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# COULD THE LOSS OF CARRIED INTEREST DOUBLE YOUR TAX BILL? HERE'S HOW TO PROTECT YOURSELF WITH A BACK-UP PLAN.

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“Carried Interest” has moved from being an obscure tax term to being one of the few policy issues to be attacked by both candidates during the 2016 US Presidential debates. What is Carried Interest, the so-called “Billionaires Loophole”? What is the impact of its possible / probable demise on those who use this tax scheme? What can those who will be impacted by change do to prepare themselves to avoid the promised effects?

In this paper we will explore all of these questions and provide real world practical steps that those who generate Carried Interest can take to protect themselves from a pending doubling of their tax bills.

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OCTOBER 2016

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## 1) INTRODUCTION

What would you do if you were suddenly facing a doubling of your tax bill? Politicians and tax analysts who carry out ‘static analysis’ believe the answer is ‘nothing’. However in the real world, Newton’s Third Law of Physics prevails...”For every action, there is an equal and opposite reaction”.

This paper will examine a particular tax policy that both the 2016 Democratic and Republican Presidential candidates have vowed to enact, Specifically, the changing of the current taxation of “Carried Interest” as capital gains.

In the first part of this paper we will examine:

*-What is Carried Interest?*

*-Who generates Carried Interest?*

*-Why is Carried Interest under threat to be closed?*

*-If tax reform occurs, what would be the financial impact on those who currently generate Carried Interest?*

The second part of the paper will offer practical solutions for those who would be seriously impacted by a change in the tax treatment of Carried Interest. Specifically:

*-Lobbying;*

*-How to Play the Game Better: Reorganizing your financial affairs; and finally*

*-Being properly equipped to ‘Leave the Game’: Having the elements of a Back-up Plan in place to have the power to leave the US tax system permanently;*

The third part of the paper will give two case studies that demonstrate the practical steps that those who will be affected by the demise of Carried Interest can take to protect themselves.

## **2) WHAT IS CARRIED INTEREST?**

The concept of “carried interest” emerged during the Italian Renaissance and refers to a ship captain’s share of a voyage’s profit earned by their efforts. In the 1920’s, the US oil and gas industry adopted this concept to deal with a common situation where some partners put up capital, while other partners contributed ‘sweat equity’ by performing the actual daily work on a particular venture. When cashing out, the I.R.S. taxed all partner profits at capital gains rather than the higher ordinary income rates. In the 1950’s, Carried Interest was incorporated into the US tax code.

## **3) WHO GENERATES CARRIED INTEREST?**

Eventually US partnerships in real estate, venture capital, private equity and hedge funds adopted the concept of ‘Carried Interest’. While Real Estate and Venture Capital Partnerships may vary substantially in their ‘capital’ vs. ‘sweat equity’ division between partners, Private-Equity and Hedge Fund Partnerships have come to develop a more standard “2 and 20” model.

This involves the PE or HF partnership charging 2% of “Assets under Management” (“AUM”) for basic costs and then 20% (sometimes higher) of profits over a set standard “high water mark” for compensation if their sweat equity results in a profit for the partnership overall. This later payment (if success occurs) is then taxed at the long term capital gains rate, which is currently 15% for capital gains from \$37,651 to \$413,350 and 20% on capital gains above this threshold.

## **4) WHY IS CARRIED INTEREST UNDER THREAT TO BE CLOSED?**

During the 2008 fiscal crisis, the term “Carried Interest” went from an archaic industry term to Occupy Wall Street placards. Barack Obama promised to do away with what was termed “The Billionaire Loophole”. While legislation was introduced during both his presidential terms, it was not passed because of successful industry lobbying combined with an intransigent Congress.

Several elements have acted as catalysts to make the reform of Carried Interest taxation a centerpiece of the platforms of both 2016 Presidential candidates. First, the economic recovery of the last 8 years has been predominately painted by the media and politicians as overly favouring “the undeserving wealthy” and “increasing inequality”. Second, the idea that Congress could be bypassed through an Executive Order ending Carried Interest, gained credibility when leading tax authorities such as Professor Victor Fleischer stated early in 2016 that this was possible. Indeed, Professor Fleischer has recently become the Democratic advisor to the powerful Senate Finance Committee. Third, the surprisingly strong primary run of Senator Bernie Saunders ensured that carried interest reform was part of the Democratic platform. Finally, unanswered questions around Donald Trump and taxation may have prompted him to also promise to address what is, in the general voting public’s mind, considered a ‘poke in the eye’ of the middle class.

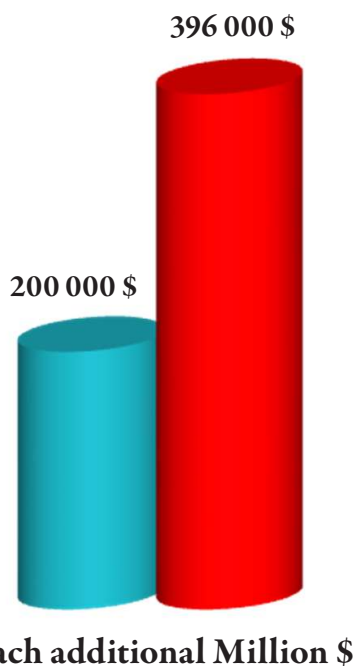
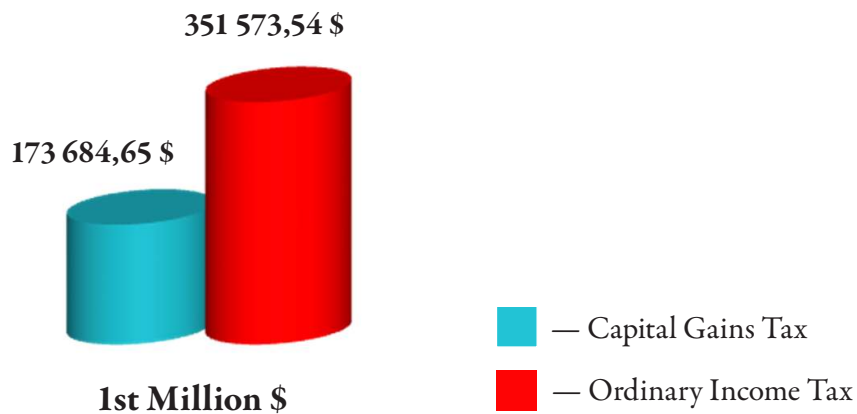
## **5) IF REFORM OCCURS, WHAT WOULD BE THE FINANCIAL IMPACT ON THOSE WHO CURRENTLY GENERATE CARRIED INTEREST?**

In considering any tax question it is essential to always remember the “Tax Equation”:

“Taxable Income” times “Tax Rate” equals “Tax Paid”

As previously noted, Carried Interest is currently taxed at the long term capital gains rates of either 15 or 20%. If the promised changes are made, Carried Interest would be taxed at the standard income tax rates of up to 39.6%. In the case of Ms. Clinton being elected the next President, she has promised the top normal income tax rate would be 46.3% and that certain limits would be made on current deductions which would increase the amount of taxable income which would be subject to this higher rate. The result is a minimum doubling of the tax bill for those who generate Carried Interest.

Although less clear, Mr. Trump's tax reform proposals could also see a massive increase in the tax paid by this same group.



Current tax paid at Capital Gains rate is \$173,684.65 on 1st. \$ Million of Carried Interest, \$200,000 on each million thereafter

Future tax paid at Normal Income rate is \$351,573.54 on 1st. \$ Million of Carried Interest, \$396,000 on each million thereafter

## 6) WHAT SHOULD THOSE WHO WOULD BE AFFECTED DO?

For those facing such a massive increase in taxation, there are practical and logical steps that should be undertaken:

**LOBBYING:** There are several industry trade groups that are engaged directly with Congress in trying to point out the long-term benefits of the current tax treatment of Carried Interest. These include the US Chamber of Commerce (<https://www.uschamber.com>), The American Investment Council (formerly “Private Equity Growth Capital Council” <http://www.investmentcouncil.org>) and the National Venture Capital Association (<http://nvca.org>). Contacting your industry association and seeing how to assist their lobbying efforts is a first step.

**PLAYING THE GAME BETTER:** While lobbying efforts have successfully fought off changes in the tax treatment of Carried Interest over the last eight years, there is significant reason to fear that lobbying will not prevail against the current tidal wave of populist sentiment. For this reason, it is wise for those who will be negatively affected to take steps to re-organize their financial affairs in the event lobbying is not able to stem the tide of legislation changing the rules of the game.

The inherent difficulty in trying to play the game better in relation to Carried Interest, is that one cannot predict the precise new rules which will emerge from the legislative process. This difficulty is compounded by the fact that often new tax legislation is effective from the date of its first introduction. Therefore one must try to anticipate which rules are most likely to remain in tax law and plan accordingly.

One of the most attractive strategies to consider implementing is to move the Carried Interest compensation into a Private Placement Life Insurance (“PPLI”) structure. The insurance industry’s congressional lobby is very strong and unlike Carried Interest there is not a current loud voice for change in the taxation of PPLIs. Currently income and gains within a PPLI policy roll up free of federal income tax and/or capital gains tax, creating a compounding benefit for investors. During the life of the policy, the policy owner has access to the cash value through withdrawals of capital treated as policy loans. Unlike a pension plan, where money is tied up until retirement, there is unrestricted access to the cash value within the policy. Finally the PPLI pays a tax-free death benefit to the beneficiary.

**C) CREATING A ‘BACK-UP PLAN’ TO BE ABLE TO ‘LEAVE THE GAME’:**

An ever increasing number of High Net Worth (“HNW”) Americans are taking the steps necessary to equip themselves with the necessary elements of the Back-Up Plan to enable them to leave the US tax system permanently, if they ever wish to do so.

**Americans who are securing their own Back-Up Plan fall into two categories:**

1) American citizens living in the US: These individuals want to have the security of knowing that they can leave the US tax system at any time of their choosing. The triggering of a Back-Up Plan involves a onetime overcoming of ‘life inertia’ and relocating to another jurisdiction, where they can reproduce their current business and personal lifestyle at a reduced global tax burden. If triggered, these individuals can still visit the US freely in the future. However they will need to limit their time in the US to less than 4 to 6 months (depending on whether they relocate to a tax treaty country). Whether one ever decides to overcome their personal life inertia and trigger this Back-Up Plan depends on such diverse factors as pending increase in tax that they feel is “unfair”; a desire for change from their current situation; or business or personal factors which make the new location more attractive than their present one. The decision to trigger a Back-Up plan may never come, but the presence of this option provides the holder with a sense of security; and

2) American citizens or resident aliens who are already living outside the US: These individuals have already established themselves in a situation that they find comfortable and want the ability to sever their future US income, capital gains, gift and estate tax. As with the first group, they will still be able to visit the US freely in the future, but must be careful not to spend an extraordinary amount of time there.

To give an American citizen the ability to “Leave the Game”, there are two key elements that must exist or be acquired:

**Element 1)** Second Citizenship other than the US: The US is unique amongst developed countries in taxing not only “residents” but also citizens who are not resident in the US. Therefore, in order to leave the US tax system it is necessary for the individual to have a second citizenship.



As was the case with Facebook co-founder Eduardo Saverin, naturalised Americans already possess another citizenship at the time they acquired US citizenship. As long as their original country of citizenship allowed dual nationality, they will still have their original citizenship.

Other Americans may be able to claim another citizenship through lineage or religious affiliation (e.g. Israeli Law of Return).

Those Americans already living abroad may already or soon be entitled to naturalisation in their current country of residence.

Finally, it is possible for American citizens who do not fit into any of these categories to acquire another citizenship through an 'Economic Citizenship' program. Countries which offer such opportunities have decided to accept an economic contribution in lieu of normal naturalisation requirements for properly screened, qualified applicants.

**Element 2)** new and suitable "Tax Home" outside of the US: In order for a New jurisdiction to be a suitable 'Tax Home', it must be one where the individual can reproduce their current personal and business lifestyle as they limit their future time in the US. Furthermore, through either legal pre-immigration tax planning or an existing tax regime, the new jurisdiction must have a tax burden which is less than the US burden to which the individual currently is subject.

While traditional 'tax havens' such as Monaco, Bermuda, United Arab Emirates and the Cayman Islands often leap to mind, it is also important to note that many countries which are considered, 'high tax rate' also attract new residents with greatly reduced tax burdens. This may be achieved through special tax regimes or through legal pre-immigration tax planning. The list of "High Rate/ Low Burden" includes, Canada, the UK, Portugal, Switzerland, New Zealand, Australia, Hong Kong and Singapore.

## 7) TWO CASE STUDIES

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## **Hedge Fund Manager Burt:**

### **Background**

- NYC native who relocated several years ago to Connecticut to avoid the NYC personal income tax;
- Operates a trading floor in Connecticut with 20 employees and offshore feeder funds in Cayman, etc.;
- Married with 4 school age children (from primary to entering college);
- Polish Jewish ancestry, parents left Poland when WW2 began;
- Personally open to renouncing US citizenship to realize significant tax savings but spouse and children are currently very emotionally entrenched in the US.

### **Proposed Back-Up Plan**

- Secure Polish citizenship through descent for the whole family;
- Consider applying for Israeli Aliyah visa;
- Open office in Hamilton, Bermuda as a functional satellite to Connecticut office; Secure residence in Bermuda;
- Organise financial affairs to minimize possible impact of Capital Gains Deemed Disposition as he will be a Covered Expatriate (<https://www.irs.gov/individuals/international-taxpayers/expatriation-tax>) if he triggers the Back-Up Plan; and
- Update succession planning so that every tax dollar saved could be available for strategic philanthropy.

### **Outcomes of the Back-up Plan**

This Back-Up Plan will allow Burt to be in a position to immediately renounce his US citizenship to realize significant tax savings. In addition, he will be able to easily commute between Bermuda and Connecticut or London without reacquiring US tax status. If necessary he can acquire a non-immigrant L-1 Visa to allow him to work while he is in the US. After 5 years he will be able to add a UK citizenship to his Passport Portfolio™.

It is worth noting that only Burt, and not his whole family, needs to trigger this

Back-Up Plan in order for him to leave the US tax regime behind. This means that the acquisition of a Back-Up Plan and the decision to trigger same are easier for Burt to sell at home.

### **Venture Capital Fund Manager Ernie:**

#### **Background**

- Senior Silicon Valley Venture Capitalist General Partner;
- Divorced with 2 adult children;
- Trying to move to life-split between business, philanthropy and personal athletic hobbies;
- No claim to citizenship elsewhere through descent or religious affiliation;
- Well-travelled with prior periods of residence outside of the US;
- Open to renouncing US citizenship to realise significant tax savings

#### **Proposed Back-Up Plan**

- Review various “Economic Citizenships” available with a view to acquiring best value (cost, speed, visa-free travel, residence rights) for his situation;
- Open a office in Vancouver as a functional satellite to Silicon Valley office;
- Secure a work permit followed by permanent residence in Canada;
- Organize financial affairs to minimize possible impact of Capital Gains Deemed Disposition since he will be a Covered Expatriate if he triggers the Back-Up Plan.
- At the same time, take advantage of pre-immigration tax planning to minimise or even avoid future Canadian income and capital gains tax. (It is worth noting that Canada does not have a gift, estate or wealth taxes);
- Update succession planning so that every tax dollar saved could be available for strategic philanthropy.

#### **Outcomes of the Back-up Plan**

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This Back-Up Plan will allow Ernie to be in a position to immediately renounce his US citizenship to realize significant tax savings.

In addition, he will be able to easily commute between Vancouver and San Francisco (2 hr, 20 min flight) without reacquiring US tax status by proper use of the Canada-US Tax Treaty and the Substantial Presence Test exemption for the days that he commutes from Canada (<https://www.irs.gov/individuals/international-taxpayers/substantial-presence-test>)

If necessary, Ernie can acquire a non-immigrant L-1 Visa to allow him to work while he is in the US. After 4 years he will be able to add a Canadian citizenship to his Passport Portfolio™.

## **8) CONCLUSION**

Clearly, those who are currently paying lower long-term capital gain rates on their Carried Interest should be worried about their future US tax burden should they be forced to pay normal tax rates. Prudence dictates that they should continue or start lobbying to stop change. However prudence also points to taking the practical steps of reorganising their financial affairs in light of likely change and to acquire a Back-Up Plan that gives them the option to “Leave the Game” should they decide this is in their long-term best interest. Compared to the looming future tax costs, taking these practical steps makes clear financial sense.

*Success depends upon previous preparation, and without such preparation there is sure to be failure.*

*Confucius*

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