Gresham

05.20.2024

The Power of Planning with Carried Interests

A carried interest is a unique asset that can be one of the most powerful tools for wealth transfer planning. Yet careful planning is required to transfer the value successfully.

What is carried interest?

It is a form of compensation paid to investment executives such as managers of private equity, venture capital, or hedge funds. The managers receive a share of the fund's profits, typically 20% of the total, which is known as "carry" or "profit interests."

Why is it such a powerful wealth transfer tool?

In the initial stages of a fund's formation, the carry's value tends to be low and speculative while the expected future value can be substantial when the fund succeeds. This disparity over time allows the partner to transfer significant value to beneficiaries and meaningfully reduce estate tax exposure, all while preserving most of their gift and estate tax exemption for other assets.

The gift and estate tax exemption allows individuals to transfer a specific amount of assets during life or at death before paying federal gift or estate tax. Transfers above the exemption amount are subject to a 40% tax. Therefore, the most efficient use of this exemption involves transferring assets before they appreciate so a minimal exemption amount is used but significant future value is transferred. Carried interests are ideal assets to use in such transfers.

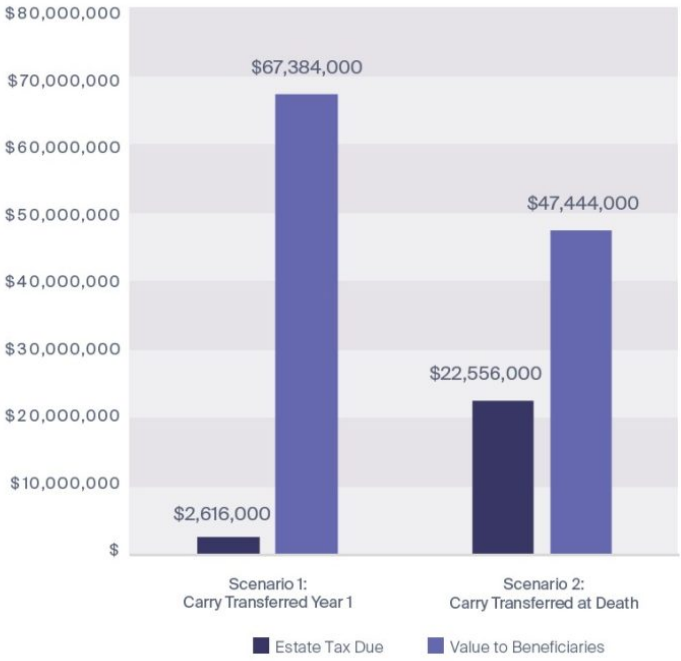
How does it work?

Here's an illustration demonstrating substantial estate tax savings: Say a partner forms a fund, and at the time of formation, an appraiser values the carried interest at $150,000. The fund has a successful 15-year term, and as it is winding down, the carry grows to be worth $20 million. Now, assume the partner invests that $20 million carry over the next 15 years, earning just over 6% annually until the partner's death in Year 30. This would bring the value of their invested assets to $50 million at the date of the partner's death. Let's further assume that the partner owned $20 million of other assets, bringing the size of their estate to $70 million.

If the partner were to wait to transfer these assets until death, nearly $23 million of estate tax would be due. Yet as the chart shows, the partner can save nearly $20 million in estate taxes by transferring the value of the carry in Year 1 to a trust for the benefit of the partner's descendants, rather than waiting to transfer fully appreciated assets at death in Year 30. That means the partner can transfer $20 million more to beneficiaries.

Value of Carry in Year 1	$150,000
Value of Carry in Year 15	$20,000,000
Value of Invested Assets in Year 30	$50,000,000
Value of Other Assets in Year 30	$20,000,000
Total Value of Assets in Year 30	$70,000,000

1. Both scenarios assume the partner has their entire estate tax exemption remaining and that the $20m of other assets are transferred at death in year 30.



How Can a Partner Actually Transfer a Carried Interest?

The two most common methods of transferring the value of the carried interest are the **vertical slice method** and the **carry derivative method**.

The **vertical slice method** involves transferring to a trust a portion of the carried interest along with a proportional share of all the partner's other interests in the fund – i.e., a vertical slice of all the partner's interests in the fund (G.P., L.P., co-invests). For example, if a partner wants to transfer 10% of the fund's carry, the partner will also need to transfer 10% of their fund equity. Because this method follows specific provisions in the Internal Revenue Code and Regulations, it has relatively low risk. The drawbacks include the inflexibility to transfer only the carry (because the entire vertical slice must be transferred), the less efficient use of estate tax exemption (because additional value in the form of the fund interest must also be transferred), and the administrative complexity in implementing such a transfer with the fund's administrator (because the recipient trust must become a limited partner in the fund).

The **carry derivative method** involves selling a derivative contract to a trust rather than transferring the carried interest itself. The derivative contract specifies the payments the partner must make upon settlement. There could be liquidity risk with this method if the derivative contract is not drafted precisely. The principal must eventually satisfy the payments under the derivative contract at maturity, which could prove difficult if the contract maturation does not align with the distributions from the carried interest and cash is required to satisfy the payments. However, because no fund interest is transferred, this method is administratively simpler than the vertical slice. Additionally, this method gives the partner much more flexibility in controlling the economics of the derivative contract without having to transfer a corresponding interest in the fund equity.

What are the Risks of these Strategies?

A primary risk relates to the income tax burden associated with the carried interest. Typically, the trust to which the asset is transferred is a grantor trust, meaning the partner continues to pay tax on the income generated by the trust's assets. This is a very powerful estate planning tool, as it amounts to a tax-free gift to the trust in an amount equal to the income tax due on the trust's income and allows the trust assets to grow income-tax free. However, over time, the amount of income tax owed by the partner can become burdensome, particularly if liquidity is a concern.

Another risk relates to the very trait of a carried interest that makes it so good for planning – the uncertainty of its future value. Just as a carried interest may have no value if a fund does not succeed, it can very well have an enormous value if the fund succeeds. The risk in such a situation is that the partner transfers too much value, or at least more value than intended, to the beneficiaries of the trust.

The derivative contract does provide more flexibility in managing this risk. For example, the derivative contract can include a hurdle that the carried interest must clear before the trust receives any benefit. The value of the carry can also be split between multiple parties. The partner could retain 50% of the benefit of the carry and pay the remaining 50% to the trust. Additionally, the contract can cap any benefit flowing to the trust to ensure the partner does not transfer more than intended. These additional points of flexibility can give the partner confidence their planning goals will be met.

What is Gresham's Role in Implementing these Strategies?

Successful implementation of these strategies requires the foresight to time the transfer appropriately, the technical expertise to work with legal counsel to prepare the transfer documentation correctly, and the understanding of the family's goals and objectives to ensure that the right people benefit from the transfer at the right time and with the right guardrails in place. Because Gresham is closely integrated with all our families and their legal teams, we are uniquely situated to coordinate the execution and monitoring of these strategies.

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Gresham Partners LLC
May 20, 2024

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