Carry derivatives

What are they, and how can they benefit you?

Private equity (PE) professionals often require unique and innovative financial instruments to help offset long-term tax liabilities and the gains achieved through their funds. A carry derivative is one such strategy.

A carry derivative is a financial instrument designed for those who've amassed substantial wealth, typically exceeding $30 million, and a desire to not allow the estate tax to cannibalize future growth of their assets within PE investment vehicles.

Carry derivatives allow individuals to move the growth of "carry" outside of their estate while minimizing the amount of lifetime gift exclusion utilized. By leveraging this tool, PE professionals can strategically transfer carried interest distributions into irrevocable trusts. As these assets appreciate in value, the irrevocable trust shields the growth from any additional estate taxes.

That said, before pursuing a carry derivative, one should understand the pros and cons of the strategy as well as the rules involved for gift giving.

The current gifting rule

The current gifting rules for carry derivatives involve a careful balance between maximizing the benefits of lifetime gifting while being mindful of the changing tax landscape. As of now, there are two key limitations to consider:

Annual gifting limit. Under current regulations, you can gift up to $18,000 annually to an individual without it counting against your lifetime estate exemption. This means that you can give $18,000 per year to each recipient, commonly referred to as "per donee."[1]

Lifetime estate exemption. The temporary lifetime estate exemption increase of $13.61 million for an individual, $27.22 million for a married couple is set to sunset at the end of 2025.[2] This means that as of January 2026, the amount you can gift during your lifetime and at death will be cut in half, reducing your ability to leverage gifting strategies effectively. This impending deadline adds a sense of urgency to act promptly.

What is an irrevocable trust? How can it help me?

To make the most of carry derivatives, individuals often utilize irrevocable trusts to safeguard and strategically manage family assets. These trusts offer several valuable features and benefits, including:

Creditor protection. Assets held in an irrevocable trust may be shielded from judgments by the beneficiaries' creditors. In the event of legal claims or financial liabilities, the trust may be protected.

Exemption from divorce claims. If funds are placed in a trust for a beneficiary, those assets are typically exempt from claims in divorce proceedings. This helps to ensure that the trust's assets remain intact and reserved for the trust beneficiaries.

Beneficiary flexibility. Beneficiaries of irrevocable trusts have the flexibility to access trust funds or receive benefits as described in the trust agreement. Trustees can distribute funds for the beneficiaries' well-being according to the trust's terms.

Grantor trust structure. Some individuals opt for a grantor trust structure, which allows them to pay all federal and state income taxes on behalf of the trust. This approach effectively enables the trust assets to grow "tax-free" until the grantor's death as the grantor is permitted to pay taxes on behalf of the trust. This allows the grantor to reduce the size of their taxable estate while accelerating the growth of the trust assets. In a grantor trust, the person who contributed assets to the trust retains a limited but not beneficiary interest in the trust, while the beneficiaries enjoy the aforementioned asset protection and creditor safeguards.

Challenges with gifting carried interest

The primary goal of gifting carried interest is to maximize the proportion of carry placed into an irrevocable trust to achieve IRS recognition as a completed gift but in doing so it introduces a multitude of complex issues and obstacles.

Vesting schedule complexity. Gifting carried interest involves a complex vesting schedule. The IRS does not consider the gift complete until the carry has fully vested, which typically takes several years. By the time this occurs, it may be in year five to seven, which can have significant implications for your lifetime gift exemption.

Uncertainty in valuation. The value of carried interest can fluctuate significantly over time. This unknown can create a challenge when declaring the value of the gift for tax purposes.

Ownership as a "control person". Under Section 2701 of the IRS tax code,[3] an individual gifting carried interest may be considered a "control person." If the tax code applies, and the donor retains a capital interest, the gift could be valued as a combination of both the carried and capital interests, potentially leading to an overvaluation of the gift.

Risk in vertical slices. Gifting carried interest via a vertical slice approach, where capital interest is retained, introduces additional complexities. Even if the carry isn't formally gifted, the capital interest becomes a gift, further consuming the lifetime gift exemption without necessarily transferring a corresponding benefit to the recipient.

How does the carry derivative work?

As mentioned, a carry derivative is a financial instrument designed to mitigate the risks associated with gifting carried interest. Here's how it works:

1. Create and fund a trust.
The process begins by creating and funding a grantor trust with sufficient funds to purchase the carry derivative.

2. Enter into a derivative contract.
The grantor enters into a derivative contract with the trust, effectively selling the derivative to the trust. The derivative contract may include hurdles or guardrails that specify conditions that must be met before the trust is required to make payments. For example, these conditions can include reaching a specific dollar threshold or a certain percentage return on the carried interest. The contract settles upon the earlier of the contract's expiration date or the grantor's death. Typically, the expiration date is strategically set to capture most of the gains from the private equity fund's life, typically the back third of the fund's life.

3. Payments made based on carry.
The trust is obligated to make a payment at a future date, which is determined based on the total amount of carried interest. To determine the payment amount at settlement, a third party, professional appraiser assesses the fair market value of the derivative. The longer the term, the higher the price of the derivative. Hurdles, such as a certain dollar threshold needing to be reached before anything is paid out, lower the price.

4. Contract settlement.
The settlement occurs when the grantor exercises the option to cash out the derivative. At this point, the grantor pays the trust an amount equal to the carried interest referenced in the agreement, plus any distributions made by the general partner net of a clawback.[4]

Example

As an example, carry is initially valued at **$2 million** via third party valuations, it is determined that the trust should pay **$500,000** to you at the exercise of the derivative contract.

To make the most of this arrangement, a **$2 million** hurdle is set in the contract. When the settlement date arrives, with **$7 million** in distributions and a current value of **$3 million,** you would transfer **$8 million** to the trust.

This approach enables you to minimize transfer taxes and utilize just **$500,000** of your lifetime exemption. Even if the total return falls short of the **$2 million** hurdle, you'd only have used $500,000 of your exemption, which is far more advantageous than risking **$2 million** without the derivative.

The net benefit is **$8 million** moved outside of your estate while using only **$500,000** of your lifetime exemption.

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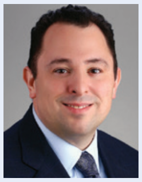

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Benefits of using a carry derivative

A carry derivative may offer multiple advantages when gifting carried interest in private equity. It allows partners to keep ownership of carried interest and avoids the complex Section 2701 tax code requirements that can complicate gifting. By only gifting the carried interest via derivative, the utilization of the grantor's lifetime gift exemption may be minimized, both reducing the risk of gifting underperforming assets and maximizing the opportunities to gift highly appreciating assets.

In the event of a valuation dispute, the IRS contests the derivative's value rather than the entire gift, limiting potential impacts.

Ultimately, PE professionals may benefit from the carry derivative, as it potentially offers a strategic means to safeguard and grow wealth while minimizing tax liabilities. It's a powerful tool for maintaining financial control in the ever-evolving landscape of high finance.

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[1] Internal Revenue Service "IRS provides tax inflation adjustments for tax year 2024," Nov. 9, 2023.

[2] Forbes "Using The Federal Estate, Gift Tax Exemption Before It Sunsets," October 25, 2023.

[3] Cornell Law School "26 U.S. Code § 2701 - Special valuation rules in case of transfers of certain interests in corporations or partnerships," accessed November 7, 2023.

[4] Investopedia "Clawback: Definition, Meaning, How It Works, and Example," May 13, 2021.

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