Moving Investment Operations to Puerto Rico: Tax Benefits for Hedge Fund and Private Equity Managers

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This article focuses on recently enacted Puerto Rican legislation and its implications for U.S.-based hedge fund and private equity managers, who otherwise face very high taxes on their offshore carried interest, which up till now had enjoyed favorable rates and tax deferral. The addition of Section 457A to the tax code has effectively ended a long era of deferred tax recognition of carried interest in investment managers' offshore funds. But with careful planning, a combination of an F reorganization and a move to a tropical island could help such fund managers find a new tax paradise.

Introduction

While the battles over the extension of the Bush tax cuts raged in Congress in 2012, the Puerto Rican government without much fanfare passed significant tax legislation which has the potential to radically change the tax landscape for hedge fund and private equity managers and other U.S. based service businesses.

As the budget sequestration continues and the prospect of a final budget proposal from Congress weighs in the balance, one of the items that remains pending is the change in the favorable tax treatment of carried interest. President Obama's Budget provides for such a change.[1] Proposals to change the tax treatment of carried interest have come and gone a few times over the years. The author has marveled at the private equity industry's lobbying success in the nation's capital. Following the most recent presidential election and the negative media attention to the low effective tax rate of presidential candidate

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[1] Budget of the United States Government, Fiscal Year 2014.

Mitt Romney as a result of this tax benefit for investment managers, however, this would seem to bes the end of the road for the carried interest tax benefit.

Some people may have already forgotten about the repatriation of the $200 billion offshore deferred compensation of carried interest that fund managers have enjoyed. Since the addition of Internal Revenue Code Section 457A, it has been a foregone conclusion to most managers and their advisors that taxes on this deferred compensation will have to be paid at substantial rates. Nobody seems to have the perfect solution to minimize taxation on the repatriated offshore funds. Most managers seem to be waiting until the dismal end, hoping that a tax miracle will fall out of the sky, or that some advisor will come up with a clever solution.

And perhaps there is a solution. The new Puerto Rican legislation has something to offer for both the repatriation of offshore deferred compensation as well as the tax minimization of management fees and carried interest on a going-forward basis. Like anything worthwhile in life, of course, it comes with strings attached—namely, managers will have to become Puerto Rican residents for tax purposes and run their investment management firms from Puerto Rico.[2] On one level the trade-off appears to be pretty small, considering that millions of dollars of taxation are at stake. On the other hand, everything in life is not about money and taxes, or is it?

This article will summarize the Puerto Rican tax provisions and evaluate some planning options for investment managers with respect to existing offshore deferred compensation of carried interest as well planning to minimize taxation going forward.

Puerto Rican Tax Basics

Two important pieces of legislation were passed by the Puerto Rican legislature in 2012. both the Export Services Act[3] and the Individual Investors Act[4] were signed into law by the Governor of Puerto Rico on January 17, 2012.

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[2] Recently a number of financial media outlets (including Bloomberg and the Wall Street Journal) published stories regarding the possibility of billionaire hedge fund manager John Paulsen becoming a Puerto Rican resident. Shortly after that, the same financial media outlets focused negatively on the formation of Bermuda-based reinsurance companies as a tax-motivated maneuver. See Katherine Burton, Stephanie Ruhl & Zachary R. Mider, "Paulsen Said to Explore Puerto Rico as Home With Low Tax" (Bloomberg Online, Mar 11, 2013), available at http://www.bloomberg.com/news/2013-03-11/paulson-said-to-explore-puerto-rico-as-home-with-low-tax.html; Juliet Chung, "Paulson Not Planning Move to Puerto Rico" (Wall Street Journal Online, Mar 15, 2013), available at http://online.wsj.com/article/SB10001424127887323393304578362173680040826.html.

[3] Act to Promote the Exportation of Services, Act 20 of 2012, P.R. [hereinafter the Export Services Act].

[4] Act to Promote the Relocation of Investors to Puerto Rico, Act 22 of 2012, P.R. [hereinafter the Individual Investors Act],

Puerto Rico is an unincorporated territory of the U.S., commonly referred to as a U.S. commonwealth. It is subject to most federal laws unless "locally inapplicable." The currency is the U.S. currency, and the banks in Puerto Rico are regulated by the U.S. Federal Deposit Insurance Corporation. No U.S. passport is required for travel to Puerto Rico for U.S. citizens. The definition of a U.S. person under Section 7701(a)(30),[5] however, does not include Puerto Rican entities. As a result, a Puerto Rican entity is not subject to U.S. income taxation unless the entity is engaged in a trade or business within the U.S. and its income is considered effectively connected income (ECI), or investment income that would be subject to a withholding tax under Section 871 with an exemption for portfolio interest under Section 881(a).

Under Section 933, bona fide residents of Puerto Rico who have Puerto Rico-sourced income are exempt from U.S. taxation.[6] Section 937 defines a bona fide resident for tax purposes.[7] A person is a Puerto Rican resident for tax purposes if the person is present in Puerto Rico for at least 183 days during the taxable year and he or she does not have a tax home outside Puerto Rico and does not have a closer connection to the U.S. or a foreign country than to Puerto Rico.[8]

Section 2209 provides that Puerto Rican residents are not subject to U.S. estate taxation at death providing the Puerto Rican resident acquired his or her U.S. citizenship by virtue of birth in Puerto Rico or naturalization as a U.S. citizen in Puerto Rico.[9] Puerto Rico administers its own estate and gift tax system which largely parallels the U.S. system, however. Hence, Puerto Rican residency will not allow hedge fund or private equity managers to avoid federal estate taxes on their U.S.-situs assets.

The Export Services Act. A businesses that relocates to Puerto Rico can significantly reduce its tax liability providing the Puerto Rican entity is not engaged in a U.S. trade or business. The top U.S. corporate tax rate is 35 to 40 percent for most corporations, assuming a federal rate of 35 percent and a state rate of 5 percent.[10] Under Puerto Rico's Export Services Act, the tax rate

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[5] References herein to Section(s) are to the Internal Revenue Code of 1986 (as amended) (the "Code" or "IRC"), unless otherwise specifically indicated.

[6] See IRC § 933.

[7] See IRC § 937.

[8] See IRC §§ 937(a)(2) , 911(d)(3).

[9] See IRC § 2209.

[10] See IRC § 11(b).

is 4 percent.[11] Additionally, shareholders who relocate to Puerto Rico will have a 100 percent exemption on corporate distributions.[12]

Under the Export Services Act, services that are directed to foreign markets may qualify as services the income from which will be eligible for the special tax rate. Services for foreign markets include services performed for non-resident individuals and businesses. In order to qualify as "promoter services" under the Act, the net income must be earned and service performed within the 12-month period ending on the day preceding the day the business commenced operations within Puerto Rico.[13] The term "eligible services" includes a wide range of service-oriented businesses from research and development to investment management.

A business (service provider) must request and obtain a tax exemption decree on or before December 31, 2020. The decree has a 20-year term and may be renewed for an additional 10 years providing certain conditions are met.[14] During the period of the exemption, the business will enjoy a 4 percent tax rate on its export services income and a 100 percent exemption on the distributions of earning and profits from the services income. The business will also be eligible for a 100 percent property tax exemption during the first five years of operation and 90 percent after the fifth year.[15]

Existing businesses that become eligible for benefits under the Export Services Act receive the special tax rate (4 percent) only on the portion of net income that exceeds the average net income for the three years preceding the request for a tax exemption decree. This aspect of the law is designed to prevent existing businesses from becoming tax exempt without a corresponding increase in economic activity in.[16]

The Individual Investors Act. Capital gains, interest, and dividends under the Individual Investors Act are not subject to Puerto Rican taxation.[17] Dividend income would still be subject to federal income taxation as would interest income unless the interest income is exempt under the portfolio interest exemption.[18] Long-term capital gains derived by the resident individual investor that (1) were deemed to have accrued before the individual became

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[11] Export Services Act, supra note 3, § 4.

[12] Id., § 6.

[13] Id., § 3(j), (e).

[14] Id., §§ 8, 9.

[15] Id., § 5.

[16] Id., § 4(c).

[17] Individual Investors Act, supra note 4.

[18] See IRC § 871(h); see also IRC §§ 881(c) and 871(a).

a Puerto Rican resident and (2) are recognized within the first 10 years after the date the individual becomes a resident, will be taxed at a 10 percent rate. The Puerto Rican legislature recently adopted a proposal to extend the favorable tax treatment to short-term capital gains, which should suit hedge fund investors very well.[19]

If the gains are recognized after the 10-year period but before January 1, 2036, the gains will be taxed at a 5 percent rate. Gains considered to have accrued after the investor becomes a U.S. resident will receive a 100 percent exemption. Dividend and portfolio interest income are exempt from Puerto Rican taxation under the new law.

Carried Interest for Hedge Funds and Private Equity Funds

Typical Fee Structure. The typical fee structure of a hedge fund provides for a 2 percent annual management fee and a twenty percent carried interest (incentive fee) based upon investment performance.[20] Section 702(b) provides as a general rule that the character of income included in the partner's distributive share is determined as if the item of income were realized at the partnership level.[21] The management fee is ordinary income to the general partner and is included in income as it is received on an annual or quarterly basis.

U.S. Tax Treatment of Carried Interest. When the general partner of a hedge fund or private equity fund receives a profits interest in the fund, the receipt is not treated as a taxable event.[22] Revenue Procedure 93-27 provides a safe harbor for most partnership profits interests, including carried interests. In order to qualify under the safe harbor, the profits interest must not relate "to a substantially certain and predictable steam of income from partnership assets such as income from high quality debt securities or a high quality net lease" and must not be disposed of within two years of receipt. Furthermore, the partnership must not be publicly traded.

Revenue Procedure 93-27 defines a capital interest as an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were then distributed in a complete

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[19] Jeanelle Alemar-Escabi & Edgar Rios-Mendez, "Investment Distribution: Puerto Rico New Tax Incentives to Lure Business and Individual Investment," Tax Mgm't Wkly. St. Rep. (June 1, 2012).

[20] Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," 83 NYU L. Rev. 3 (2008).

[21] See IRC § 702(b).

[22] Notice 2005-43, 2005-1 CB 1221.

liquidation of the partnership.[23] A profits interest is a partnership interest other than a capital interest. The determination as to whether an interest is a capital interest is made at the time the partnership interest is received.

The carried interest provides a timing benefit for general partners by allowing a deferral on their compensation as long as the compensation is structured as a profits interest and not a capital interest in the partnership. The treatment of carried interest as investment income rather than services income allows the character of realized gains to be capital rather than ordinary. The maximum long-term capital gain rate for a general partner in Silicon Valley could be as high as 37.1 percent versus an ordinary rate of 56.7 percent rate.[24]

Use of Deferred Compensation Arrangements for Offshore Funds. Domestic hedge funds typically taxed as pass-through entities and investment management firms that are the general partners or managing members have never able to defer the carried interest from domestic funds. However, investment management firms were able to enter into deferred compensation agreements with the firms' offshore funds. The offshore funds are normally taxed as corporations and are normally formed in a jurisdiction without any taxation.[25] This arrangement allowed investment management firms to defer the receipt of this carried interest income from the offshore hedge fund through deferred compensation arrangements between the investment management firm and the offshore hedge fund.

The arrangements were normally structured as back-to-back arrangements. The principals of the investment firm made deferral elections with respect to their portions of the compensation from the investment manager. The investment management firm made a corresponding deferral election with respect to a corresponding portion from the offshore fund. The principals

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[23] Rev. Proc. 93-27, 1993-2 CB 343.

[24] American Taxpayer's Relief Act of 2012, PL 112-240. The top marginal rate bracket, for personal income of $450,000 or more on a joint return is 39.6 percent. The new Medicare tax imposes a 3.8 percent tax on unearned income. The Medicare surtax adds an additional 0.9 percent for income greater than $200,000. The impact of the phase-out of miscellaneous itemized deductions and personal exemptions has the effect of adding an additional 2 percent approximately to the effective rate. The tax rate for long-term capital gains increased to 20 percent. The top marginal tax rate in California for personal income in excess of $1 million is 13.3 percent. Long-term capital gain income is also taxed at ordinary rates in California. Tax Foundation Online, State Individual Tax Rates 2000-2013, available at http://taxfoundation.org/article_ns/state-individual-income-tax-rates-2000-2013

[25] Walkers Law Firm, "Cayman Islands—Exempted Company v. Exempted Limited Partnerships" (summarizing Cayman Corporations Law and amendments in 2012), available at http://www.walkersglobal.com/Lists/News/Attachments/98/(Cayman)%20Exempted%20Companies%20v%20Exempted%20Limited%20Partnerships.pdf.

became entitled to deferred compensation from the investment firm. At that time, the investment manager paid the investment firm so that it could make its obligation to the principals.[26]

Private equity funds are usually closed end funds with an 8- to 12-year time horizon. Generally most of the income is long-term capital gain. As a result, the carried interests for private equity and venture capital general partners usually receive long term capital gain treatment.

Congress passed Code Section 457A to put an end to the unlimited IRA arrangement of fund managers. The discussion below outlines Section 457A and its requirements to repatriate offshore carried interest no later than December 31, 2017.

Section 457A—An End to Deferral for Offshore Carried Interest

The Emergency Economic Stabilization Act of 2008 ended the not-so-well-kept secret of hedge fund managers' deferred compensation arrangements with their offshore funds—what the *New York Times* described as "Big IRAs" for the super-wealthy.[27]

A reporter recently told the author that the estimated amount of offshore carried interest is in excess of $200 billion, based on a review of materials from the Joint Committee of Taxation.[28] The addition of Section 457A effectively ended the ability of investment managers to defer tax recognition of the carried interest in the investment manager's offshore fund. As noted above, under Section 457A, hedge fund managers must repatriate the offshore deferred compensation no later than December 31, 2017.

Substantial Risk of Forfeiture. In many ways, Section 457A is more restrictive than the deferred compensation rules of Section 409A. The definition of "substantial risk of forfeiture" under Section 457A covers only the performance of substantial services and not conditions related to the purpose of compensation such as performance conditions.[29] Section 457A provides

[26] Jonathan F. Lewis, "Private Equity and Hedge Fund Arrangements," ch. 18, *Section 409A Handbook* 611 (2010).

[27] Jenny Anderson, "Managers use hedge Funds as Big IRAs," N.Y. Times, Apr. 17, 2007, at A-1.

[28] The author received a phone call from a Bloomberg reporter recently to discuss planning strategies for hedge fund managers and offshore carried interest. During that call, the reporter indicated a source affiliated with the Joint Committee on Taxation indicating the amount of offshore carried interest as approximately $200 billion.

[29] Shane M. Tucker, "Deferred Compensation for the Employees of Tax Indifferent Private Equity Funds," 10 Hous. Bus. & Tax J. 298 (2010).

an exception for "gain recognized on the disposition of an investment asset" (frequently referred to as a side-pocket investment).[30]

Unlike Section 409A, deferred compensation subject to Section 457A cannot be structured in a way that provides for the proper deferral of compensation and the avoidance of adverse tax consequences. Section 457A requires the service provider to include in income deferred compensation on the first date that it is no longer subject to a substantial risk of forfeiture unless the compensation is not determinable on the vesting date.[31] If an amount is not determinable on a vesting date, taxation will not occur until the time that the amount of the deferred compensation is determinable but will be subject to an additional tax of 20 percent plus interest.[32]

Transitional Relief. Deferred compensation attributable to services performed before January 1, 2009, is entitled to 10-year transition relief. The deferred compensation must be included in income by the later of:

- The last tax year of "the nonqualified entity" beginning before 2018; or
- The taxable year in which the deferred compensation ceases to be subject to a substantial risk of forfeiture.[33]

For transition-relief purposes, a "nonqualified entity" is any foreign corporation unless substantially all of its income is (1) effectively connected with a U.S. trade or business or (2) subject to a comprehensive foreign income tax. Any partnership (foreign or domestic) is a "nonqualified" entity unless substantially all of its income is allocated to persons other than (1) foreign persons that are not subject to a comprehensive foreign income tax and (2) tax-exempt organizations.[34]

A foreign person will be considered subject to a comprehensive foreign income tax if the person is eligible for benefits under a comprehensive tax treaty with the U.S. An operating partnership will be a nonqualified entity under Section 457A unless its income is allocated directly to someone taxed in the U.S. or under a comprehensive income tax treaty.[35]

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[30] Lewis, supra note 26, at 627.

[31] Tucker, supra note 29, at 298.

[32] Id.

[33] Notice 2009-8, 2009-1 CB 347, Q&A 22.

[34] IRC § 457A(b)(1); Notice 2009-8, supra note 33, Q&A 6.

[35] Notice 2009-8, supra note 33, Q&A 6.

Minimizing the Taxation on the Repatriation of Offshore Carried Interest

Generally speaking, a U.S. commonwealth is on par with a foreign jurisdiction subject to a comprehensive income tax treaty.[36] The regulations pursuant to Section 457A do not address specifically whether an entity in a U.S. commonwealth such as Puerto Rico qualifies as a domestic corporate subsidiary or whether a U.S. commonwealth can be treated as a foreign jurisdiction subject to a comprehensive foreign income tax.

Needless to say, the benefits for hedge fund managers may be two-fold. The investment management firm and the principals of the investment management firm may be able to minimize the taxation on the repatriated offshore carried interest by having the investment firm move to Puerto Rico, with the principals personally becoming Puerto Rican residents. The process might be easily achieved through an F reorganization—"a mere change in identity, form, or place of organization, of one corporation, however effected."[37]

F Reorganization Requirements. A valid F reorganization has several important requirements:

- ***Valid Business Purpose:*** All reorganizations must be motivated by a valid business purpose other than tax avoidance.[38] The taxpayer must be able to prove the existence of that business purpose. The reorganization must meet the economic substance test.
- ***Shareholders and Capital Structure of NEWCO:*** The shareholders and the capital structure of the new corporation should be absolutely identical to that of the existing corporation.
- ***Continuity of Business Enterprise:*** In general, there must be a continuation of the existing corporation's business in order to have a reorganization. The transferee corporation in a reorganization must either (1) continue the transferor's historic business ("business continuity") or (1) use a significant portion of the transferor's historic business assets in a business ("asset continuity"). Where the transferor has more than one line of business, the transferee must continue a

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[36] Tax Coordination Agreement between the United States of America and the Commonwealth of Puerto Rico December 31, 1988. Joint Committee of Taxation, Federal Tax Law and Issues Related for U.S. Territories, Before the U.S. Senate Finance Committee on May 15,2012, p.15.

[37] IRC § 368(a)(1)(F).

[38] Gregory v. Helvering, 293 U.S. 465 (1935), Treas. Reg. §§ 1.368-1(b), 1.368-1(c), and 1.368-2(g).

"significant" line of business.[39] In order to have a valid F reorganization, the continuity of business enterprise rules are even stricter than those set forth above. The business and the assets of the old corporation must continue substantially unchanged in the new corporation.

- ***Plan of Reorganization:*** One of the essential elements of any reorganization is the existence of a plan of reorganization. Treasury Regulation Section 1.368-3(a), describing certain information that must be filed with the tax returns of parties to the reorganization, provides: "The plan of reorganization must be adopted by each of the corporations parties thereto; and the adoption must be shown by the acts of its duly constituted responsible officers, and appear upon the official records of the corporation." The evidence must clearly show that the transaction was the result of a preconceived plan that existed at the time the transaction was undertaken.[40]
- ***Liquidation of the Existing Corporation:*** The existing corporation must be completely liquidated to comply with the F reorganization rules. However, a legal dissolution of the transferring corporation is not required. This is a subtle legal distinction but allows the parties to comply here with only a liquidation. However, prudence would dictate a complete dissolution in most cases.

Using an F Reorganization to Become a Puerto Rican Firm. Can it really be this easy to minimize taxation on the repatriation of the carried interest? Maybe so! Under an F reorganization, the investment management firm would merge into a new Puerto Rican corporation. The business of the enterprise would remain the same; the ownership structure would remain the same. The assets and liabilities of the new Puerto Rican corporation would be the same as those of the prior firm. Puerto Rican tax counsel even suggested that the corporation's Employer Identification Number (EIN) might remain the same.[41]

The significant consequence of the F reorganization is the tax rate of the repatriated deferred compensation payments. The rate of taxation would be 4 percent under the provisions of the Export Services Act—versus an effective rate of 52 to 55 percent for East Coast- and West Coast-based U.S. managers. Furthermore, personal funds from the repatriation of offshore carried interest could be reinvested within the firm's offshore fund and distributed as capital gains on a tax-free basis pursuant to the provisions of the Individual Investors Act.

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[39] Treas. Reg. § 1.368-1(d)(5).

[40] Mathis v. Comm'r, 19 TC 1123 (1953); Kind v. Comm'r, 54 TC 600 (1970), acq. 1970-2 CB xx; Simon Trust v. U.S., 402 F2d 272 (Ct. Cl. 1968).

[41] The author had a discussion with Puerto Rican tax counsel posing the question as to whether or not the taxpayer would even have change in its EIN. Puerto Rican tax counsel was of the legal impression that the EIN would not even change.

Not every decision is tax motivated in this life but when you have a deferred compensation payment of $50 million or $250 million or even $1 billion, the possibility of being taxed at a rate of only 4 percent is an enormous financial incentive. The idea of becoming Puerto Rican (for at least a few years) is not a bad trade-off compared to taxation at rates as high as 50 to 55 percent. No one would ever consider spending a few years in a tropical paradise that is part of the U.S. in order to preserve the "family fortune" as a prison sentence!

Under the theory of "getting down to business," a hedge fund manager might consider accelerating the repatriation of his offshore deferred compensation before December 31, 2017. Under some circumstances, Section 409A permits the acceleration of benefits through the termination and liquidation of the deferred compensation plan.[42] The following requirements are necessary to terminate and liquidate the deferred compensation arrangement:

- The termination and liquidation do not occur concurrently with a downturn in the financial health of the firm.
- The service recipient terminates and liquidates all agreements, method sponsored by the service recipient.
- No payments in liquidation of the plan are made within 12 months of the date on which the service recipient takes all of the necessary steps to irrevocably terminate and liquidate the plan.
- All payments are made within 24 months of the date the service recipient takes all of the necessary action to irrevocably terminate and liquidate the plan.
- The service recipient does not adopt a new plan that would be aggregated with the old plan.

In the event a hedge fund manager elected to become a Puerto Rican resident for tax purposes in August 2013, he could receive a lump-sum payment in December 2014 by terminating his Plan in November 2013.

The provisions of the new Puerto Rican legislation do not appear to require a minimum length of residence in order to secure the benefits under the Export Services Act or the Individual Investors Act. The critical necessity is meeting the requirements during the time period of repatriation of the offshore carried interest.

A New Era—Planning for Hedge Funds and Private Equity Firms Going Forward

The combination of the Export Services Act and Individual Investors Act is the perfect antidote for private equity and hedge fund managers to higher

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[42] Treas. Reg. § 1.409A-3(j)(4)(ix)(C).

taxation at both the federal and state levels. The U.S. tax environment is uncertain at best, with the real possibility of higher taxation. As discussed earlier, the likelihood of repeal of the favorable taxation of carried interest is extremely high. The number of hedge funds and funds-of-funds in the United States exceeds 5,000.[43] The number of private equity funds based in the U.S. is approximately 2,670.[44] The numbers represent a significant target base for the Puerto Rican government.

Private equity managers will find Puerto Rico extremely attractive. Under the Export Services Act, service fee income is taxed at only 4 percent. As a result, management fee income will be taxed at rates that are approximately 90 to 95 percent less than the tax rates for ordinary taxation in the U.S. Individually, the managers will be exempt from taxation on their personal investment income. Capital gains are not subject to taxation. Dividend income is also exempt under the Individual Investors Act.

The provisions of the Export Services Act create an incentive to emphasize an offshore fund in order to avoid effectively connected income (ECI) treatment on the investment firm's management activities with U.S. investors. Based upon the extremely low rates under the Export Services Act, there is no need to defer taxation.

The next section presents a detailed example to illustrate how these benefits might be incorporated by a U.S. hedge fund.

Example of the Strategy

Fact Pattern. Acme Investment Management, LLC, a Delaware LLC, is currently a New York-based hedge fund specializing in mortgage backed securities. The firm has $5 billion of assets under management primarily in Acme's offshore fund which is located in the Cayman Islands. The firms' assets under management have quadrupled in the last 15 years.

Acme's investment performance has been strong and consistent and has averaged 15 percent per year over the last decade and a half; the firm continues to attract new investor capital. Acme's fee structure includes a 2 percent management fee and 20 percent incentive fee.

The fund has 40 employees in New York. Principals John Smith, age 65, and Bob Jones, age 60, each own 50 percent of the investment management firm. John has $800 million in offshore carried interest that must be repatriated in 2017. Bob has $250 million in offshore carried interest. The arrangement is a back-to-back arrangement and has been in place since the beginning of operations.

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[43] Coalition of Private Investment Companies, available at http://www.hedgefundfacts.org

[44] Private Equity Growth Capital Council, available at http://www.pegcc.org/education/pe- by-the-numbers.

John and Bob both reside in New York City and each has a combined marginal tax bracket of 55 percent. Both principals are married and have grown children. The firm's gross revenues were 2012 were $225 million. Net profits were $115 million to the two principals.

The Problem. If John's and Bob's offshore carried interest is repatriated, it will be subject to federal, New York State, and New York City taxes at an effective rate of approximately of 53-55 percent. Additionally, the repatriated funds will ultimately be subject to a combined income and estate tax rate of approximately 86 percent.

The Solution. The principals decide to restructure Acme, creating a new investment management company based in San Juan. The new firm will serve as the investment manager for all Acme funds, and it is designed to qualify for special tax treatment under the auspices of the Export Services Act. There will continue to be a New York-based office that provides services to the new San Juan-based investment management firm.

The two entities complete an F reorganization. The Delaware LLC will merge into the new Puerto Rican LLC, Acme Investment Management. The ownership of the new Puerto Rican corporation is identical to that of the Delaware LLC. The assets and liabilities of the existing company transfer to the new company. The new Puerto Rican corporation retains the same Employer Identification Number (EIN) with the IRS.

John and Bob retain their New York City and Boca Raton residences but become Puerto Rican residents effective September 1, 2013. The two principals agree to reside in Puerto Rico for at least 183 days during the year—they will register to vote in Puerto Rico, and obtain a Puerto Rican driver's license. They move Acme's senior management with them to the new headquarters in San Juan. They will meet the closer connection test. The Smith and Jones families will each purchase a home in Puerto Rico, and each will consider Puerto Rico their tax home. The families will spend six months of the year on the mainland, visiting their children and grandchildren. (New York is only a four-hour flight from San Juan; Florida is even closer.)

Acme elects to terminate its existing deferred compensation program in 2013. The plan will make a lump sum payment to the new Puerto Rican firm in 2014, 13 months following the termination of the plan. The deferred compensation benefits will be taxed at 4 percent under the Export Services Act. The Puerto Rican corporation will reinvest the after-tax proceeds back into the Acme offshore fund. Under the Individual Investor Act, all of the investment income distributed to John and Bob will receive tax-free treatment.

Acme enjoys repeat investment performance in 2013 and 2014. The difference is that the net profits of $115 million per year in 2013 and 2014 will be taxed at 4 percent instead of 55 percent. The Puerto Rican relocation will enable John and Bob to save in excess of $500 million on the repatriation of their carried interest. Furthermore, the reinvestment of the proceeds will generate passive income that will be completely exempt from personal income taxation to a resident of Puerto Rico when distributed from the company or paid individually.

Concurrent Estate Tax Planning. John's and Bob's Puerto Rican tax residency does not extend any estate tax benefits. As a result, they each will need to consider the necessary tax planning to mitigate the estate tax consequences of the arrangement. Both have dynasty trusts established in South Dakota. Each considers the merits of a new split dollar arrangement between the trustee of each dynasty trust and the Puerto Rican corporation in order to leverage the benefits.

Each will use a frozen cash value private placement life insurance policy (PPLI), with second-to-die coverage. The policy cash value will be "frozen" at the initial single premium; the death benefit will be equal to 105 percent of the policy account value. Each taxpayer will be taxed for both income and gift tax purposes on the value of economic benefit using the life insurer's term rates for second-to-die coverage. The death benefit will increase each year by the investment growth within the policy plus 105 percent.

Based upon an initial single premium of $250 million, the initial death benefit for each of man is $262 million. Assuming a net return of 10 percent, the projected death benefit is $1.1 billion. The economic benefit for two 65 year old insureds in Year 1 is $3,000 for income and gift tax purposes. At age 80 (both alive) the economic benefit is $830,000 based upon a death benefit of $437 million. In the event of death, the death benefit in excess of the cash value ($1.1 billion) will be paid income and estate tax-free to each principal's dynasty trust.

Conclusion

As Congress prepares to change the tax treatment of carried interest, which will impact every investment manager—hedge fund, real estate, private equity and venture capital—the relocation of investment firms to Puerto Rico is a viable solution financially. The preferential taxation provides tax reduction possibilities that do not exist anywhere else. Furthermore, it may be the most practical way to deal with the onerous taxation on the repatriation of offshore carried interest and inability to defer carried interest going forward.

The Puerto Rican government has done a brilliant job creating financial incentives for businesses and high-net-worth individuals to move to Puerto Rico and become Puerto Rican residents. As this legislation was being considered, several members of Congress had raised concerns about Puerto

Rico's becoming a tax haven. The author's own view is that, based upon the heavy subsidization of the Puerto Rican economy over decades, this type of legislation to create economic incentives should serve as a guide to the federal government in overcoming the U.S. economic woes.

So far the programs have attracted approximately 10 high net worth families and one well known hedge fund manager married to a Puerto Rican native.[45] The programs have not been heavily marketed on the mainland by the Puerto Rican government, but the word will spread quickly as the personal and corporate tax burdens of hedge funds and private equity firms continue to increase.

Bottom line, the financial appeal for hedge fund managers to move to Puerto Rico is staggering. In spite of these incentives, however, investment managers (or, more likely, their spouses) may be put off by any foreign language and cultural differences and schooling choices in Puerto Rico. Needless to say, if you have visited cities such as Miami, San Diego, and San Antonio, the influences may be the same. The author might argue, facetiously, that there is more English spoken in Puerto Rico than in Miami.

[45] Lynnley Browning and Julie Creswell, "Puerto Rico Creates Tax Shelter in Appeal to the Rich" (New York Times Legal/Regulatory, Mar. 25, 2013), available at http://dealbook.nytimes.com/2013/03/25/puerto-rico-creates-tax-shelters-in-appeal-to-the-rich/?_r=1.