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A WORD FROM CHERRY BEKAERT AND CHOREO

Use it or lose it: Estate tax exemption "sunset"

On December 31, 2025, the current federal lifetime estate and gift tax exemption amount is scheduled to revert to pre-2018 limits, effectively reducing the tax benefit by 50%.[8]

To understand its full implications, Cherry Bekaert and its strategic alliance partner, Choreo, respond to private equity (PE) fund managers' most frequently asked questions regarding this relatively complicated, but high-stakes, tax code change.

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With over 25 years of experience, Marci serves the unique tax and consulting needs of high-net-worth individuals. Marci specializes in federal and multistate individual and fiduciary income tax planning and compliance, gift and estate tax, investment partnerships, professional services partnerships, and S corporations.

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With nearly 40 years of experience, Mike helps closely held and family-owned companies implement strategic tax plans that anticipate growth and accommodate change. He develops estate plans that minimize transfer taxes and maximize available assets that can be passed on to heirs.

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Clint leverages his 15-year legal career to support advisors and clients in advanced transfer tax, income tax, estate, and business planning matters. Clint has extensive expertise using trusts and business entities to optimize generational wealth transfer and income tax minimization.

How does the sunset present a planning opportunity for fund managers?

The federal estate tax is, generally, a tax on the retained wealth or "taxable estate" of individuals at death. The amount of estate tax paid by an estate generally depends on two variables:

Exemption: If the taxable estate is below the exemption amount indicated in the tax code, the estate tax should not apply.

Tax rate: The estate tax rate is, generally, 40% of the value of the taxable estate above the exemption amount.[9]

The exemption amount has changed over the years under various tax code revisions. Though taxpayers currently enjoy historically high exemption amounts, the sunset will cause the exemption to decrease by roughly 50% after 2025.

Is the federal gift tax also important for sunset planning?

The gift tax, unlike the estate tax, applies to asset transfers made during life rather than at death but draws from the same exemption amount. The exemption can be used in whole or in part during life or at death, but represents a lifetime aggregate of allowable transfers. In other words, the exemption does not reset each year.

Apart from the time value of money, estate and gift taxes are generally neutral as to when individuals transfer their assets to heirs and beneficiaries. Many wealthy individuals choose to make lifetime gifts of assets instead of waiting to transfer them at death. This allows post-gift appreciation to escape the taxable estate at death, significantly reducing estate tax liability for beneficiaries.

Why should fund managers care?

Successful fund managers can generate significant personal wealth through fund management activities. Many fund managers have, or expect to, become wealthy enough to have estate tax exposure from equity holdings in their funds.

8: "26 USC 2010: Unified Credit Against Estate Tax," United States House of Representatives, n.d., accessed May 23, 2024.
9: "26 USC 2001: Imposition and Rate of Tax," United States House of Representatives, n.d., accessed May 23, 2024.

For those fund managers, the current enhanced exemption levels represent a "use-it-or-lose-it" scenario.[10, 11] By engaging in wealth transfer prior to the sunset, fund managers can lock in the larger exemption. Sunset planning may be especially apt for PE principals holding carried interests, since those assets begin at lower values with the potential to increase by multiples over time.

What are possible challenges in PE wealth transfers?

Tax considerations

Section 2701 of the tax code must be carefully considered in the design of any wealth transfer structure involving carried interests. Mishandling this provision could have costly results for principals gifting fund interests.

"Vertical slice" planning is often used to avoid the potentially negative impact of Section 2701 by aggregating all limited partner and carried interests owned by a fund manager. This strategy allows those interests to be gifted to the recipient in the same proportion.

Carried interest derivatives are becoming a popular way to avoid the complications of vertical slice planning and avoiding partnership admittance issues. Fund managers must also consider the tax implications of vesting when giving compensatory fund interests.

Estate planning considerations

A thoughtful wealth transfer plan for principals must also account for a variety of practical and lifestyle concerns.

While later-career fund managers may already have implemented estate wealth transfer structures, younger partners might be uneasy over parting with a large portion of their asset base. To alleviate these concerns, using a Spousal Lifetime Access Trust (SLAT) can allow a fund manager to create a trust that includes his or her spouse as a beneficiary, thereby retaining indirect access to the gifted property.

Both midcareer and later-career fund managers might also consider the Family Limited Partnership (FLP) strategy to import a business-like discipline to estate planning. This may enhance SLAT benefits like oversight, management control, succession planning, and education of the next generation.

A customized planning approach is also needed to design gifts that maximize asset protection and avoid creating an attitude of entitlement among beneficiaries.

How can I seize this sunset planning opportunity?

First, begin now. Thoughtful planning involving complicated PE fund interests takes months and may be best positioned over multiple tax years prior to the sunset. It is also expected that estate planning professionals will be very busy leading up to the sunset. Here are some proactive planning steps you can undertake immediately:

1. **Gather an advisory team:** PE principals might assess if their advisory team (CPA, wealth manager, and attorney) is complete and conversant with planning for PE fund interests. Address any gaps by sourcing professionals who seek to collaborate on comprehensive, multidisciplinary planning.

2. **Create a financial plan:** The wealth manager, working in conjunction with the CPA and other advisers, should be able to develop the fund manager's balance sheet, risk profile, financial goals, and cash-flow picture.

3. **Design and implement a customized wealth transfer plan:** With the advisory team's collective efforts, guided by the financial plan, a customized wealth transfer structure can be designed and implemented to take advantage of the sunset.

4. **Maintain and maximize:** Fund managers who expect to continue earning significant wealth must consistently attend to their planning structure. A good advisory team is key to this process. Ongoing attention to the financial, estate, and tax plan can help identify opportunities to further leverage planning structures for tax and financial benefit.

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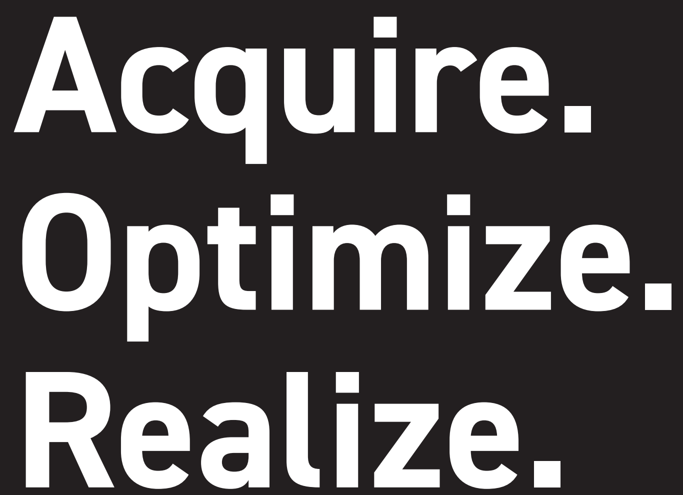
10: "26 USC 2001: Imposition and Rate of Tax," United States House of Representatives, n.d., accessed May 23, 2024.
11: "Estate and Gift Taxes; Difference in the Basic Exclusion Amount," The Office of the Federal Register, November 26, 2019.



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