

# Carried Away!

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Utilizing Carried Interest to  
Transfer Wealth Efficiently

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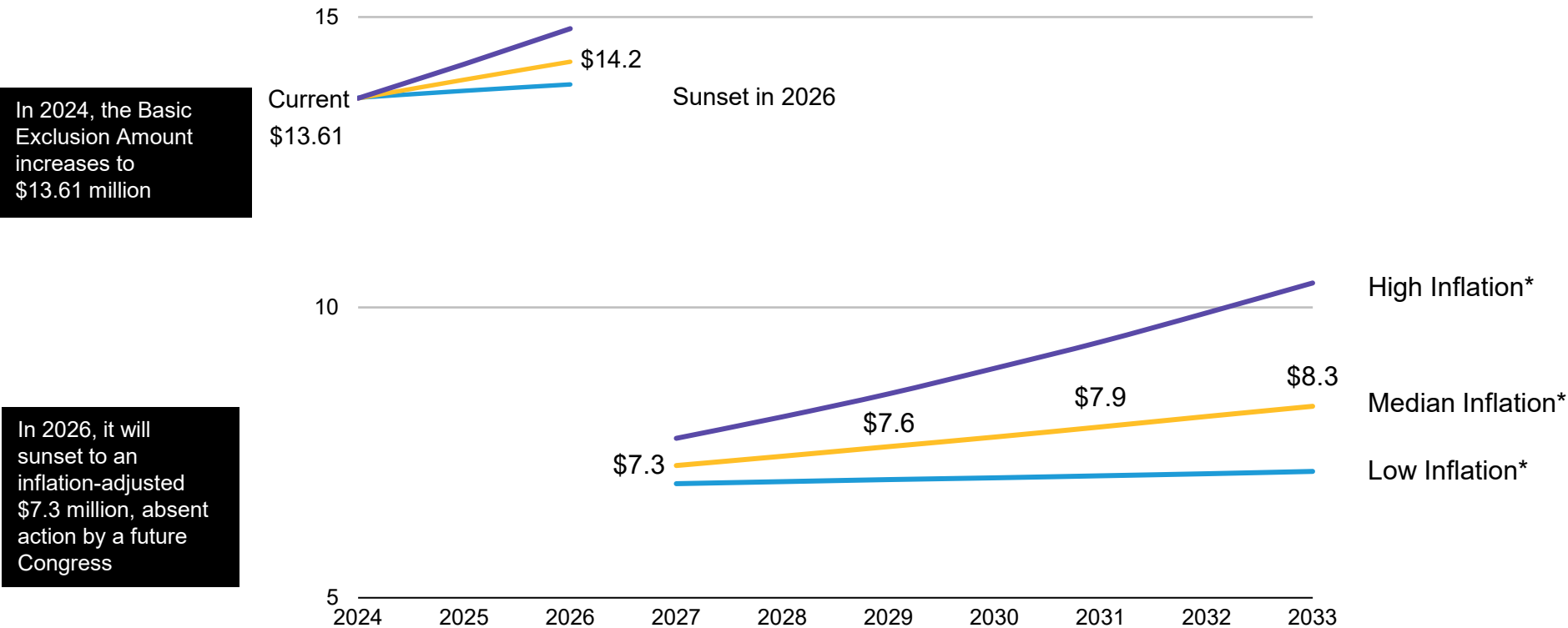
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# Projected Basic Exclusion Amount under Current Tax Law

## Basic Exclusion Amount Nominal (USD millions)



\*Based on projected increases in “chained” CPI-U, rounded to the nearest \$100,000 in this display. Basic exclusion amount shown is for an individual, based upon 10th (“high”), 50th (“median”), and 90th (“low”) percentile outcomes for the inflation-adjusted basic exclusion amount.

Based on Bernstein’s estimated range of returns for the applicable capital markets. **Data do not represent past performance and are not a promise of actual results or a range of future results.** See Notes on Bernstein Wealth Forecasting System in the Appendix for further details.

Source: AB

# Ways to Reduce Taxable Estate

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## Spend More

- Increase spending to maximum sustainable rate
- Reevaluate periodically

## Give to Charity

- Direct or structured gifts
- Partly philanthropic strategies
- Can be done during lifetime or through estate

## Ed/Med Gifts

- Unlimited amount\*
- Paid directly to *service provider*

## Annual Exclusion Gifts

- \$18,000/yr. in 2024 (\$36,000/yr. for married couple)
- No limit to number or identity of beneficiaries

## Lifetime Gift-Tax Exemption

- \$13,610,000 (\$27.22 MM for married couple)\*\* in 2024
- This gift can be made directly to, or in trust(s) for, the benefit of one or more beneficiaries

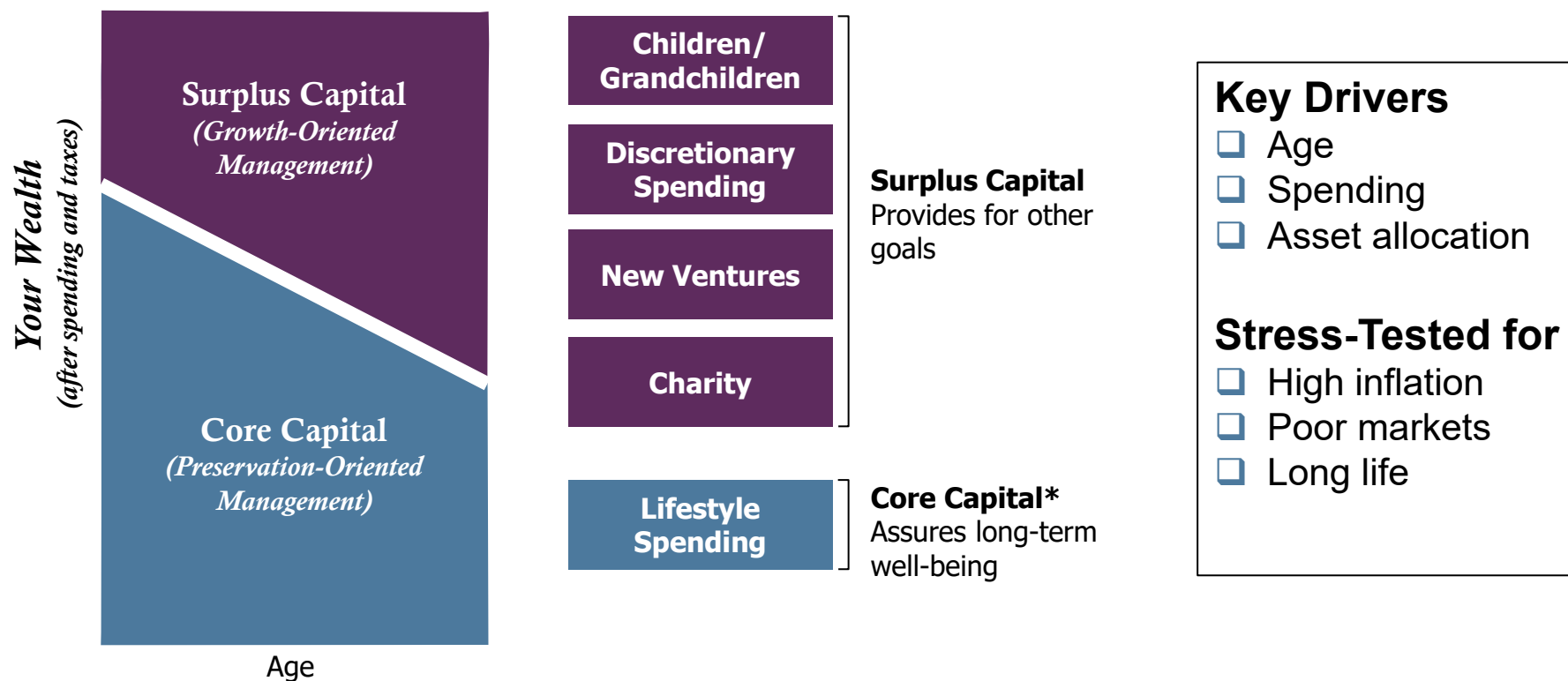
\*These unlimited educational and medical gifts are allowed under Section 2503(e) of the Code. In addition, other strategies are available for educational and medical gifts, apart from those covered by Section 2503(e), which can be given directly to beneficiaries but are subject to various restrictions. One example is Section 529 plans for funding higher-education costs.

\*\*Indexed for inflation until the end of 2025. Scheduled to revert to approximately \$7 million in 2026, subject to legislative changes.

# Core and Surplus Capital

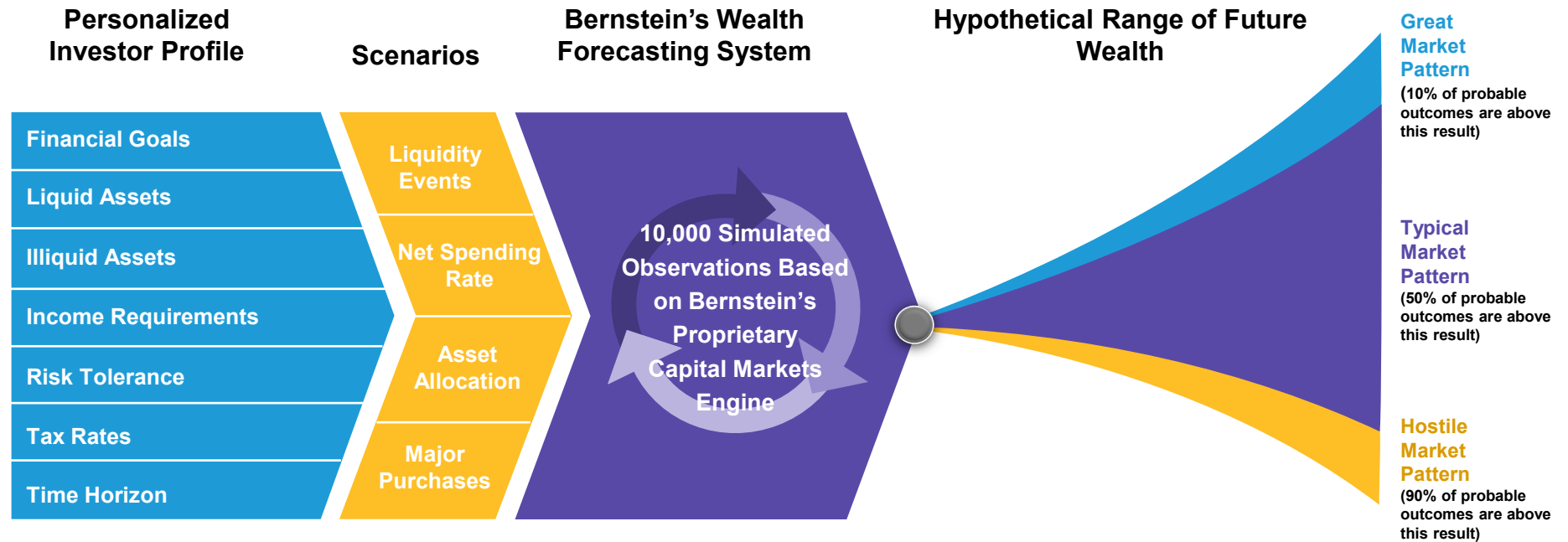
## The Critical Goal:

Meeting Lifetime Spending Needs



\*The amount needed to support your lifestyle as long as you live  
Source: AB

# Bernstein's Wealth Forecasting System



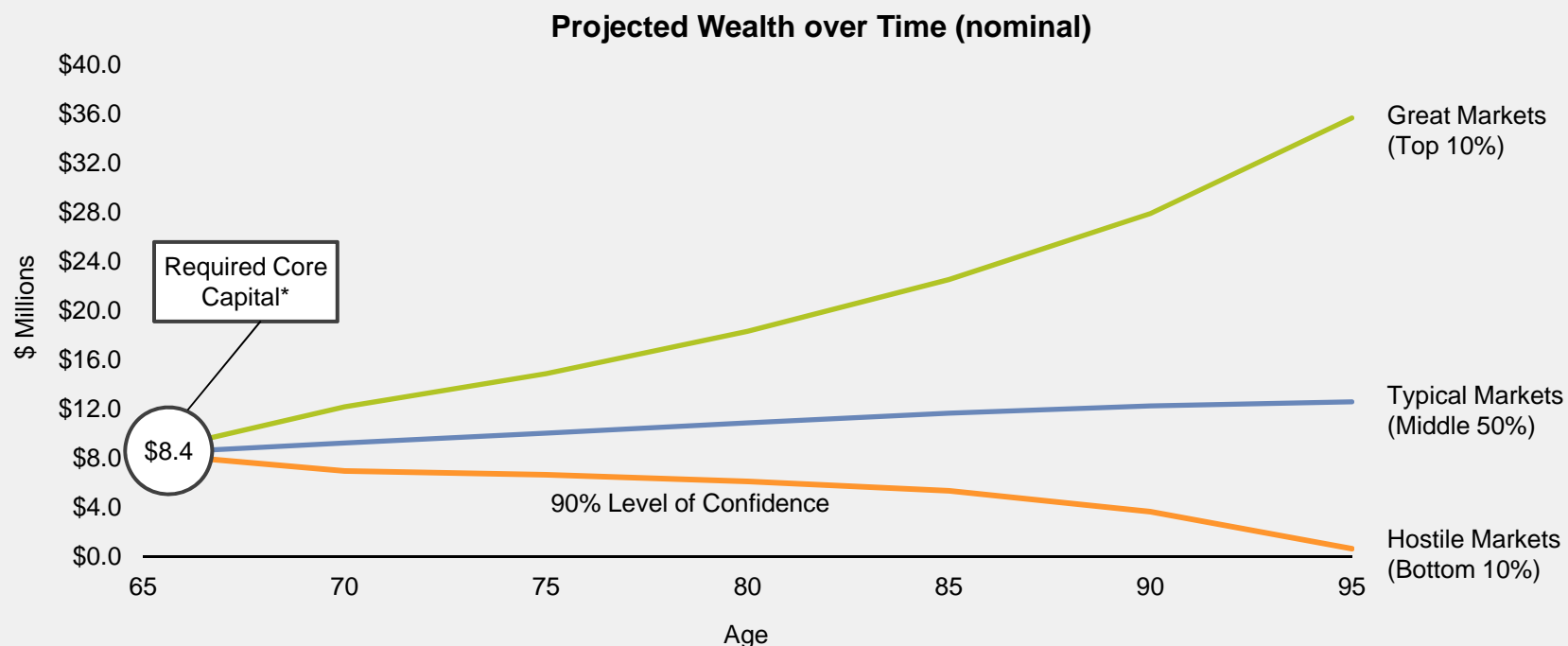
- Based on the current capital-market environment
- Customized to analyze expected financial outcomes of scenarios of your choice
- Incorporates various account types and planning vehicles
- Predicts likelihood of meeting long-term goals, reflecting what is known and unknown

Bernstein's Wealth Forecasting System<sup>SM</sup> is based upon our proprietary analysis of historical capital-market data over many decades. We look at variables such as past returns, volatility, valuations, and correlations to forecast a vast range of possible outcomes relating to market asset classes, not Bernstein portfolios. While there is no assurance that any specific outcome suggested by the model will actually come to pass, by quantifying the possibilities of achieving financial goals under changing, and sometimes extreme, capital-market conditions, the tool should help our clients make better choices. See Notes on Wealth Forecasting System at the end of this presentation for further details.

Source: AB

# Core Capital Is Sized to Sustain Lifetime Spending Even with Hostile Markets and High Inflation

**Example: 65-Year-Old Retired Couple Spending \$300,000 Annually from 60% Stocks/40% Bonds Portfolio**  
Required Core Capital = ?



\*Core capital amount calculated at a 90% level of confidence for a 65-year-old couple spending \$300,000 annually (inflation-adjusted) from their portfolio. Based on Bernstein's estimates of the range of returns for the applicable capital markets over the periods analyzed. **Data do not represent past performance and are not a promise of future results or a range of future results.** See Notes on Wealth Forecasting System in the Appendix for further details.  
Source: AB

# Agenda

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- Background: What is Carried Interest, and why is it attractive for wealth transfer
- Hurdle for Wealth Transfer: IRC Section 2701
- Overview of wealth transfer strategies available
- Quantification of the efficiency of strategies, and planning takeaways



# Overview of Carried Interest

- Carried interest is a significant source of incentive compensation for private equity, venture capital, real estate, and hedge fund managers.
- In exchange for services, the general partner's carried interest entitles the fund's manager to a percentage (usually 20%) of the fund's profits over a minimum return.<sup>[i]</sup>
- Upon liquidation of investments within the partnership, cash proceeds are distributed between the general partner and limited partners according to the fund's partnership agreement, often referred to as a "distribution waterfall."
- History: Carried interest dates to the sixteenth and seventeenth centuries, when European merchant bankers funded trading voyages between Europe, the New World, and the Far East, in exchange for a share of the profits.

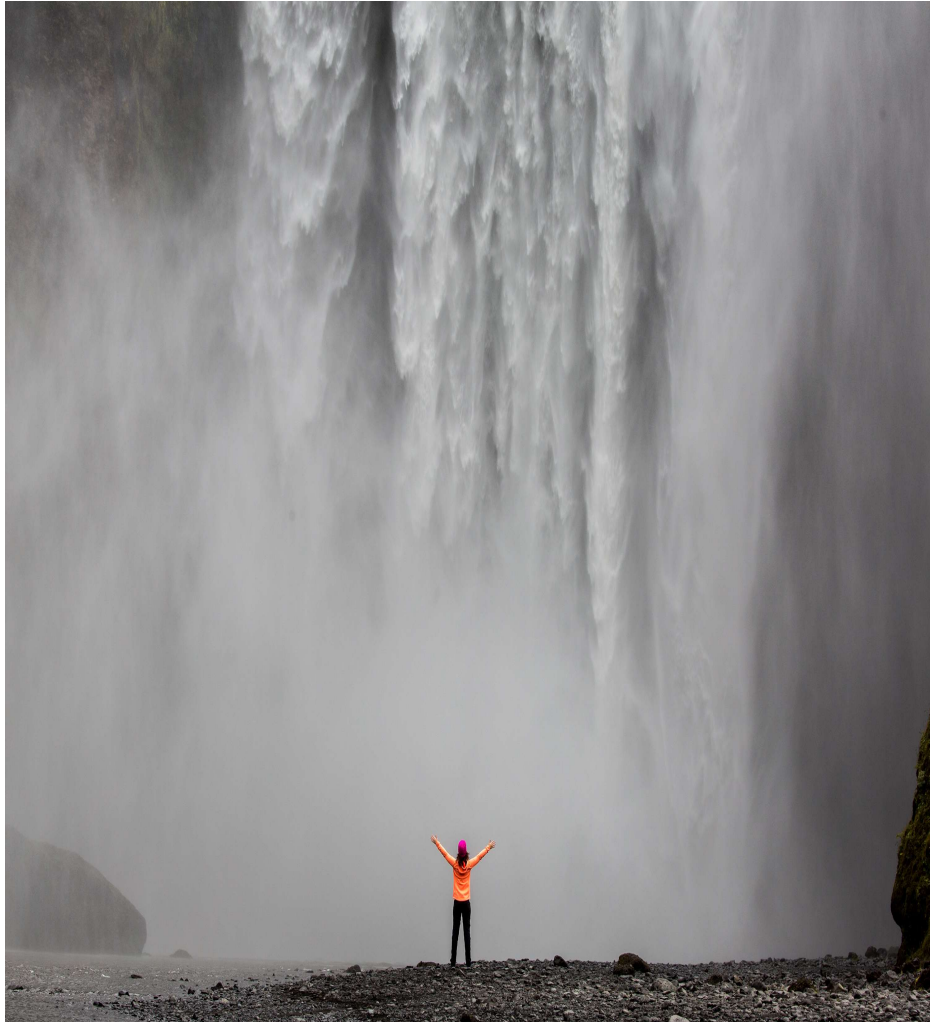


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[i] Often, the fund's GP is structured as an LLC which the fund's investment manager controls.

Source: AB

# Distribution Waterfall



Source: AB

Typically, the distribution waterfall provides for distributions to the partners in the following order:

1. Investors receive their invested capital back
2. Preferred return is paid to investors (usually 8%)
3. Holder of the carried interest is entitled to a catch-up distribution making up for the preferred return paid to the investors
4. Finally, from the remaining profits, a percentage (20%) is distributed to the GP as the carried interest and the remaining portion is allocated to investors

## Case Study: HENRY

### Henry is a founding fund partner, and owns 5% of GP and Carried Interests

- Fund Committed Capital – \$3 Billion
- Henry's Capital Interest – \$1.5 million (5% of GP interests)
- Carried Interest Appraised Fair Market Value – \$600,000
  - Preferred Rate for LP interests – 8%
  - Carried Interest (with GP Catchup) – 20%

For illustrative purposes only

## Valuation of Carried Interest

Generally, carried interest has little value during the early stages of an investment fund's life since its ultimate payout is contingent on its investment performance

Carried Interest Valuation Summary (Fund Level)			
	Potential Future Value	Discounted Cash Flow Valuation of Payout	Probability Weighting
Optimistic—20% IRR*	\$600,000,000	\$50,000,000	20%
Base Case—16% IRR	\$450,000,000	\$18,100,000	40%
Conservative—12% IRR	\$300,000,000	\$8,400,000	20%
Breakeven—8% IRR	\$0	\$0	20%
<b>Total Funds Level Carried Interest Valuation (Probability Weighted)</b>	<b>\$360,000,000</b>	<b>\$18,920,000</b>	
Henry's Interests (5%)		\$946,000	
<b>Henry's interest with applicable valuation discount</b>		<b>\$600,000</b>	

These returns are for illustrative purposes only and do not reflect the performance of any AB product.

\*IRR is net of management fees, gross of carry

# Valuation of Carried Interest—Cash Flow Timing Impacts Value

USD millions

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Contributions to Portfolio Companies	-\$600	-\$750	-\$600	-\$600	-\$450	—	—	—	—	—	-\$3,000
Distributions from Portfolio Companies	—	—	\$150	\$435	\$945	\$1,200	\$1,200	\$900	\$810	\$360	\$6,000
Net Annual Cash Flows	-\$600	-\$750	-\$450	-\$165	\$495	\$1,200	\$1,200	\$900	\$810	\$360	\$3,000
<b>Cumulative Cash Flows</b>	<b>-\$600</b>	<b>-\$1,350</b>	<b>-\$1,800</b>	<b>-\$1,995</b>	<b>-\$1,470</b>	<b>-\$270</b>	<b>\$930</b>	<b>\$1,830</b>	<b>\$2,640</b>	<b>\$3,000</b>	<b>\$3,000</b>
<b>Carried Interest Projection (Fund Level)</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	<b>\$186</b>	<b>\$180</b>	<b>\$162</b>	<b>\$72</b>	<b>\$600 Mil.</b>

These returns are for illustrative purposes only and do not reflect the performance of any AB product .

Often, the fund's GP is structured as an LLC which the fund's investment manager controls.

Source: AB

# Income Tax Treatment of Carried Interest

- Generally, when allocated to carried interest, **realized gains from capital assets held for more than three years are taxed as long-term capital gains** instead of less preferable ordinary income.\*
- The three-year holding period requirement was introduced by the Tax Cuts and Jobs Act (“TCJA”) of 2017<sup>†</sup> for tax years after December 31, 2017. The requirement applies to gain allocated to applicable partnership interests (“API”) held in connection with the performance of certain services generally performed by fund managers.<sup>‡</sup>
- An API is any partnership interest held by a taxpayer in connection with the performance of services in any applicable trade or business, defined as any activity that consists of:
  - Raising or returning capital and either investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition) or developing specified assets.<sup>§</sup>

\*IRC § 1061(a)(2). Gain realized on capital assets held for not more than three years is recharacterized to ordinary income.

<sup>†</sup>Pub. L. No. 115–97

<sup>‡</sup>IRC § 1061(a)(2)

<sup>§</sup>IRC § 1061(c)(2)

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Source: AB

## Wealth Transfer Considerations—Section 2701 Special Valuation Rules

- The gift tax value of the transferred interest is determined by the subtraction method.\* Under the subtraction method, the transfer value for gift tax purposes is calculated see chart below:

$$\begin{array}{|c|} \hline \text{Value of Transferor's Equity} \\ \text{Before Transfer} \\ \hline \end{array} - \begin{array}{|c|} \hline \text{Value of Transferor's Equity} \\ \text{After Transfer} \\ \hline \end{array} = \begin{array}{|c|} \hline \text{Value of} \\ \text{Gift} \\ \hline \end{array}$$

- If the interest retained by the transferor is classified as an applicable retained interest†, its value for purposes of this calculation is zero—resulting in the transferor being treated as transferring their entire equity interest in the entity.

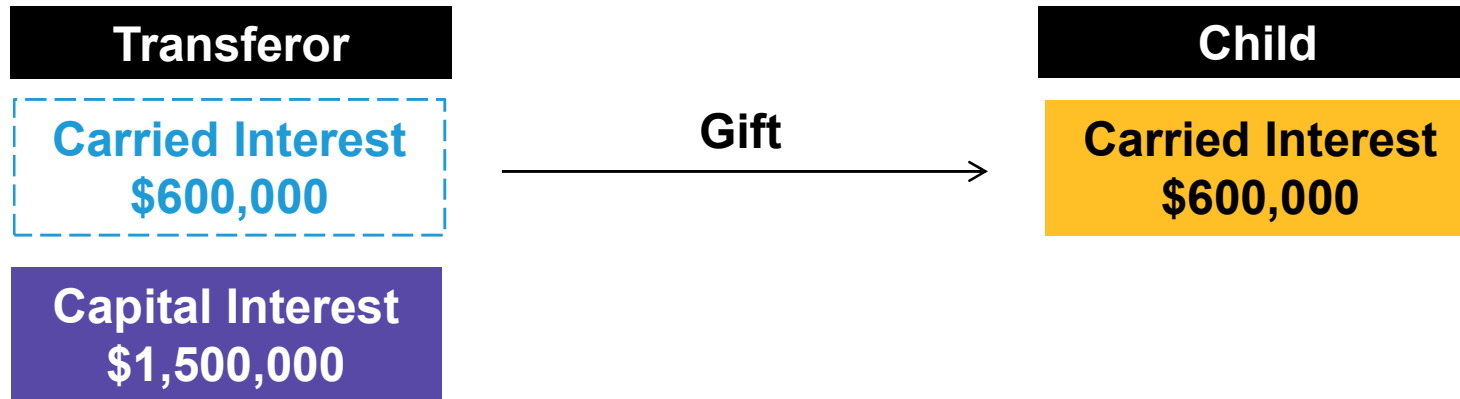
\*Treas. Reg. § 25.2701-1(a)(2)

†IRC § 2701(b)(1)

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Source: AB

## Example: Subtraction Method



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$$\begin{array}{|c|} \hline \text{Value of Transferor's Equity} \\ \text{Before Transfer} \\ \$2,100,000 \\ \hline \end{array} - \begin{array}{|c|} \hline \text{Value of Transferor's Equity} \\ \text{After Transfer} \\ \$0 \\ \hline \end{array} = \begin{array}{|c|} \hline \text{Value of} \\ \text{Gift} \\ \$2,100,000 \\ \hline \end{array}$$

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Source: AB

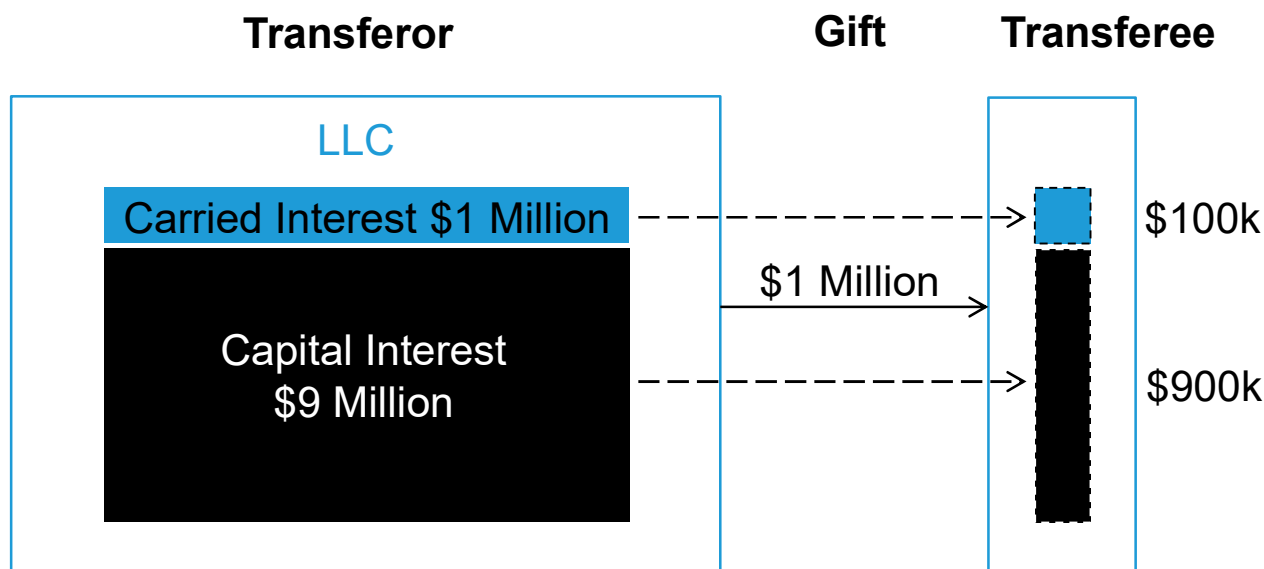


## When Does IRC Section 2701 Apply?

What is transferred?	An interest in a corporation or partnership from someone with an applicable retained interest
To whom?	Spouse, lineal descendants and spouses, or an applicable family member
Who is an applicable family member?	Ancestor or spouse of the ancestor of the transferor or the transferor's spouse
What is an applicable retained interest?	Any interest with a distribution right if the transferor holds control or there is liquidation, put, call, or conversion rights
What constitutes control?	50% or more of the capital or profits interest, or any interest as a GP

## Wealth Transfer Strategies—Vertical Slice Exception

- Section 2701 does not apply when the transfer consists of a proportionate share of all classes of equity interest (i.e., capital and profit interest).\*
- The most efficient way to accomplish a vertical slice is for the fund manager to transfer all their equity interests to an LLC. The fund manager can then gift a portion of the LLC.
- A vertical slice may still have significant gift tax implications since the LLC's valuation reflects both the carried interest and the relatively higher value of the capital interest.



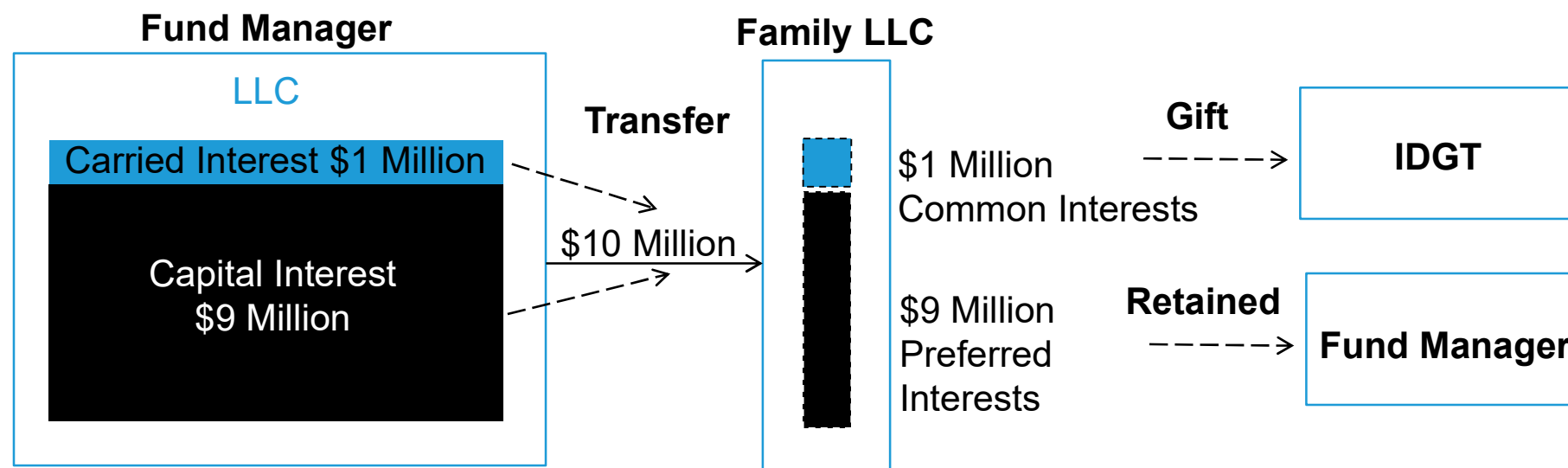
\*Treas. Reg. §25.2701-1(c)(4)

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Source: AB

## Wealth Transfer Strategies—Qualified Payment Right Exception

- Transfer all of the owner's GP interests to a LLC or other holding entity in exchange for preferred and common interests
- Then transfer the common interests of the new LLC to or for the benefit of family members, and retain the preferred interests.
- If the retained preferred interest confers a "qualified payment right" on the holder within the meaning of Section 2701(a)(3)(B), then owner's transfer of the common interests should not be subject to the special valuation rules of Section 2701.



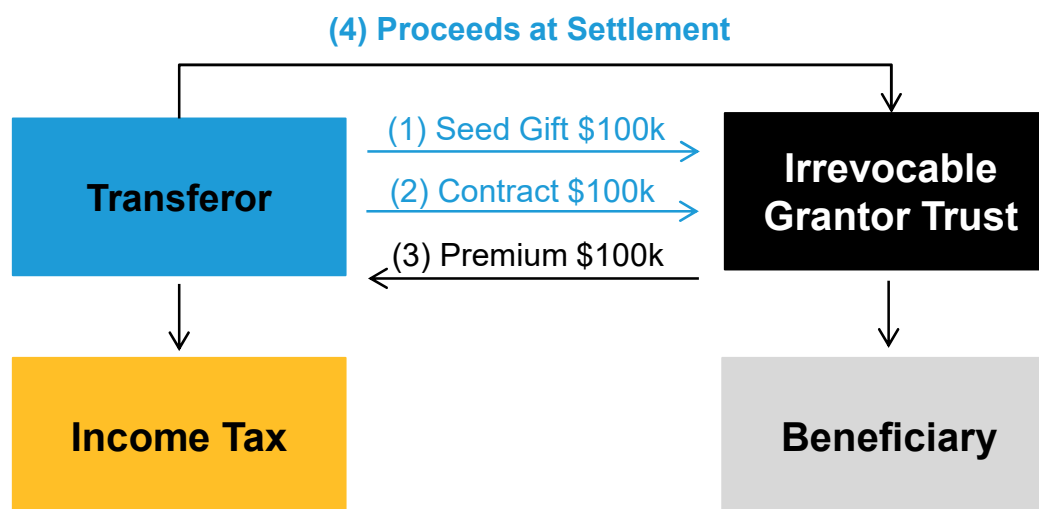
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Source: AB

# Wealth Transfer Strategies—Private Derivative Contracts

- Private derivatives do not require the actual transfer of the carried interest, eliminating any Section 2701 implications.
  - Transferor establishes an irrevocable grantor trust (IGT) with an initial gift of cash.
  - Transferor creates a derivatives contract with the IGT, whereby the Transferor agrees to make future payments to the trust based on the fair market value of the carried interest.
  - In exchange, the IGT pays a premium to the Transferor equal to the present value of the payment rights.
  - The Transferor makes any required payments to the IGT upon settlement.



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Source: AB

## Wealth Transfer Strategies—Private Derivative Contracts (cont'd)

- The contract may include a hurdle and cap to control the amount of wealth transferred.
- The fair market value is determined by a qualified appraiser and is a function of the hurdle amount, the fund's volatility, interest rates, and the contract term.
- The contract's term is generally a fixed date or the transferor's death, whichever occurs first.\*
- Double taxation may result if the irrevocable grantor trust becomes a non-grantor trust before the settlement date of the contract.
- In a series of private letter rulings, the IRS has ruled favorably on private derivatives used by charitable remainder trusts (CRTs) to avoid unrelated business taxable income (UBTI).†
  - **PLR 201408034**—The IRS ruled that a university endowment, with investments in real estate and other Unrelated Business Taxable Income (“UBTI”) producing investments, could issue private derivatives contracts with payment rights based on the performance of an investment portfolio managed by the endowment to CRTs the endowment controls without triggering UBTI within the CRTs (UBTI is subject to a 100% tax rate for CRTs).

\*Treas. Reg. § 20.2053-1(d)(4)(i); Estate of Bailly v. Commissioner, 81 T.C. 246 (1983); Estate of Graegin v. Commissioner, T.C. Memo 1988-477

†PLRs 201408034, 201311036, 201218015, 200711037, 200711034, 200711025, 200704036, 200352019, 200352018 and 200352017

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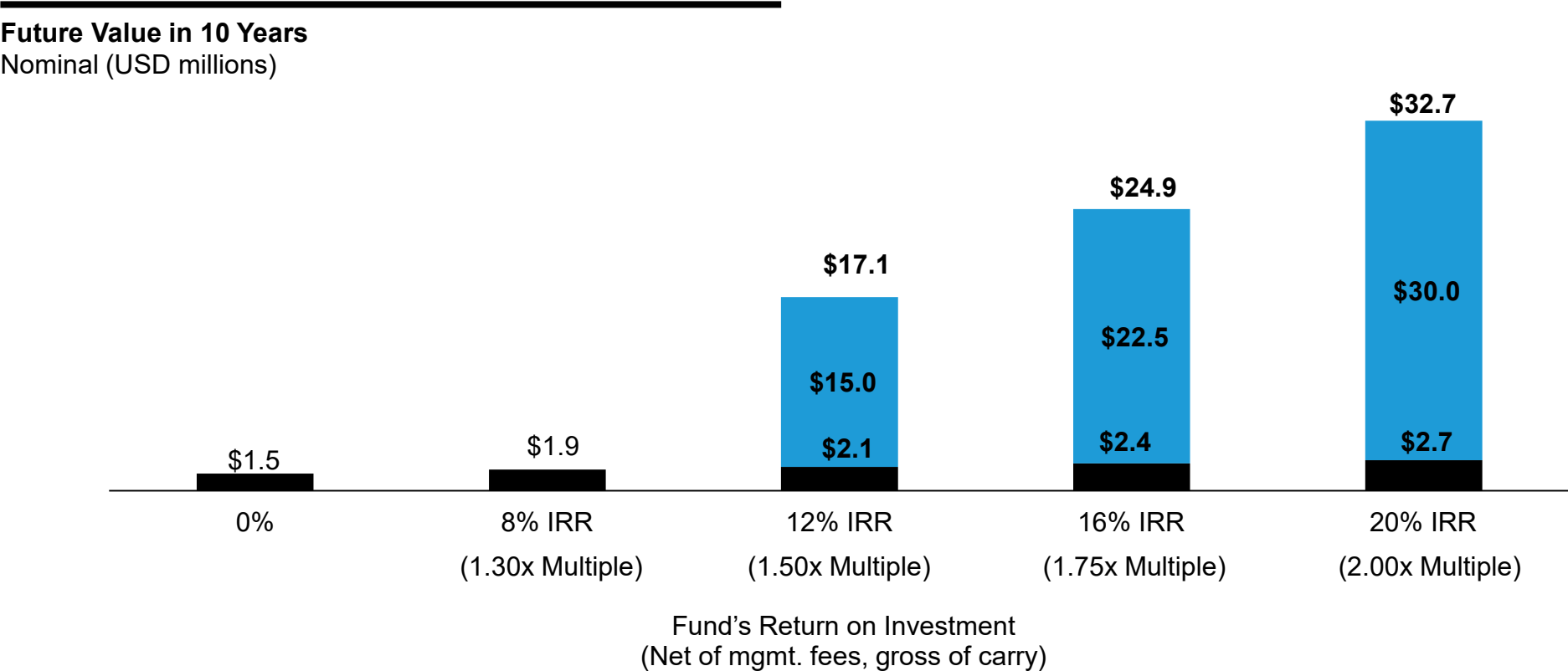
## Case Study: HENRY

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- Fund Committed Capital – \$3 billion
- Henry's Capital Interest – \$1.5 million (5% of GP interests)
- Carried Interest Appraised Fair Market Value – \$600,000
  - Preferred Rate for LP interests – 8%
  - Profit Interest (with GP Catchup) – 20%

For illustrative purposes only.

# Henry's Share of Capital and Carried Interests



Carried Interest % of Assets	0%	0%	88%	90%	92%
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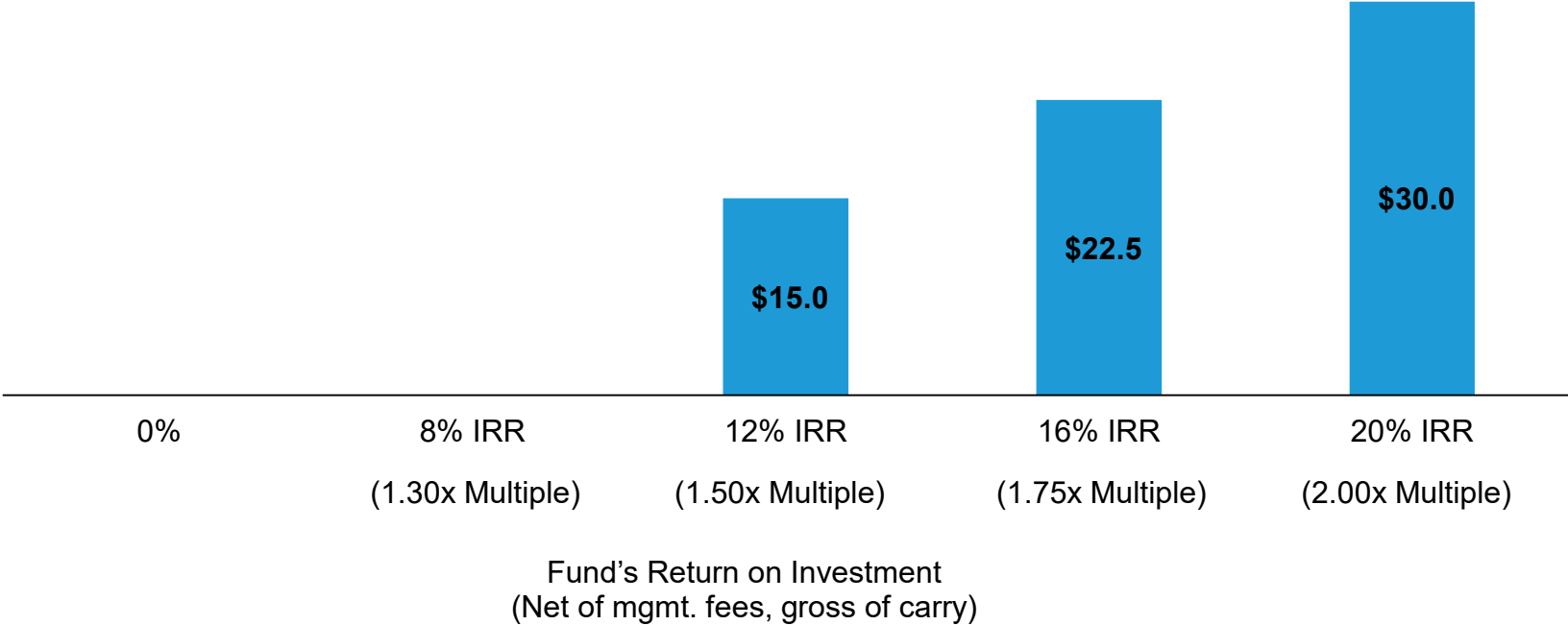
\*Multiple reflects multiple of total value paid in. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice.  
Source: AB

# If Henry Can Transfer His Carried Interest Outside of His Estate...

Initial valuation of carried interest is \$600,000

## Future Value in 10 Years

Nominal (USD millions)



Estate Tax Savings*	-\$0.2	-\$0.2	\$5.8	\$8.8	\$11.8
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\*Multiple reflects multiple of total value paid in. Assumes 40% estate tax on indicated values from carried interest, which further assumes other assets utilize the full remaining applicable exclusion amount. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. Source: AB



# Income Tax Liability on Transferred Assets Must Be Considered

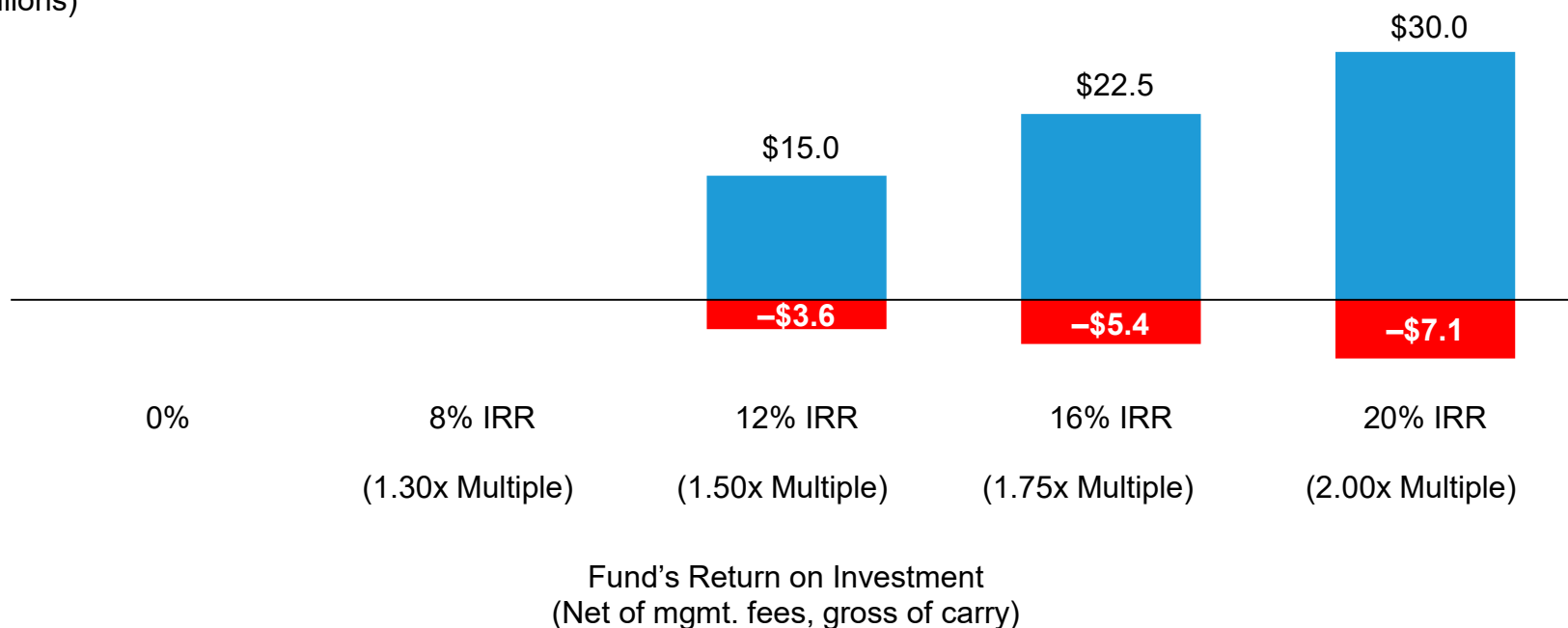
100% of Henry's carried interests

## Future Value of Gift in 10 Years

Nominal (USD millions)

■ Gift Interests

■ Income Tax\*



**Did Henry Keep Enough Assets to Pay the Income Tax on Behalf of the Grantor Trust?**

\*Multiple reflects multiple of total value paid in. Income tax reflects federal capital gains tax of 23.8%. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice.

Source: AB

# Gift of Pro-Rata Vertical Slice—29%

Valuation of gift is \$600,000

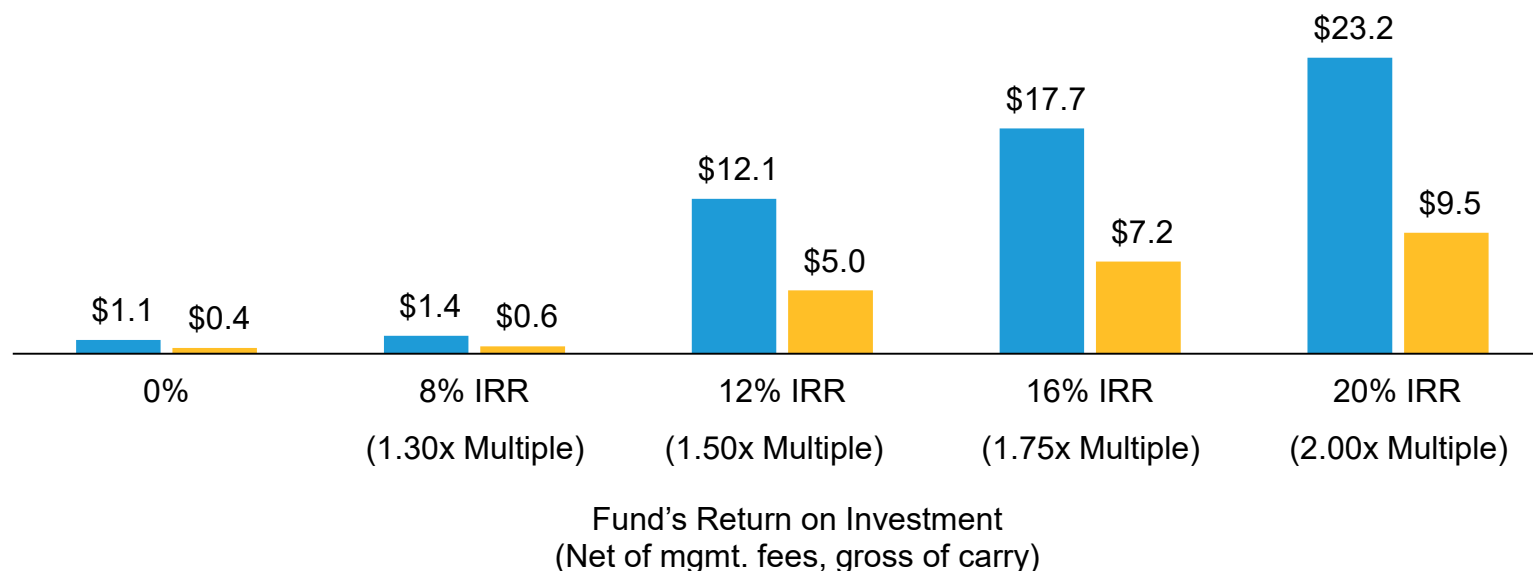
## Future Value in 10 Years

Nominal (USD millions)

■ Retained Interests

■ Value of 29% Gift

29% of all  
GP Interests  
(includes capital  
and carry interests)



Estate Tax Savings\*  
(29% gift)

-\$0.1

\$0.0

\$1.7

\$2.6

\$3.5

Gift Efficiency  
Multiple\*

0.7x

0.9x

8x

12x

16x

\*Multiple reflects multiple of total value paid in. Assumes 40% estate tax on indicated values from carried interest, which further assumes other assets utilize the full remaining applicable exclusion amount. The Gift Efficiency Multiple is defined as the estimated future wealth transfer value divided by the appraised value of the initial gift. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. Source: AB

# Qualified Payment Rights with Preferred Interests and Common Interests

## Preferred Interests and Common Interests

- Establish LLC and split interests into preferred and common
  - Preferred have a 8% preferred return
  - Common receive any additional return in excess of the 8% preferred return
- Initial value of common interests is \$600,000
- Make a gift of 100% of the common interests to an irrevocable grantor trust
  - Value of gift \$600,000 (common interests to irrevocable grantor trust)
- Returns generated in excess of the preferred return are owned by the common interests
  - 100% of the common interests are owned by the trust

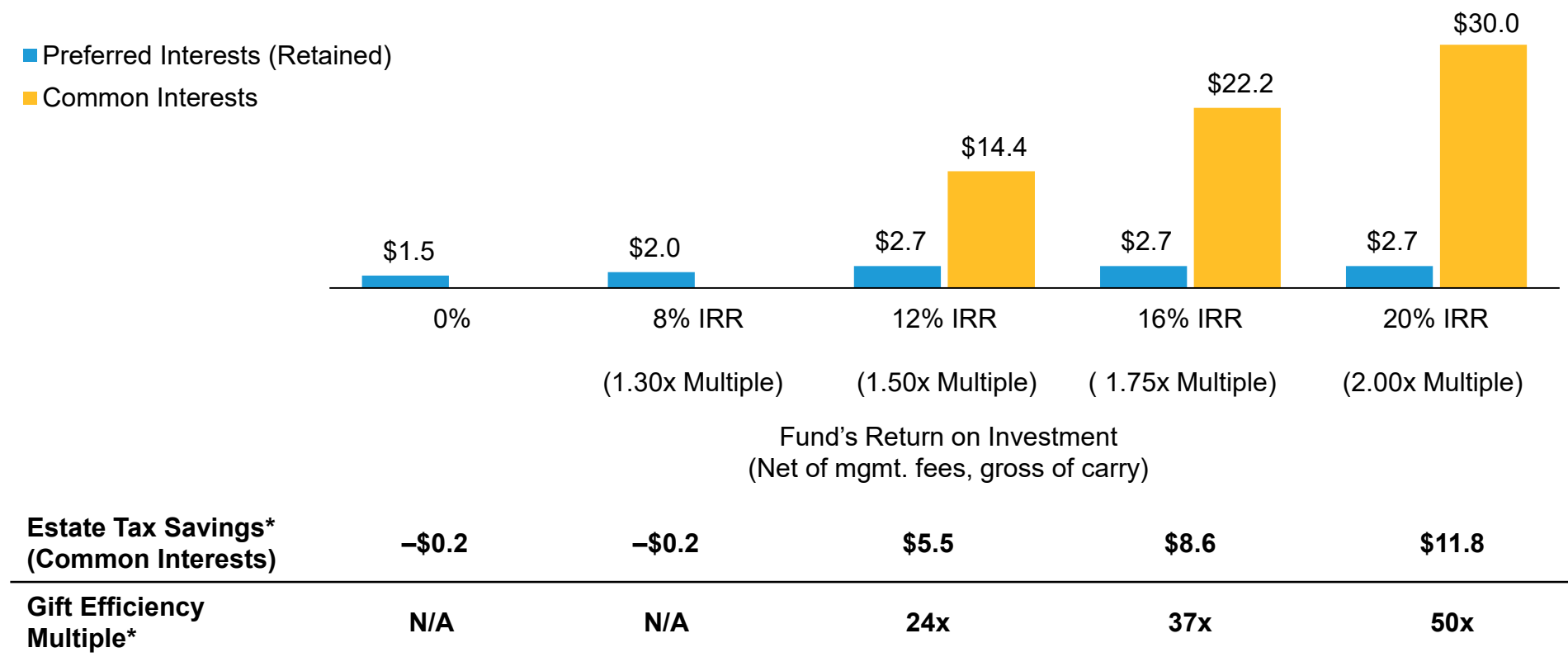
Source: AB

# Preferred Partnership with Qualified Payment Right

Valuation of gift is \$600,000

## Future Value in 10 Years

Nominal (USD millions)



\*Multiple reflects multiple of total value paid in. Assumes 40% estate tax on indicated values from common interests, which further assumes other assets utilize the full remaining applicable exclusion amount. Gift Efficiency Multiple is the future gift value divided by the initial value of the gift. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. Source: AB

# Private Derivative

## Preferred Interests and Common Interests

- Trustee of Heir's trust (IDGT) purchases private derivative contract with owner of carried interest. Derivative is designed to appreciate in line with carried interest value.
- Owner of carried interest agrees to make a cash payment upon settlement date equal to the distribution value of 100% of the carried interest
- Initial value of derivative is appraised to be \$500,000
- In exchange for the future payment right, the trustee makes a \$500,000 premium payment to the transferor

# Private Derivative

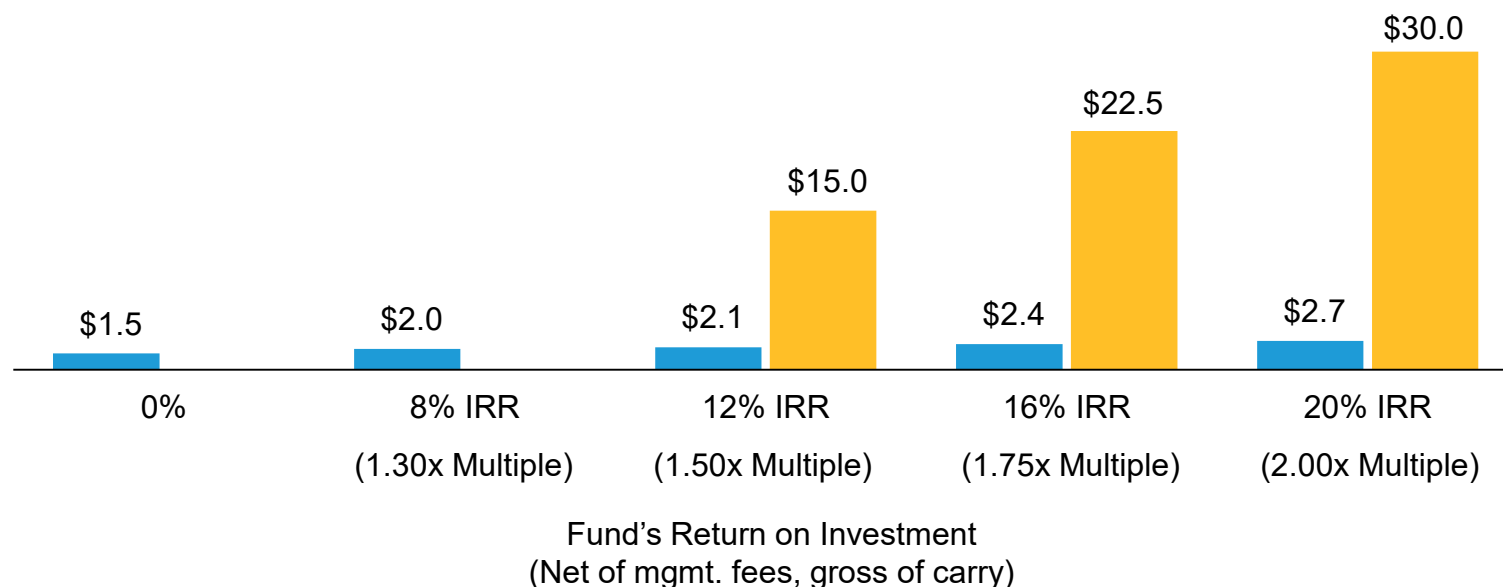
Valuation of gift is \$500,000

## Future Value in 10 Years

Nominal (USD millions)

■ Retained Interests

■ Private Derivative



**Estate Tax Savings\*  
(Derivative)**

-\$0.2

-\$0.2

\$5.8

\$8.8

\$11.8

**Gift Efficiency  
Multiple\***

N/A

N/A

30x

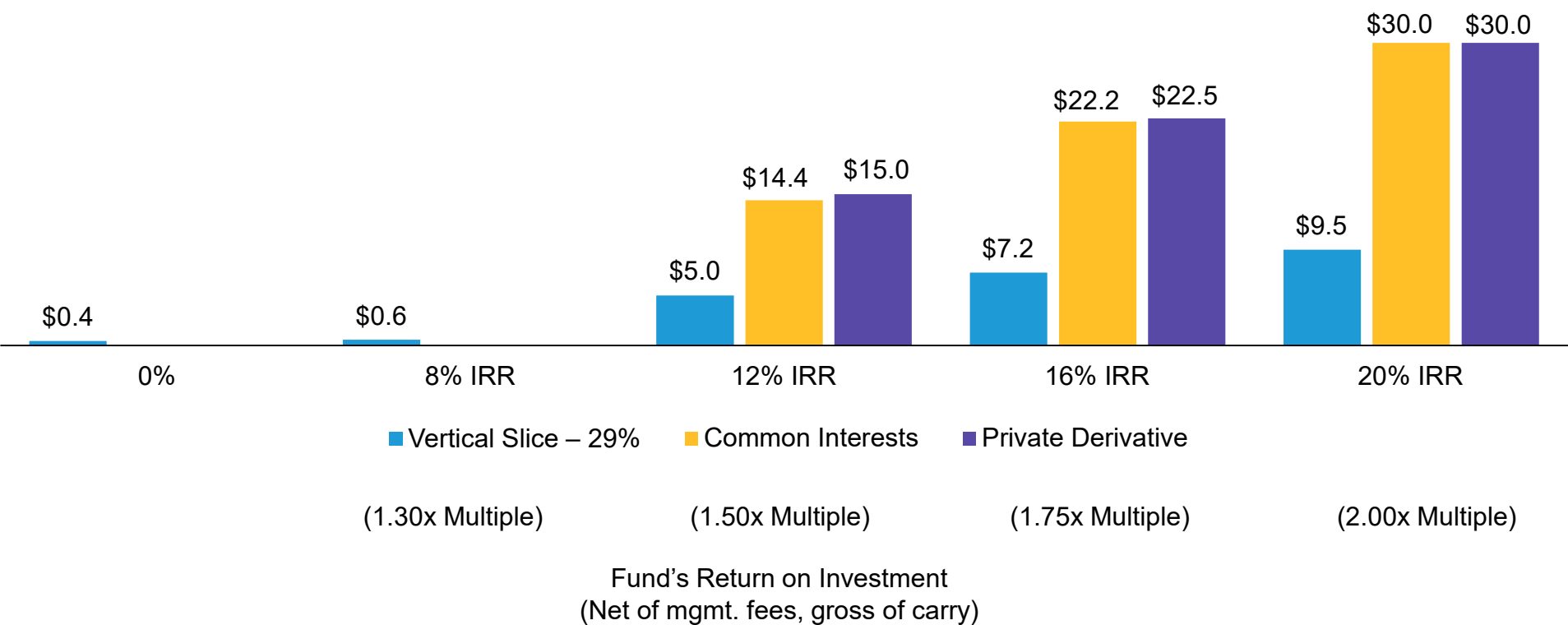
45x

60x

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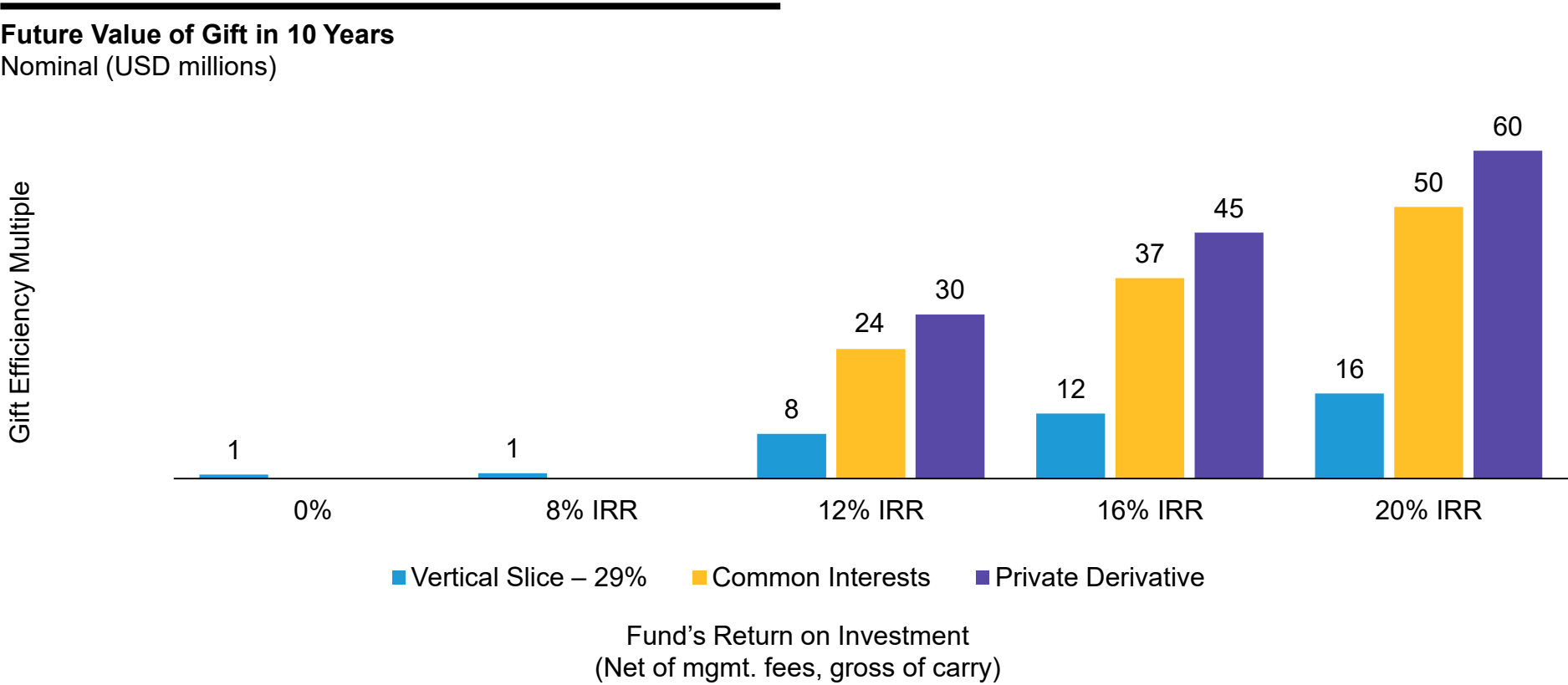
# Comparison of Projected Wealth Transfer

**Future Value of Gift in 10 Years**  
Nominal (USD millions)



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# Comparison of Strategies—Gift Efficiency Multiple



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# Preferred Partnership with Qualified Payment Right—90% Preferred

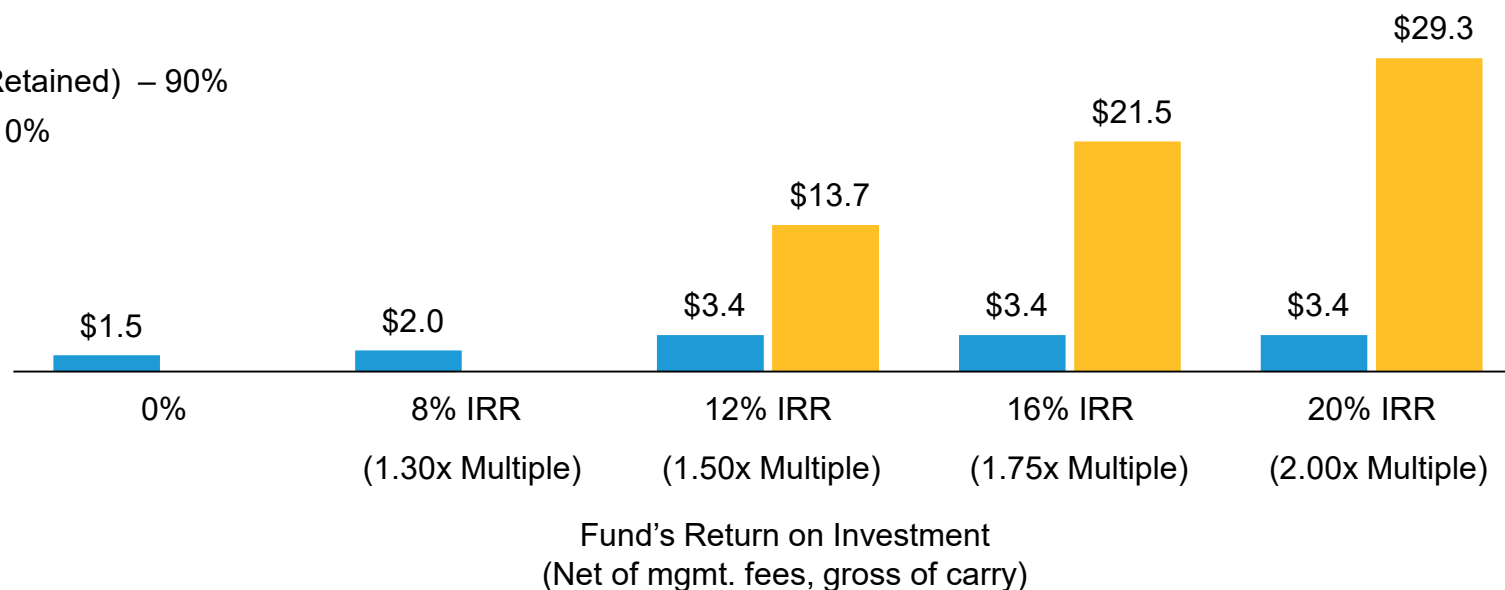
Valuation of gift is \$210,000

## Future Value in 10 Years

Nominal (USD millions)

■ Preferred Interests (Retained) – 90%

■ Common Interests – 10%



**Estate Tax Savings\*  
(Common Interest)**

–\$0.1

–\$0.1

\$5.4

\$8.5

\$11.6

**Gift Efficiency  
Multiple\***

N/A

N/A

65x

102x

140x

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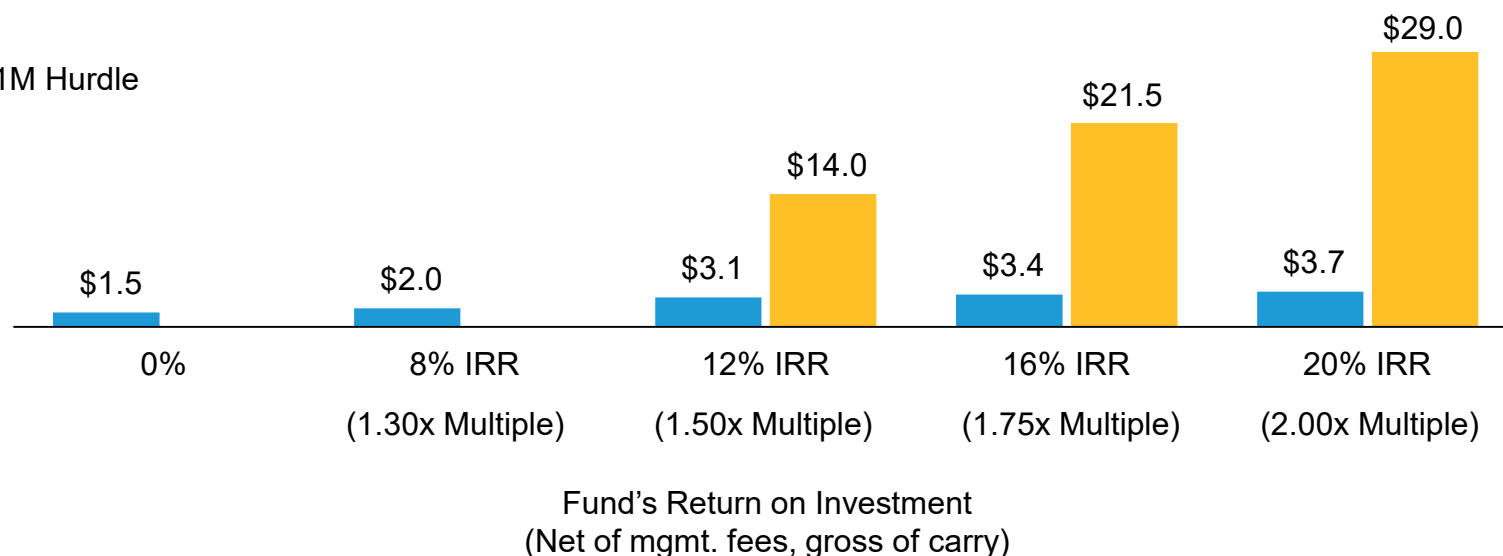
# Private Derivative—With \$1 Million Hurdle

Valuation of gift is \$200,000

**Future Value in 10 Years  
Nominal (USD Millions)**

■ Retained Interests

■ Private Derivative w/\$1M Hurdle



**Estate Tax Savings\*  
(Common Interest)**

-\$0.1

-\$0.1

\$5.5

\$8.5

\$11.5

**Gift Efficiency  
Multiple\***

N/A

N/A

70x

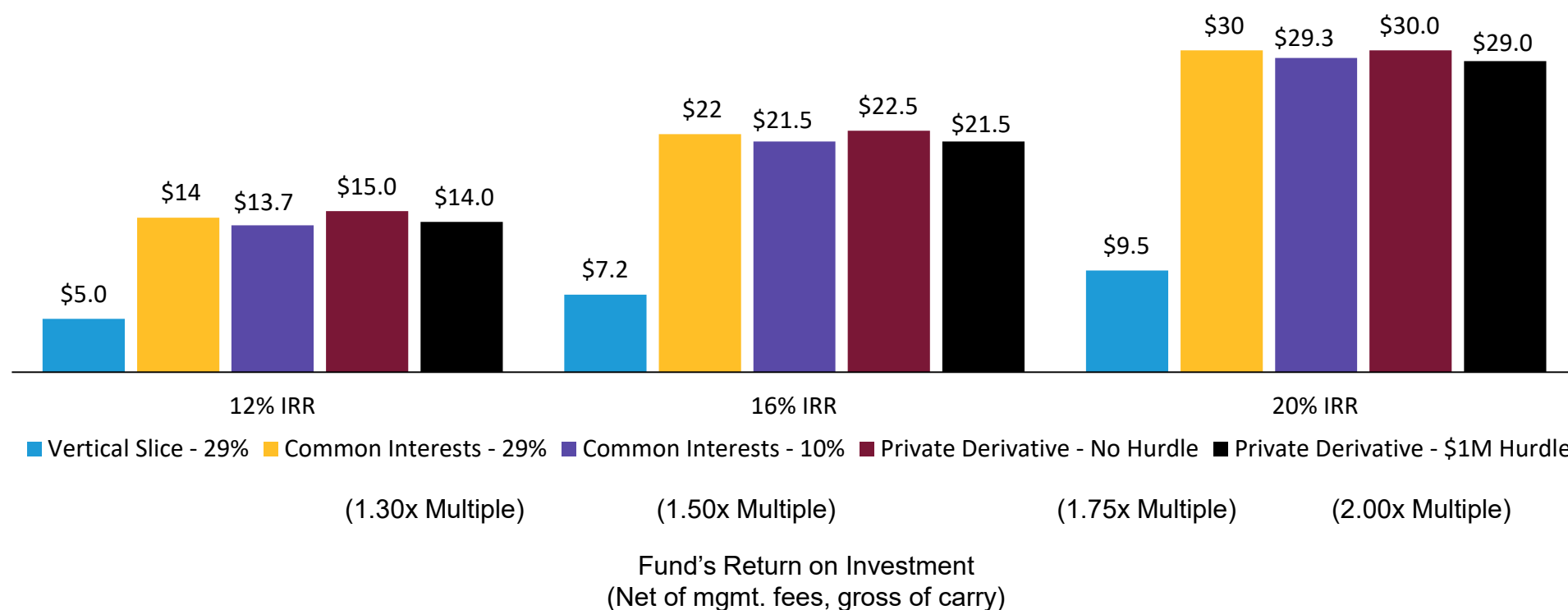
107x

145x

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# Impact of Structure Changes

**Future Value of Gift in 10 Years  
Nominal (USD Millions)**

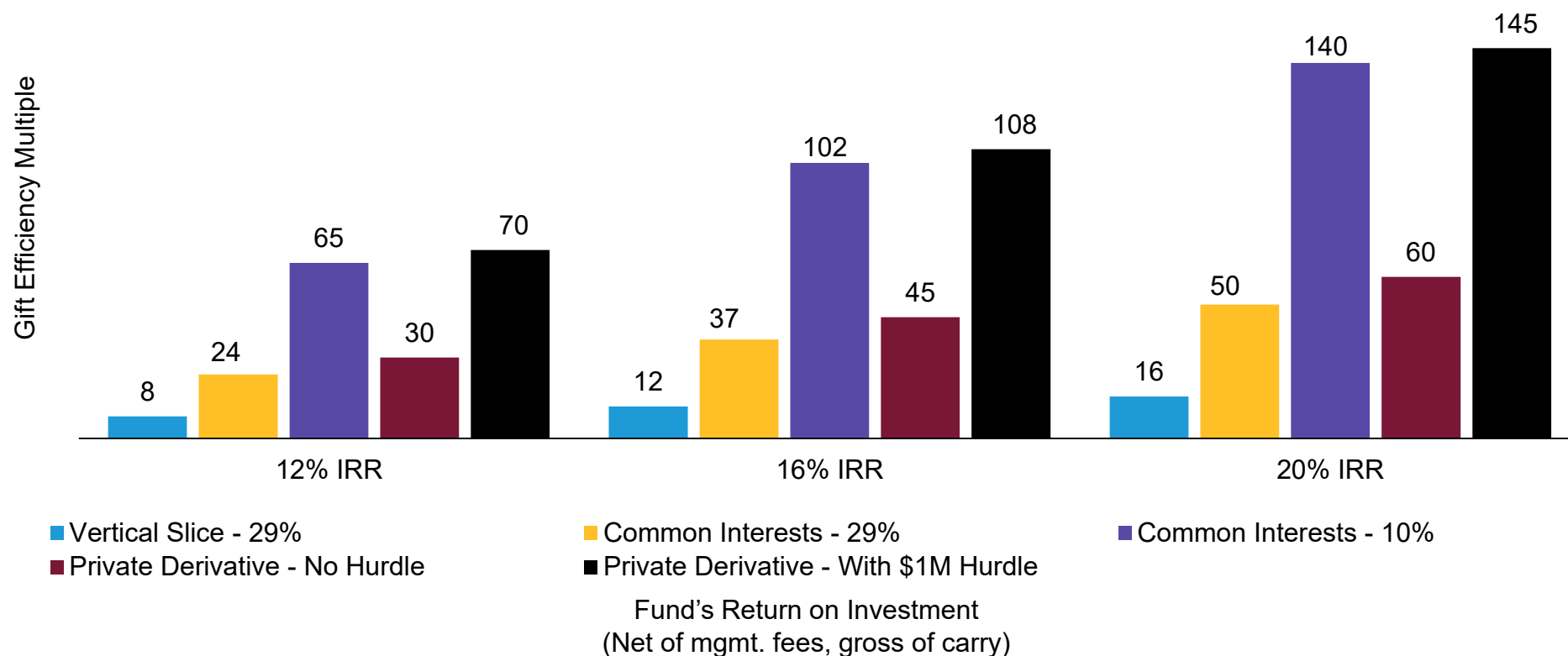


\*Multiple reflects multiple of total value paid in. Assumes 40% estate tax on indicated values from carried interest, which further assumes other assets utilize the full remaining applicable exclusion amount. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. Source: AB

# Comparison of Strategies—Gift Efficiency Multiple

## Future Value of Gift in 10 Years

Nominal (USD millions)



\*Multiple reflects multiple of total value paid in. Assumes 40% estate tax on indicated values from carried interest, which further assumes other assets utilize the full remaining applicable exclusion amount. Gift Efficiency Multiple is the future gift value divided by the initial value of the gift. For illustrative purposes only. Data does not represent past performance and is not a promise of actual or range of future results. Bernstein does not provide tax, legal, or accounting advice. Source: AB

## Key Takeaways

- Carried interest is an extremely attractive asset for wealth transfer.
- The commonly accepted Vertical Slice method is safe, but lacks efficiency relative to other strategies.
- The preferred partnership strategy with qualified payment right can be almost as effective as transferring the carried interest by itself, but avoids Section 2701 and avoids transferring the carried interest outside of fund manager's control.
- The derivative strategy can be as effective as transferring the carried interest itself, without transferring the carried interest at all. However, legal questions remain due to lack of specific guidance.
- The Gift Efficiency Multiple can be used to help evaluate the relative efficiency of the strategy.

Source: AB

# Key Takeaways

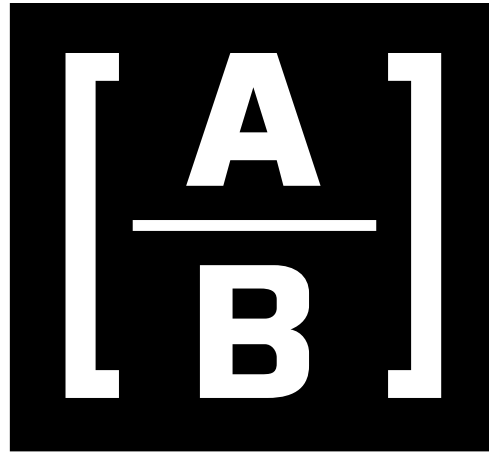
## Before transferring, gifts should be sized and forecasted per client to:

- Ensure client retains access to at least their full CORE CAPITAL—the amount they will conservatively need to fund lifetime spending needs.
- Account for future taxes on transferred interests to grantor trusts —this could mean structuring the retention of beneficial exposure to at least 24% of the carry as follows:
  - Preferred partnership—gift no more than 76% of the common interests
  - Derivative—structure the derivative formula to be worth 76% of the value of the carry
- **Forecast** the long-term family wealth impact from the transfer strategy to confirm and quantify its long-term benefit—after the carried interest is successfully transferred, the resulting wealth outside the estate could continue to grow tremendously over the following 20+ years!

Source: AB

## Disclosures and Important Information

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