



Perspectives October 2024



KEY CONSIDERATIONS IN THE VALUATION OF CARRIED INTEREST FROM A TAX PERSPECTIVE

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With the arrival of a new administration in 2025, the ramifications of tax reform are a hot topic for certain players in the investment management industry. In particular, investment fund general partners and managers and their valuation professionals will be taking a keen interest in values ascribed to a financial vehicle called “carried interest” or, simply, “carry” when making near-term tax planning decisions.

Introduction

Estate tax planning, financial reporting, and litigation are the main circumstances where a valuation of carried interest may be required. For purposes of this article, we are focused on the valuation of carried interest for estate tax planning, although the valuation approaches considered for such planning may be the same for the other aforementioned areas.

The roots of carried interest date back hundreds of years, but the concept has become a stalwart in the modern-day financial sector with the rise of private equity, venture capital, and hedge funds (as well as real estate funds). Most simply, carried interest is a form of compensation to general partners and fund managers that represents a share of fund profits. It is typically calculated as a percentage of the investment gains above a specific threshold, known as the “hurdle rate” or “preferred return,” depending on the type of investment

fund. The theory behind the use of carried interest is that it aligns the interest of the fund manager with that of investors.

CARRIED INTEREST IS A FORM OF COMPENSATION TO GENERAL PARTNERS AND FUND MANAGERS THAT REPRESENTS A SHARE OF FUND PROFITS.

Overview of Tax Treatment

From a tax perspective, the treatment of carried interest as capital gains versus ordinary income has long been



a subject of debate. Under U.S. Internal Revenue Code Section 1061, carried interest on investments held longer than three years is subject to capital gains tax rates, which are lower than ordinary income tax rates. Outside the U.S., the tax treatment of carried interest varies by jurisdiction.

Many oppose tax treatment of carried interest as long-term capital gains, because they believe the income is earned in the ordinary course of business for investment managers and provides an unwarranted tax break to already-wealthy fund managers and general partners. Supporters, however, contend that the current tax treatment is justified and view carried interest as akin to the equity that a business owner builds over time because of his or her business acumen and strategic decision-making. Either way, with potential tax reform looming, the issue of how carried interest is valued will be front and center for investment fund managers and, correspondingly, valuation professionals.

Valuation Considerations

U.S. tax code requires that carried interest be valued under the standard of fair market value. Fair market value is defined as “the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.”¹

Hence, when undertaking a carried interest valuation for tax planning purposes, the valuation professional must take the perspective of a market participant when developing the assumptions to be used in the analysis.

There are three generally accepted approaches to consider in any business or asset valuation: the income approach, the market approach, and the asset-based approach.

The income approach provides an estimation of the value of a business or asset based on the cash flow that the business or asset can be expected to generate over its life and is the preferred approach to use in the valuation of carried interest. The market approach values a business or asset based on comparison of the business or asset to comparable publicly traded companies or to transactions involving comparable businesses or assets. However, finding data on companies and transactions involving carried interest can be difficult, making this

approach less useful when valuing carried interest. The asset-based approach estimates the value of a business by adjusting the assets and liabilities on a subject company's balance sheet to fair market value and, practically speaking, is not relevant to apply in the case of carried interest.

In applying the income approach to value carried interest, three generally accepted methods are typically used: the option pricing method, the Monte Carlo simulation, and the discounted cash flow method.

The Option Pricing Method

The basis of this method is that the carried interest is like an option on the profit of the investment fund. The Black-Scholes option pricing model (“BSOPM”) is the tool most often applied under this method. The BSOPM is a mathematical formula that calculates the value of the option based on the current value of the asset, holding period, expected volatility, risk-free rate and exercise price.

THE VALUATION PROFESSIONAL MUST TAKE THE PERSPECTIVE OF A MARKET PARTICIPANT WHEN DEVELOPING THE ASSUMPTIONS TO BE USED IN THE ANALYSIS.

Given the ease of its application, that is, based on the need for only five simple inputs, the BSOPM can be useful in valuing carried interest. However, the drawback of this method also lies in its simplicity. That is, it relies heavily on market inputs rather than fund-specific data, which other methods use to estimate the value of carried interest.

Monte Carlo Simulation

The Monte Carlo simulation models the probability of thousands of possible outcomes, perhaps even more, for a fund's returns to estimate the value of the carried interest. Each simulation is based on randomly changing the key assumptions used to measure the fund's returns.



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In performing thousands of simulations, the valuation professional can generate a probability distribution from which a value for the carried interest can be derived.

The advantage of this model lies in its capability to synthesize a wide array of potential outcomes. But the method requires a high level of mathematical and modeling power, so the valuation professional must weigh whether the cost of performing a Monte Carlo simulation provides a better, more supportable answer than other simpler methods.

The Discounted Cash Flow Method

The discounted cash flow (“DCF”) method is a well-recognized technique used to value income-producing assets. It has intuitive appeal because it incorporates the risk/return perspective. It also has practical appeal as the underlying assumptions for the analysis are developed based on a fund’s historical data and can be corroborated with market observations.

Moreover, the use of the DCF method is transparent to a reviewer of the analysis and can be easily audited. As a result, in many cases, this method is the preferred method to use when valuing carried interest.

The DCF method estimates the value of a carried interest by projecting the carry’s expected future cash flow, or distributions, over the life of the fund and calculating the present value of the cash flow using a risk-adjusted discount rate.

The first step in the DCF method is the development of future cash flow for the carry over the life of the fund. This forecast starts with management’s expectation of the liquidation values for the assets held in the fund. Often, management will rely on an expected internal rate of return (“IRR”) for the fund, based on historical experience with similar funds, to develop the liquidation values. The valuation professional can look to publicly available market data on returns for investments in similar strategies to substantiate management’s expected IRR.

THE DCF METHOD ESTIMATES THE VALUE OF A CARRIED INTEREST BY PROJECTING THE CARRY’S EXPECTED FUTURE CASH FLOW, OR DISTRIBUTIONS, OVER THE LIFE OF THE FUND AND CALCULATING THE PRESENT VALUE OF THE CASH FLOW USING A RISK-ADJUSTED DISCOUNT RATE.



Once expected liquidation values have been developed, the second step in the process is to allocate the expected proceeds from the investments to the subject carried interest. Typically, the fund agreement contains a formula for this allocation (also known as the “waterfall”). In general, the carry begins to receive its distribution once the capital has been returned to limited partners in the fund and the preferred return, or hurdle rate, has been exceeded.

The third step in the DCF method is to discount the expected carried interest cash flow (after application of the capital gains tax rate) to present value using a risk-adjusted discount rate. The stage of the fund life cycle, timing of asset liquidations, and fund performance are all variables that create a high level of uncertainty around how much cash flow will be distributed to the carried interest, as well as when it will be distributed.

Quantitative methods used to develop discount rates, such as the capital asset pricing model (“CAPM”), may provide one data point for consideration; however, given the riskier nature of the carried interest compared to the businesses and assets traditionally valued using the CAPM, a higher discount rate is often warranted. Observable historical returns on private capital and other asset classes with risk profiles akin to carried interest may be more relevant to use as the primary basis for the discount rate. Best practice is to consider the facts and circumstances surrounding the subject carried interest, including its specific risk profile, and

develop an appropriate discount rate based on sound logic and support.

Conclusion

Given its compensatory purpose, carried interest has always been a key issue for investment fund general partners and managers. Over the next few years, the circumstances surrounding how carried interest will be treated by tax authorities likely will be revisited once again and potentially modified. Consequently, carried interest and, specifically, how its fair market value is calculated are certain to become areas of focus for fund managers and their valuation professionals.

As discussed above, there are three generally accepted methods valuation professionals use to value carried interest, each with certain advantages and no one method necessarily better than another from a technical perspective. That said, the method a valuation professional chooses should fit the structure and complexity of the specific carried interest being valued, be transparent in how it is applied, rely on inputs and assumptions that are defensible from a qualitative standpoint and be supported quantitatively, and be easily explained to users and reviewers of the analysis.

Reference:

- 1 Code of Federal Regulations, § 20.2031-1(b) and Revenue Ruling 59-60, 1959-1 C.B. 237.

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