KAYE SCHOLER LLP

# INVESTMENT FUNDS NEWSLETTER

# U.S. Estate Planning with Private Equity and Hedge Fund Interests

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## *IN THIS ISSUE*



Estate planning is the process of transferring wealth to beneficiaries (such as spouses, children, grandchildren and significant others) during one's lifetime and at one's death, in a manner that is tax-efficient and that provides an appropriate management structure for the beneficiaries. This article will briefly (i) describe the basics of the transfer tax regimes that are relevant to estate planning for U.S. citizens*, (ii) explain how private equity and hedge fund interests are uniquely suited for estate planning, and (iii) highlight certain important issues related to estate planning with private equity and hedge fund interests.

## U.S. Transfer Tax Basics

### *Gift Tax*

All U.S. citizens and residents are subject to gift tax on lifetime transfers regardless of where they are domiciled or where the assets are located when they make transfers. Certain lifetime transfers are not taxable for gift tax purposes. Direct payments of medical and educational expenses made on behalf of any number of people, in any amount, are nontaxable. Annual exclusion gifts—currently $12,000 (or $24,000 for a married individual who splits gifts with his or her U.S. citizen or resident spouse on a gift tax return)—made to any number of donees are nontaxable. Certain other transfers—transfers to charities and to U.S. citizen spouses—are taxable but fully deductible. Generally every other transfer is subject to gift tax. The gift tax is currently 45%, and there is a lifetime exemption (per donor) of $1 million ($2 million for a married individual who splits gifts with his or her U.S. citizen or resident spouse on a gift tax return). In addition, several U.S. states have their own separate gift tax regimes.

### *Estate Tax*

All U.S. citizens and residents are subject to estate tax on the value of the assets they own at death, regardless of where they are domiciled or where the assets are located when they die. Certain transfers at death—bequests to U.S. citizen spouses and to charities—are taxable but fully deductible. Generally all other transfers at death are subject to estate tax. The estate tax is currently 45%, and there is an exemption of $2 million (reduced by any portion of gift tax exemption used during life). Under current law, in 2010 there is no estate tax and, starting in 2011, the top estate tax rate returns to 55% and the estate tax exemption returns to $1 million. In addition, most U.S. states have their own separate estate or inheritance tax regimes. For example, the current combined top federal and state estate tax rate for a New York resident is 54%.

* Estate planning for non-U.S. citizens who own assets in the U.S. is beyond the scope of this article.

### Generation-Skipping Transfer ("GST") Tax

A GST tax is imposed at the top estate tax rate—currently 45%—on all transfers to grandchildren and more remote descendants. Every individual is allowed an exemption that is tied to the estate tax exemption, which is currently $2 million.

### Basis for Income Tax Purposes

Assets that a decedent owns at death receive a step-up in basis to fair market value as of date of death. Assets transferred by gift, including to an irrevocable trust, generally maintain the donor's original basis (plus basis for the amount of federal gift tax paid if any) and receive no step-up at the donor's death.

### Estate Planning Goals

Estate planning has tax and non-tax goals. The tax goals involve making efficient and early use of exemptions and exclusions, to maximize what passes tax-free to beneficiaries. This often means transferring assets before they have appreciated (for example, pre-IPO stock or carried interests in a new fund) so that assets are transferred at a low gift tax value and post-transfer appreciation takes place outside the donor's estate and is never subject to estate tax at the donor's death. Depending on the situation, this can also entail paying gift tax because, while the nominal rates for gift tax and estate tax are the same, gift tax is much cheaper than estate tax given the base against which it is imposed. (For example, assume an individual has $150 and wishes to maximize what passes on to his or her beneficiary; at a 50% gift/estate tax rate. He or she can either give the beneficiary $100 during his or her lifetime and pay $50 of gift tax (imposed on what is given), or hold the $150 until death, at which point the estate tax (imposed on what is owned at death) is $75 and the beneficiary receives only $75.) Also certain states, *e.g.*, New York, have no gift tax but have an estate tax. The related non-tax goals involve creating structures—often trusts—that manage assets appropriately for beneficiaries and are protected from their creditors; these structures are often designed to avoid another transfer tax when a beneficiary dies. They are also often structured as "grantor trusts" for income tax purposes, *i.e.*, they are owned by the donor for income tax purposes, but are not owned by the donor for transfer tax purposes. With a grantor trust, the

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donor must pay income tax on trust income and gains as if he or she still owned the assets personally. This can be a tremendous benefit since it effectively allows the donor to pay his or her beneficiaries' income taxes—reducing his or her estate further and allowing the trust to grow income tax-free during his or her lifetime—without such payments being treated as gifts. Finally, there are a number of other estate planning structures, such as grantor-retained annuity trusts, that allow for gift tax-free transfers of appreciation in assets to beneficiaries; those structures work very well under certain circumstances.

### *EXAMPLE*

Assume a New York resident married individual owns $100 million of assets that will appreciate by 8% (half realized income and half unrealized appreciation) annually over the course of the individual's 25-year life expectancy. If the individual does no estate planning, at his or her death in 25 years his or her assets subject to estate tax will be $452,400,000 and the estate tax (at today's rates and with today's exemption) will be $242,200,000; his or her beneficiaries will receive **$210,200,000**. If, on the other hand, he or she transfers $2 million now to a grantor trust for income tax purposes for the benefit of his or her beneficiaries, then at his or her death in 25 years the trust assets will be $12,400,000, his or her estate will be worth $438,500,000, the estate tax on his or her estate will be $235,100,000, and his or her beneficiaries will receive **$215,800,000** net of all taxes. The results are more dramatic with larger gifts—a $25 million gift now to a grantor trust (which creates a current gift tax liability of $10,300,000) would leave the beneficiaries with a net **$263,100,000**—and are much more dramatic with higher rates of asset appreciation.

### Estate Planning with Private Equity and Hedge Fund Interests

Fund interests, and particularly new carried fund interests, are perfect assets with which to do estate planning. Simply put, they have very significant appreciation potential relative to their value at the start of a new fund. While a carried interest has arguably little value at the start of the fund—because of the real risk that, depending on returns in the fund, it will be paid nothing over the course of the fund—it may, in fact, become very valuable over the course of the fund. In addition, given the significant restrictions to which the carried interest is typically subject, valuation discounts are often appropriate for lack of marketability and lack of control. Therefore, a relatively small lifetime gift of a portion of carried interests in a new fund to a trust for beneficiaries allows for the possibility of avoiding a transfer tax on a substantial amount, *i.e.*, the actual post-transfer appreciation.

### Important Issues Related to Estate Planning with Fund Interests

While estate planning with fund interests can be very worthwhile, there are certain issues that need to be considered.

Section 2701 of the Internal Revenue Code of 1986, as amended ("Section 2701"), was enacted in 1990 and was geared to minimizing gift tax valuation abuses in the case of family-controlled entities. In the case of a family-controlled entity, if a parent transfers a junior or growth-like interest to a child and retains a senior or preferred-type interest, the parent is effectively subject to gift tax not only on the value of the interest gifted but also on the value of the entire retained interest, a horrible result. Section 2701 also applies to a contribution to capital. There is an exception to these onerous rules if the parent gives a "vertical slice" of all of his or her interests in the entity, *e.g.*, 15% of the senior interest and 15% of the junior interest. In that case, gift tax is imposed only in the usual fashion on the value of the assets gifted. Unfortunately, there is very little guidance under Section 2701 and, on its face, it may apply to individuals who are deemed to control a private equity or hedge fund. Under Section 2701, "control" is defined in the case of a corporation as holding at least a 50% interest by vote or value, in the case of a partnership as holding at least a 50% capital or profits interest, and, in the case of a limited

***Fund principals may from time to time waive management fees in return for a particular type of junior equity interest in the fund.***

## INVESTMENT FUNDS
*London Breakfast Series*

**The London Breakfast Series is held the first Tuesday of the month in the London office. Over the past several months, we have addressed the following topics:**

**February**
*SEC's New Rules for Private Fund Managers: What the Future Holds for Non-U.S. Fund Manager*

**March**
*Listing an Alternative Investment Fund: What You Need to Know in 2007*

**April**
*FSA's Financial Promotion Rules Post-MiFID*

**May**
*10 Lessons from the Fortress and Blackstone IPOs for European Fund Managers*

**June**
*EU and UK Regulatory Developments for Alternative Investment Funds and UCITS III*

Should you wish to attend any of our future breakfasts or request additional information, please send an email to: londonevents@kayescholer.com.

partnership, as holding any interest as a general partner. There is no guidance as to what constitutes control in the case of a limited liability company ("LLC"), a preferred vehicle through which fund principals own fund interests; it is certainly possible that it will be treated as a limited partnership. In addition, under Section 2701, at least for certain purposes an individual is treated as owning any interest to the extent such interest is held indirectly through a corporation, partnership, trust, or other entity. Typically, the LLC through which the fund principals own fund interests is the general partner of the fund that is itself a limited partnership. Therefore, while one Private Letter Ruling (9639054) indicates otherwise, there remains some risk that a fund principal could be deemed to control the fund for Section 2701 purposes if the fund is a limited partnership and he or she, albeit indirectly, owns a general partnership interest in the limited partnership. Also, for Section 2701 purposes, it is unclear whether a carried interest should be deemed a senior or junior interest. Given the control issue and assuming that a carried interest may be deemed a junior interest, it is important to decide on a case-by-case basis whether a fund principal should gift a carried interest only, or whether the downside risk of being deemed to control the fund makes more appropriate a "vertical slice" gift, *i.e.*, a gift of a portion of carry and of the same portion of any side-by-side or other fund interests. A vertical slice gift may have greater value pro rata and less upside potential, given the nature of side-by-side interests. In either case, consideration must also be given to future capital call commitments. The trust may fund its commitments with other assets, or with gifts or loans from the donor.

### *Management Fee Waivers*
Fund principals may from time to time waive management fees in return for a particular type of junior equity interest in the fund. If a principal wishes to remain "vertical" with his or her trust in order to minimize the risk of a Section 2701 deemed gift, he or she should make a "vertical slice" gift of the equity interests each time he or she receives such interests as a result of a fee waiver.

### *Vesting*
Fund principals' interests are often subject to a vesting schedule. In a published ruling in the context of unvested employee stock options—Revenue Ruling 98-21—the Internal Revenue Service held that a gift of an unvested interest is not a property right that may be gifted for gift tax purposes. In the case of a gift of an unvested fund interest, the risk is that under Revenue Ruling 98-21 the

gift is incomplete until the interest vests in accordance with the vesting schedule, which could be at a time when the value of the interest is far greater than it was at the time of the initial transfer. Many practitioners believe that Revenue Ruling 98-21 is distinguishable from the fund interest context, since in the fund interest context the fund principal generally has rights to distributions with respect to the interest even before the interest vests. If the principal leaves the firm, he or she loses rights going forward with respect to the interest but is usually not required to return any distributions already received. Therefore, it is arguable that the interest is more akin to a vested interest that is merely subject to divestment in the future.

### *SEC Considerations*

The trust may be required to be an accredited investor or a qualified purchaser.

### *Valuation and Reporting*

Gifts are reported on gift tax returns that are due on April 15 in the year following the year in which the gifts were made. To be properly disclosed on a gift tax return and therefore start running a statute of limitations, the valuation of gifts must be explained on the return, either by attaching an independent appraisal of the gifted interests or by giving a detailed description of the method used to determine the fair market value of property transferred. Appraisers, in evaluating interest in new funds, often look at the track record of the fund principals in prior funds.

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## *UPCOMING SPEAKING ENGAGEMENTS*

**June 5, 2007**
*Dr. Andreas Striegel*
*Country report on*
"Interest Taxation – New Tendencies"
*Annual Meeting of the International Fiscal Association (Germany)*
Frankfurt

**June 26, 2007**
*Simon Firth*
"Key Points in Fund Structuring and Fundraising"
*European Venture Capital Association's Pan-European Tax and Legal Course*
Brussels

**July 5, 2007**
*Dr. Andreas Striegel*
New German GAAP Law
Frankfurt

**September 26-27, 2007**
*Dr. Thomas Jesch,* Conference Director
*Dr. Andreas Striegel and Timothy Spangler*
*Private Equity Transactions Conference*
Frankfurt

# Complex Derivative Instruments in Global Insolvency Proceedings

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In today's global economy, competing interests with regard to complex financial instruments can often involve parties from varying international locales and can implicate the laws of several jurisdictions. In a recent case, Kaye Scholer LLP represented a Cayman Islands hedge fund known as Univest Multi-Strategy Fund II, Ltd. ("Univest"), whose principal asset was a Cash Settled Equity Barrier Option (the "Option"). Because of competing claims to the Option, Univest had been forced into liquidation proceedings before the Grand Court of the Cayman Islands. The Option had been terminated and liquidated, and the proceeds of the Option were held in New York.

Univest acquired the Option from Mosaic Composite Limited (U.S.), Inc. ("Mosaic"), a Minnesota company. Mosaic was originally organized under the laws of the Bahamas, subsequently migrated to Anguilla and was eventually re-incorporated under the laws of the State of Minnesota. Mosaic was the subject of liquidation proceedings in the Bahamas.

Litigation with respect to the Option began in the Bahamas when two Bahamian entities, Globe-X Management Limited and Globe-X Canadiana Limited (collectively, "Globe-X"), which were themselves the subject of liquidation proceedings in the Bahamas, asserted an interest in the proceeds of the Option based upon claims of fraud and constructive trust. Thereafter, the Globe-X liquidators and the Univest liquidators commenced their respective ancillary proceedings under section 304 of the Bankruptcy Code (the predecessor statute to Chapter 15 of the Bankruptcy Code) in the United States Bankruptcy Court for the Southern District of New York. After obtaining permission from the Bankruptcy Court, the Univest liquidators commenced a lawsuit in the Commercial Division of the New York State Supreme Court, seeking a declaration that the Univest liquidators (acting on behalf of Univest) were entitled to the proceeds of the Option.

The pendency of the New York litigation led to further litigation among the parties and other claimants to the Option proceeds before the courts of the Cayman Islands, the Bahamas and Canada. Ultimately, Kaye Scholer was able to facilitate a global settlement with each of the parties asserting an interest in the Option proceeds. Consummation of the global settlement was dependent upon the approval of courts in the Bahamas, Canada, the Cayman Islands and New York. In furtherance of the global settlement, the Bankruptcy Court in New York entered a permanent injunction that was designed to insulate Univest and the Option proceeds from attack and bring true finality to a lengthy, multi-jurisdictional and multi-faceted litigation.

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In order to minimize volatility, U.S. bankruptcy law has long accorded special treatment to transactions involving complex financial instruments such as swaps, forward contracts and other derivatives. *See* Pub. L. 101-311 (1990); H.R. Rep. No. 101-484, at

2 (1990). As Congress indicated, the purpose of the 1990 amendments to the Bankruptcy Code was "to ensure that the swap . . . financial markets are not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code." H.R. REP. NO. 101-484, at 1.

More specifically, where a party to a swap agreement is in default under the swap agreement based upon the filing of a bankruptcy petition, section 560 of the Bankruptcy Code insulates the swap participant's contractual right to liquidate, terminate or accelerate the swap agreement or to offset or net out any termination values or payment amounts arising in connection with such termination, liquidation, or acceleration from the effects of the automatic stay, the trustee's avoidance powers and any other limitation that might be imposed under the Bankruptcy Code. 11 U.S.C. § 560. To clarify an ambiguity as to whether section 560 permitted a swap participant to offset contracts of different types under section 560, Congress enacted section 561 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCA"). *See* Pub. L. 109-8 (2005). Section 561 further insulates swap participants from the effects of a bankruptcy filing by providing that the right of termination, liquidation, acceleration or setoff across different types of protected financial contracts under a master netting agreement, also known as cross-netting, is not subject to the automatic stay or a trustee's avoidance powers. 11 U.S.C. § 561(a)-(b)(1).

Section 553 of the Bankruptcy Code was also amended under BAPCA to ensure that a creditor's setoff rights under swap and master netting agreements would not be disturbed by the filing of a bankruptcy petition. Section 553 generally protects a creditor's right to setoff notwithstanding the filing of a bankruptcy petition. Under certain circumstances, section 553 provides that the trustee may avoid claims that were acquired during the preference period (the 90-day period prior to the petition date for non-insiders) and while the debtor was insolvent. 11 U.S.C. § 553(a)(2), (a)(3). As a result of the BAPCA amendments, however, the trustee may not avoid setoff claims arising in connection with a swap or master netting agreement. 11 U.S.C. § 553(a)(2)(B)(ii), (a)(3)(C). In fact, the protection afforded a creditor's setoff rights arising in connection with swap or master netting agreements under section 553 is arguably more broad than the protections under sections 560 and 561 because there is no requirement under section 553 that the setoff rights arise from a default caused by the filing of a bankruptcy petition.

***Several material limitations imposed by the filing of a bankruptcy petition on the contractual rights of the counter-parties to a swap agreement have been removed by Congress in an effort to insulate the swap market from disturbance and allow participants in the swap market to realize upon the contractual terms of their swap agreements.***

Other sections of the Bankruptcy Code work in tandem with sections 553, 560 and 561 to amplify the protections afforded swap agreements. Sections 362(b)(17), (b)(27) and (o) insulate the swap participant's contractual right of setoff from the effects of the automatic stay. 11 U.S.C. §§ 362(b)(17), (b)(27) and (o). Sections 546(g) and 548(d)(2)(D) exempt prepetition transfers relating to swap agreements from avoidance except in cases of actual fraud. 11 U.S.C. §§ 546(g), 548(d)(2)(D). Thus, several material limitations imposed by the filing of a bankruptcy petition on the contractual rights of the counter-parties to a swap agreement have been removed by Congress in an effort to insulate the swap market from disturbance and allow participants in the swap market to realize upon the contractual terms of their swap agreements.

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# Final 409A Deferred Compensation Regulations: Not the Hoped for Relief

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On April 10, 2007, the IRS issued the long-awaited, and oft-delayed, final regulations under Section 409A of the Internal Revenue Code of 1986 (the "Code"). Their length (397 pages) and overall complexity requires more study before we can offer definitive guidance. It is clear, however, that, while the final regulations offer some relief from the difficulties presented by the breadth of Section 409A, in some areas they actually create new compliance problems. Some highlights of the final regulations are set forth below:

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## Effective Date

The final regulations are effective January 1, 2008. Any non-complying plan therefore must be amended or terminated by that date to avoid the excise tax imposed for non-compliance.

## Good Reason Termination

The IRS had taken the position that a termination for "good reason" under an employment agreement was not necessarily involuntary and thus could be subject to Section 409A. The final regulations modify this position somewhat by providing that good reason may constitute an involuntary termination, but still require that the parties must be able to demonstrate that the termination was the result of a "material adverse change" in the employment relationship, (*e.g.*, a change in an executive's duties, working conditions, or compensation). The final regulations also provide a safe harbor definition of good reason, adding that the executive must quit within one year of the good reason breach and must give timely notice of the breach. Many executives, however, are likely to conclude that they need more protection than the safe harbor provides, making its value problematic.

## Severance Payments

The proposed regulations provided an exemption for severance payments of up to two times the limit on compensation under qualified retirement plans (capped at $450,000 in 2007) if the payments are completed by December 31 of the second calendar year following the termination date. The final regulations expand this rule by providing that only amounts in excess of the capped limit will be subject to Section 409A.

## Partnerships

Like the prior guidance, the final regulations do not address partnerships in any meaningful way, leaving unanswered a number of significant questions about the application of Section 409A to partnerships.

## Definition of Service Recipient Stock

The final regulations expand the definition of service recipient stock to include any class of the service recipient's common stock (the proposed regulations limited it to the highest class of common).

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# European Commission Published Expert Group Report on Cross-Border VC Issues

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*VC deals, funds raised and overall size of markets in Europe are much smaller than their U.S. equivalents.*

The European Commission (EC) recently published a report on the findings by an expert group on how to remove obstacles to cross-border investments by venture capital funds and how to encourage the development of a European venture capital market for small and medium sized enterprises (SME).

## The Facts

The group report recognized the following conditions affecting the European market:

- No single VC market exists in Europe, since the countries are unevenly developed. For example, the UK and Ireland are recognized as advanced countries, whereas Germany is considered an underdeveloped VC market.

- VC deals, funds raised and overall size of markets in Europe are much smaller than their U.S. equivalents. The EC stressed that VC fund structures should meet requirements of domestic and nondomestic institutional and private investors. Simplicity in structure, administration and handling and the avoidance of a double taxation are considered means to standardization, since taxation is still considered detrimental to any kind of harmonized and marketable fund structure.

## The Barriers

The report saw the following barriers for a blossoming pan-European VC market:

- VC funds often need to register with the financial supervisory authorities of each member state of the EU, resulting in additional costs.

- An improved entrepreneur's investment readiness must be achieved to increase the supply of venture capital.

- Different tax treatments within several EU member states make it necessary to install complex investment fund structures including potential parallel and side fund structures for each investor and investment country. Complex tax issues arise from the member states' various characterizations of funds for tax purposes, the conflicting treatment of capital gains derived from exits, the lack of common criteria for general partners, and the differing definitions of accredited investors.

## The Solutions

The report considers the following possible solutions:

- Formulate an EU definition of institutional and private investors in order to achieve a common basis.

- Implement a prudent man rule comparable to the definition of the pension fund directive 2003/41/EC to enable investors to no longer be bound by national investment restrictions.

- Devise common EU rules for private placements so that VC funds are able to rely on a common marketing strategy in Europe.

- Tax capital gains only in investor's home country in order to simplify the current complex fund structures that need to synchronize the different qualifications in the several home and investment countries.

- Treat quoted and unquoted equity equally in order to avoid complex fund structures and synchronize different tax systems leading to an avoidance of double taxation.

- Create common EU rules for tax transparent VC fund structures so that double tax issues connected to a differing characterization (asset management vs. trade or business) can be avoided.

- Enact common EU rules to also allow nontransparent VC funds to benefit from tax treaties in order to avoid double taxation.

- Allow self-imposed professional standards that permit VC funds to have synchronized rules for valuation and reporting purposes applicable in each EU member state.

- Approve guidelines for management companies to control where permanent establishments are maintained.

### The Assessment

These possible solutions are assessed as follows:

- Initially, preliminary mutual recognition between the EU Member countries should be established, followed by an EU harmonization in the long term.

- EU VC/PE reports supporting the idea of mutual recognition and providing for a common understanding of tax transparency and standardized private placement procedures can provide a tool toward long-term mutual recognition.
- On the basis of mutual recognition, registration should be limited to a home-country-only approach.

- The management company should be allowed to refer to registration guidelines that ensure the application of the home-country-only approach.

- A transparent tax structure should lead to an investor taxation equal to a direct investment.

The expert group recommended that a mutual recognition of VC funds be the basis for a home-country-only registration. The report is the basis for the creation of further expert groups to monitor current developments.

### The Comment

The group report joins the age-old sentiment of pan-European groups, such as the European Venture Capital Association (EVCA) and other national European VC lobby groups, calling for a transparent pan-European fund vehicle with management entities that freely choose their place of management.

It remains to be seen whether the EU member states are willing to give up national sovereignty when it comes to the tax classification of VC fund vehicles. Germany, for example, is on its way to a tax reform that would label venture capital/early-stage funds as "useful," qualifying for a number of tax breaks, but on the other hand leave a number of tax burdens to private equity/buyout funds that are seen more as black boxes containing financial engineering and future job loss.

Theoretically, this could be in line with the group report that mainly deals with SMEs. The question is whether a long-term perspective would justify such a differentiation: In fact, the buyout funds are responsible for a significantly higher GDP share and are having and keeping many more people on the payroll. Above all, the EC should make sure that the planned easements on cross-border VC investments are made available to buyout funds too.

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## NEWS ALERT

## *Hedge Fund Manager Pays $250,000 to Settle Charges That He Violated Hart-Scott-Rodino Reporting Requirements on Exercise of Stock Options*

On May 21, 2007, hedge fund operator James D. Dondero agreed to pay a $250,000 civil penalty to settle charges that he violated reporting requirements of the Hart-Scott-Rodino Act. This penalty was imposed because Dondero, as the "ultimate parent entity" of hedge fund Highland Capital Management, L.P., had exercised options in February 2005 to acquire shares in Motient Corporation without first filing required pre-merger notification forms with the U.S. Federal Trade Commission and the Department of Justice and observing a 30-day waiting period. Because the HSR Act and its regulations include numerous highly technical provisions, clients are well-advised to seek legal advice before acquiring stock whenever their current holdings in a company exceed a value of $59 million. The case is an important reminder that, under appropriate circumstances, officers and directors may be required to make HSR filings, even when exercising options to acquire stock in their own companies.

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