Estate Planning, Charitable Giving and Other Considerations

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Kim focuses his practice in the areas of estate planning, trusts, charitable foundations, tax planning and estate administration. A Fellow of the American College of Trust and Estate Counsel and a former member of its Business Planning Committee, Kim is also a former member of the New York State Bar Association and a past member of the NYSBA Tax Section's Executive Committee and a past co-chair of the Committee on Taxation of Trusts and Estates. He serves as an adjunct professor in the Graduate Tax Program of the NYU School of Law.

Kim has been selected for inclusion by *New York Super Lawyers*, which lists the top five percent of attorneys by state and practice area as selected by their peers. He presented "Understanding Grantor Trusts" at the NYU Income Taxation of Trusts & Estates II conference and "Structuring and Restructuring Your Management Company" at a past SRZ Annual Private Investment Funds Seminar, and he also publishes in the areas of will drafting and estate administration.

After receiving his undergraduate degree from Yale University, Kim obtained a J.D. from Boston University School of Law, where he served as note and case editor on the *Boston University Law Review*, and an LL.M. in Taxation from New York University School of Law.

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Sue concentrates her practice on providing high-net-worth individuals with services in the areas of estate planning, estate administration, charitable giving and organizations, family law and litigation. She creates sophisticated plans for her estate-planning clients, including considerations involving possible incapacity or institutionalization, and she coordinates inter vivos and testamentary gift-giving with income, gift and estate tax laws. Sue also oversees all aspects of the administration of small and large estates, including representing clients in Internal Revenue Service estate tax audits. She develops and implements charitable giving plans, negotiates contributions to charitable organizations and oversees the administration of U.S. and foreign tax-exempt organizations. In the family law area, she negotiates and prepares cohabitation, prenuptial, postnuptial and separation agreements and counsels married couples on income, gift and estate tax planning issues. Sue also represents clients in tax court proceedings and in family law litigation, trust and estate disputes, and other matters.

Recognized as a leading lawyer by *The Best Lawyers in America* and as one of the "Top Women Attorneys" in the New York Metro Area by *New York Super Lawyers*, Sue is a Fellow of the American College of Trust and Estate Counsel. She is also a member of the New York City Bar Association, a former member of its Trusts, Estates & Surrogate's Courts Committee, and a member of the New York State Bar Association. She is a board member of The JPB Foundation, a member of the Museum of Modern Art's Planned Giving Advisory Committee, a member of The Rockefeller University's Committee on Trust and Estate Gift Plans, a former David Rockefeller Fellow of the New York City Partnership and Chamber of Commerce, and a former member of the board of directors of the Center for Children and Families Inc. Sue is also a co-author of Westlaw's *Trusts and Estates Practice in New York* and she presented "Management Company Structuring and Operations" at the SRZ 23rd Annual Private Investment Funds Seminar.

Sue obtained her J.D. from Columbia Law School, where she was editor of the *Columbia Law Review* and a Harlan Fiske Stone Scholar. She graduated *summa cum laude* and Phi Beta Kappa with a B.A. from Tufts University.

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Daniel F. Hunter

Dan concentrates his practice on the design, structure and regulation of alternative investment products, including hedge funds, hybrid opportunity funds and private equity funds. Among the various investment advisers he represents are some of the larger and more well-known fixed income, bank loan and distressed debt managers. Dan also provides day-to-day regulatory, operational, mergers and acquisitions and restructuring advice to his fund clients, and advises funds regarding the receipt or allocation of seed capital.

Dan has been recognized in *The Legal 500 United States* in the Investment Fund Formation and Management and Private Equity Funds categories. A sought-after speaker, he recently presented "AIFMD: Practical Implications for U.S. Managers" at the KB Associates Global Fund Distribution: New Opportunities, New Challenges conference and "Global Regulatory Issues" at the IIR 3rd Annual InvestorOps conference. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), and he served as a guest lecturer at the New York University School of Continuing and Professional Studies, where he taught "Introduction to Hedge Funds."

Dan received his J.D. from the University of Michigan Law School, where he was articles editor of the *University of Michigan Journal of Law Reform*, and his A.B., *cum laude* and with high honors in history, from the University of Michigan.

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Catherine focuses her practice on complex estate and tax planning for high-net-worth individuals and families, entrepreneurs and real estate owners, and on planning for the generation-skipping transfer tax. Through the use of sophisticated techniques such as qualified personal residence trusts, grantor retained annuity trusts, dynasty trusts, intentionally defective grantor trusts and limited liability companies, among others, as well as traditional wills and revocable trusts, she assists clients in minimizing the impact of estate and gift taxes on their estate plans, and in transferring family wealth to their children and grandchildren. She also has considerable experience in the administration of large estates and trusts, advising clients on private foundation matters and representing clients in contested estate and gift tax audits. In addition to numerous audits settled at the initial and appeals levels, she has also represented clients before the U.S. Tax Court, achieving favorable settlement results and trial victories.

Catherine has been recognized by *The Best Lawyers in America* in Trusts and Estates and in *Super Lawyers* in the area of Estate Planning and Probate. She has received Martindale-Hubbell's highest peer-reviewed "AV Preeminent" rating for excellence in the law and ethical conduct and is included on several local and national lists of preeminent women attorneys by such publications as LexisNexis, *Avenue Magazine* and Martindale-Hubbell. She is a former member of the Trusts, Estates and Surrogate's Court Committee of the New York City Bar Association, and she also served as chair of the Subcommittee on Portability. Catherine is also a former member of the Committee on Estate Planning of the New York State Bar Association. She writes about estate and gift tax topics and is a frequent speaker for programs sponsored by, among others, the Estate Planning Council of New York, the New York State Bar Association, New York University School of Continuing Legal Education and the New York State Society of Certified Public Accountants. She is often cited in publications including *Forbes*, *Kiplinger's*, *New York Daily News* and *The Wall Street Journal* with respect to legal issues in trusts and estates and is also a regular contributor to the *New York Daily News* "Money Pros" column.

Catherine earned her J.D., *magna cum laude*, from New York University School of Law, where she served on the *New York University Law Review* and was Order of the Coif. She received her Ed.M. from Harvard University and her B.S., *cum laude*, from Georgetown University, where she was a member of Psi Chi.

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I. Overview of Transfer Tax System

A. Federal Tax Regime

1. Tax Rate: The federal gift tax rate and estate tax rate are each currently 40 percent.

2. Exemption from Tax: Currently, no federal gift or estate tax will be imposed on: (1) an outright transfer to a spouse or a charity;[1] (2) certain transfers in trust for a spouse's benefit;[2] (3) gifts of $14,000 per person per year (with an additional $14,000 per person per year exempt with a spouse's consent);[3] (4) medical and tuition payments on another's behalf made directly to the provider of services;[4] and (5) additional cumulative transfers to others, by lifetime gift or at death, of $5,430,000 (indexed annually for inflation).[5] Any unused portion of this $5,430,000 exemption can be used by a surviving spouse (in addition to the surviving spouse's own $5,430,000 exemption).

3. Generation-Skipping Transfer Tax: Additionally, subject to limited exceptions, a Generation-Skipping Transfer ("GST") tax currently applies to transfers to or in trust for grandchildren and more remote descendants or for other persons who are more than 37½ years younger than the transferor. The GST tax rate is currently 40 percent. Currently, no GST tax will be imposed on: (1) some, but not all, gifts of $14,000 per person per year (with an additional $14,000 per person per year exempt with a spouse's consent); (2) medical and tuition payments on another's behalf made directly to the institution or provider of services; and (3) additional cumulative transfers of $5,430,000 (indexed annually for inflation). Unlike the exemption from estate and gift tax, the unused portion of a person's $5,430,000 exemption from GST tax cannot be used by a surviving spouse.[6]

B. New York Tax Regime

1. New York Estate Tax Rate: New York State imposes an estate tax on certain property transfers at death. Among other exclusions, certain transfers to a spouse and transfers of real property and tangible personal property not located in New York are not subject to New York estate tax. Transfers subject to tax are taxed at a marginal rate that reaches 16 percent (but tax paid is deductible against federal estate tax).

2. No New York Gift Tax: Currently, there is no New York gift tax, but the donor must survive at least three years from the date of the gift, or the amount of the gift will be subject to New York estate tax (if certain exclusions do not apply).

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[1] *See* Internal Revenue Code (the "Code") §§ 2522, 2523, 2055 and 2056.

[2] *See* Code §§ 2523 and 2056.

[3] *See* Code §§ 2503(b) and 2513.

[4] *See* Code § 2503(e).

[5] *See* Code § 2010(c).

[6] *See generally* Code §§ 2601-2664.

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3. New York Exemption from Estate Tax: New York State assesses its estate tax on estates with a taxable value in excess of $2,062,500. On April 1, 2015, this "threshold" amount will increase to $3,125,000, and it will further increase incrementally until Jan. 1, 2019, at which time the New York exemption is scheduled to equal the then-applicable federal exemption.

4. No New York GST Tax: New York state has repealed its GST tax.

C. Connecticut Tax Regime

1. Connecticut Gift and Estate Tax Rate: Connecticut imposes a gift tax on certain lifetime property transfers and an estate tax on such transfers at death. Among other exclusions, certain transfers to a spouse and transfers of real property and tangible personal property not located in Connecticut are not subject to Connecticut transfer tax. Transfers subject to tax are taxed at a marginal rate that reaches 12 percent (but tax paid is deductible against federal estate tax). Connecticut is the only state in the United States that currently imposes a gift tax.

2. Connecticut Exemption from Gift and Estate Tax: The first $2,000,000 of cumulative transfers, by lifetime gift or at death, that would otherwise be subject to Connecticut gift or estate tax is exempt from Connecticut gift and estate taxes.

3. No Connecticut GST Tax: Connecticut does not have a GST tax.

II. Estate Planning Techniques for Fund Managers

A. Transfer of Interest in Incentive Allocation

1. Estate Planning Goal: Given the high gift and estate tax rates noted above, the goal of any estate planning strategy is to remove assets from the fund manager's taxable estate by transferring assets, the appreciation on them and the income produced by them to trusts for members of the manager's family. Ordinarily the assets with the greatest growth potential in a hedge or private equity fund are interests in the entities that receive the funds' incentive allocation. Typically, these include an interest in the LLC that serves as the general partner of the domestic fund and a limited partnership interest in the management company that receives the management fee and in some fund structures the offshore incentive fee. Transferring such interests early in a fund's existence when their value is presumably low allows the manager to remove from his or her estate at little or no gift tax cost a valuable asset as well as the potentially significant growth on it.

2. Need for a Vertical Slice: If a manager makes a gift of a portion of his or her incentive allocation or any other profit participation, federal gift tax law requires the manager to also make a gift of the same percentage of his or her investment capital in the fund. This is known as a "vertical slice."[7] Thus, if the manager transfers 20 percent of the general partner entity that receives the incentive allocation from the domestic fund, the manager must also give away the same 20 percent of his or her investment capital in the fund. But, as discussed below, virtually all of such investment capital will be returned to the manager through the annuity payments.

B. GRATs: There are several means of transferring assets from a manager's taxable estate. First, if the value of the gift (including the portion of the incentive allocation and investment capital being transferred) is less than $5,430,000 (or $10,860,000 if the manager is married), the manager can just make a gift of the interest to a trust for his or her children or his or her spouse and children. The spouse can only be a

[7] *See* Code § 2702.

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permissible beneficiary if the spouse's $5,430,000 exemption is not also being used for the gift. However, this is not without risk, because if the IRS ultimately determines in a gift tax audit that the transferred interest was worth more than $5,430,000, the manager will owe federal gift tax. If valuation is an issue, or if the manager prefers to preserve his or her estate tax exclusion for another use, the safer course for transferring fund interests may be to transfer them to a grantor retained annuity trust ("GRAT").

1. Summary of GRAT: A GRAT is an irrevocable trust that pays the grantor, the creator of the trust (in this case, the manager), either: (1) a fixed annual dollar amount (i.e., the annuity) for a specified number of years; or (2) an escalating annuity that increases by up to 20 percent each year during the specified annuity term. The annuity is typically expressed as a percentage of the value of the property transferred to the GRAT (i.e., the incentive allocation and investment capital). For gift tax purposes, the manager is treated as making a taxable gift of the difference between the value of the property the manager contributed to the GRAT and the present value of the annuity interest the manager retained. At the end of the annuity term, if any property remains in the GRAT after the final annuity is paid, such property will be removed from the manager's taxable estate and will pass to a trust for his or her children (or spouse and children) free of gift and estate tax.

2. No Gift Tax on Contribution to GRAT: It is possible to "zero out" a GRAT for gift tax purposes, so that no gift tax is payable on formation of the GRAT. For purposes of valuing the remainder interest for gift tax purposes, the IRS assumes that the assets in the GRAT will generate income and appreciation combined at a prescribed rate that is published monthly (sometimes referred to as the "benchmark rate"). The benchmark rate in January 2015 is 2.2 percent.[8] By tailoring the size of the annuity and the length of the GRAT term, the GRAT can be structured so that all of the property initially transferred to the GRAT as well as all of the assumed income and appreciation (equal to the applicable benchmark rate) will be returned to the manager through the annuity payments, and the remainder interest of the GRAT will be valued at zero for gift tax purposes.

3. Example of Zeroed-Out GRAT: Consider the following example. In 2015, at a time when the benchmark rate is 2.2 percent, a manager contributes fund interests with a fair market value of $5,000,000 to a GRAT with a term of five years. Assume that the assets produce a 5-percent annual return and appreciate by 10 percent annually. In addition, assume that the GRAT is drafted to provide that the annuity payments escalate by 20 percent each year. The manager will pay no gift tax upon funding the GRAT (or at a later date). In the first year of the GRAT's term, the required annuity will be approximately 14.5 percent of the fair market value of the initial contribution, which is approximately $725,000. This amount will increase by 20 percent each year during the five-year GRAT term, so that the last payment will be approximately 30 percent of the fair market value of the initial contribution, which is approximately $1,500,000. Under this scenario, the total amount paid to the manager over the five-year GRAT term will be $5,376,796, which is the initial $5,000,000 contributed plus the amount generated by a $5,000,000 asset that is assumed to grow at a 2.2-percent interest rate and makes escalating annuity payments each year. In essence, a GRAT operates like a fully amortized loan over the annuity term with a 2.2-percent coupon. This means that the manager will receive back from the GRAT the full value of what he or she contributed to the GRAT (i.e., the incentive allocation and investment capital) plus interest at 2.2 percent. Because the manager receives back the full value of what he or she contributed to the GRAT, the manager is not treated as having made a taxable gift.

   The value of the GRAT's remainder (i.e., the balance remaining after $5,376,796 is distributed to the manager over a five-year period) is expected to be $3,245,400 under the income and appreciation

[8] *See* Code § 7520.

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assumptions in the example stated above. This amount will pass free of transfer tax to the GRAT's remainder beneficiaries. The remainder beneficiaries could be the manager's children or trusts for their benefit or a trust for the manager's spouse and children over which the Trustee has the discretion to pay any part or all of the trust income or principal to any one or more of the trust beneficiaries. Generally, while the manager's children are young, this means that no distributions are made. Rather, the trust just continues to grow as distributions from the fund's incentive allocation are made to it. Although the annuity term has ended, the remainder trust continues as a partner in the fund. However, it no longer has any obligation to pay anything to the manager. Thus, if the GRAT initially had a 20-percent interest in the fund, the remainder trust will as well, meaning that each year it will be entitled to 20 percent of the fund's incentive allocation.

4. Income Tax Benefit: A GRAT also provides a significant income tax benefit in that it is a grantor trust, which means that the manager will pay the income tax on any income earned by the trust during the annuity period.[9] By paying this tax, the manager is essentially making an additional tax-free gift of the amount of the tax. In addition, the remainder trusts for the manager's children (or spouse and children) can be structured as a grantor trust so that the manager can continue to pay any income tax on any income earned by the trust.

5. GRATs and GST Tax: For the above reasons, GRATs are well-suited for conferring transfer tax benefits in planning for a manager's children or other chosen beneficiaries. However, GRATs are not ideal candidates for passing assets below the manager's children's generational level because the manager's exemption from GST tax cannot be allocated to the GRAT until the end of the GRAT term, at which time the GRAT may hold significant assets. As a result, a greater amount of the manager's GST exemption would need to be applied to the GRAT at that time relative to what would have been needed to be applied to a different type of trust created by the manager on the same date that the GRAT was created.

6. No Gift Tax on GRAT's Appreciation: The estate planning benefit of a GRAT will be achieved if the assets in the GRAT generate income and appreciation that exceeds the benchmark rate. If that is the case, there will be property remaining in the GRAT at the end of the annuity term and, as described above, such property will pass to the GRAT's remainder beneficiaries free of gift and estate tax, outright or in trust.

7. Valuation: An appraisal of the fair market value of the assets contributed to the GRAT as of the date of such contribution must be obtained. The lower the value of the contributed assets, the lower the annuity payments to the manager that will be required to zero out the GRAT, and the greater the likelihood that some assets will remain to pass to the remainder beneficiaries at the end of the GRAT term. The valuation of the assets contributed must be performed by a professional appraiser who will consider a number for factors, such as assets under management and projected returns (based upon the manager's past performance, current market conditions, the business model, etc.). The appraiser will then prepare a discounted cash flow analysis to determine the value of the fund interests transferred to the GRAT, subject to significant discounts for lack of control and lack of marketability. It is preferable for the valuation (and funding of the GRAT) to occur as early in the life of the fund as possible before there is substantial positive investment performance. However, GRATs also can be used successfully for an established fund as long as it is likely to generate an annual return that exceeds 2.2 percent (or other monthly IRS benchmark).

8. No Estate Tax on GRAT's Appreciation If the Manager Survives the GRAT Term: At the conclusion of the GRAT's term, the GRAT's remaining assets will pass to the GRAT's remainder beneficiary, which,

[9] *See generally* Code §§ 671-679.

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as noted above, frequently is a successor trust for the manager's children (or spouse and children). Provided that the manager survives the GRAT's term, these assets will no longer be includable in the manager's estate (i.e., no estate tax will be due on these assets), and the successor trust will not be required to pay the manager an annuity payment. (If the manager does not survive the GRAT term, included in the manager's estate will be the lesser of: (1) the amount of assets held by the GRAT necessary to produce the outstanding annuity payments; and (2) the full amount of the assets remaining in the GRAT.)

9. Upside but No Downside: A transfer tax benefit will result if: (1) the GRAT generates income and appreciation above the benchmark rate; and (2) the manager survives the GRAT term. Namely, the income and appreciation on the GRAT's assets above the benchmark rate will have been transferred from the manger's estate free of estate and gift tax. As mentioned above, if the manager does not survive the term, some portion of the assets in the GRAT may be included in his or her estate. If the assets do not generate income and appreciation above the benchmark rate, nothing will be left in the GRAT for the remainder beneficiaries. In either event, however, the manager will be no worse off from a transfer tax perspective than if the manager had never created the GRAT.

10. Payment of the Annuity: One critical requirement of a GRAT is that the annuity must be paid each year within 105 days after the anniversary of the date the GRAT was created.[10] If the annuity is not paid in a timely manner, the GRAT will not be a valid trust and all of the property contributed to the GRAT will be considered a taxable gift as of the date of the creation. The annuity can be paid in several different ways. It cannot, however, be paid by having the GRAT give the manager a promissory note.

11. The simplest way of paying the annuity is for the GRAT to pay it with the cash it receives from its portion of the incentive allocation. Assuming the fund is doing well, there should be ample revenue to meet the GRAT's annuity obligations. A second way to pay the annuity is for the GRAT to transfer funds from its capital account in the domestic fund to the manager's capital account. The GRAT's capital account will consist of the original capital the manager transferred to the GRAT as part of the vertical slice plus the earnings it has received as a result of the fund's performance. Thus, when the annuity is due, a book entry is made from one capital account to the other. In this way, the manager will essentially receive back all of the capital he or she initially contributed to the GRAT with an interest factor of 2.2 percent. The last means of paying the annuity is to borrow the amount needed from a source other than the manager, such as another family member or trust.

C. Installment Sales

1. Generally Used by Managers with Illiquid Investments: Since a GRAT requires annuity payments, illiquid investments generally are not the best assets to be contributed to a GRAT. Alternatively, a technique known as an "installment sale" may be utilized in many situations.

2. Summary of Installment Sale: In an installment sale, the manager will create an irrevocable grantor trust (often, a "dynasty trust") and sell investment assets to the trust in exchange for a promissory note given by the trust to the manager. The trust is structured so that, for income tax purposes, it is not a separate entity from the manager. Therefore, the manager is treated as if he or she sold the assets to him- or herself, so the sale is not deemed to be a realization event and no capital gains tax is due upon the sale. The manager generally must also make a taxable gift of cash or another asset (that serves as seed money) to the grantor trust so that the transaction will have economic

[10] *See* Reg. § 25.2702-3(b)(4).

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substance. Typically, the taxable gift need not exceed 10 to 15 percent of the value of the property sold to the trust. Appreciation and income on the investment assets after the sale will be used to pay interest as well as a balloon principal payment at the end of the note's term. The interest rate on the note would be low in the current economic climate. Currently, the IRS requires that the interest rate equal or exceed 0.41 percent for a term of not more than three years, 1.75 percent for a term of three to nine years and 2.67 percent for a term of more than nine years.[11] Again, because the trust is not separate from the manager for income tax purposes, the manager is treated as paying interest to him- or herself, so no income tax is due on the interest payments. Any remaining income and appreciation after payment of interest and the balloon principal payment will be transferred to the trust free of transfer tax.

3. Dynasty Trust: An installment sale can be made to any grantor trust, though it is most often made to a so-called "dynasty trust" in order to build up assets for multiple generations (rather than just a donor's children). A dynasty trust is typically structured as a multi-generational discretionary trust for the manager's descendants (or spouse and descendants). At inception, exemption from GST is allocated to the dynasty trust in order to avoid transfer tax at each generation. Generally, a dynasty trust is not used as a remainderman to a GRAT for the reasons discussed above. The dynasty trust may last the longest permissible period under law, which, depending on the law of the state that governs the trust, could be approximately 100 years (as in New York, for example) or in perpetuity (as in Delaware, for example). The trustees can have complete discretion to distribute as much or as little of the trust income and principal to any one or more of the beneficiaries in whatever shares they choose. The manager's children can have full access to the trust property, subject to the trustee's discretion, but the typical intention is to build the trust assets for lower generations. Any trust property not distributed will accumulate and grow for future generations. Obviously, if such growth continues for a long period without ever being subject to a wealth transfer tax, even at very conservative growth rates, the trust assets can grow substantially over time. The trust is structured as a grantor trust, so the manager (not the trust) pays the income taxes on the trust's income during the manager's lifetime. (As a result, the trust is undiminished by such taxes without any additional gift being made.) If the manager's spouse is in fact named as a discretionary beneficiary of the trust, the manager will retain de facto access to the trust property so long as he or she remains married and the spouse is living. If the manager ever wanted to reclaim some portion of the trust property, whether because he or she needed the money or felt that the children did not need it, the trustees, if they deemed it advisable, could make a discretionary distribution to the manager's spouse (or a loan to him or her). Such a distribution would diminish the estate-planning benefit of the trust and should be considered carefully. It would also be possible for the trustees to terminate the trust at any time by making a discretionary distribution to the children or other beneficiaries if the manager decided that the trust was no longer necessary or desirable.

D. Low-Interest Loans

1. Many of the strategies referenced in this outline can confer a sizable estate planning benefit in part due to the low interest rates required by the IRS on certain transfers. A manager can take advantage of current market conditions by making a large loan, payable by annual interest payments and a principal balloon payment at the end of the loan's term, to a child (or a child's trust) or other persons (or their trusts). The borrowed assets would then be invested by the borrower (or by the manager on his or her behalf), who would strive to earn an investment return that exceeds the interest rate on the loan.

[11] *See* Code § 7520.

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2. As with notes used in installment sales, the IRS currently requires that the interest rate on personal loans equals or exceeds 0.41 percent for a term of three years or less, 1.75 percent for a term of three to nine years and 2.67 percent for a term of more than nine years. Two estate planning benefits can be realized if the contemplated transaction is successful (i.e., if the return on the investment exceeds the applicable interest rate). First, in many instances, income can be shifted to a person in a lower marginal income tax bracket than the manager — this may result in significant net income tax savings for the manager's family. Second, any return on the investment above the applicable interest rate will be includible in the estate of the borrower (or in a trust not includible in anyone's estate for at least a few generations) and not in the estate of the manager. As a result, the manager will have transferred the net return from his or her estate to a member of a lower generation (or a trust) without paying any gift tax on the transfer.

E. Drafting the Management Company Partnership Agreement

1. The partnership agreement that governs the management company should provide that transfers by operation of law, such as in death or divorce, are explicitly limited to economic transfers and do not pass on rights to participate in decision-making to ex-spouses or estates (except, in the latter case, where specifically discussed and agreed to). Furthermore, each of the management company agreements and affiliated agreements (e.g., the limited liability company agreements of each general partner) should be drafted to ensure that transfers by operation of law do not inadvertently transfer certain voting rights to ex-spouses or estates.

2. In general, the relevant agreements should permit transfers of certain interests to trusts (or other estate-planning vehicles) only if the transferor is to retain decision-making authority over the transferred interests. Such provisions on the transferor's retention of authority, however, must take into account certain IRS rules that govern the legal requirements that must be met when determining whether a gift is complete for federal gift tax purposes.

3. Important rights and remedies, such as the rights to removal and transfer, should be drafted to apply equally to the individual partner in the management company as well as to any trust created for his or her benefit. Each of the management company agreements (and affiliated agreements) should require that, to the extent it is practical to do so, contributions to and withdrawals from the management company (or the general partner, as the case may be) occur pro rata with respect to the investor and any trust created for his or her benefit that holds such investor's investment. If not, adverse consequences could result (e.g., an individual could hold a smaller interest in the investment than does the individual's trust, or the investment manager could seek to remove the individual from the fund but lack the authority to remove such individual's trusts, which is not the intended result in most cases).

4. At the time a management company and related entities are being formed, it is often prudent to have a spouse sign a written agreement whereby the spouse consents to the provisions on involuntary transfers referenced above.

F. Admission of Trusts to Management

1. Any issuance of a security by the management company (or any parent company) to a trust will be a private placement and must meet the "accredited investor" test in Regulation D of the Securities Act of 1933 ("1933 Act"). Any trust must meet each of the following tests to be an "accredited investor":

(a) Total assets in excess of $5,000,000;

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(b) Not formed specifically to purchase the securities; and

(c) Must be directed by a *sophisticated person* (i.e., a person who has sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the prospective investment in the management company).

Alternatively, a trust of any size may be an accredited investor under Rule 501(a)(1) so long as a bank, insurance company, registered investment company, business development company or small business investment company is serving as a trustee and/or has authority to make investment decisions on behalf of the trust. The SEC has determined that while a trust standing alone may not be an accredited investor under Rule 501(a)(1) of Regulation D, if a bank is its trustee and makes the investment on its behalf, the trust will be accredited by virtue of the bank's status as an accredited investor under Rule 501(a)(1).

Additionally, Rule 501(a)(8) of Regulation D provides that an entity in which all of the equity owners are accredited investors is an accredited investor. However, in the case of an irrevocable trust, the trust beneficiaries are not considered to be "equity owners," and it is not the case that if all of the trust beneficiaries are accredited investors the trust is an accredited investor. The result is different in the case of a revocable trust where the trust is established by the grantor during his or her lifetime; the trust may be amended or revoked by the grantor during such time period and all the tax benefits of investments made by the trust pass through to the grantor. In that case, the grantor is considered the "equity owner," and if the grantor is an accredited investor under Rule 501(a)(5) or Rule 501(a)(6) (i.e., he or she meets the net worth or income tests), the revocable trust is an accredited investor.

2. It is also possible for an existing partner in the management company to give an interest to a trust. Gifts are not subject to the 1933 Act because they are not transfers for value.

3. The Investment Company Act of 1940 ("1940 Act") will not apply to the admission of the trust because the management company is not an investment company for purposes of the 1940 Act and therefore the trust does not need to be a "qualified purchaser" or meet the "knowledgeable employee" tests.

4. However, the 1940 Act *will apply* when admitting the trust to the manager's affiliated general partners because the trust will almost always want to invest in the underlying fund and, assuming the underlying fund is a 3(c)(7) fund (as opposed to a 3(c)(1) fund), the trust will need to meet the "qualified purchaser" test of the 1940 Act. Any trust must meet each of the following tests to be a considered a "qualified purchaser":

(a) Family-Owned Companies with at Least $5,000,000 in Investments: Section 2(a)(51)(A)(ii) of the 1940 Act provides that any company that owns not less than $5,000,000 in investments and is owned directly or indirectly by two or more persons of a certain family relationship (or estates, organizations or trusts established by or for the benefit of such persons) is a qualified purchaser. As it is used in Section 2(a)(51)(A)(ii), "company" is defined in Section 2(a)(8) of the 1940 Act to include a trust. The 1940 Act does not define who the "owners" of a company are; however, the SEC has stated that the beneficiaries of certain family trusts could be considered the "owners" for purposes of Section 2(a)(51)(A)(ii) when those beneficiaries are the only persons holding economic interests in the trusts. In the case of a trust, all the beneficiaries of the trust must be comprised of siblings, a spouse (including former spouses), direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or

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foundations, other charitable organizations, or trusts established by or for the benefit of such persons. Further, there must be at least two natural persons who are beneficiaries of the trust.

(b) Trusts in Which the Trustee and Each Settlor Are Qualified Purchasers: Section 2(a)(51)(A)(iii) of the 1940 Act defines a trust as a qualified purchaser if: (1) the trustee or other person authorized to make decisions with respect to the trust and (2) each settlor or other person who has contributed assets to the trust is a qualified purchaser. To determine who must be a qualified purchaser, the SEC looks at the trustee (or other authorized person such as an investment advisor) who is responsible for making the investment decision and therefore responsible for assessing the risks associated with the investment. If the trust has more than one trustee, the SEC only requires that the trustee responsible for making the investment decision be a qualified purchaser.

(c) Employees of the Management Company Who Meet the "Knowledgeable Employee Test" (Rule 3c-5 Under the 1940 Act): Any such employee may also invest in 3(c)(7) funds through a trust so long as such employee is responsible for the trust's investment decision-making and its source of funds.

III. Charitable Planning Techniques

A. Public Charities

1. Summary: A public charity is a tax-exempt trust or corporation that is established exclusively for charitable, educational, scientific or religious purposes and that is financially supported by more than a small number of donors (and/or meets certain other technical requirements).

2. Income Tax Deductions: A manager will receive an immediate income tax deduction for contributions to a public charity. Contributions of cash to a public charity entitle a manager to an income tax deduction that is limited to 50 percent of the manager's adjusted gross income ("AGI") for the year of the contributions. Any appreciated securities and many other kinds of assets transferred to a public charity will also entitle the manager to an immediate income tax deduction, but the deduction will be limited to 30 percent of the manager's AGI for the year of the contributions. (Any excess contribution deductions above these AGI caps can be carried forward for use in the succeeding five years.)

B. Private Foundations

1. Summary: A private foundation is a tax-exempt trust or corporation established for one or more of the same purposes that public charities are established. However, a private foundation does not undertake certain actions that a public charity can undertake and is typically funded by one person or a small number of donors. Typically, a private foundation makes grants to other charitable organizations. A private foundation must distribute at least 5 percent of the average value of its assets annually. Through a private foundation, a manager can accomplish a variety of charitable goals, including obtaining an immediate tax deduction (regardless of the date when the foundation's funds are ultimately distributed to public charities), maintaining investment control over donated assets, teaching children philanthropy and money management (through their positions on the board of directors or as informed advisers to the foundation), assuring the manager's charitable vision will be realized and perpetuating the manager's name in connection with charitable works.

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2. Income Tax Deductions: However, the income tax deductions afforded for gifts to private foundations are less favorable than the deductions afforded for gifts to public charities. The income tax deduction for cash contributions to a private foundation is limited to 30 percent of the manager's AGI for the year of the contributions, and such limitation for transfers of appreciated stock traded on a recognized securities exchange to a private foundation is limited to 20 percent of the manager's AGI for the year of the contributions. In addition, if contributions are made to a private foundation of assets other than cash and marketable securities, the donor's income tax deduction is limited to his or her basis in the asset contributed. Depending on the circumstances, this can be a significant detriment to contributing an interest in an investment fund to a private foundation.

3. Contributing a Fund Interest to a Private Foundation: If a manager wishes to transfer to a private foundation an interest in the incentive allocation in a hedge fund or private equity fund, numerous issues arise in addition to the basis limitation on income tax deductibility. First, there may be concerns about the risks and lack of diversification presented by this "investment." Second, because the foundation is an owner of the fund, the IRS and the Attorney General of the state in which the foundation is created will have the right to examine whether or not the foundation received its fair share of the incentive allocation. This can lead to unwanted scrutiny, even when everything is done "by the book."

4. Investing Private Foundation Assets in the Management Company: Many managers want their private foundations to invest all or a significant portion of the foundation's assets in the management company. There are serious concerns with any such investment. For example, the Attorney General of the state in which the private foundation is organized can apply its broad authority over charitable organizations to review the books and records of the management company and possibly its affiliates, which could, as above, bring an unwanted level of additional scrutiny on the manager's business. Also, the manager will not have the same arm's-length relationship with the private foundation as he or she will with other partners, and the private foundation may not agree to the fiduciary duty standard provided for in the management company agreement (which is typically set as low as is permitted under Delaware law).

C. Donor-Advised Funds

1. Summary: Because private foundations require certain annual distributions and have ongoing costs of operation (legal, accounting and administrative fees, annual tax forms, etc.), the manager may prefer to make charitable gifts through a donor-advised fund ("DAF"). A gift to a DAF permits a manager to take an immediate tax deduction and to "recommend" the identity of grant recipients at a later date. DAFs invest donated assets and make grants to charities from a manager's individual account based largely on the manager's recommendations. DAF fees are usually lower than the costs of operating a private foundation, and typically a manager's name can be used in connection with gifts made from a DAF. Of note is that contributions to a DAF are irrevocable and the DAF has final discretion to decide where to donate (though in practice, the donor's wishes are usually followed) and how to invest the DAF assets. (Many DAFs do not like to hold (or allow) interests in illiquid assets.)

2. Income Tax Deductions: The same income tax deduction limitations as apply to public charities apply to DAFs. Therefore, in certain situations, a contribution to a DAF can provide an income tax deduction to a manager that would not be conferred upon the manager if he or she made the same contribution to a private foundation.

D. Charitable Lead Annuity Trusts

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1. Summary: A charitable lead annuity trust ("CLAT") annually pays a fixed amount to a designated charity for a number of years, with the remainder directed to noncharitable beneficiaries, typically the manager's children (outright or in further trust). A taxable gift is made to the remaindermen when the CLAT is created. The amount of the gift equals the value of the property transferred minus the present value of the annuity interest to be paid to the charity. If the value of the annuity interest equals the value of the property transferred to the CLAT, the CLAT is "zeroed-out" and no taxable gift is made. Any assets that remain at the end of the charitable annuity term will pass to the remaindermen free of transfer tax. If the return on the assets in a zeroed-out CLAT exceeds the IRS's assumed rate of return for the month in which the CLAT is funded or either of the two previous months if lower (the rate is 2.2 percent in January 2015, was 2.0 percent in December 2014 and was 2.2 percent in November 2014), the difference between the assumed and actual rates of return will pass to the remaindermen free of transfer tax. The CLAT can be structured as either a grantor trust or a nongrantor trust. If the CLAT is structured as a nongrantor trust, the manager will not receive an income tax deduction when the trust is created, but the trust can deduct the portions of its income paid to charity, and the trust's net income is taxable to the trust. If the CLAT is structured as a grantor trust, the manager is entitled to an income tax deduction when the trust is created, and the CLAT's income is taxable to the manager. Generally speaking, during the term of the CLAT the manager will recapture some or all of the income claimed as an up-front deduction. Thus, the selection of grantor versus nongrantor trust status is often an income timing issue.

2. Advantageous to Use with Low Interest Rates: As will be seen below, CLATs are most advantageous when the IRS benchmark rate is low. An example of a "zero-ed out" CLAT is as follows: A manager contributes $1,000,000 to a CLAT with a term of 10 years in 2015 when the assumed rate of return is 2.2 percent. Assume further that annually, until the CLAT's term ends, the CLAT's assets yield a 10-percent return, and an annuity payment in the amount of 11.25 percent of the CLAT's initial fair market value (i.e., $112,500) is made to a charity designated by the manager at the time the CLAT is created. The CLAT is structured as a grantor trust. Upon the CLAT's creation, the manager is entitled to an immediate charitable deduction of $1,000,000, which is the present value of the stream of annuity payments projected to grow at the IRS benchmark rate. The manager would pay all income taxes owed by the trust since the trust is a grantor trust. The value of the CLAT's remainder (i.e., the balance remaining after the annuity payments are made to the charity) is $800,782. This amount will pass free of transfer tax to the CLAT's remainder beneficiaries.

   Now consider if interest rates rose and the benchmark rate were increased to 6.2 percent and the annuity to 13.715 percent. The charity would receive higher annuity payments — $137,150 annually — and the CLAT's remainder beneficiaries would receive a significantly lower remainder — $407,924 — than they would each receive in the prior example. The manager will receive a charitable deduction of $999,933, which is almost the same as the manager would receive in the prior example. The reason that the charity receives more (and the remainder beneficiaries less) when interest rates are higher is because when the CLAT is projected to grow at a higher rate, the annuity payments to "zero out" the CLAT must increase (leaving a lower remainder).

E. Charitable Remainder Trusts

1. Summary: A charitable remainder trust ("CRT") allows a manager to provide income for a period of time to any person designated by the manager, with the remaining trust assets passing to charity once such period elapses. There are two types of CRTs: a charitable remainder annuity trust ("CRAT") and a charitable remainder unitrust ("CRUT"). If a manager makes a transfer to a CRT during the manager's lifetime, the manager will receive an income tax charitable deduction based on the present value of the remainder interest that will ultimately pass to charity. Of note, a CRT can be funded with appreciated assets to bypass (or, at a minimum, defer) capital gains taxes upon the sale

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of the contributed assets. With a CRAT, the income beneficiary will receive a predictable stream of payments during the trust term. The income payments are fixed at the inception of the trust and do not fluctuate based on the performance of the trust assets. With a CRUT, the income beneficiary receives a fixed percentage of the fair market value of the trust assets as revalued annually. The income payment will increase or decrease each year based on the performance of the CRUT's assets. A CRT must make a minimum annual distribution of at least 5 percent (but no more than 50 percent) of the fair market value of the trust assets for either the lifetime of an individual or individuals or a term not to exceed 20 years.

2. Advantageous to Use with High Interest Rates: An example of a CRAT is as follows: Assume in 2015 at a time when the assumed rate of return is 2.2 percent that a manager contributes $5,000,000 of appreciated securities (with a basis of $1,000,000) to a CRAT with a term of 10 years, retains the right to receive annuity payments for the duration of the CRAT's term equal to 5 percent of the initial fair market value of the CRAT (i.e., $250,000) and the CRAT yields an annual return of 5 percent. The CRAT will sell the securities in part to have funds available to pay to the manager as annuity payments. The present value of the stream of annuity payments projected to grow at a rate of 2.2 percent (the IRS benchmark rate) is $2,222,325. The manager is entitled to an immediate charitable deduction of $2,777,675 (i.e., $5,000,000 minus $2,222,325). Under the assumed rate of return in this example, the value of the CRAT's remainder (i.e., the balance remaining after the 10 annuity payments are distributed to the manager over the CRAT's term) is $5,000,000; essentially, in this example, the manager retained all of the CRAT's income and appreciation, and the initial funding of the CRAT passed to charity. Of significance, neither the manager nor the CRAT paid any capital gains tax on the $4,000,000 in profit realized by the CRAT upon the sale of the appreciated securities, although some part or all of the gain could be taxed as the CRAT annuity payments are made.

   It is important to note that while the above transaction was advantageous to the manager in that the manager received an immediate charitable deduction and may avoid or reduce his or her capital gains tax on the securities, it would be more advantageous if the IRS benchmark rate were higher. Consider if interest rates rose and the benchmark rate were increased to 6.2 percent and all other assumptions remained the same. The manager would receive the same potential capital gains tax benefit and would still receive annuity payments of $250,000 each year, and the charity would still receive $5,000,000 at the end of the CRAT term. However, since the present value of the stream of annuity payments would be projected to grow at 6.2 percent, not 2.2 percent, the present value of the stream of payments would only be $1,822,700. In turn, the manager would receive a higher charitable deduction than when the benchmark rate was only 2.2 percent; the manager's charitable deduction would be $3,177,300 (i.e., $5,000,000 minus $1,822,700). The reason that the manager's charitable deduction increases when interest rates are higher is because when the CRAT is projected to grow at a higher rate, the anticipated remainder to be paid to charity at the CRAT's termination is higher.

F. Charitable Gift Agreements

1. Naming Opportunities: Many managers wish to share their financial success through large gifts to public charities such as colleges, hospitals and museums. Often, in exchange, the manager receives a naming opportunity — of a scholarship, a building, a program or a similar project or structure. A manager's income tax deduction for the charitable gift is not reduced or jeopardized by reason of such naming.

2. Use a Written Gift Agreement: These kinds of charitable gifts or pledges are typically (and should always be) memorialized in a written agreement between the manager and the charity in order to

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be sure that both parties are legally bound to carry out their mutual promises. Important provisions of such an agreement include: (1) a statement of whether the naming will remain in perpetuity; (2) consequences of default by the charity (e.g., if the donor's name is removed in violation of the agreement's provisions); and (3) the ability of the donor to enforce the contract. In many states, only the Attorney General of the state in which the charity is located can enforce the gift agreement against the charity unless the agreement states otherwise, so it is crucial for the agreement to expressly state that the charity agrees that the donor also has the right to enforce the terms of the gift agreement in case the donor ever needs to enforce the agreement or seek its interpretation by a court.

IV. Marital Considerations

A. Prior to Marriage

1. Marital Rights: Spouses (or, in some states, non-marital partners) can have rights to certain business and other property rights if a couple separates or divorces. In many instances, these rights extend to income earned on and the appreciation of assets held prior to marriage. This can be a significant risk to investment fund managers who come into a marriage or relationship with an existing fund interest that is likely to grow and evolve over the course of a marriage. It can also impact other owners of the fund, as well as major investors who may worry about a spouse's claims to, or interference in, a fund if the marital relationship falters.

2. State Law Varies: The law can vary significantly (based upon where the spouses live) as to what rights a spouse might have in an asset that is owned prior to marriage. For example, in New York, property that was owned prior to marriage is typically protected from a spouse's claims, but income and appreciation on such property during the marriage can be subject to a spouse's claims if and to the extent that such income and appreciation are generated as a result of the efforts of either spouse (rather than the efforts of others or market forces). In other states, however, including Connecticut, all property owned by each spouse at the time of a divorce is potentially subject to the other spouse's claims — even if it was owned prior to marriage — though the timing and circumstances of ownership are factors to be considered.

3. Prenuptial Agreement: Thus, even prior to marriage (or, in some instances, cohabitation), it is important to consider the benefits of a prenuptial agreement that would prevent a spouse from ever obtaining an interest in the fund that could harm the governance and ongoing viability of the fund. Such an agreement typically would also restrict a spouse's economic rights in the fund (often in exchange for some other economic benefit).

B. During Marriage

1. Postnuptial Agreement: Married couples who have not entered into a prenuptial agreement can enter into a "postnuptial" agreement. A postnuptial agreement typically covers the same economic issues as are addressed in a prenuptial agreement, though these issues may be sensitive and difficult to raise and address during the marriage.

2. Risk of Diminution of Control for Manager: In the case of a fund manager who does not have a prenuptial agreement or a postnuptial agreement, it can be even more important than in other situations that the governing documents of the fund preclude an involuntary transfer of an interest in the general partner and the management company to a spouse (or other person). This type of provision is beneficial for certain other reasons as well. Many courts honor these types of provisions

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so long as they meet certain requirements, including that they are not entered into to defraud a spouse or in contemplation of divorce.

C. Upon a Separation or Divorce

1. If Marital Agreement Governs: A well-drafted prenuptial or postnuptial agreement should protect the manager and the fund from a former spouse's claims to a direct and ongoing interest in the fund, even if the former spouse has certain economic rights that are satisfied with respect to the fund's ongoing performance.

2. If Marital Agreement Does Not Govern: If spouses have not entered into a prenuptial or postnuptial agreement, the law will determine how the spouses' property is to be divided, with the controlling law generally to be the law of the state in which they reside. In many (but not all) instances of divorce, courts tend not to award a non-owner spouse a direct ongoing interest in a business venture if ownership of the interest includes the right to participate in control of the business.

3. Potential Regulatory Disclosure Obligations Post-Divorce: A divorce between a partner in the management company and his or her spouse may need to be disclosed on the management company's Form ADV. For example, in certain instances, Form ADV can require disclosure of the divorced spouse's economic ownership in the management company, which of course could raise privacy and other concerns for the relevant parties.

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