice exception."

Vertical Slice Exception

- Sometimes called the "vertical slice rule," the phrase refers to an exception to Section 2701 that applies when the retained interest is proportionately the same as the transferred interest, without regard to non-lapsing differences in voting power (or for a partnership, non-lapsing differences with respect to management and limitations on liability).
- Broadly requires a parent who wishes to transfer a percentage of his carried interest to his children (or a trust for their benefit) to also transfer a proportional interest of his LP interest (e.g., 25% carry + 25% LP interest).
- Drawback: the LP interest is generally worth much more than the carried interest so the parent's gifting power may be too limited by the LP interest.

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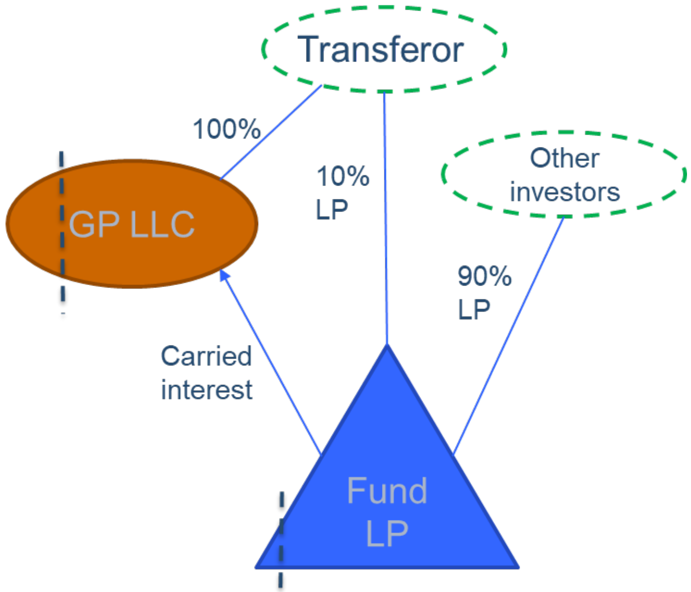
What is Included in Vertical Slice?

- A proportionate reduction of each class of equity interest held by the individual and all applicable family members.
- Hedge Funds:
  - Common to see a slice of all of the client's interests (ManCo, GP, Fund).
  - Also common to see a slice of just the client's GP & Fund Interest.
- Private Equity:
  - Typically just GP and Fund Interests.
  - Funds typically have a dedicated GP.
- Attribution rules apply so that proportionality is determined after taking into account interests held by applicable family members, and may not result in a proportionate reduction of the transferor's interest.

Typical Private Equity Vertical Slice

- Transferor owns 100% of the GP carried interest worth $1 million and 10% interest in the LP worth $10 million (other 90% is held by third party investors).
- Transfer of 20% of the GP requires proportionate transfer of 2% of the LP interest (i.e. 20% of Transferor's 10% LP interest) to qualify for vertical slice exception.
- Value of GP transferred is $200K, value of LP transferred is $2M.



Planning Tools

- Straight Gift
- Sale to an Intentionally Defective Grantor Trust (“IDGT”)
- Grantor Retained Annuity Trust (“”GRAT”)
- “Derivative” Contract
- Other Non-Vertical Approaches

Transfer Tax Landscape in 2020

- Federal estate, gift and generation-skipping transfer (GST) tax exemption amount of $11,580,000 per person.
- Federal tax rate above exemption amount is 40%.
- Effect of December 2017 legislation.
  - Increased exemption only available through 2025.
  - No clawback after 2025 per subsequent regulations.
  - Political uncertainty.
- Interest rates continue to be low.
  - Section 7520 rate for April 2020 is 1.2%.
  - Mid-term AFR for April 2020 is 0.99% (annual compounding).

Gift / Sale Planning

- Good for transfers of interests at fund inception, where values are low and cash flows from fund will not support GRAT annuity payments in early years.
- Increased exemption amounts currently available greatly expand gifting power.
- Installment sale permits larger transfer with smaller gift (or use of less existing trust resources) compared to gift or sale without a debt component.
- Multi-generational planning because able to allocate GST tax exemption (unlike GRAT).
- Greater risk in valuation that can be addressed with formula and adjustment clauses or by not maxing out exemption.

Managing Valuation Risk

- An appraisal should be obtained from a qualified appraiser with experience in the private fund space.
- If IRS increases valuation of fund and/or FLLC interest, there will be a current taxable gift of the excess value.
  - Preserve some gift and GST exemption as a cushion for increase in value upon audit.
  - Use a formula clause or purchase price adjustment to avoid a taxable gift.

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But My Client Says His Carry is Worthless!!!

- **Have your clients ever said…**
  - "The Fund has not done anything yet."
  - "Who would ever buy this??!!"
  - "We haven't made a single investment."
  - "There won't be carry for many years, if ever!!"

How Might You Respond?

- Carried Interest = Out-of-the-Money Call Option.
- While the carry may not be worth a lot at inception, it likely has some speculative, option-like value.
- Imagine an out-of-the-money option on Amazon stock:
  - Current Price: $2,050
  - Strike Price: $3,253
  - Time: 5 years
  - Volatility: 19.2%
  - Treasury Rate: 1.45%
  - Black-Scholes Estimated Value: $104
- While the intrinsic value is zero, the option has time and volatility value. Carry is similar.
- If all else fails, offer the client $200 for his carry points!!

Option Pricing Model Illustration:
Amazon as a Private Equity Investment

Black-Scholes Option Model Valuation	1	2	3	4
Stock Price	$ 2,050	$ 2,050	$ 2,050	$ 2,050
Exercise Price	0	2,050	3,012	3,253
Expected Term (Years)	5.000	5.000	5.000	5.000
Risk Free Rate	1.45%	1.45%	1.45%	1.45%
Volatility	19.2%	19.2%	19.2%	19.2%
Dividend Yield	0.0%	0.0%	0.0%	0.0%
Call Option Values	**$ 2,050**	**$ 413**	**$ 138**	**$ 104**
Incremental Values	**$ 1,638**	**$ 274**	**$ 34**	**$ 104**

Percent of Incremental Option Value				
LPs	99.000%	99.000%	0.000%	79.200%
GP as LP	1.000%	1.000%	1.000%	1.000%
GP Carry	0.000%	0.000%	99.000%	19.800%
Total	100.0%	100.0%	100.0%	100.0%

Percent of Incremental Option Value					Totals
LPs	1,621	272	-	83	1,976
GP as LP	16	3	0	1	21
GP Carry	-	-	33	21	54
Total	1,638	274	34	104	2,050

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Alternative Planning Ideas - Derivatives

- Partner sells derivative contract that tracks economic return of fund GP's carried interest to trust.
- Contract entitles trust to receive at settlement date (e.g., earlier of 9th anniversary of fund or partner's death) payment equal to (1) ___% of carry distributions made as of that date, plus (2) present value of ___% of carry distributions expected to be made after that date less a hurdle amount.
- Contract Terms:
  - Strike Price (Client Discretion) – most use a strike equal to or greater than the current FMV of the carry.
  - Term – typically mirroring or somewhat shorter than the expected fund term.
  - Volatility – estimated by appraiser as function of underlying portfolio characteristics.
  - Current value of underlying – appraised FMV of carry.
  - Risk free rate – find Treasuries maturing on or about the settlement date.
  - Dividend Yield – zero (fund will not distribute for many years).

Derivatives Continued…

- Because a partnership interest in the fund GP has not been transferred, section 2701 should not apply.
  - Important to differentiate partner's economic rights in carry and trust's rights under derivative contract to avoid IRS argument that partner has transferred actual carry and violated section 2701.
- Risk that IRS will treat amount paid to trust at settlement as a gift to the extent it exceeds purchase price for derivative under section 2703.
  - This analysis is probably incorrect.
- Possible double-taxation of carry if partner dies during the term of the contract (once when received by the partner and again when settlement amount is paid to trust at partner's death, when trust is no longer a grantor trust).
  - Risk can be mitigated by adding one or more interim settlement dates.

Other Planning Nuggets

- Do your clients own early stage company stock with significant upside potential?
  - If there is a recent financing round, there may be an opportunity for planning that includes meaningful discounts from the latest round value.
- Do your clients own restricted stock or unvested stock in public companies?
  - Planning opportunities may exist using derivative strategies or other more traditional techniques, both including discounts.

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