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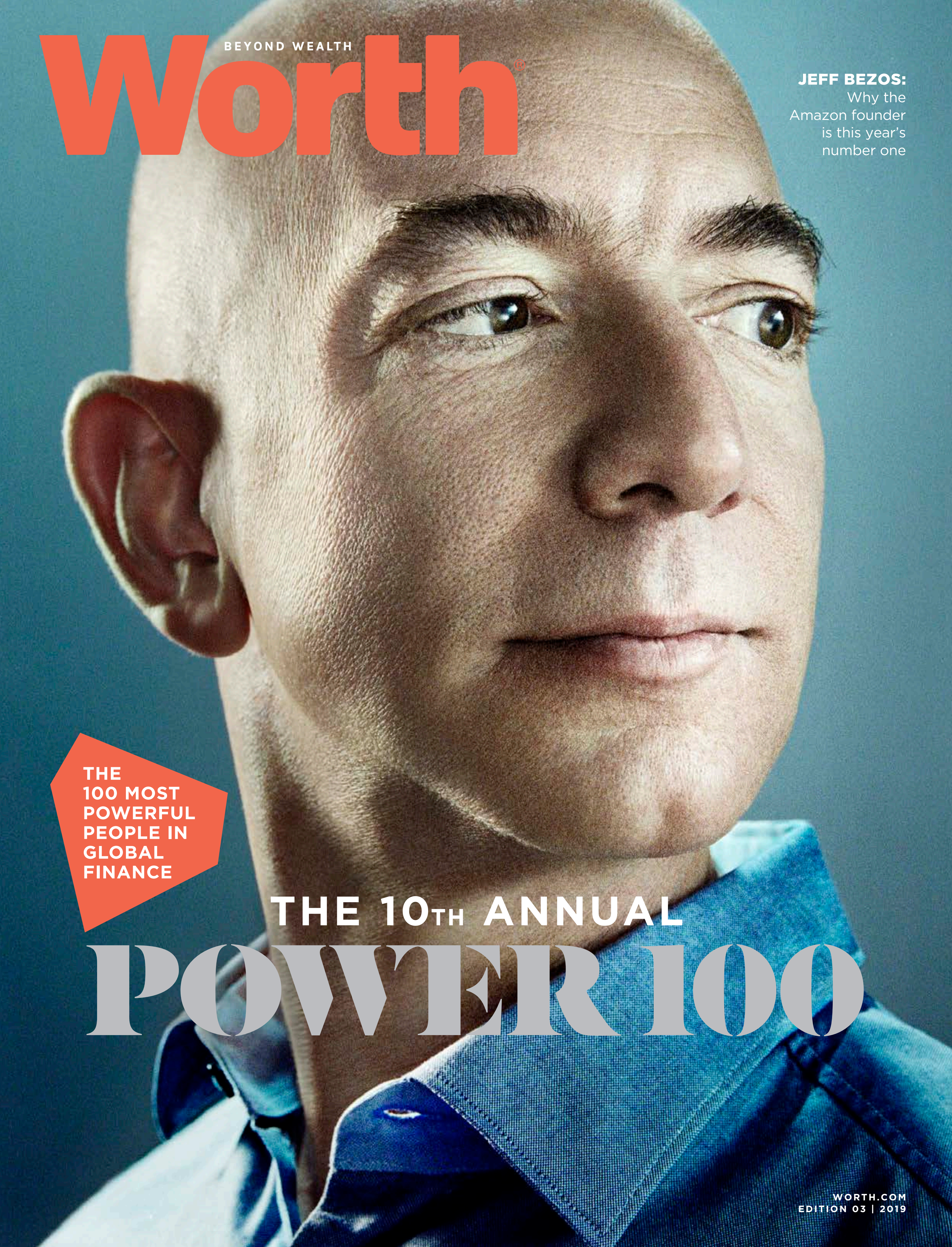

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Q:

How can private equity and venture capital partners and executives control liquidity risk?

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▶ **The fast-paced and demanding private equity and venture capital industries** can provide opportunity for significant wealth accumulation to partners and executives. Compensation packages typically consist of salary or guaranteed payments, bonuses and, most importantly, a share of fund-carried interest. Managing this complex compensation structure brings a unique set of challenges to these individuals and may expose them to significant risks. Most risks can be mitigated when anticipated and planned for in advance.

There are three areas of liquidity risk that private equity and venture capital partners are particularly susceptible to: unpredictable cash flow (having enough when it's needed); tax planning (avoiding unnecessary penalties and dealing with changing tax laws); and estate planning (providing for family in the event of death and paying estate taxes).

PLANNING FOR UNPREDICTABLE CASH FLOW

A key consideration is forecasting the timing of cash flows and expected compensation by building a baseline financial plan that is not overly dependent on projected future fund distributions and liquidity events. Outside of salary or draw, bonus payments and fund distributions will vary based on the long-term performance of the underlying portfolio companies. It is essential to establish personal financial goals, quantify them and prioritize cash flow given these constraints. Cash flow considerations should include maintaining liquidity for future capital calls and taxes and building a cash reserve for managing unexpected personal expenses.

PLANNING FOR COMPLEX TAXES

Income tax planning must account for all compensation. Partner income may have no tax withholding, requiring quarterly estimated tax payments to avoid penalties and interest. Tax withholding on cash bonus payments generally occurs at a flat statutory rate which, in most cases, will be lower than the individual's actual marginal tax bracket. Fund distributions carry their own unique set of tax characterizations. These may consist of partial return of capital, ordinary income and short- and long-term capital gains, all of which may be taxed at different rates. Long-term capital gains may be treated differently for federal and state tax purposes or may qualify for special tax rates or exclusions, including for qualified small business stock. At times, fund income to the partner may be taxable even though a cash distribution has not yet occurred. Estimated tax payments will almost certainly be required to avoid late-payment penalties.

Carried interest may vest over a period of years. Individuals should consider making a section 83(b) election at the time of fund formation in order to avoid taxation on the appreciated value of the carried interest at vesting. Failing to make this election at inception could result in significant taxes and strained cash flow.

Without properly understanding their complete tax picture, partners and executives may find themselves facing meaningful underpayment penalties, a surprise tax bill and a lack of available cash to cover their liability.

PLANNING FOR LIQUIDITY IN THE EVENT OF DEATH

Estate planning for private equity and venture capital partners can be complex. Liquidity is just one issue. Because fund interests are often tied up for many years, it is essential to ensure sufficient cash for the family through life insurance in the event of a premature death. In considering life insurance needs, it is important to understand the effect of a partner's death on his or her interest in the partnership and the investment funds. For partners with substantial accumulated wealth in their funds, permanent insurance may be required to provide the cash necessary to pay estate taxes.

The rewards for private equity and venture capital partners can be substantial. So too are the risks, especially if they are disregarded. Fortunately, with the right advice and expertise, executives can anticipate these obstacles and gain more control over their personal financial lives. ●

> “Without properly understanding their complete tax picture, executives may find themselves facing a surprise tax bill and a lack of available cash to cover their liability.”

PHOTO: NADINE GORDON LEE, STEPHEN R. STELLJES, ELISABETH L. TALBOT, CARY GELLER, MICHAEL NATHANSON

ABOUT THE COLONY GROUP

Founded in 1986, The Colony Group is an independent, fee-only financial advisory firm that seeks to provide peace of mind to clients. Its team of trusted experts delivers objective financial advice, striving to provide clients with the highest level of personalized service. The Colony Group works with high net worth individuals and families, corporate executives, athletes, professionals, entrepreneurs and institutions, providing deep expertise that goes beyond investment management. The firm's clients have access to a full suite of investment-management, institutional-consulting and financial-advisory services, including tax, estate, retirement and philanthropic planning, asset allocation and cash and risk management.

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