

Trust planning for carried interest: What it is and why it matters to your private equity or venture capital fund



Ann Lucchesi
Managing Director, SVB Access

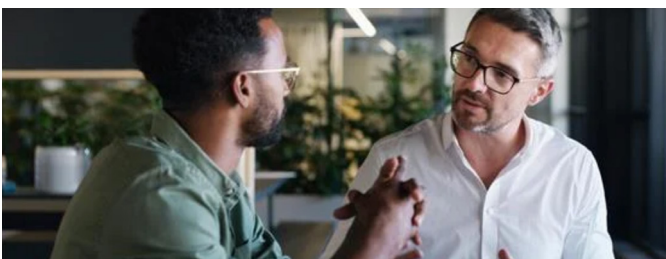
Key takeaways

- **Carried interest** can be difficult to value and highly speculative, but it can also be worth a tremendous amount, which makes it great for advanced estate planning.
- **IRS code** greatly restricts your ability to gift carried interest, but you can avoid running afoul of it.
- You can help benefit your fund's general partners by creating **vertical slices** and using **carry derivatives**.

Carried interest is a share of the profits earned from a private equity or venture capital fund's investments and is allocated to a fund's General Partners (GPs). It's a form of compensation provided to fund managers for their services. The share of the profits is provided once a predetermined minimum rate of return – a 'hurdle rate' – has been achieved.

While it's difficult to value and can be highly speculative, carried interest has the potential to be worth a tremendous amount. As an example, if a GP is part of a \$200 million fund with '2 and 20' structure that achieves a 2.5X return, the carry could be worth \$10 million to that GP. This makes it great for advanced estate planning – generational transfer and philanthropic planning alike – but it does come with certain limitations.

Section 2701 of the Internal Revenue Code greatly restricts the ability to gift carried interest to family members and still retain the underlying capital interest, or the amount committed by the GP to invest in the fund. This means that if a GP transfers their entire carried interest in the fund to their children, the entire interest, including the underlying capital investment shall be deemed to have been gifted.



The Value of the Vertical Slice

It is possible, however, to avoid running afoul of Section 2701 by creating a **vertical slice**. This is done by proportionately reducing each class of ownership interest in the fund.

For example, let's say your capital commitment is \$1 million and your carried interest is 20%. To gift half your carried interest, you must gift half the capital interest too. (Keep in mind that the giftee will be responsible for capital calls on the gifted portion if the fund requires additional capital.) Whether the gift is made directly to a trust or to an individual, it must be proportionate and will need to have an independent appraisal.

An easy way to manage the process is by putting the fund interests into a family limited partnership (FLP) or into a limited liability company (or LLC), and then transfer interests in the new entity. The gifts themselves can be made to either individuals or trusts that move the assets outside the estate. Before gifting, however, a valuation of the carried interest and capital must be done to determine the actual value of the gift; this can be costly and time consuming.

The Advantages of Carry Derivatives

Another creative strategy is to use **carry derivatives** for your estate planning. With a carry derivative, the contract amount determines how much will be paid into the fund at a future date. You can also stipulate a floor or hurdle return rate that must be exceeded before funds are due to the trust account.

1. While this can be an amazing estate planning tool, keep in mind the following:
2. Review the operating agreement of the fund to determine which transfers, if any, are permissible.
3. Borrowing against fund interests may be more challenging.
4. Vesting restrictions may have a different treatment by the IRS.
5. It may affect any management fee waivers that are in place.

Finally, remember to account for GP commitments paid after the time of the original gift.

To learn more, [speak to an SVB Private wealth advisor](#) today.

Important Disclosures

The views expressed in the article are those of the author and/or person interviewed and do not necessarily reflect the views of SVB Private, a division of First-Citizens Bank and First Citizens BancShares, Inc. This material is for informational purposes only, are subject to change and do not take into account your particular investment objective, financial situation or need. Since each client's situation is unique, you should consult your financial advisor and/or tax planning professional before acting on any information provided herein.

This material is for informational purposes only and is not intended to be an offer, recommendation or solicitation to purchase or sell any security or product or to employ a specific investment strategy. Silicon Valley Bank, a division of First-Citizens Bank & Trust Company ("SVB") does not represent, warrant or guarantee that this material is accurate, complete or suitable for any purpose or any investor and it should not be used as a basis for investment decisions. It is not to be relied upon or used in substitution for the exercise of independent judgment.

SVB, its affiliates, employees, SVB Wealth LLC investment adviser representatives and SVB Investment Services Inc. registered representatives do not provide, and nothing contained herein should be construed as, legal, tax or accounting advice. Prior to making any investment or financial decisions, an investor should consult their own legal and/or tax advisors for individualized advice that takes into account all of the particular facts and circumstances of an investor's own situation.

Investing involves risk, including the potential loss of money invested. Past performance does not guarantee future results. Asset allocation and diversification do not guarantee a profit or protect against loss.

The term "SVB Private" is the marketing brand name for the private banking, lending, brokerage and wealth management and investment advisory services offered by the following First-Citizens Bank & Trust Company divisions, subsidiaries, or affiliates: Silicon Valley Bank, a division of First-Citizens Bank & Trust Company, SVB Investment Services Inc., and SVB Wealth LLC. Each legal entity is subject to distinct regulatory requirements and certain products and services may not be available in all jurisdictions or to all client types.

[^]Banking, lending, and trust products or services are offered by Silicon Valley Bank, a division of First-Citizens Bank & Trust Company.

SVB Wealth LLC ("SVBW") and SVB Investment Services Inc. ("SVBIS") are wholly owned, non-bank subsidiaries of First-Citizens Bank & Trust Company. Neither SVBW nor SVBIS is a chartered bank, trust company or depository institution.

^{*}Wealth management and investment advisory services are offered through SVBW, an SEC-registered investment adviser. Detailed information on the services offered through SVBW is contained in the SVBW Form ADV Brochure which can be obtained at adviserinfo.sec.gov or from your SVBW investment adviser representative. Brokerage products and services are offered through SVBIS, a registered broker-dealer, Member [FINRA](#) and [SIPC](#). To learn more about SVBIS, please review the [SVBIS Client Relationship Summary](#).

There are important differences between brokerage and investment advisory services, including the type of advice and assistance provided, the fees charged, and the rights and obligations of the parties. For more information about these services and their differences, speak with your SVBW investment adviser representative. Not all products/services are offered by all investment adviser representatives of SVBW or registered representatives of SVBIS, and not all investment adviser representatives of SVBW are registered representatives of SVBIS.

Wealth management and investment advisory services offered by SVBW, and brokerage products and services offered by SVBIS are:

NOT FDIC INSURED • NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY • NOT BANK GUARANTEED • NOT A BANK DEPOSIT • MAY LOSE VALUE

All loans provided by Silicon Valley Bank, a division of First-Citizens Bank & Trust Company, are subject to underwriting, credit, and collateral approval. Financing availability may vary by state. Restrictions may apply. All information contained herein is for informational purposes only and no guarantee is expressed or implied. Rates, terms, programs, and underwriting policies are subject to change without notice. This is not a commitment to lend. Terms and conditions apply. NMLSR ID 503941.



©2023 First-Citizens Bank & Trust Company. All rights reserved. Silicon Valley Bank, a division of First-Citizens Bank & Trust Company. Member FDIC.