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Tax Strategy as a Capital Allocation Consideration in Entrepreneurial Acquisition

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May 2023

IESE Business School
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> *"I think it's essential that we bring the subject of tax back to the fore: that we study, discuss and debate tax, as people did during the Enlightenment."*
>
> Dominic Frisby

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Disclaimer

Each of the tax programs discussed is highly complex, and anyone interested in pursuing these programs should consult with expert tax counsel.

Although the content of this paper has been reviewed by expert tax lawyers, specific personal or company circumstances may differ, and so may the tax implications. In addition, tax legislation is dynamic and may change at any time, for any reason. In general, anywhere that a declarative statement is made about US tax throughout this paper—"is," "will," or "does"—readers are encouraged to interpret that statement cautiously and conservatively as "may" or "could."

As is custom in tax white papers, the authors of this paper, nor the publishing institution, assume any responsibility for its content.

TABLE OF CONTENTS

Introduction

The 2022 Stanford GSB Search Fund Study reports that, since 1986, search funds in the Unites States and Canada have generated approximately $9.8 billion for their investors and $2.4 billion for the entrepreneurs managing them.[1] Assuming the reported gains were subject to US federal capital gains taxes, search fund investors and entrepreneurs have paid approximately $2.1 billion and $504 million in federal capital gains taxes, respectively.

Capital allocation decisions, such as taking on additional debt or equity financing to accelerate organic or inorganic growth, issue dividends, or repurchase shares, are some of the most important decisions a CEO and their Board of Directors (BoD) can make. In this technical note, we argue that tax optimization is another important tool in the capital allocation arsenal, one that must be considered pre-launch. We further argue that search funds create positive social impact by creating jobs[2] and economic growth and that optimizing an entrepreneurial project's tax strategy is an exercise that unequivocally creates a positive social impact, especially because the rationale for the tax schemes is to foster employment and opportunity.

We examine three key pieces of tax legislation that allow eligible operating companies in the United States to legally reduce their capital gains and/or corporate tax burden at the federal level: 1) the Economic Opportunity Zone program (EOZ), 2) Section 1202 Qualified Small Business Stock exclusion (QSBS), and 3) Puerto Rico's Act 60 Incentives ("Act 60").

First, we model the potential impact of the EOZ and QSBS programs on search fund companies and on the funds returned to both investors and entrepreneurs.[3] Second, we examine the implications of share repurchases under the QSBS program, as well as the risks and mitigants for projects pursuing QSBS strategies. Third, we study the potential impact of Puerto Rico's Act 60 tax incentives at both the company and shareholder levels, demonstrating the impact of purposeful tax strategy on the free cash flow (FCF) of an Act 60 company compared with a US-based search fund company. Additionally, we analyze the implications of Act 60 for both entrepreneurs and investors. Fourth, we reflect on which search fund strategies are the best fit for each of the tax programs. Finally, we reflect on topics that merit further exploration and research that are related to the theme of the present paper.

[1] Peter Kelly and Sara Heston. "2022 Stanford GSB Search Fund Study Selected Observations." Stanford Graduate School of Business. Accessed May 2, 2023. https://www.gsb.stanford.edu/faculty-research/case-studies/2022-search-fund-study-selected-observations., p. 2 and 28.
[2] TTCER's 2021 High Performing Companies (HPC) study, which examined 25 top search outcomes, found that the median HPC started its hold with 33 employees and ended with 200 employees (a ~6x increase in jobs over a median 6.5-year hold).
[3] The model assumes a purchase price of $12M, the median search fund acquisition price reported in Peter Kelly and Sara Heston. "2022 Stanford GSB Search Fund Study Selected Observations." Stanford Graduate School of Business. Accessed May 2, 2023. https://www.gsb.stanford.edu/faculty-research/case-studies/2022-search-fund-study-selected-observations., p. 22, of which two-thirds is financed by equity. For simplicity's sake, it assumes solo searchers, vesting 25% of the common equity. To calculate absolute dollars returned to investors and management, we assume an 8% preferred return, and that post-tax proceeds are subject to a 21% federal capital gains tax. Because it is beyond the scope of this study and nondiscriminatory, no US state-level income tax is levied, assumed, or modeled.

Table 1. Summary of tax programs and benefits

		Tax Program Benefits		
		QSBS Benefit	**EOZ Benefit**	**PR Act 60 Benefits**[4]
Required Hold	**Immediate and Ongoing**			For PR-domiciled entities: • 2–4% corporate tax rate on income derived from export of services For PR-domiciled shareholders (including management): • 100% exemption of income taxes on interest and dividend distributions from a PR-domiciled company • 100% exemption of capital gains taxes for US-domiciled and PR-domiciled entities
	5+ years	For shareholders, 100% exemption of gains up to USD $10M or 10x basis	For shareholders, defer gains on investment basis +10% step-up of investment basis	
	7+ Years		For shareholders, defer gains on investment basis +15% step-up of investment basis	
	10+ Years		For shareholders, defer gains on investment basis +15% step-up of investment basis, +100% exemption of accrued gains	

Table 2. Search fund strategies[5]

Variation	Illustrative Company
1. Traditional Search Fund	A niche software enterprise resource planning (ERP) company
2. Self-funded Search Fund	Indoor landscaping for office buildings
3. Search to Start (Greenfield)	Assisted living facilities, outdoor advertising
4. Roll-up/Consolidation Strategy	Pond and lake management, dental practices
5. Long-Term Holding Company Structure	Software or B2B services holding company

[4] PR incentives can be achieved only if they are matched by certain US exclusions, as explained further throughout this paper.
[5] As referenced in Section 4 of this paper.

1. The Economic Opportunity Zones (EOZ) Program

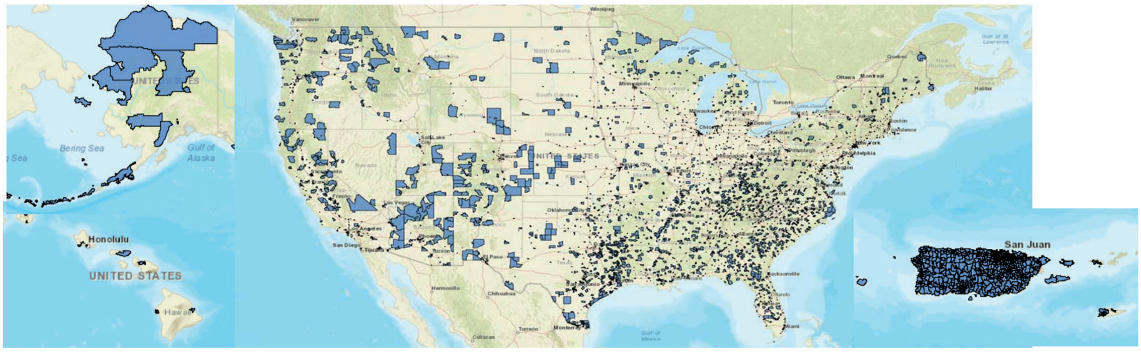
Benefit: permanent exclusion of all federal capital gains after a 10+ year holding period (with no cap).

The Tax Cuts and Jobs Act (December 22, 2017) added the EOZ legislation to the US tax code, introducing tax incentives to invest in disadvantaged communities across America for the first time. The initial interest in the EOZ program came from the commercial real estate industry. This changed on December 19, 2019, when the US Treasury and Internal Revenue Service (IRS) published clarifications on how operating businesses could participate in the EOZ program.[6]

Opportunity zones are economically deprived communities that are defined by individual census tracts, nominated by America's governors, and certified by the US Secretary of the Treasury via their delegation of that authority to the IRS. Currently, there are >8,700 Opportunity zones in the United States, many of which have experienced a historical lack of investment, like former industrial or manufacturing regions.

Opportunity zones are located in all 50 US states, including Alaska, Hawaii, the US Virgin Islands, and across more than 90% of the island of Puerto Rico. They are highlighted in blue in **Figure 1**.[7]

Figure 1. Map of economic opportunity zones in the United States



The EOZ program allows investors holding money in a qualified EOZ fund for 10+ years to receive a 15% step-up on their original investment and permanently exclude taxable income on all gains generated from the investment.[8] In addition, businesses acquired in or relocated to an opportunity zone that meet certain criteria are eligible to benefit from the exclusion of capital gains, assuming they have been held for 10 or more years.

[6] U.S. Department of the Treasury. "Treasury and IRS Issue Final Regulations on Opportunity Zones." U.S. Department of the Treasury. Last modified November 19, 2019. https://home.treasury.gov/news/press-releases/sm864.
[7] Opportunity Db. "What Are Opportunity Zones?" Wealth Health Channel. Last modified October 30, 2020. https://opportunitydb.com/guide/opportunity-zones/.
[8] Tax Policy Center. "What Are Opportunity Zones and How Do They Work?" Urban Institute and Brookings Institution. Last modified 2022. https://www.taxpolicycenter.org/briefing-book/what-are-opportunity-zones-and-how-do-they-work.

Eligibility

To qualify for the program, a Qualified Opportunity Zone Business (QOZB) must meet a 50% threshold in one of the three following manners,[9] as clarified by the IRS:

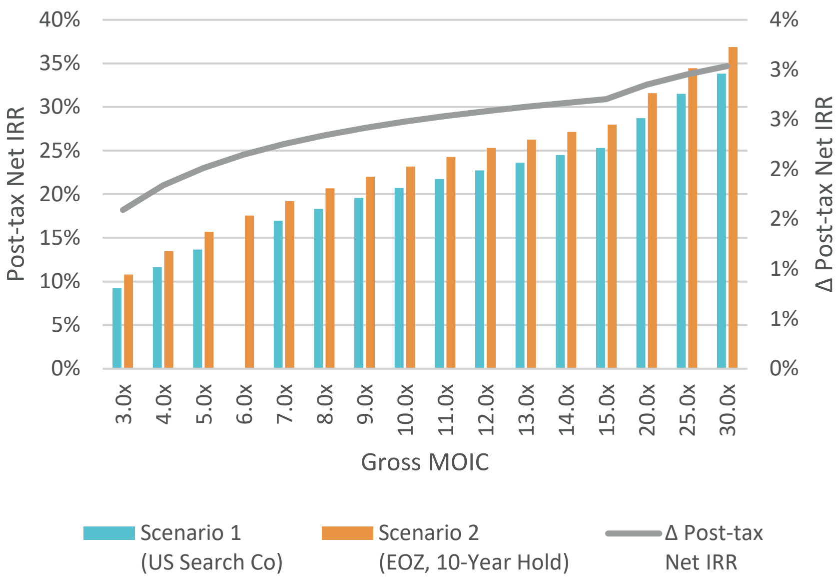
- Whether at least half of the aggregate hours of services received by the business were performed in a QOZB;
- whether at least half of the aggregate amounts that the business paid for services were for services performed in a QOZB; or
- whether necessary tangible property and necessary business functions were located in a QOZB.

Interestingly, the IRS clarifies that an operating business may qualify for the program if it meets the 50% threshold in one or more opportunity zones. For instance, an operating business could qualify for the program if it has offices or operations in multiple opportunity zones, be it in one or more states.

1a. The Impact of the EOZ Program on a Project Exiting in Y10

Figure 2 compares two hypothetical outcomes in year 10.

Figure 2. Impact of the EOZ program on post-tax net internal rate of return (IRR)



Scenario 1, the blue bars, shows a US search fund company[10] not taking part in an EOZ program.

Scenario 2, the orange bars, shows a US search fund company that takes part in an EOZ program.

Over a 10-year period and across outcomes ranging from a multiple on invested capital (MOIC) between 3.0x to 30.0x (gross[11]), the company that partakes in the program enjoys a ~2–3% increase in post-tax IRR.

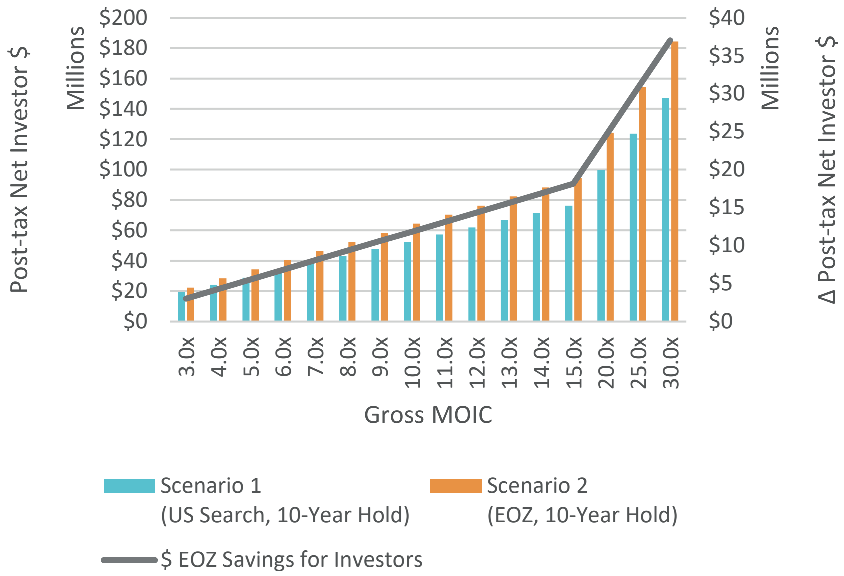
Exhibit 6 provides a more granular breakdown.

[9] IRS. "Opportunity Zones Frequently Asked Questions." Internal Revenue Service. Last modified November 10, 2022. https://www.irs.gov/credits-deductions/opportunity-zones-frequently-asked-questions#qof-50.

[10] In our modeling, we assume a purchase price of $12M, which is the median search fund acquisition price reported on p. 22 of Peter Kelly and Sara Heston. "2022 Stanford GSB Search Fund Study Selected Observations." Stanford Graduate School of Business. Accessed May 2, 2023. https://www.gsb.stanford.edu/faculty-research/case-studies/2022-search-fund-study-selected-observations., p. 2, and an equity investment of two-thirds of that amount, or $8 million.

[11] All reported MOIC are gross.

Figure 3. Impact of the EOZ program on funds returned to investors

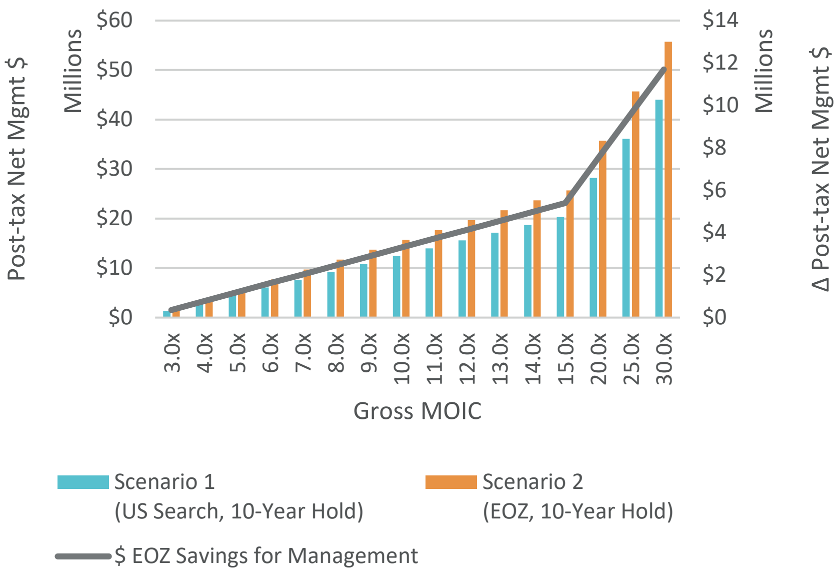


Applying a similar analysis to absolute dollars returned to investors, the EOZ company exiting at year 10 at a 3.0x MOIC returns an extra ~$3M (post-tax) to its investors, and an exit at a 10.0x MOIC returns an extra ~$12M to its investors.

At a 30.0x MOIC, Scenario 2 provides the investor group with ~$37M in extra funds (an extra 4.6x MOIC), which would otherwise be returned to the federal tax authorities.

See **Exhibit 7** for a more granular breakdown.

Figure 4. Impact of the EOZ program on funds returned to entrepreneurs



EOZ programs also create benefits for the entrepreneur. Over a 10-year horizon, a 3.0x MOIC makes the "EOZ entrepreneur" ~$0.35M richer. This difference grows to ~$3.3M in the case of a 10.0x MOIC, and if the entrepreneur were to exit at a 30.0x MOIC, they would net an extra ~$11.7M.

See **Exhibit 8** for a more detailed breakdown.

2. The Section 1202 or Qualified Small Business (QSBS) Exclusion

Benefit: permanent exclusion of capital gains up to 10x the investment basis, with a 5+ year holding period.

The Revenue Reconciliation Act (1993) added Section 1202 to the US tax code and was amended through the Protecting Americans from Tax Hikes Act (2015) to ensure that all qualified gains from the sale of small business stock could be excluded from federal capital gains tax.

The Section 1202 exclusion allows 100% of the capital gains from the sale of Qualified C-Corp stock to be excluded from federal income tax, capital gains tax, 3.8% Net Investment Income Tax, and Alternative Minimum Tax (AMT). It also provides that all capital gain resulting from the sale of "Qualified" C-Corp stock will not have to pay state income tax in states that conform to federal tax rules.

Eligibility

To benefit, investors must have held stock in a QSBS corporation for at least 5 years, and a business will qualify as a QSBS when it is:

- A domestic C-Corporation;
- an entity with cash and other assets totaling $50M or less (which has never exceeded $50M in gross assets) on an adjusted basis;
- any business other than one of the following: (a) services firms such as health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial, or brokerage services; (b) banking, insurance, financing, and similar businesses; (c) farming; (d) mining and other natural resource businesses; (e) operation of hotel, motel, restaurant, or similar business; and
- an entity that is actively running a business. In other words, at least 80% of the firm's assets must be used to actively run the business, not for investment purposes.

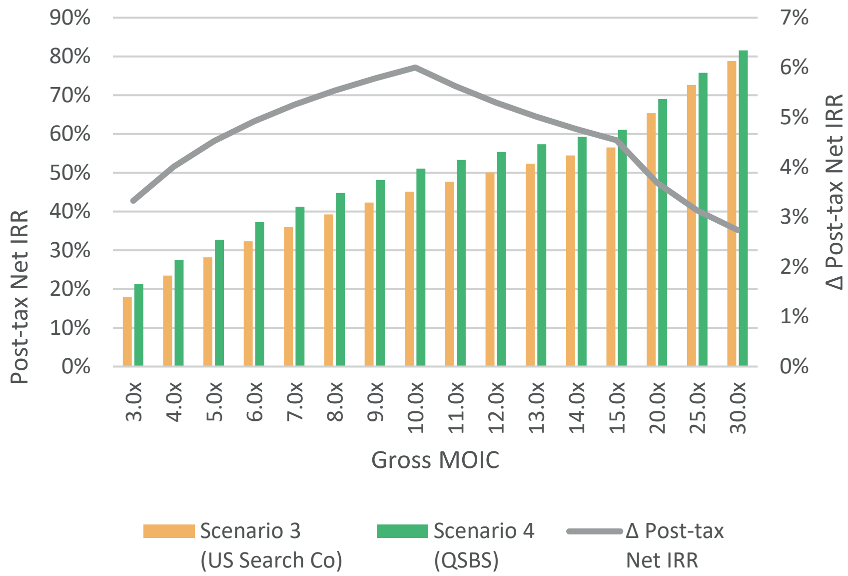
If companies meet these requirements and investors hold their qualified stock for at least 5 years, they will be eligible to claim the discussed tax benefit by filing Form 8949 and Schedule D.[12]

[12] Investors in eligible businesses (as defined above) who are structured as individuals or partnerships are eligible to benefit from the QSBS incentives, while institutional investors structured as a corporation (C-Corp) are not eligible to benefit from the QSBS incentives.

2a. The Impact of QSBS on a Project Exiting in Y5

Figure 5 compares two hypothetical outcomes in year 5.

Figure 5. Impact of the QSBS program on post-tax net IRR



Scenario 3, the yellow bars, shows a US search fund company that does not take part in the QSBS program.

Scenario 4, the green bars, shows a US search fund company taking part in the QSBS program.

Over a 5-year period and MOIC ranging from 3.0x to 30.0x (gross), the company in Scenario 4 enjoys a ~3–6% increase in post-tax IRR.

Because the QSBS program shields up to 10.0x the investment basis or $10M (whichever is greater), tax savings beyond a 10.0x gross MOIC are equal to the tax savings at a 10.0x gross MOIC outcome.

Consequently, the impact on post-tax net IRR diminishes after a 10.0x MOIC, as illustrated by the gray line dipping from a 10.0x MOIC onwards.

See **Exhibit 9** for a more granular breakdown.

Investors also enjoy a performance pick-up until a 10x MOIC. At a 3.0x MOIC, for instance, the company taking advantage of the QSBS Program (Scenario 4) provides its investors an extra ~$2.7M over a 5-year period. At a 10.0x MOIC, the additional benefit reaches ~$11.5M.

Because the QSBS program shields up to 10.0x the investment basis or $10M (whichever is greater), tax savings beyond a 10.0x MOIC are constant and equal to the tax savings at a 10.0x MOIC. In our example, this would be ~$11.5M. Its effect can be observed by the flat gray line post 10x in **Figure 6**.

Figure 6. Impact of the QSBS program on funds returned to investors

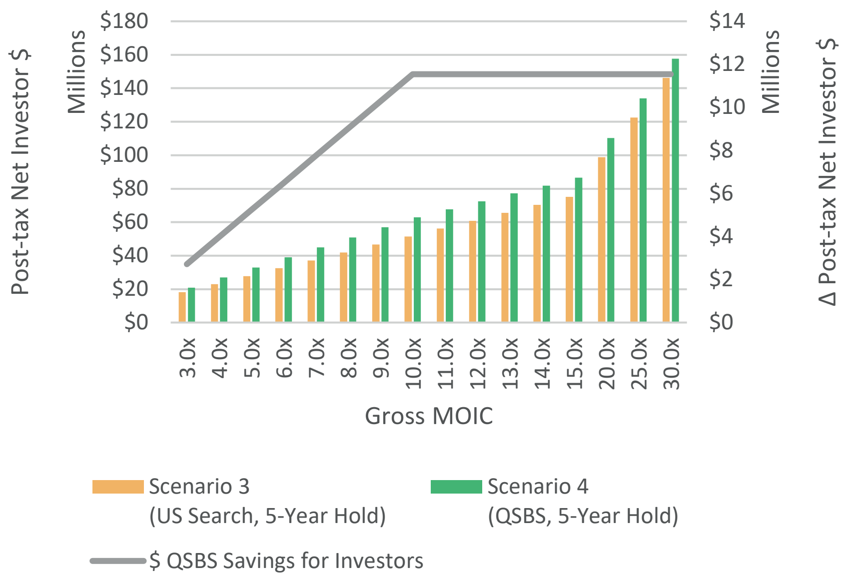
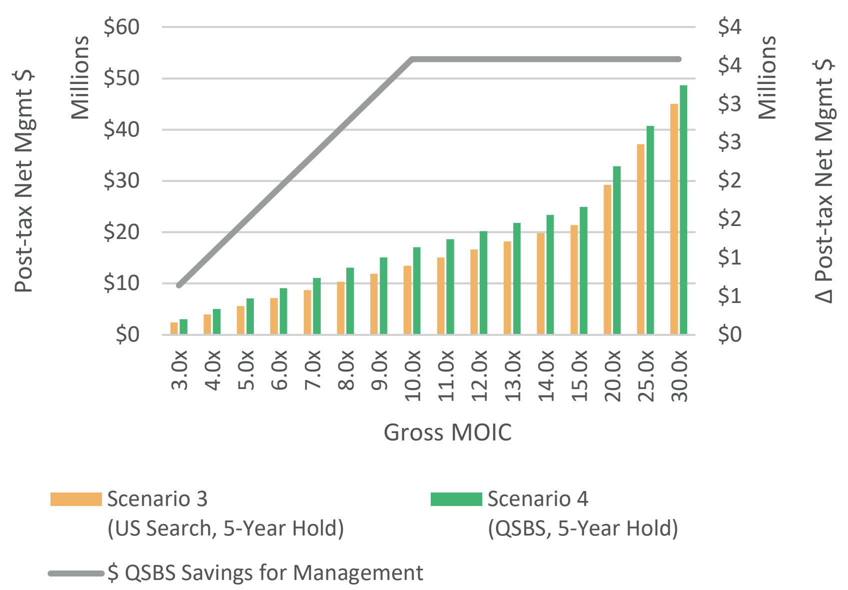


Exhibit 10 provides further details.

The QSBS program also offers benefits to entrepreneurs, or searchers. If the entrepreneur returns 3.0x MOIC, the "QSBS entrepreneur" will receive an additional carry of ~$0.64M vs. an entrepreneur (who has not used the QSBS program.) At a 10.0x MOIC, this difference grows to ~$3.6M.

As pointed out before, because the QSBS program shields up to 10.0x the investment basis or $10M (whichever is the greater), there are no additional tax savings beyond the 10.0x (resulting in a horizontal gray line post 10x in **Figure 7**).

Figure 7. Impact of the QSBS Program on funds returned to entrepreneurs



Entrepreneurs considering pursuing a QSBS strategy are encouraged to file an 83(b) election as early as possible during their hold period. This election allows startup founders (or, in our case, newly minted search fund CEOs) to pay taxes on the total fair market value of their restricted stock at the time of granting. An entrepreneur's expert tax counsel should suggest this to the entrepreneur proactively, but we call it out here specifically, for good measure.

See **Exhibit 11** for a more granular breakdown.

2b. Internal Capture of QSBS Tax Savings through Share Repurchases after Y5

QSBS C-Corps may be "double taxed" when issuing dividends to investors. This is not the case, however, when shares are repurchased.

Note that share repurchases through a QSBS C-Corp are taxed at normal capital gains rates if completed within the first 5 years after acquisition. Share repurchases completed after year 5 can avoid the issue of double taxation, hence serving as a tax-advantaged mechanism for returning capital to shareholders. This is subject to the following QSBS redemption rules:

- Redemption must occur more than 2 years after the last issuance of QSBS stock by the company and more than 2 years before any future issuance of QSBS stock; and
- redemption must "significantly" reduce a shareholder's ownership in the company, generally by 20% or more.

Gains realized through share repurchases after year 5 and meeting the criteria above would meet all QSBS criteria and be exempt from federal capital gains taxes.[13]

If share repurchases were completed on a pro rata basis, shareholders could take profits off the table without dilution while avoiding "double taxation" while the company continued to grow toward the optimal point of exit.

Qualifying projects could return up to 10x their initial investment through share repurchases after Y5 and prior to exit, subject to the rules above. Most QSBS C-Corps realize tax savings at the time of exit and must do so through a stock sale. By capturing all potential tax savings through share repurchases, a company becomes neutral and has no preference for exiting via a stock or asset sale. This neutrality—or indifference—gives it more flexibility to sell based on the preferences of its buyer. For example, a QSBS C-corp could sell through an asset sale while having already captured tax savings on 10x its investment basis through a share repurchase.

[13] Special thanks to Kelsey Lemaster, Partner, Goodwin Procter Tax Practice for helping confirm the nuances of share repurchases for QSBS C-Corps.

2c. Risks & Mitigants for Structuring as a QSBS C-Corps

Several of the stakeholders interviewed (see **Acknowledgements section**) for the present paper shared concerns about structuring an acquisition as a C-Corp or pursuing the tax savings offered by the Section 1202 exclusion. In the following table, we address their key concerns and the ways these risks may be mitigated.

Table 3. The QSBS C-Corp structure risks and mitigants

Risks	Mitigants
• Decreased flexibility for governance compared with an LLC	• QSBS C-Corps can be held by LLCs to combine flexibility with the potential upside of tax savings
• Increased risk of liability because of stock purchase	• Align with lead investor(s) for extra support through the diligence process • Indemnity escrow funded by sales proceeds to remain outstanding for 12–18 months after close
• Tax reform reduces or eliminates tax savings of the program before exit	• Assume no realized tax savings in base investment case, treating tax savings as a potential upside only • The C-Corp structure allows OpCo to retain more capital within the company as C-Corps do not have to pay tax distributions to investors like pass-through structures do
• Buyer may prefer to acquire through an asset purchase, reducing or eliminating tax savings of the program	• Internal capture of tax savings through share repurchases could allow an OpCo to realize some or all potential savings prior to exit

Although these perceived risks are worth considering, we believe they can be mitigated. The ability to retain more capital in the company through a C-Corp structure, combined with the potential upside of tax savings offered through the program, make the QSBS C-Corp an interesting structure for search fund acquisitions. QSBS C-Corps held by LLCs can offer flexibility, optionality, and an upside while simultaneously limiting downside risk.

3. Puerto Rico's Act 60 Incentives

Benefit: Fixed 4% corporate tax rate (at the entity level) on Puerto Rican–sourced export services income and 0% income taxes on certain capital gains, dividends, and interest for bona fide Puerto Rican residents.[14]

Puerto Rico's Act 60 ("Act 60" or the "Act") was signed into law in 2019 and is perhaps the most flexible and valuable of all the tax programs examined in the present paper. Chapter 3 of Act 60 provides Puerto Rican–domiciled entities with a 4% income tax rate on "export services." Under Chapter 2 of Act 60, bona fide Puerto Rican tax residents enjoy 100% exemption of Puerto Rican income taxes on capital gains, dividends, and interest. These incentives are enabled by tax decrees (a legally binding contract) issued by the Government of Puerto Rico and are valid for an initial 15-year period, with possible reauthorization for an additional 15 years.

The Act 60 incentives dovetail with Section 933 of the US tax code, which exempts from US federal income taxation "Puerto Rican source income" earned by "bona fide residents of Puerto Rico" (the "Section 933 exemption"). Section 937 and the regulations thereunder provide rules for determining whether income is from Puerto Rican sources[15] and whether a person is a bona fide resident of Puerto Rico.[16]

Absent sections 933 and 937, the Act 60 incentives would not materially reduce the effective tax rate on the income of Puerto Rico (thereafter PR) companies distributed to US citizen owners and engaged in exporting services from Puerto Rico. Income that is not considered to be from Puerto Rican sources generally will continue to be subject to full US federal income taxation.[17,18]

Although the EOZ and QSBS programs only allow investors in eligible companies to reduce capital gains tax liabilities, Act 60 allows both companies and investors (including entrepreneurs) to dramatically reduce their effective corporate and personal income tax, as well as their capital gains taxes.

In the section below, we model the impact of Chapters 2 and 3 of PR Act 60 on the median search fund company, here under different growth scenarios, over 6-year and 10-year hold periods.

3a. Act 60, Chapter 3: Tax Efficiencies at the *Company* Level

Chapter 3 of Act 60 promotes "export services" from Puerto Rico by providing a reduced corporate income tax rate of 4% on eligible export services income of decree-holding Puerto Rican businesses. Income is eligible for the reduced rate if the service is rendered from within Puerto Rico to customers located outside of Puerto Rico, including the United States. Some of the activities considered eligible export services include software development, data processing, consulting, financial advisory services, blockchain technology services, professional services (i.e., legal and accounting services), and hospital and laboratory services, among others.[19]

[14] It should be noted that as of 2023, the IRS has an ongoing "campaign" focused mainly on individuals who have reduced their US tax burden by claiming benefits under Chapter 2 of Act 60 (formerly included under Act 22-2012). Audits pursuant to such "campaign" are initially focused on the legitimacy of the individual's bona fide residency claims, but may expand the audit's scope (like, for example, into a review of Chapter 3 entities providing sources of income into such individuals). See the note Clark Armitage, Dianne Mehany, Amanda Reed, and Tom Duffy. "IRS To "Campaign" Into Puerto Rico; How Can Taxpayers Defend?" Mondaq. Last modified February 5, 2021. https://www.mondaq.com/unitedstates/transfer-pricing/1033584/irs-to-campaign-into-puerto-rico-how-can-taxpayers-defend.

[15] And not effectively connected with a trade or business in the US. See 1.937-2. Income effectively connected with U.S. trade or business—general rules. Treasury Regulation. 26 CFR § 1.937-2.

[16] An individual will be treated as a bona fide resident of Puerto Rico if they (1) meet a physical presence test; (2) does not have a tax home—most often defined as a principal place of employment—outside of Puerto Rico during the taxable year; and (3) does not have a closer connection to the US or a foreign country than to Puerto Rico.

[17] In addition, some US states may tax Puerto Rican source income in certain circumstances.

[18] It is critical to understand the Act 60 incentives as they are related to the Section 933 exemption because several other provisions of the US tax code impact its scope. For example, Section 957(c)(1) provides that a bona fide resident of Puerto Rico is not a "US shareholder" with respect to a corporation organized under the laws of Puerto Rico, which means that the US subpart F and GILTI regimes (in Sections 951 and 951A), which ordinarily would require US citizens to include as income certain earnings of foreign corporations, may not apply in the case of a Puerto Rico corporation controlled by US citizens who are bona fide residents of Puerto Rico.

[19] Act 60 applies only to services specified in the company's Act 60 grant application and decree. A company may need to apply to amend its decree to obtain the 4% rate on later-added services.

A Puerto Rican corporation is a "foreign corporation" for US federal income tax purposes.[20] As a result, it is generally exempt from US federal income taxation, provided it does not have a trade or business in the United States or derive certain passive income streams from US sources.[21] If the Puerto Rican corporation did have a US trade or business, however, the results would be markedly different and could be highly unfavorable.[22] In practical terms, this means that, to the extent that the company's operations were not fully located in Puerto Rico, say with operations involving resources located outside Puerto Rico (i.e., engineering, sales, implementation, or customer support), additional (and, likely, more complex) corporate structuring and implementation will be required.[23]

For example, income generated from "licensing" software (distinct from Software as a Service, or SaaS delivery models) is generally sourced to the United States if the licensee runs the software in the United States and, as such, would be subject to US income taxation. This tax is imposed through withholding, with the users required to withhold 30% of the gross amount of payments made to a Puerto Rican company for a software license. Hence, the service nature of the offering is critical to achieving net tax benefits under Chapter 3.[24]

In summary, the tax rate on income generated through the provision of services from Puerto Rico can be very low. The more "value" is created by eligible export services rendered from Puerto Rico, the more the blended effective corporate tax rate will approach 4%.

From an FCF standpoint, businesses that leverage intellectual property and/or data processing capabilities and operate decentralized business models, domiciling in or relocating an entity to Puerto Rico could keep substantially more cash under Chapter 3 of Act 60. Cash can then be used to grow the business, make strategic acquisitions, repay debt, or pay dividends.[25] A similar logic applies to other service businesses that are often targeted by search fund entrepreneurs.

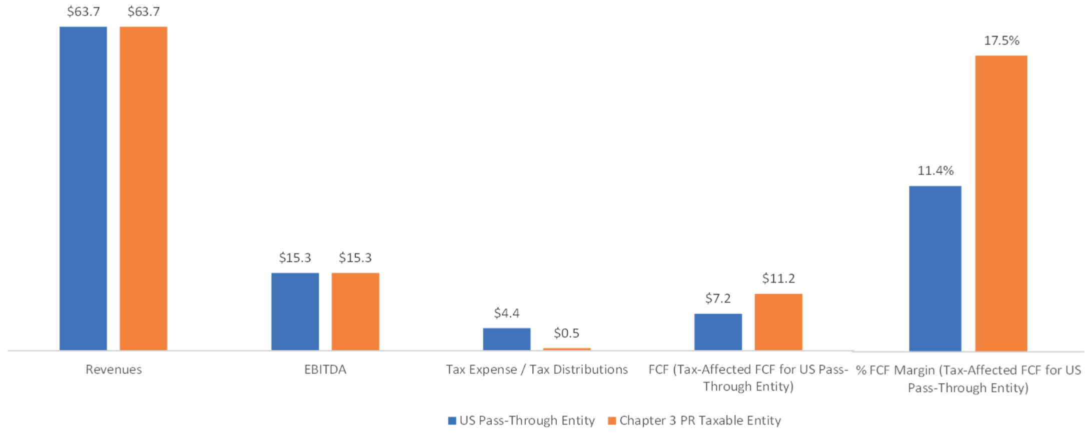
Let's see how Chapter 3 of the Act affects the search fund Operating Company's FCF profile.

Chapter 3's Impact of Act 60, Chapter 3 on the Median Search Fund Acquired Company's Cumulative Cash Flow[26]

In **Figure 8**, the blue bars denote metrics for the median search fund company operating as a US pass-through entity, while the orange bars represent the same business structured as a PR taxable entity established to take advantage of PR's Act 60 incentives.

[20] See 7701(a)(3) and (4). Definitions. Treasury Regulation. 26 CFR § 7701(a)(3) and (4).
[21] See 882. Tax on income of foreign corporations connected with United States business. Treasury Regulation. 26 CFR § 882. Certain types of income are specifically made subject to US income taxation. See 881. Tax on income of foreign corporations connected with United States business. Treasury Regulation. 26 CFR § 882. Dividends from a Puerto Rican corporation to its shareholder may be exempt if the shareholder is a bona fide resident of Puerto Rico. If the shareholder is instead a US resident, dividends from a Puerto Rican corporation would be generally taxed as qualified dividends (i.e., subject to a 23.8% federal income tax rate, plus any applicable state income tax).
[22] The US could impose several categories of income taxation: a corporate income tax at a rate of 21%, a branch profits tax at a rate of 30%, or a dividend tax at a 23.8% rate. There may also be other applicable state and local income taxation.
[23] For example, the implementation of intercompany structures such as arm's length transactions or cost-plus models on intercompany charges to segregate "value" created in Puerto Rico (i.e., income from eligible export services taxed at 4%) versus "value" created outside of Puerto Rico (i.e., US-sourced income likely subject to US federal and state taxation).
[24] See Note 6 in Section 3b: Puerto Rican versus Non-Puerto Rican Income for additional details.
[25] The relocation of a US company with built-in gain assets (including intangibles) to Puerto Rico can produce negative US tax consequences under Section 367 or Section 7874. The applicability and effect of these provisions must be evaluated before attempting to redomicile a US business or entity to Puerto Rico. Refer to Note 5 in Section 3b for additional context.
[26] Unless otherwise indicated throughout the paper, for a basis of comparison, the US search fund company is assumed to be a taxable entity, subject to 21% federal corporate tax rate at the entity level. When we discretely benchmark a US search fund company operating under a pass-through structure, no tax expense is considered at the entity level, but tax distributions are assumed at the higher marginal tax bracket (37%) of pass-through earnings.

Figure 8. Impact of Chapter 3 on a US pass-through entity's cumulative cash flow over a 6-year horizon, assuming a 10% CAGR ($ in millions & %)[27]

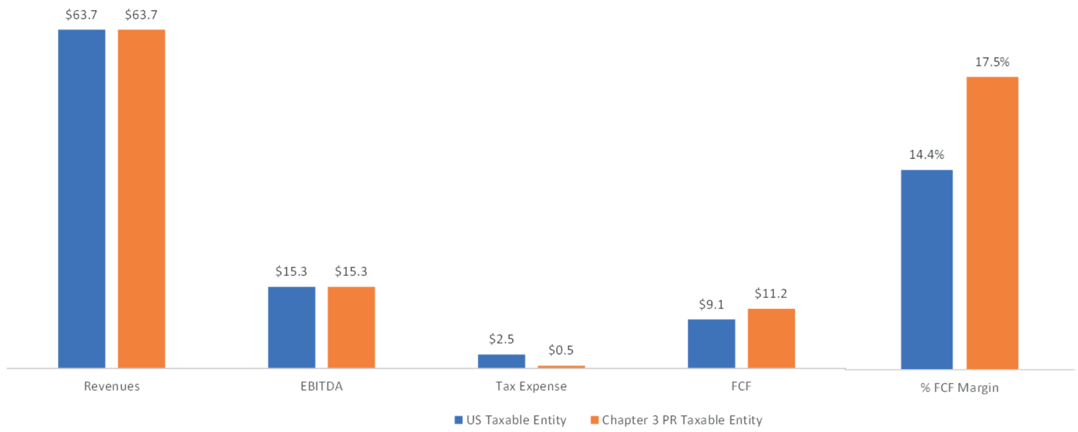


Over a 6-year period, under Chapter 3, a median search fund–acquired company generates $2M in tax savings. This improves the cumulative FCF margin by 3.1% over the projected period.

Figure 8 conservatively assumes that tax savings are accumulated on the balance sheet until an exit. In other words, we do not assume that the incremental tax savings generate any additional impact on the growth of the company, are used for debt paydown, or are distributed to investors.

Figure 9 shows the results of the same analysis, showing the difference between the median search fund company structured as a PR Chapter 3 company versus a US taxable entity like a C-corp.

Figure 9. Impact of Chapter 3 on a US taxable entity's cumulative cash flow over a 6-year period assuming a 10% CAGR ($ in millions & %)[28]



Although the PR scenario is identical, the US-based pass-through structure assumes no tax expense at the entity level and mandatory tax distributions at the highest marginal income tax (37%).

[27] In-line with the median search fund company reported on Peter Kelly, Sara Heston. "2022 Search Fund Study: Selected Observations." Stanford Graduate School of Business. Last modified 2022. https://www.gsb.stanford.edu/faculty-research/case-studies/2022-search-fund-study-selected-observations., our base case projections assume a $7.5M revenue, $1.8M EBITDA business at entry that grows top-line at 10% CAGR through the projection period at constant 24% EBITDA margin. The transaction structure at entry assumes $8M of equity and $4M of debt at close (2.2x EBITDA), amortizing linearly over a 5-year period, with an 8% fixed interest rate. Additionally, for simplicity purposes, (a) the analysis assumes no net increase in PP&E and linear working capital increases as the business scales, and (b) we have assumed incremental FCF resulting from a Chapter 3 structure is accumulated to the balance sheet and distributed as part of the exit proceeds.

[28] Same underlying assumptions, as in Footnote 26, except that only cash in excess of mandatory tax distributions is accumulated on the balance sheet.

In this scenario, the benefit of accumulating post-tax profits (taxed at the preferential rate of 4% at the entity level) under Chapter 3 is augmented, given that, under a pass-through scenario, the cash outlays for tax distributions following the income allocations are considered at 37% of pass-through earnings (not taxed at the entity level), which is higher than the 21% effective tax rate on pre-tax earnings considered in the previous scenario.[29]

This results in a $4M incremental cumulative FCF for the PR-based Chapter 3 entity vs. the US-based pass-through structure, providing the PR company with an extra 6.1% cumulative FCF margin improvement over the projected period.

Tables 4, 5, and **6** compare the impact of the two different structures for a median search fund company under different growth scenarios and for different hold periods.[30] **Tables 4, 5,** and **6** conservatively assume that all dollars of tax savings accumulate on the balance sheet and are distributed to investors upon exit. In other words, the tables below do not assume that the company reinvests tax savings or redistributes them prior to exit.[31]

[29] We have purposefully avoided presenting a scenario of a pass-through PR Chapter 3 entity because it would result in an inefficient tax structure with respect to US tax resident investors. Within the context of Chapter 3, having the PR entity be a taxable entity serves as a necessary "blocker" to allow for compounding at the preferential 4% tax rate at the entity level. Otherwise, as more thoroughly discussed in Note 2 of Section 3b in the current paper, tax leakage may result from US tax residents being subject to worldwide income taxation at the US federal level on pass-through income allocations.

[30] Post-tax investor returns assume US-based investors are subject to 21% federal capital gains tax under a stock sale (see Note 4 in Section 3b). Both the 6-year and 10-year hold period projections use the same exit assumptions.

[31] Please see **Exhibit 12** for alternative analysis where we model the potential impact of reinvesting tax savings into sales and marketing on the cumulative cash flow profile and post-tax proceeds.

Table 4. Impact of Chapter 3 on investment performance assuming a 10% CAGR ($ in thousands, x & %)

	6-Yr. Hold Period					10-Yr. Hold Period				
	Taxable US-Based Search OpCo	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo	Delta: Chapter 3 PR vs. US Taxable	Delta: Chapter 3 PR vs. US Pass-Through	Taxable US-Based Search OpCo	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo	Delta: Chapter 3 PR vs. US Taxable	Delta: Chapter 3 PR vs. US Pass-Through
Entity Level Tax Consequences										
Cumm. Corporate Income Tax Expense	$2,505	–	$477	($2,028)	$477	$5,354	–	$1,020	($4,334)	$1,020
Cash on Balance Sheet at Exit	$5,136	$3,227	$7,164	$2,028	$3,937	$15,545	$11,465	$19,879	$4,334	$8,414
Pre-Tax Peformance, Gross										
Pref. Equity Invested at Entry	$7,520	$7,520	$7,520	–	–	$7,520	$7,520	$7,520	–	–
Proceeds	$40,213	$42,718	$42,241	$2,028	($477)	$66,901	$72,255	$71,235	$4,334	($1,020)
MOIC	5.3x	5.7x	5.6x	0.3x	(0.1x)	8.9x	9.6x	9.5x	0.6x	(0.1x)
IRR	32.2%	36.2%	33.3%	1.1%	(2.9%)	24.4%	28.5%	25.2%	0.8%	(3.3%)
Pre-Tax Peformance, Net of Searcher Carry										
Pref. Equity Proceeds	$33,143	$36,126	$34,664	$1,521	($1,462)	$54,234	$60,609	$57,485	$3,251	($3,123)
Pref. Equity MOIC	4.4x	4.8x	4.6x	0.2x	(0.2x)	7.2x	8.1x	7.6x	0.4x	(0.4x)
Pref. Equity IRR	28.0%	32.5%	29.0%	1.0%	(3.5%)	21.8%	26.4%	22.6%	0.7%	(3.9%)
Pref. Equity Tax Consequences										
Pass-Through Tax Liability (Tax Distributions)	–	$4,414	–	–	($4,414)	–	$9,434	–	–	($9,434)
Capital Gains Tax Liability	$5,381	$5,080	$5,700	$319	$620	$9,810	$9,168	$10,493	$683	$1,325
Effective Cap. Gains Tax Rate (%)	21.0%	21.0%	21.0%	–	–	21.0%	21.0%	21.0%	–	–
Total Blended Tax Liability	$5,381	$9,495	$5,700	$319	($3,794)	$9,810	$18,601	$10,493	$683	($8,109)
Total Blended Effective Tax Rate (%)	21.0%	33.2%	21.0%	–	(12.2%)	21.0%	35.0%	21.0%	–	(14.0%)
Post-Tax Performance, Net of Searcher Carry										
Pref. Equity Proceeds	$27,762	$26,631	$28,964	$1,202	$2,333	$44,424	$42,007	$46,993	$2,568	$4,985
Pref. Equity MOIC	3.7x	3.5x	3.9x	0.2x	0.3x	5.9x	5.6x	6.2x	0.3x	0.7x
Pref. Equity IRR	24.3%	23.5%	25.2%	0.9%	1.7%	19.4%	18.8%	20.1%	0.7%	1.3%

Table 5. Impact of Chapter 3 on investment performance assuming a 20% CAGR ($ in thousands, x & %)

	6-Yr. Hold Period					10-Yr. Hold Period				
	Taxable US-Based Search OpCo	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo	Delta: Chapter 3 PR vs. US Taxable	Delta: Chapter 3 PR vs. US Pass-Through	Taxable US-Based Search OpCo	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo	Delta: Chapter 3 PR vs. US Taxable	Delta: Chapter 3 PR vs. US Pass-Through
<u>Entity Level Tax Consequences</u>										
Cumm. Corporate Income Tax Expense	$3,586	–	$683	($2,903)	$683	$9,644	–	$1,837	($7,807)	$1,837
Cash on Balance Sheet at Exit	$8,744	$6,012	$11,646	$2,903	$5,634	$30,334	$22,986	$38,142	$7,807	$15,155
<u>Pre-Tax Peformance, Gross</u>										
Pref. Equity Invested at Entry	$7,520	$7,520	$7,520	–	–	$7,520	$7,520	$7,520	–	–
Proceeds	$67,866	$71,452	$70,769	$2,903	($683)	$152,931	$162,575	$160,738	$7,807	($1,837)
MOIC	9.0x	9.5x	9.4x	0.4x	(0.1x)	20.3x	21.6x	21.4x	1.0x	(0.2x)
IRR	44.3%	48.9%	45.3%	1.0%	(3.6%)	35.2%	40.0%	35.8%	0.7%	(4.1%)
<u>Pre-Tax Peformance, Net of Searcher Carry</u>										
Pref. Equity Proceeds	$53,883	$58,151	$56,060	$2,177	($2,092)	$118,757	$130,238	$124,612	$5,856	($5,626)
Pref. Equity MOIC	7.2x	7.7x	7.5x	0.3x	(0.3x)	15.8x	17.3x	16.6x	0.8x	(0.7x)
Pref. Equity IRR	38.8%	44.0%	39.8%	0.9%	(4.2%)	31.8%	37.1%	32.4%	0.6%	(4.7%)
<u>Pref. Equity Tax Consequences</u>										
Pass-Through Tax Liability (Tax Distributions)	–	$6,317	–	–	($6,317)	–	$16,992	–	–	($16,992)
Capital Gains Tax Liability	$9,736	$9,306	$10,193	$457	$887	$23,360	$22,202	$24,589	$1,230	$2,387
Effective Cap. Gains Tax Rate (%)	21.0%	21.0%	21.0%	–	–	21.0%	21.0%	21.0%	–	–
Total Blended Tax Liability	$9,736	$15,623	$10,193	$457	($5,430)	$23,360	$39,195	$24,589	$1,230	($14,605)
Total Blended Effective Tax Rate (%)	21.0%	30.9%	21.0%	–	(9.9%)	21.0%	31.9%	21.0%	–	(10.9%)
<u>Post-Tax Performance, Net of Searcher Carry</u>										
Pref. Equity Proceeds	$44,147	$42,528	$45,866	$1,720	$3,338	$95,397	$91,043	$100,023	$4,626	$8,980
Pref. Equity MOIC	5.9x	5.7x	6.1x	0.2x	0.4x	12.7x	12.1x	13.3x	0.6x	1.2x
Pref. Equity IRR	34.3%	33.5%	35.2%	0.9%	1.7%	28.9%	28.3%	29.5%	0.6%	1.2%

Table 6: Impact of Chapter 3 on investment performance assuming a 30% CAGR ($ in thousands, x & %)

	6-Yr. Hold Period					10-Yr. Hold Period				
	Taxable US-Based Search OpCo	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo	Delta: Chapter 3 PR vs. US Taxable	Delta: Chapter 3 PR vs. US Pass-Through	Taxable US-Based Search OpCo	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo	Delta: Chapter 3 PR vs. US Taxable	Delta: Chapter 3 PR vs. US Pass-Through
Entity Level Tax Consequences										
Cumm. Corporate Income Tax Expense	$5,056	–	$963	($4,093)	$963	$17,285	–	$3,292	($13,992)	$3,292
Cash on Balance Sheet at Exit	$13,584	$9,732	$17,676	$4,093	$7,945	$56,229	$43,059	$70,221	$13,992	$27,162
Pre-Tax Peformance, Gross										
Pref. Equity Invested at Entry	$7,520	$7,520	$7,520	–	–	$7,520	$7,520	$7,520	–	–
Proceeds	$109,154	$114,210	$113,247	$4,093	($963)	$329,188	$346,473	$343,181	$13,992	($3,292)
MOIC	14.5x	15.2x	15.1x	0.5x	(0.1x)	43.8x	46.1x	45.6x	1.9x	(0.4x)
IRR	56.2%	61.4%	57.1%	1.0%	(4.2%)	45.9%	51.3%	46.5%	0.6%	(4.8%)
Pre-Tax Peformance, Net of Searcher Carry										
Pref. Equity Proceeds	$84,849	$90,868	$87,919	$3,069	($2,949)	$250,950	$271,527	$261,444	$10,494	($10,083)
Pref. Equity MOIC	11.3x	12.1x	11.7x	0.4x	(0.4x)	33.4x	36.1x	34.8x	1.4x	(1.3x)
Pref. Equity IRR	49.8%	55.6%	50.7%	0.9%	(4.9%)	42.0%	48.1%	42.6%	0.6%	(5.5%)
Pref. Equity Tax Consequences										
Pass-Through Tax Liability (Tax Distributions)	–	$8,907	–	–	($8,907)	–	$30,454	–	–	($30,454)
Capital Gains Tax Liability	$16,239	$15,632	$16,884	$645	$1,251	$51,120	$49,046	$53,324	$2,204	$4,278
Effective Cap. Gains Tax Rate (%)	21.0%	21.0%	21.0%	–	–	21.0%	21.0%	21.0%	–	–
Total Blended Tax Liability	$16,239	$24,540	$16,884	$645	($7,656)	$51,120	$79,500	$53,324	$2,204	($26,176)
Total Blended Effective Tax Rate (%)	21.0%	29.4%	21.0%	–	(8.4%)	21.0%	30.1%	21.0%	–	(9.1%)
Post-Tax Performance, Net of Searcher Carry										
Pref. Equity Proceeds	$68,610	$66,328	$71,035	$2,425	$4,707	$199,830	$192,027	$208,120	$8,290	$16,093
Pref. Equity MOIC	9.1x	8.8x	9.4x	0.3x	0.6x	26.6x	25.5x	27.7x	1.1x	2.1x
Pref. Equity IRR	44.6%	43.7%	45.4%	0.8%	1.7%	38.8%	38.3%	39.4%	0.6%	1.1%

Two important notes on the analysis shown in **Tables 4, 5**, and **6**. First, when comparing a US pass-through entity to the PR Chapter 3 taxable entity, it is critical to focus on post-tax performance because distributable pass-through tax allocations (i.e., tax distributions) are considered a part of the gross proceeds, so pretax performance includes pass-through tax liabilities that are disguised as gross proceeds.

Second, the analysis presented above would suggest that, absent an efficient use of tax savings resulting from Chapter 3 Chapter 3's benefits may not be meaningful enough to merit the legal hassle and expense of redomiciling a company to Puerto Rico (please see **Exhbit 12** for the impact of long-term compounding at higher FCF margins resulting from reinvesting tax savings into sales and marketing). Intuitively, a higher yield on every dollar reinvested, combined with a higher baseline organic growth rate, can generate increasingly meaningful post-tax performance results.

3b. Act 60, Chapter 2: Tax Efficiencies at the *Shareholder* Level

Chapter 2 of Act 60 is intended to encourage operators and individual investors to move to Puerto Rico by providing favorable tax treatment on Puerto Rico ("PR")- sourced income, which can include capital gains from both PR-domiciled and non-PR-domiciled entities.[32] It does so by, under Section 933 exclusion of the US tax code, exempting Puerto Rican–sourced income realized by Puerto Rican ***bona fide*** residents from federal income taxation. The end result is that capital gains, dividends, and interest earned from a PR-domiciled business by Puerto Rican ***bona fide*** residents are exempt from federal income taxes and from Puerto Rican income taxes by virtue of holding a Chapter 2 decree.

Our analysis shows that the benefits of these complementary US and Puerto Rican tax provisions can be material. As has been stated earlier, before pursuing any of the present paper's tax strategies, it is necessary to seek expert legal advice because the relevant legislation may not apply to one's current circumstances, or could have changed.

Eligibility for Chapter 2 Treatment

For an individual to be treated as a *bona fide* resident of Puerto Rico under Section 933 of the US tax code (and also under Chapter 2 of Act 60), the individual must meet the following criteria:

- meet the physical presence test (e.g., 183+ days of physical presence in Puerto Rico for the taxable year);
- not have a tax home outside of Puerto Rico during the taxable year (which generally requires that Puerto Rico be the principal place where the individual is employed); and
- not having a closer connection to the US or a foreign country other than Puerto Rico (which generally requires that the individual's personal connections be closer to Puerto Rico than to any other tax jurisdiction).

Other eligibility requirements for Chapter 2 of the Act include (a) making a $10,000 donation to a local not-for-profit, (b) within two years of receipt of the decree, purchasing property in Puerto Rico for use as a principal residence, and (c) filing an annual report with the Government of Puerto Rico with a filing fee of $5,000.[33]

[32] The current paper does not intend to discuss the benefits of Chapter 2 for a shareholder outside the context of search funds, and neither does it intend address all of the potential the benefits of Chapter 2 to a search fund investor. The scope of the discussion of Chapter 2 in the present paper is centered around the search fund entrepreneur.

[33] It is important to note that, as of the date of publishing of the present paper, the eligibility requirements for individual investors under Chapter 2 of Act 60 are being revisited by Puerto Rico's legislature. As of December 2022, the potential changes being discussed include, among others, a higher threshold ($1 million) for investment commitment in Puerto Rican–based businesses that create at least five new jobs on the Island. We are not aware of any changes to benefits under Chapter 3 of the Act being debated.

Potential Benefits of Chapter 2 Treatment

Whereas Chapter 3 of Act 60 applies to business income (i.e., the entity), Chapter 2 applies to the individual who has become a ***bona fide*** resident of Puerto Rico ("PR"). As a result, entrepreneurs vesting common equity interests in a company can save up to 100% of the US capital gains tax liability on their carried interest, provided the carried interest was acquired after becoming a ***bona fide*** resident of Puerto Rico and during the holding period preceding any capital gain allocation or realization (refer to Note 1 below for further details).

A PR-domiciled entrepreneur can benefit from Chapter 2's 100% exemption on capital gains tax in cases when (a) the company is a PR-domiciled entity and (b) the company is a US-domiciled taxable entity (i.e., a C-Corp).[34] Because the capital gains for a PR ***bona fide*** resident are generally considered PR-sourced income, these gains are exempt from capital gains tax under the US code. As shown below, the impact of Chapter 2 on management carry can be meaningful.

[34] Generally, when the capital gain results from the sale of participation units or partnership interests of a US-domiciled pass-through entity (i.e., LLC, partnership) that is actively engaged in a US trade or business, other sourcing rules may apply. Under such rules (which are inherently more complex), such a sale may produce US-sourced income and, as a result, be subject to US taxation, undermining the benefits of Chapter 2. For illustrative purposes in the present paper, we have assumed that the capital gains of a Chapter 2 decree-holder resulting from the sale of a US-domiciled pass-through entity is treated as PR-sourced income (i.e., not subject to US taxation).

Table 7. Impact of Chapter 2 on management carry assuming a 10% CAGR ($ in millions)[35]

	6-Yr. Hold Period					10-Yr. Hold Period				
	US Taxable OpCo & US-Domiciled Entrepreneur	US Pass-Through OpCo & US-Domiciled Entrepreneur	US Taxable OpCo, Ch. 2 PR-Domiciled Entrepreneur	US Pass-Through OpCo, Ch. 2	Ch. 3 PR Taxable OpCo, Ch. 2	US Taxable OpCo & US-Domiciled Entrepreneur	US Pass-Through OpCo & US-Domiciled Entrepreneur	US Taxable OpCo, Ch. 2 PR-Domiciled Entrepreneur	US Pass-Through OpCo, Ch. 2 PR-Domiciled Entrepreneur	Ch. 3 PR Taxable OpCo, Ch. 2 PR-Domiciled Entrepreneur
Pre-Tax Proceeds	$7.1	$6.6	$7.1	$6.6	$7.6	$12.7	$11.6	$12.7	$11.6	$13.8
(-) Capital Gains Tax Liability	($1.5)	($1.4)	–	–	–	($2.7)	($2.4)	–	–	–
Post-Tax Proceeds	**$5.6**	**$5.2**	**$7.1**	**$6.6**	**$7.6**	**$10.0**	**$9.2**	**$12.7**	**$11.6**	**$13.8**

Table 8. Impact of Chapter 2 on management carry assuming a 20% CAGR (USD in millions)[36]

	6-Yr. Hold Period					10-Yr. Hold Period				
	US Taxable OpCo & US-Domiciled Entrepreneur	US Pass-Through OpCo & US-Domiciled Entrepreneur	US Taxable OpCo, Ch. 2 PR-Domiciled Entrepreneur	US Pass-Through OpCo, Ch. 2	Ch. 3 PR Taxable OpCo, Ch. 2	US Taxable OpCo & US-Domiciled Entrepreneur	US Pass-Through OpCo & US-Domiciled Entrepreneur	US Taxable OpCo, Ch. 2 PR-Domiciled Entrepreneur	US Pass-Through OpCo, Ch. 2 PR-Domiciled Entrepreneur	Ch. 3 PR Taxable OpCo, Ch. 2 PR-Domiciled Entrepreneur
Pre-Tax Proceeds	$14.0	$13.3	$14.0	$13.3	$14.7	$34.2	$32.3	$34.2	$32.3	$36.1
(-) Capital Gains Tax Liability	($2.9)	($2.8)	–	–	–	($7.2)	($6.8)	–	–	–
Post-Tax Proceeds	**$11.0**	**$10.5**	**$14.0**	**$13.3**	**$14.7**	**$27.0**	**$25.5**	**$34.2**	**$32.3**	**$36.1**

Table 9. Impact of Chapter 2 on management carry assuming a 30% CAGR ($ in millions)[37]

	6-Yr. Hold Period					10-Yr. Hold Period				
	US Taxable OpCo & US-Domiciled Entrepreneur	US Pass-Through OpCo & US-Domiciled Entrepreneur	US Taxable OpCo, Ch. 2 PR-Domiciled Entrepreneur	US Pass-Through OpCo, Ch. 2	Ch. 3 PR Taxable OpCo, Ch. 2	US Taxable OpCo & US-Domiciled Entrepreneur	US Pass-Through OpCo & US-Domiciled Entrepreneur	US Taxable OpCo, Ch. 2 PR-Domiciled Entrepreneur	US Pass-Through OpCo, Ch. 2 PR-Domiciled Entrepreneur	Ch. 3 PR Taxable OpCo, Ch. 2 PR-Domiciled Entrepreneur
Pre-Tax Proceeds	$24.3	$23.3	$24.3	$23.3	$25.3	$78.2	$74.9	$78.2	$74.9	$81.7
(-) Capital Gains Tax Liability	($5.1)	($4.9)	–	–	–	($16.4)	($15.7)	–	–	–
Post-Tax Proceeds	**$19.2**	**$18.4**	**$24.3**	**$23.3**	**$25.3**	**$61.8**	**$59.2**	**$78.2**	**$74.9**	**$81.7**

[35] Assumes the same company performance and outcome as in **Table 4**.
[36] Assumes the same company performance and outcome as in **Table 5**.
[37] Assumes the same company performance and outcome as in **Table 6**.

Impact on Management Carry under 10%, 20%, and 30% Growth Scenarios

Assuming typical search fund economics over a 6-year holding period, the management of a US-based pass-through search fund company could realize between ~$1.4M and ~$4.9M of incremental post-tax proceeds by operating the business as a ***bona fide*** resident of Puerto Rico under Chapter 2. Over a 10-year holding period, this results in between ~$2.4M and ~$15.7M in incremental post-tax proceeds for the entrepreneur, depending on the company's growth trajectory.

The impact on management is the greatest when combining Chapter 2 status with operating a Chapter 3 entity, as evidenced by the outcomes in the red boxes in **Tables 7, 8,** and **9**. Although Chapter 3 and Chapter 2 can be utilized separately, applying them together provides maximum tax efficiencies for both management and investors.

Note 1: Limitations on Capital Gains Exemption

In general, capital gains earned by a ***bona fide*** resident of Puerto Rico are exempt from US federal income taxation under Section 933 of the US tax code, as long as those gains are from Puerto Rico sourced income. This is because capital gains are treated as Puerto Rico–sourced income under the so-called "mirror" rule of Section 937 and its regulations thereunder, which generally would source a gain from the sale of personal property (such as stocks) based on the seller's residence, regardless of the place of organization of the issuer of the securities.[38] However, any of several exceptions may apply to limiting, or preventing exclusion.

First, if the individual acquired the property before establishing residency and a tax home in Puerto Rico, by default, the gain is from a US source and subject to US tax. The individual can elect to split the source of the gain between US sources and Puerto Rican sources based on one of two conventions. First, if the property is marketable securities, the property is marked to market, generally at the close of business on the day the individual established their Puerto Rican tax home. Gains accrued prior to that date would be subject to US tax, while the gains accrued and realized during the period of ***bona fide*** residency in Puerto Rico would be exempt from US federal taxation.

For other personal property—such as an ownership interest in a privately held LLC—the gains are split, here being sourced based on the amount of time that the individual owned the property before and after establishing a tax home in Puerto Rico. For example, if the individual's holding period in the property began on January 1, 2020, the person established residency and a tax home in Puerto Rico on January 1, 2022, and the individual sold the property on January 1, 2023, approximately two-thirds of the person's gains would be a US source and subject to US federal taxation. The remaining third would be exempt from US federal income taxation and, if the person holds an Act 60 decree, it may also be exempt from PR income taxation under Chapter 2.

Second, the sale of an interest in a US partnership that is engaged in US trade or business may be treated as income effectively connected with US trade or business and, therefore, subject to US federal income taxation.[39]

Third, if gains are "attributable" to a "US office" of the seller, the gains will not be considered Puerto Rico source income and, hence, subject to US federal income taxation.[40] To be attributable to any such "office", the gains must be earned in a trade or business conducted by that office.[41]

[38] See 1.937-2(b). Income effectively connected with U.S. trade or business—general rules: Source of income. Treasury Regulation. 26 CFR § 1.937-2(b).
[39] See 864(c)(8). Income from disposition of certain partnership interests. Treasury Regulation. 26 CFR § 864(c)(8).. A US federal tax advisor should be consulted to determine as to whether and how this provision may apply to a specific individual who establishes bona fide residency in Puerto Rico.
[40] See 865(e)(2)(A). Gain or loss from the sale, exchange, or other disposition of certain interests in partnerships engaged in the conduct of a trade or business within the United States. Treasury Regulation. 26 CFR § 865(e)(2)(A).. A US federal income tax advisor should be consulted to determine whether this is the case.
[41] See 1.864-6 and-7. Allocation of expenses and interest for purposes of determining taxable income from sources within and without the United States. Treasury Regulation. 26 CFR § 1.864-6 and-7.

Note 2: Tax Elections for Both Puerto Rico and US Federal Purposes

As a Chapter 3 entity under Act 60 and pursuant to US federal and PR tax rules, a tax treatment will need to be chosen—pass-through (i.e., partnership) or taxable (i.e., C-Corp)—for both PR and US federal purposes. These determinations may be different at the US and PR levels. For example, the entity may choose to be treated as a partnership for PR tax purposes and a corporation for US tax purposes or vice versa.[42]

As such, assuming that most investors in any Chapter 3 search fund company will be US tax residents, it is important to consider the implications of the elections made at both levels on the ultimate effectiveness of implementing a Chapter 3 strategy.[43]

If an entity elects to be treated as a partnership for both Puerto Rican and US income taxation purposes, the entity's income would flow to its members. For Puerto Rico tax purposes, this income would flow up and be "tainted" by the entity's Chapter 3 decree tax benefits. US investors would have to file a PR tax return for their pro rata share of pass-through income, which would be taxed at the 4% preferential rate at the PR level. For US tax purposes, because US investors are taxed on worldwide income, they would be subject to taxation on all PR-sourced pass-through income at their ordinary rates, net of a foreign tax credit taken for taxes paid in Puerto Rico.[44] Because of the tax distributions that are likely required to cover such tax liabilities at the investor level, having the entity treated as a partnership would dilute the benefits realized by the company. Hence, a pass-through election at both the PR and US levels would result in an inefficient structure in the context of Chapter 3 because the entity would not effectively serve as a blocker against pass-through worldwide income taxation for US investors.

For a Puerto Rican LLC taxed as a corporation for both US and Puerto Rican income tax purposes, the results would be different. In this case, income would not flow to its members, but the entity would be subject to taxation. Under Chapter 3, the entity would pay the 4% preferential rate on all eligible export services income at the PR level, and the dividends to PR resident investors would be exempt from taxation. For US investors, under US rules, a PR LLC would be exempt from US federal income taxation, provided it is not treated as operating a US trade or business.[45] Because the company would be a tax-paying entity in PR, there would be no need for tax distributions (i.e., there would be no pass-through income allocations that would generate tax liabilities at the investor level), and there would be no need for ongoing PR tax returns to be filed by US investors in connection with the entity. In this scenario, the company can realize Chapter 3's benefits at the entity level without creating tax liabilities for investors, thus compounding FCF at the preferential 4% tax rate.

Other dual-election combinations are feasible, such as having the entity be treated as a partnership at the PR level and as a corporation at the US level or vice versa. The most suitable combination of PR and US tax treatment elections will depend on the entity's investor composition and long-term capital management objectives. What is certain, however, is that the flexibility afforded by this dual-election mechanism helps prevent disparate, potentially suboptimal tax considerations at levels "above" the entity.

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[42] In the context of international tax frameworks, having disparate tax treatment elections for US federal and for another foreign jurisdiction is commonly referred to as a hybrid or reverse hybrid structure. A Puerto Rican LLC is, by default, a C-Corp for both US and Puerto Rican income tax purposes. Elections must be made for the entity to be treated as "tax transparent" (i.e., as a partnership or a disregarded entity). An LLC formed under the laws of any of the 50 states or the District of Columbia is, by default, tax transparent for US federal income tax purposes. Again, elections can be made to elect C-Corp status.

[43] Unless otherwise stated, we have assumed that "investors" are US tax resident individual investors subject only to US federal income tax. Additional considerations should be evaluated for any other investor with a different profile.

[44] For PR tax resident investors, pass-through income from a Chapter 3 entity would also be excluded from US federal income taxation to the extent it is considered to be Puerto Rican–sourced income.

[45] See the CFC considerations included in Note 3. If and when the "80/50 test" applies, and provided that the entity meets the "80/50 test", which requires that the substantial majority of the entity's income (at least 80%) is earned from Puerto Rican operations, the dividends from the PR entity would be considered PR-sourced income and be excluded from federal income taxation for Puerto Rican bona fide resident investors. See § 1.937-2(g)(1). If the entity does not meet the "80/50 test", a portion of dividends received by bona fide PR resident investors holding at least 10% of the voting stock will be subject to US federal income taxation at qualified dividend rates (presently 23.8% at the US federal level), provided the entity is neither a CFC nor a passive foreign investment company (PFIC).

Note 3: Controlled Foreign Corporation (CFC) Considerations for Cap Table Composition

It is important to note that Chapter 3 of Act 60 imposes no specific requirements on the ownership structure or jurisdiction of the shareholders of the entity. However, under Subpart F of the US federal tax code[46], certain structuring constraints may be applicable (i.e., controlled foreign corporation global intangible low-taxed income, or "CFC-GILTI," rules); hence, searchers would be well-advised to consider how to compose their cap table with respect to their Act 60 strategy.

Under Subpart F, for a PR entity not to be categorized as a CFC—and thus be subject to CFC taxation rules—the sum of all US resident investors holding 10% or more of the company (measured by vote or value) cannot exceed 50%.

This implies that, in the context of CFC rules, under US federal regulations and Act 60, a Chapter 3 entity could be 100% owned by US resident investors; if US investors holding 10% or more of the membership interests do not own more than 50% of the company in aggregate, it will not be considered a CFC.[47]

Note 4: Key Considerations Concerning Stock Sales vs. Asset Sales Under Chapter 3

For Chapter 3 companies, a stock sale is the most tax-efficient exit mechanism for both US and PR investors. Under a Chapter 3 company stock sale scenario, US tax resident investors would have no capital gains tax liability at the Puerto Rico level and would only be subject to federal and state (if applicable) capital gains tax rates in their jurisdiction. In this case, US tax resident investors could potentially use carryover losses to amortize the tax liability resulting from the divestiture of shares. PR tax resident investors would enjoy 100% exemption of capital gains at both the PR and US federal levels (subject to the exceptions and limitations described herein).

If the exit transaction is structured as an asset sale, particularly as it relates to the sale of intangibles (i.e., intellectual property), a regime similar to Chapter 3 (known as Chapter 6 under Act 60) could be leveraged to minimize tax leakage. Under Chapter 6, a 4% tax rate could apply to the realized gains at the entity level on the sale of intangibles, before any distributions are made to investors.[48] Subsequent distributions to US tax resident investors would be subject to a qualified dividend tax rate at the federal level (23.8%) and have no further tax liabilities at the PR level beyond what already had been paid by the Chapter 3 or 6 entity. Under such scenario, distributions to PR tax resident investors stemming from such entity would be fully exempt from taxes at both the PR and US federal levels.

Additional structuring alternatives might be available to mitigate tax leakage for US-based investors in the event of an asset sale in a Chapter 3 entity. For example, in Chapter 3, companies exiting via an asset sale could repurchase shares from US-based investors prior to the sale of the company, giving investors the benefit of a stock sale prior to exiting via an asset sale.

Please refer to **Exhibit 5** for a comparison of the tax impact of stock versus asset sales for US-based and PR Chapter 3 companies.

Note 5: High-Level Observations on Redomiciling a Company to Puerto Rico

It is possible to redomicile a going concern entity from the US to Puerto Rico while layering in Chapter 3's benefits in a way that dramatically changes the company's FCF generation. In practice, this is a complex and challenging proposition.

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[46] 26 U.S.C. § 951. "Income of controlled foreign corporations." United States Government Publishing Office. Accessed May 2, 2023. https://www.govinfo.gov/app/details/USCODE-1999-title26/USCODE-1999-title26-chap1-subchapN-partIII-subpartF-sec951/context.

[47] Another foreign tax regime under the US federal tax rules to take into consideration is the Passive Foreign Investment Company ("PFIC") regime, which could be relevant if 75% or more of the gross income derived by the business operation is considered passive or 50% or more of the assets held by the entity produce passive income. Bona fide residents of Puerto Rico may not be considered US shareholders for these purposes. It is important to note that the rules regarding the scope and applicability of the GILTI (and certain other subpart F rules) are complex and that specialized tax advisory should be considered.

[48] Under Chapter 6 (not addressed in detail in this paper), the company could remain a Chapter 3 entity with a flowthrough election solely for Puerto Rican income tax purposes (for US federal tax purposes, it would be treated as a corporation) to obtain the desired result upon an asset sale. Under this scenario, a 0% PR income tax would apply to the PR bona fide resident investors and a 24% Puerto Rican income tax to non-PR resident investor individuals, which should be creditable against the tax applicable on the qualified dividend of 20% for US resident investor individuals.

The administrative process of redomiciling an entity itself is not necessarily the most complex part of the move. The main challenge lies in restructuring the company's ongoing operations to (i) minimize the tax liabilities arising from past profits (i.e., built-in gains or accumulated untaxed earnings), (ii) avoid being subject to US taxation on a go-forward basis, and (iii) maximize Chapter 3's benefits. That being said, through more sophisticated tax and legal structuring, there are numerous examples of entities successfully redomiciling Puerto Rico.[49]

Below, we address each of the three key considerations.

First, when thinking about redomiciling, it is critical to consider the potential tax liabilities that may arise from "moving" the operations and assets of a business to a tax jurisdiction outside the US. If the entity being redomiciled is a corporation for US tax purposes, US tax rules will consider retained earnings as accumulated untaxed distributions to shareholders; hence, these will be subject to taxation as qualified dividend income (23.8% all-in) upon relocation. In addition, if a US "exit tax" applies, all inherent gains in the assets of the US business could be subject to one or more levels of US federal income taxation, including at ordinary rates.[50] If it is a pass-through entity, US tax rules will consider the move in the same way that it considers an S-Corp to C-Corp (i.e., pass-through-to-taxable entity) transition, which taxes the capital gains on the "appreciated assets" at the time of the conversion. Generally, the built-in gains tax is imposed at a higher corporate tax rate. In both of these scenarios, the tax consequences to investors may be material but not necessarily fatal to the operation. Sophisticated (though not novel) tax and legal structuring may be helpful in managing this risk and alleviating the potential tax burden on investors upon the move.

Second, for redomiciling to be successful, it is critical for the entity to avoid being subject to US taxation on a go-forward basis. As part of the process of registering the entity as a PR corporation and applying for a Chapter 3 decree, special attention should be paid to anti-inversion rules[51] to ensure that the entity would no longer be subject to US federal taxes. Anti-inversion rules were established to discourage US companies from "inverting" or reincorporating the US parent company outside of the US. According to these rules, a PR corporation could be treated as a "US domestic corporation" (and, therefore, be subject to US taxes) if ***all three*** of the following conditions are satisfied:[52]

- The Puerto Rican corporation completes the acquisition of "substantially" all the assets of a US corporation;
- at least 60% of the stock of the Puerto Rico corporation is acquired by former shareholders of the US corporation by reason of holding shares in the US corporation; and
- after the acquisition, the expanded group that includes the Puerto Rico corporation does not have substantial business activities in Puerto Rico when compared with the total business activities of the expanded affiliated group.

Third, to fully ***maximize*** the benefits of redomiciling an entity to PR under Chapter 3, 100% of the entity's income needs to be considered PR-sourced income. To the extent that certain business operations or processes—in connection with the product or service delivery—are performed outside of Puerto Rico, the benefits of Chapter 3's preferential tax rate will be diluted (i.e., the consolidated effective tax rate will be higher than the 4% statutory rate under Chapter 3). In essence, if a US entity redomiciled to PR under Chapter 3 maintains certain operations in the US (i.e., an affiliate entity, a branch, and/or certain functions, such as sales, customer support, and software development), it may endanger the classification of its income as "Puerto Rican–sourced income."

[49] There is a group of professionals in the US mainland and Puerto Rico specialized in executing these types of operations, some of which were consulted when drafting this paper.
[50] Internal Revenue Code § 367. "Effect of reorganizations." Internal Revenue Service, United States Department of the Treasury. Accessed May 2, 2023. https://www.irs.gov/irm/part4/irm_04-061-011.
[51] 26 U.S.C. § 7874 (2018). United States Government Publishing Office. Accessed May 2, 2023. https://www.govinfo.gov/content/pkg/US-CODE-2018-title26/pdf/USCODE-2018-title26-subtitleA-chap1-subchapC-partIII-sec7874.pdf.
[52] Internal Revenue Service. "International Practice Units- IRC § 7874: Expatriated Entities and Foreign Parent Stock Attribution." Accessed May 2, 2023. https://www.irs.gov/pub/int_practice_units/isocup_1_10_01.pdf. and Duffy, Tom. "Corporate Inversions." Tom Duffy, CPA. Accessed May 2, 2023. https://tomduffycpa.com/corporate-inversions/.

The more the PR entity is responsible for creating "value" (e.g., management and key company executives are *bona fide* PR residents, software development, customer service, training, and sales happens from PR, and/or intellectual property is registered in PR), the more "value" can be legitimately attributed to the PR entity and the more the consolidated entity's effective tax rate will approach 4%.

Note 6: Puerto Rican vs. Non-Puerto Rican Income

After moving a business to Puerto Rico, management should understand the key considerations for attributing income to Puerto Rican operations instead of US operations.[53] Income attributed to Puerto Rican operations can benefit from preferential tax rates under Act 60, whereas income attributed to US operations is taxed at normal US rates. If a company incorrectly reports what would effectively be US-sourced income as PR-sourced income, the IRS could impose back taxes, as well as penalties.

What are some of the key considerations for establishing Puerto Rican–sourced income?

In general terms, trading and services income can be legitimately attributed to Puerto Rico as long as it is effectively attributed to the company's operations in Puerto Rico and is separated from the company's US operations or offices. More specifically, for services (including software), to be considered PR-sourced income, (a) the "property" (e.g., SaaS platform) must be developed and/or maintained by the PR entity, (b) the "property" must be owned and used by the service provider in PR—not the service recipient in the US—and (c) the service provider may use the "property" concurrently to provide significant services to other entities, provide maintenance service or upgrades to the "property," and/or maintain the rights to remove and replace the "property."

What are some of the key circumstances that could endanger Puerto Rican–sourced income?

Although not an all-inclusive list, some of the below circumstances could bring into question the classification of PR-sourced income. For example, having an office or a "permanent establishment" in the US (e.g., a sales office) owned by the PR company could challenge the classification of income derived from such an office as PR-sourced income, unless such establishment demonstrably restricts itself to soliciting only, with no management discretion or closing sale contracts. Other circumstances could include providing training related to the business service within the US, having owned servers (not third-party servers) in the US, and using a US entity to process credit card transactions without charging a fee for payment processing to the PR entity, among others.

3c. How Can Searchers and Investors Leverage Act 60?

How a searcher or investor can best take advantage of Act 60's incentives depends upon their specific circumstances. As such, we offer selected takeaways for the sample profiles below.

Searchers and prospective searchers: If the search could be performed from anywhere, the searcher could consider becoming a *bona fide* Puerto Rico tax resident and perform the search from Puerto Rico. Assuming the typical search structure, the search vehicle can be a Delaware entity (where the search capital is raised) and the searcher may establish a Puerto Rican pass-through entity[54] under Chapter 3 of Act 60 (of which the searcher would be the only shareholder) that provides services to the Delaware entity during the search stage (the "Management Services Entity," or "MSE")[55]. Under Chapter 3, the net taxable income of the MSE (calculated after the payment of a "market salary" to the searcher, as sole manager of the entity)[56] derived from the exportation of services from the PR entity to the Delaware search vehicle would be subject to preferential tax rates of 2%.[57] Subsequently, under Chapter 3, dividends paid from the MSE to the searcher (as sole shareholder of the MSE) would not be taxed at the Puerto Rico nor US federal levels.

[53] See IRS Publication 570 (2021), Tax Guide for Individuals with Income from U.S. Possessions (Internal Revenue Service. "Tax Guide for Individuals With Income from U.S. Possessions (Publication 570)." Accessed May 2, 2023. https://www.irs.gov/pub/irs-pdf/p570.pdf.). Also, see torrescpa.com/white-papers/moving-intellectual-related-businesses-to-puerto-rico-under-act-20.
[54] Under the dual election discussed in Note 1, the searcher would optimally choose the PR LLC to be taxed as a corporation for US federal tax purposes.
[55] As opposed to the traditional search fund model whereby the searcher is an employee of the search vehicle and earns 100% of his compensation from salary (taxed at ordinary personal income tax rates).
[56] Unofficial research conducted by the authors estimates that the "market salary" for a position akin to that of a searcher based in Puerto Rico would be between $70,000 and $80,000 per year.
[57] Under Chapter 2 of PR Act 60, for entities generating $3M of less in revenues, the applicable income tax rate on net income from the exempt operation is 2% for 5 years and 4% thereafter. The income tax rate can be further reduced to 1% if the exempt business is engaged in a "Novel Pioneer Activity."

In essence, the searcher could enjoy a 2% effective tax rate on any salaries paid in excess of her salary, dramatically lowering her overall tax burden relative to what it would be in a traditional search structure outside of the MSE model.[58] It would be the searcher and the investors' prerogative as to how to best make use of these savings (effectively, the would be realizing a higher "FCF margin" on your compensation from day 1 of your search!). It is important to note that you do not need to be an eligible investor under Chapter 2 of the Act to realize the benefits as a sole member of a Chapter 3 management company in Puerto Rico; the only requirement is that you are a Puerto Rican tax resident and that the services are rendered from Puerto Rico.[59]

Searchers in the process of an acquisition: For searchers thinking about tax structuring strategies, consider whether the business (or assets) could be redomiciled to Puerto Rico as part of the transaction. Decentralized operating models where services are provided and/or processes are executed remotely could be ideal candidates for this (Chapter 3 of the Act). Moreover, businesses that have proprietary intellectual property ("IP") as part of the value proposition or service delivery (i.e., a software business) could be ideal candidates to be organized in Puerto Rico under Chapter 3.[60]

In terms of the searcher's carry, if the searcher thinks that she could be the CEO of the newly acquired company as a Puerto Rican tax resident under Chapter 2 of the Act, she could effectively have her carry be 100% tax free, regardless of whether the company is a PR-domiciled entity or not. In the scenario where the target company is not a PR-domiciled entity, the searcher could be the sole proprietor of a PR-domiciled management company providing management services to the non-PR entity (akin to the MSE structure described in number 1, above) and enjoy Chapter 3's preferential tax rate on part of her cash compensation[61].

The bottom line is that, if the company the searcher acquires is a good fit for Chapter 3 and/or if the searcher could be performing CEO duties as a Puerto Rican tax resident under Chapter 2, the searcher could potentially lower the corporate tax burden for the operating company and / or minimizing the tax burden on her cash compensation, as well as future capital gains tax liabilities.

CEOs who have already acquired a business: Similar to the previous subsection, CEOs who have already acquired a business should consider whether the business (or assets) could be a candidate to be redomiciled Puerto Rico. Generally speaking, the longer the searcher has been operating the business under a jurisdiction outside of Puerto Rico, the more complex it will be to execute a strategy whereby the entity ends up maximizing the benefits from Chapter 3 of the Act.

As an illustrative example, if the company operates under a pass-through structure, redomiciling it as a Puerto Rican taxable entity under Chapter 3 could have the following implications on an ongoing basis (not necessarily an inclusive list): (i) the entity will start operating as a Puerto Rican taxable entity, subject to a 4% statutory corporate tax for eligible services rendered from Puerto Rico; (ii) dividend distributions to Puerto Rican resident investors would be 100% tax free at both the Puerto Rican and US federal levels, and (iii) dividend distributions to US resident investors would be subject to 23.8% qualified dividend tax rate at the US federal level and 100% tax free at the Puerto Rican level. Aside from these ongoing considerations, the pass-through-to-taxable entity conversion transaction itself may or may not have tax consequences, depending on any untaxed earnings and profits or built-in gain considerations that may be applicable upon redomiciling the company outside of the US.

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[58] Refer to footnote 57. In essence, this structure could lower the effective tax burden to a typical searcher resulting from its compensation during the search stage by +$32k per year, if we assume (a) $150k search salary subject to 30% personal income tax rate for a traditional searcher and (b) $150k total compensation to the MSE shareholder-searcher, comprised of a $75k salary (subject to ordinary income tax rates in Puerto Rico) and $75k in net taxable income subject to 2% at the MSE level and that is subsequently dividended out (tax free) to the searcher-shareholder.

[59] This structure would likely have to be revisited as you transition into the operating stage; nonetheless, the same general construct could apply in the case where you, as CEO, could provide management services to your company as a Puerto Rican resident independent contractor (i.e., a 1099 service provider) and sole member of a PR-domiciled management company under Chapter 3 of the Act.

[60] Puerto Rico is under the US legal and court system, including the US's IP legal framework and protections.

[61] Refer to logic in footnote 59.

Adding in Chapter 3's incentives, the dividend distributions to and capital gains for ***bona fide*** PR resident investors in your cap table (including the searcher's gains if that person is a ***bona fide*** PR resident) under Chapter 3 would be 100% tax free. For US investors, all else being equal, their capital gains liability upon exit would be no different from an exit of a US-domiciled entity (i.e., they would be subject to applicable US federal and local taxes).[62]

Investors: Investors could consider establishing residency in Puerto Rico as a resident investor under Chapter 2 to enjoy 100% exemption on capital gains from certain private equity investments, including search fund investments. If investors were to establish a management services entity under Chapter 3 of the Act to offer services to company boards, investment and fund management services, and other advisory services, the income generated from those activities could be eligible to be taxed at the 4% preferential tax rate and free from US federal taxation (to the extent that such services are rendered from Puerto Rico).

[62] Please refer to **Exhibit 5** for a complete comparison of the tax impact of stock versus asset sales for US investors in Chapter 3 entities.

4. Which Search Fund Strategies Might be the Best Candidates for Each Tax Program?

Although the potential benefits of each tax program are compelling, some search fund strategies are better suited to pursuing one or more of the various tax programs we analyze.

Table 10. Search fund strategies & tax programs

Search Fund Strategy	EOZ	QSBS	PR Act 60
Traditional Search Fund	Medium	Strong	Strong
Self-Funded Search	Medium	Strong	Strong
Search-to-Start (Greenfield)	Strong	Strong	Strong
Consolidation/Roll-up	Medium	Medium	Strong
Long-Term Hold ("LTH") Structure	Medium	Strong	Strong

The EOZ Program

The EOZ program is a strong potential fit for projects with geographic flexibility because the benefits of the program are constrained to businesses operating within one or more defined geographic regions.

EOZ + Search-to-Start (Greenfield) Projects:

- Greenfield projects have the most potential geographic flexibility and, as such, could be the best candidates to take advantage of the EOZ program. Management could choose to locate their office in an existing opportunity zone and stay within one or more opportunity zones as the company scales. By basing the office in an opportunity zone, the company could pass the 50% gross income test to qualify for the benefits of the program.

EOZ + Traditional and Self-Funded Searches, Consolidation/Roll-Up Strategies, and Long-Term Hold Structures:

Non-greenfield projects can meet the EOZ's 50% gross income test to qualify if:

- The acquired company or companies happen to be located within one or more opportunity zones;
- 50% or more of the clients served by the company or companies happen to be located within one or more opportunity zones; or
- the acquired company could be "re-headquartered" within an opportunity zone within the first six months post-acquisition.

The IRS performs a qualification test twice per year for operating companies trying to qualify for the benefits of the EOZ program. If a company based outside of an opportunity zone could be relocated to within an opportunity zone within the first 6 months after its acquisition, it could still comply with the requirements of the EOZ program.

Relocating a company within the first six months of operations could be disruptive to the business and would seem to contradict the historical wisdom of the search fund community to "do no harm" in the first year of operations. However, entrepreneurs and investors should evaluate the risk–reward trade-off of such a move on a case-by-case basis.

The search fund community is seeing more acquisitions of companies with fully or partially remote workforces, especially in the case of software acquisitions. Companies acquired with fully or partially remote workforces could be good candidates to consider pursuing EOZ tax incentives, especially if they have a long-term (10+ year) view.

The QSBS Program

QSBS + Traditional and Self-Funded Searches:

QSBS requires a minimum 5-year hold period, and the required C-Corp structure discourages companies from issuing dividends to shareholders. However, the median search fund company is held for a median of 5.7 years before exit,[63] and most choose to reinvest profits in growth until at least year 5. As such, most traditional and self-funded projects could choose to structure as C-Corps to take advantage of the QSBS program and can do so without major issues.

QSBS + Long-Term Hold Structures:

The search fund community has seen an increasing number of "long-term hold" projects, which seek to build portfolios of businesses funded by an initial equity investment and then funded perpetually by internally generated cash flow and debt, with 10–20+ year—or even indefinite—investment horizons.

These long-term hold structures can take advantage of the Section 1202 exclusion by structuring each acquisition as a QSBS C-Corp. Under this structure, each acquired company is subject to its own 5-year holding period.

Each company acquired as part of a long-term hold portfolio has the potential to shield capital gains up to 10x its own investment basis, so a long-term hold and QSBS structure has the potential to generate generous tax savings for its shareholders, if successful. This is especially true when combined with the share repurchase strategy examined in Section 2b. When a project has a horizon over 10 years, setting each acquisition up for its own tax-advantaged QSBS status would seem to be a sensible capital allocation strategy to consider.

It is worth noting that, in case the exit comes earlier, no harm is done.

It is also worth noting that truly long-term initiatives that plan to realize returns over decades by issuing dividends (not through share repurchases) are ***not*** a good fit for QSBS because they would be hit with "double taxation."

QSBS + Search-to-Start (Greenfield) Projects:

A search-to-start (greenfield) project with less than $50M of gross assets at inception, structured as a C-Corp, and held for 5+ years could qualify for the Section 1202 exclusion.

Greenfields best suited for Section 1202 exclusion are those that intend to embody a spirit of "equity starvation," to borrow a phrase from Will Thorndike[64], that is, those raising a single round of equity financing, funding subsequent growth through internal cashflows, and/or debt without raising additional primary equity.

Any time additional equity capital is raised, each subsequent round comes with its own 5-year "clock" starting from the date of financing. In other words, a company raising a $3M Series A round in 2020 and $6M Series B round in 2023 would need to hold Series A shares until 2025 and Series B shares until 2028 if it wished for both Series A and Series B shares to benefit from the tax savings of the QSBS program. Series A shares could exit in 2025, while Series B shares would need to be held until 2028.

[63] Peter Kelly and Sara Heston. "2022 Search Fund Study: Selected Observations." Stanford Graduate School of Business. Last modified 2022. https://www.gsb.stanford.edu/faculty-research/case-studies/2022-search-fund-study-selected-observations
[64] Interview: June 9, 2022.

QSBS + Consolidation/Roll-Up Strategies:

Consolidation projects, like the search fund community has seen in multisite healthcare or other niche industries like pond and lake management, are marked as “medium” for the QSBS program because some of these projects fund their acquisition activity with multiple rounds of equity financing.

As noted above, each equity financing round comes with its own 5-year “clock.” Consolidation projects that will only raise one round of equity and that will pursue acquisitions funded exclusively through internal cash flow and debt could be good candidates for the QSBS program.

Consolidation projects that intend to raise a Series A equity round to finance an initial platform acquisition and then a later Series B round to fund future acquisitions should be mindful of the impact of subsequent equity financing on the length of their overall hold period.

QSBS has already helped select search fund projects realize tax-advantaged returns

The QSBS program has already generated millions of dollars of tax savings for traditional and self-funded projects and is receiving increasing attention from entrepreneurs and investors within the search fund community.

One entrepreneur interviewed for this paper (see Acknowledgements section) acquired a manufacturing company located in the western United States through a stock purchase for approximately a 3x EV/EBITDA multiple when the company was generating around $11M in annual revenue. The company was well below the $50M in gross assets requirement.

The entrepreneur grew revenues approximately 4x over the holding period and sold the company through a stock sale, realizing a 10x MOIC. The entrepreneur estimated that the QSBS program generated approximately $4M in tax savings for him personally and millions of dollars of savings for other shareholders.

QSBS is currently being used by multiple high-growth operating companies

Additionally, a small number of high-growth entrepreneurial projects within the search fund community, currently in Y3–Y5 of operations, have been structured to take advantage of Section 1202 QSBS exclusion. We interviewed three operators who offered conservative estimates that the program would generate tens of millions of dollars in incremental equity value for their shareholders.

Although few or no high-profile search fund exits have benefited from the QSBS program currently, we expect the search fund community will become more widely aware of this program in the next 3 to 5 years after shareholders realize tax-advantaged returns from select projects currently on track to meet or exceed the 5-year minimum holding period required to comply with QSBS regulations.

Act 60 Tax Incentives

Act 60 + Traditional and Self-Funded:

Traditional and self-funded projects are good candidates to take advantage of Act 60’s incentives, particularly those pursuing targets with remote workforces, such as software companies. CEOs and management teams of companies of any industry with the ability to lead companies from anywhere could benefit from Act 60’s incentives —both Chapter 2 and Chapter 3—by structuring Puerto Rican–based management companies that provide services to entities outside of Puerto Rico.

Act 60 + Search-to-Start (Greenfield) Projects:

Depending on the industry focus, greenfield projects may have stricter requirements for management and operational presence in one or more specific geographies. As such, entrepreneurs pursuing a greenfield strategy should consider whether they would be able to manage their project remotely as ***bona fide*** residents of Puerto Rico.

Act 60 + Long-Term Hold Structures:

Entrepreneurs pursuing long-term hold ("LTH") projects tend to focus on how they can compound growth and returns over the longest possible horizon in the most tax- and capital-efficient manner. PR's Act 60 incentives offer a 15-year fixed contract with the Government of Puerto Rico, guaranteeing low fixed tax rates for eligible companies. This contract is renewable for another 15-year period. Entrepreneurs pursuing LTH projects may find their 10+ year investment horizon aligns neatly with the fixed 15+ year term of PR's Act 60 incentives. Within this context, interesting structures could be evaluated, whereby a Chapter 3 PR-based HoldCo provides export management services to subsidiaries and affiliates abroad and collects upstream cashflows at higher FCF margins. This could theoretically lower effective tax rates across the platform and free up liquidity sources to continue compounding over a long period of time.

Act 60 + Consolidation/Roll-Up Strategies:

Similarly, and in addition to some of the considerations above, entrepreneurs pursuing consolidation projects (especially those with a long-term horizon) could structure their HoldCo in Puerto Rico and export management services to all individual units. Whereas a traditional searcher might redomicile an asset to Puerto Rico, a searcher pursuing a consolidation effort could structure arms-length transfer pricing agreements between individual acquisitions and their Puerto Rican–based management company, potentially extending tax savings to their entire platform.

5. Areas for Further Exploration

Tax strategy and planning are rich areas for further exploration and optimization within the search fund community. We have only begun to scratch the surface in the present paper. Beyond the scope of the current study, other fascinating topics for consideration include the following:

- It may be possible to combine or “stack” the QSBS and EOZ programs to make a large tax-advantaged share repurchase at Y5 to create liquidity and hold the company until Y10+ to benefit from a permanent exclusion of federal capital gains.
- It may be possible to combine or “stack” the QSBS and Act 60 programs to create a structure that would allow for tax-advantaged returns to both Puerto Rico and US tax residents.
- It may be possible to combine these programs with the use of trusts and/or retirement accounts to further reduce the tax burden of stakeholders.
- Operating companies with excess cash may be able to generate tax-advantaged investment income through the use of captive insurance companies.
- Many countries outside of the US have their own unique tax incentive programs which may be beneficial for non-US searchers.

6. Conclusion

The historical wisdom of the search fund community encourages entrepreneurs to buy a good company in a great industry and to surround themselves with engaged investors and advisors who will mentor and coach them. This wisdom has helped generate realized returns of a 35.3% IRR and 5.2x MOIC,[65] in aggregate, without relying on tax savings from the programs examined in the current paper.

Although the tax programs examined in the present paper have the potential to create millions of dollars in value for both entrepreneurs and investors and to spur job creation and economic development, it is important that entrepreneurs and their investors carefully weigh the risks and rewards of these regimes. The tax programs discussed here have not been used extensively (or at all) within the search fund community. As such, there could be risks or complications that arise that we have not considered. Tax law can and does change at any time.

Although the community has given extensive time to the study of other areas that fall under the important umbrella of capital allocation, tax strategy presents an opportunity for further discussion, exploration, and optimization. We hope that this paper can serve to spark thoughtful conversations between entrepreneurs and investors in the search fund community, leading to (even) higher post-tax returns for all.

The appendices that follow contain additional data points, performance benchmarks, and analyses of the programs discussed in the present paper. The appendices include additional clarifying information regarding the eligibility requirements for each of the programs, and further illustrate the implications of these tax programs for company performance, net investor returns, and management carry.

[65] Kelly, Peter and Sara Heston. "2022 Stanford GSB Search Fund Study Selected Observations." Stanford Graduate School of Business. Accessed May 2, 2023. p. 2. https://www.gsb.stanford.edu/faculty-research/case-studies/2022-search-fund-study-selected-observations.

Exhibit 1

Summary of the Impact of EOZ and QSBS on the Median Search Company ($, x & %)[66]

	EOZ & QSBS	
	EOZ (at Y10)	QSBS (at Y5)
Δ Post-tax Net IRR		
3x Gross MOIC	+2%	+3%
5x Gross MOIC	+2%	+5%
10x Gross MOIC	+2%	+6%
Δ Post-tax Net MOIC		
3x Gross MOIC	+0.4x	+0.6x
5x Gross MOIC	+0.7x	+0.9x
10x Gross MOIC	+1.4x	+1.7x
Δ Absolute Investor $		
3x Gross MOIC	+$3,006,748	+$2,717,118
5x Gross MOIC	+$5,526,748	+$5,237,118
10x Gross MOIC	+$11,826,748	+$11,537,118
Δ Absolute Mgmt $		
3x Gross MOIC	+$353,252	+$642,882
5x Gross MOIC	+$1,193,252	+$1,482,882
10x Gross MOIC	+$3,293,252	+$3,582,88

[66] Assumptions about revenue, EBITDA, and growth for the median search fund company are captured in Footnote #3. Note that the post-tax figures represented in this table are not identical because of the difference between the value of the preferred coupon paid over a 5-year vs. 10-year period.

Exhibit 2

The Impact of Puerto Rico's Act 60 Incentives on the Median Pass-Through Search Company[67] under Different Growth Scenarios and Hold Periods ($ in thousands, x & %)

	6-Yr. Hold Period		10-Yr. Hold Period		Delta vs. Pass-Through Search OpCo	
	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	6-Yr. Hold Period	10-Yr. Hold Period
Post-Tax Net IRR to Pref. Equity Investors						
10% CAGR	23.5%	25.2%	18.8%	20.1%	1.7%	1.3%
20% CAGR	33.8%	35.2%	28.8%	29.5%	1.3%	0.7%
30% CAGR	43.7%	45.4%	38.3%	39.4%	1.7%	1.1%
Post-Tax Net MOIC to Pref. Equity Investors						
10% CAGR	3.5x	3.9x	5.6x	6.2x	0.3x	0.7x
20% CAGR	5.7x	6.1x	12.6x	13.3x	0.4x	0.8x
30% CAGR	8.8x	9.4x	25.5x	27.7x	0.6x	2.1x
Pref. Equity Absolute Post-Tax $ Proceeds						
10% CAGR	$26,631	$28,964	$42,007	$46,993	$2,333	$4,985
20% CAGR	$42,202	$45,866	$94,382	$100,023	$2,664	$5,641
30% CAGR	$66,328	$71,035	$192,027	$208,120	$4,707	$16,093
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Pass-Through / US-Based Entrepreneur	US Pass-Through / PR-Based Entrepreneur	US Pass-Through / US-Based Entrepreneur	US Pass-Through / PR-Based Entrepreneur		
10% CAGR >>>>>>	$5,208	$6,593	$9,201	$11,647	$1,384	$2,446
20% CAGR	$10,732	$13,300	$26,659	$32,337	$2,568	$5,678
30% CAGR	$18,440	$23,342	$59,207	$74,946	$4,902	$15,739
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Pass-Through / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur	US Pass-Through / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur		
10% CAGR	$5,208	$7,577	$9,201	$13,750	$2,369	$4,549
20% CAGR >>>>>>	$10,732	$14,709	$26,659	$36,126	$3,977	$9,467
30% CAGR	$18,440	$25,328	$59,207	$81,736	$6,888	$22,529
Cummulative FCF (or Tax-Affected FCF) Generated						
10% CAGR	$7,227	$11,164	$15,465	$23,879	$3,937	$8,414
20% CAGR	$10,012	$15,646	$26,986	$42,142	$5,634	$15,155
30% CAGR	$13,732	$21,676	$47,059	$74,221	$7,945	$27,162

Note: (1) Unless otherwise stated in KPI subtitle.

[67] Assumptions about revenue, EBITDA, and growth for the median search fund company are captured in Footnote #3.

Exhibit 3

The Impact of Puerto Rico's Act 60 Incentives on the Median Taxable Search Company[68] under Different Growth Scenarios and Hold Periods ($ in thousands, x & %)

	6-Yr. Hold Period		10-Yr. Hold Period		Delta vs. Taxable Search OpCo	
	Taxable US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	Taxable US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	6-Yr. Hold Period	10-Yr. Hold Period
Post-Tax Net IRR to Pref. Equity Investors						
10% CAGR	24.3%	25.2%	19.4%	20.1%	0.9%	0.7%
20% CAGR	34.3%	35.2%	28.9%	29.5%	0.9%	0.6%
30% CAGR	44.6%	45.4%	38.8%	39.4%	0.8%	0.6%
Post-Tax Net MOIC to Pref. Equity Investors						
10% CAGR	3.7x	3.9x	5.9x	6.2x	0.2x	0.3x
20% CAGR	5.9x	6.1x	12.7x	13.3x	0.2x	0.6x
30% CAGR	9.1x	9.4x	26.6x	27.7x	0.3x	1.1x
Pref. Equity Absolute Post-Tax $ Proceeds						
10% CAGR	$27,762	$28,964	$44,424	$46,993	$1,202	$2,568
20% CAGR	$44,147	$45,866	$95,397	$100,023	$1,720	$4,626
30% CAGR	$68,610	$71,035	$199,830	$208,120	$2,425	$8,290
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Taxable / US-Based Entrepreneur	US Taxable / PR-Based Entrepreneur	US Taxable / US-Based Entrepreneur	US Taxable / PR-Based Entrepreneur		
10% CAGR	$5,585	$7,070	$10,006	$12,666	$1,485	$2,660
20% CAGR >>>>>>	$11,047	$13,983	$26,997	$34,174	$2,936	$7,177
30% CAGR	$19,201	$24,305	$61,808	$78,238	$5,104	$16,430
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Taxable / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur	US Taxable / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur		
10% CAGR	$5,585	$7,577	$10,006	$13,750	$1,992	$3,744
20% CAGR >>>>>>	$11,047	$14,709	$26,997	$36,126	$3,662	$9,128
30% CAGR	$19,201	$25,328	$61,808	$81,736	$6,127	$19,928
Cummulative FCF Generated						
10% CAGR	$9,136	$11,164	$19,545	$23,879	$2,028	$4,334
20% CAGR	$12,744	$15,646	$34,334	$42,142	$2,903	$7,807
30% CAGR	$17,584	$21,676	$60,229	$74,221	$4,093	$13,992

Note: (1) Unless otherwise stated in KPI subtitle.

[68] Assumptions about revenue, EBITDA, and growth for the median search fund company are captured in Footnote #3.

Exhibit 4

Overview of the Eligibility Criteria

<table>
<tr><th>Program</th><th>EOZ</th><th>QSBS</th><th>Puerto Rico’s Act 60</th></tr>
<tr><td>Eligibility</td><td>The business must pass one of the following three tests to meet the IRS’ “50% threshold”
≥50% of hours of the services received by the business were performed in a QOZB.
≥50% of the amounts the business paid for services were for services performed in a QOZB.
≥50% of tangible property and necessary business functions were located in a QOZB.</td><td>The business:
Is a domestic C-Corp.
Has cash and other assets totaling $50M or less at acquisition.
Is actively running a business. In other words, at least 80% of the assets of the firm must be used to actively run the business, not for investment purposes.</td><td>Chapter 3 (Business)
Businesses domiciles in Puerto Rico exporting services in:
Software development
Data processing
Consulting and financial advisory services
Professional services (i.e., law and accounting services)
Hospital and laboratory services
And others
Chapter 2 (Individual)
Bona fide residents of Puerto Rico[69]</td></tr>
<tr><td>Exclusions</td><td>Excluded industries include
Private or commercial golf courses
Country clubs
Massage parlors
Hot tub facility
Suntan facilities
Racetracks or other facilities used for gambling
Stores the principal business of which is the sale of alcoholic beverages</td><td>Excluded industries include
Services firms, such as health, law, accounting, consulting, etc.
Banking, insurance, financing, etc.
Farming
Mining and other natural resource businesses
Hotel, motel, restaurant, etc.</td><td>Chapter 3 (Business)
Businesses serving PR-based clients (nonexport services businesses)
Chapter 2 (Individual)
Individuals who were residents of Puerto Rico at any time from January 17, 2006, to January 17, 2012</td></tr>
</table>

[69] For an individual investor to be treated as a bona fide resident of Puerto Rico under Section 933 of the US Code (and, hence, Act 60), the individual generally must (1) meet the physical presence test (i.e., 183+ days of presence in Puerto Rico), (2) not have a tax home outside of Puerto Rico during the taxable year, and (3) not have a closer connection to the US or a foreign country other than Puerto Rico. Other eligibility requirements for Chapter 2 of the Act include (a) making a $10,000 donation to a local non-for-profit, (b) within two years of receipt of the decree, the recipient must purchase real property in Puerto Rico for use as their principal residence, and (c) file an annual report with the Government of Puerto Rico with a filing fee of $5,000.

Exhibit 5

Tax Impact of Share vs. Asset Sales for US Investors by Entity Type ($)

	Chapter 3 PR Taxable Entity Treated as C-Corp				US Taxable Entity (C-Corp)		US Pass-Through (LLC)	
	Asset Sale (incl. Chapter 6)[70]		Stock Sale		Asset Sale	Stock Sale	Asset Sale	Stock Sale
	PR Investor	US Investor	PR Investor	US Investor	US Investor	US Investor	US Investor	US Investor
Net Gain	$100.0	$100.0	$100.0	$100.0	$100.0	$100.0	$100.0	$100.0
PR Corporate Income Tax (4%)	-$4.0	-$4.0	-	-	-	-	-	-
US Corporate Income Tax (21%)	-	-	-	-	-$21.0	-	-	-
PR Distribution Tax (4%)	$0.0	-	-	-	-	-	-	-
US Distribution Tax for Individual Investors Directly or Through Pass-Through Entities (e.g., LLC) (23.8%)	-	-$22.8	-	-	-$18.8	-	-	-
PR Capital Gains Tax (0%)	$0.0	-	$0.0	-	-	-	-	-
US Capital Gains Tax for Individuals Directly or Through Pass-Through Entities (e.g., LLC) (23.8%, incl. ACA)	-	-	-	-$23.8	-	-$23.8	-$23.8[71] *(Included in Goodwill)*	-$23.8
US Ordinary Income Rate (37%)	-	-	-	-	-	-	**	**
Total Tax Expense	*-$4.0*	*-$26.8*	*$0.0*	*-$23.8*	*-$39.8*	*-$23.8*	*-$23.8*	*-$23.8*
Post-Tax Proceeds	**$96.0**	**$73.2**	**$100.0**	**$76.2***	**$60.2**	**$76.2***	**$76.2**	**$76.2***

*The impact of a stock sale for Puerto Rico taxable entities is tax-neutral for US-based investors investing as individuals or from LP or LLC pass-through structures. US-based investors investing in taxable structures like a C-Corp are treated slightly differently and should consult expert tax counsel. Special thanks to Edgar Rios, Partner at Pietrantoni Mendez & Alvarez, for his help confirming the nuances of stock vs. assets sales from the perspective of both Puerto Rican–based and US-based investors across entity types.

**Current income in a pass-through is taxed at ordinary income rates (37%).

[70] See Note 4.

[71] Internally created goodwill when sold should generate a capital gain with no recapture because no amortization deductions could have been taken. However, if the goodwill was acquired and subject to amortization, part of the capital gain would be reclassified as ordinary income up to the amount of the amortization deductions claimed before the sale of the asset.

Exhibit 6

Impact of the EOZ Program on Post-Tax Net IRR at Y10 Exit (%)

Gross MOIC	Scenario 1 (US Search Co) Post-Tax Net IRR	Scenario 2 (EOZ, 10-Year Hold) Post-Tax Net IRR	Δ Post-Tax Net IRR
3.0x	9%	11%	2%
4.0x	12%	13%	2%
5.0x	14%	16%	2%
6.0x	15%	18%	2%
7.0x	17%	19%	2%
8.0x	18%	21%	2%
9.0x	20%	22%	2%
10.0x	21%	23%	2%
11.0x	22%	24%	3%
12.0x	23%	25%	3%
13.0x	24%	26%	3%
14.0x	24%	27%	3%
15.0x	25%	28%	3%
20.0x	29%	32%	3%
25.0x	31%	34%	3%
30.0x	34%	37%	3%

Exhibit 7

Impact of the EOZ Program on Absolute Dollars Returned to Investors ($)

Gross MOIC	Scenario 1 (US Search, 10-Year Hold)	Scenario 2 (EOZ, 10-Year Hold)	$ EOZ Savings for Investors
3.0x	$19,311,101	$22,317,850	$3,006,748
4.0x	$24,051,101	$28,317,850	$4,266,748
5.0x	$28,791,101	$34,317,850	$5,526,748
6.0x	$33,531,101	$40,317,850	$6,786,748
7.0x	$38,271,101	$46,317,850	$8,046,748
8.0x	$43,011,101	$52,317,850	$9,306,748
9.0x	$47,751,101	$58,317,850	$10,566,748
10.0x	$52,491,101	$64,317,850	$11,826,748
11.0x	$57,231,101	$70,317,850	$13,086,748
12.0x	$61,971,101	$76,317,850	$14,346,748
13.0x	$66,711,101	$82,317,850	$15,606,748
14.0x	$71,451,101	$88,317,850	$16,866,748
15.0x	$76,191,101	$94,317,850	$18,126,748
20.0x	$99,891,101	$124,317,850	$24,426,748
25.0x	$123,591,101	$154,317,850	$30,726,748
30.0x	$147,291,101	$184,317,850	$37,026,748

Exhibit 8

Impact of the EOZ Program on dollars of Management Carry ($)

Gross MOIC	Scenario 1 (US Search, 10-Year Hold)	Scenario 2 (EOZ, 10-Year Hold)	$ EOZ Savings for Management
3.0x	$1,328,899	$1,682,150	$353,252
4.0x	$2,908,899	$3,682,150	$773,252
5.0x	$4,488,899	$5,682,150	$1,193,252
6.0x	$6,068,899	$7,682,150	$1,613,252
7.0x	$7,648,899	$9,682,150	$2,033,252
8.0x	$9,228,899	$11,682,150	$2,453,252
9.0x	$10,808,899	$13,682,150	$2,873,252
10.0x	$12,388,899	$15,682,150	$3,293,252
11.0x	$13,968,899	$17,682,150	$3,713,252
12.0x	$15,548,899	$19,682,150	$4,133,252
13.0x	$17,128,899	$21,682,150	$4,553,252
14.0x	$18,708,899	$23,682,150	$4,973,252
15.0x	$20,288,899	$25,682,150	$5,393,252
20.0x	$28,188,899	$35,682,150	$7,493,252
25.0x	$36,088,899	$45,682,150	$9,593,252
30.0x	$43,988,899	$55,682,150	$11,693,252

Exhibit 9

Impact of the QSBS Program on Post-Tax Net IRR at Y5 Exit (%)

Gross MOIC	Scenario 3 (US Search Co)	Scenario 4 (QSBS)	Δ Post-tax Net IRR
3.0x	18%	21%	3%
4.0x	23%	27%	4%
5.0x	28%	33%	5%
6.0x	32%	37%	5%
7.0x	36%	41%	5%
8.0x	39%	45%	6%
9.0x	42%	48%	6%
10.0x	45%	51%	6%
11.0x	48%	53%	6%
12.0x	50%	55%	5%
13.0x	52%	57%	5%
14.0x	54%	59%	5%
15.0x	56%	61%	5%
20.0x	65%	69%	4%
25.0x	73%	76%	3%
30.0x	79%	82%	3%

The impact of the QSBS program on net IRR diminishes past a 10.0x gross MOIC because the QSBS program shields capital gains on 10.0x the investment basis, or $10M, whichever is greater.

Exhibit 10

Impact of the QSBS Program on Absolute Dollars Returned to Investors ($)

Gross MOIC	Scenario 3 (US Search, 5-Year Hold)	Scenario 4 (QSBS, 5-Year Hold)	$ QSBS Savings for Investors
3.0x	$18,221,538	$20,938,656	$2,717,118
4.0x	$22,961,538	$26,938,656	$3,977,118
5.0x	$27,701,538	$32,938,656	$5,237,118
6.0x	$32,441,538	$38,938,656	$6,497,118
7.0x	$37,181,538	$44,938,656	$7,757,118
8.0x	$41,921,538	$50,938,656	$9,017,118
9.0x	$46,661,538	$56,938,656	$10,277,118
10.0x	$51,401,538	$62,938,656	$11,537,118
11.0x	$56,141,538	$67,678,656	$11,537,118
12.0x	$60,881,538	$72,418,656	$11,537,118
13.0x	$65,621,538	$77,158,656	$11,537,118
14.0x	$70,361,538	$81,898,656	$11,537,118
15.0x	$75,101,538	$86,638,656	$11,537,118
20.0x	$98,801,538	$110,338,656	$11,537,118
25.0x	$122,501,538	$134,038,656	$11,537,118
30.0x	$146,201,538	$157,738,656	$11,537,118

Tax savings beyond a 10.0x gross MOIC are constant because the QSBS program shields capital gains on 10.0x the investment basis, or $10M, whichever is greater.

Exhibit 11

Impact of the QSBS Program on Management Carry ($)

Gross MOIC	Scenario 3 (US Search, 5-Year Hold)	Scenario 4 (QSBS, 5-Year Hold)	$ QSBS Savings for Management
3.0x	$2,418,462	$3,061,344	$642,882
4.0x	$3,998,462	$5,061,344	$1,062,882
5.0x	$5,578,462	$7,061,344	$1,482,882
6.0x	$7,158,462	$9,061,344	$1,902,882
7.0x	$8,738,462	$11,061,344	$2,322,882
8.0x	$10,318,462	$13,061,344	$2,742,882
9.0x	$11,898,462	$15,061,344	$3,162,882
10.0x	$13,478,462	$17,061,344	$3,582,882
11.0x	$15,058,462	$18,641,344	$3,582,882
12.0x	$16,638,462	$20,221,344	$3,582,882
13.0x	$18,218,462	$21,801,344	$3,582,882
14.0x	$19,798,462	$23,381,344	$3,582,882
15.0x	$21,378,462	$24,961,344	$3,582,882
20.0x	$29,278,462	$32,861,344	$3,582,882
25.0x	$37,178,462	$40,761,344	$3,582,882
30.0x	$45,078,462	$48,661,344	$3,582,882

Tax savings beyond a 10.0x gross MOIC are constant because the QSBS program shields capital gains on 10.0x the investment basis, or $10M, whichever is greater.

Exhibit 12: Impact of Reinvesting Chapter 3's Tax Savings on the Cumulative Cash Flow Profile and Post-Tax Proceeds for the Median Pass-Through Search Company

Assuming incremental FCF dollars can be reinvested into the company at 50% sales efficiency (i.e., every dollar reinvested into sales and marketing generates 0.50 cents of new revenue), and the company otherwise grows at the same baseline growth rate, the impact of Chapter 3's benefits compounds more rapidly. In this scenario, post-tax investment outcomes dramatically improve, particularly with longer hold periods.

For example, in the 10-year hold scenario where EBITDA grows at a 20% CAGR over the projection period, the Chapter 3 company generates $15.2M of cumulative incremental FCF (see Appendix B) vs. a traditional US-based pass-through search opco with the same baseline growth projection. These savings can be then reinvested into the business to further accelerate growth in a more capital efficiency way; assuming 50% Sales Efficiency on those reinvested dollars, the impact of Chapter 3 becomes more dramatic - +3.0 post-tax net MOIC and +2.9% post-tax net IRR to investors.

As sales efficiency increases from 50% to 75% and then further to 100% (see **Exhibit 12(c)**), the impact of Chapter 3 on equity value creation based on the same baseline revenues and EBITDA projections is further magnified.

Exhibit 12(a) – Conservative Case

The Impact of Reinvesting Tax Savings Assuming 50% Sales Efficiency in the Median Pass-Through Search Company[72] ($ in thousands, x & %)[73]

	6-Yr. Hold Period		10-Yr. Hold Period		Delta vs. Pass-Through Search OpCo	
	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	6-Yr. Hold Period	10-Yr. Hold Period
Post-Tax Net IRR to Pref. Equity Investors						
10% CAGR	24.2%	26.9%	19.7%	21.7%	2.6%	1.9%
20% CAGR	33.6%	37.1%	28.5%	31.3%	3.5%	2.9%
30% CAGR	43.7%	47.5%	38.3%	41.4%	3.8%	3.1%
Post-Tax Net MOIC to Pref. Equity Investors						
10% CAGR	3.5x	4.2x	6.1x	7.1x	0.5x	1.1x
20% CAGR	5.7x	6.6x	12.3x	15.3x	1.0x	3.0x
30% CAGR	8.8x	10.3x	25.5x	32.0x	1.5x	6.4x
Pref. Equity Absolute Post-Tax $ Proceeds						
10% CAGR	$27,666	$31,358	$45,579	$53,481	$3,692	$7,901
20% CAGR	$42,671	$49,862	$92,237	$114,893	$7,191	$22,655
30% CAGR	$66,328	$77,443	$192,027	$240,329	$11,115	$48,302
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Pass-Through / US-Based Entrepreneur	US Pass-Through / PR-Based Entrepreneur	US Pass-Through / US-Based Entrepreneur	US Pass-Through / PR-Based Entrepreneur		
10% CAGR >>>>>>	$5,553	$6,593	$10,391	$11,647	$1,039	$1,255
20% CAGR	$10,555	$13,300	$25,944	$32,337	$2,745	$6,393
30% CAGR	$18,440	$23,342	$59,207	$74,946	$4,902	$15,739
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Pass-Through / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur	US Pass-Through / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur		
10% CAGR	$5,553	$8,587	$10,391	$16,488	$3,034	$6,096
20% CAGR >>>>>>	$10,555	$16,395	$25,944	$42,400	$5,840	$16,456
30% CAGR	$18,440	$28,032	$59,207	$95,326	$9,592	$36,119
Cummulative FCF (or Tax-Affected FCF) Generated						
10% CAGR	$7,227	$11,941	$15,465	$26,689	$4,714	$11,224
20% CAGR	$10,012	$16,817	$26,986	$47,665	$6,806	$20,678
30% CAGR	$13,732	$23,401	$47,059	$84,769	$9,669	$37,710

Note: (1) Unless otherwise stated in KPI subtitle.

[72] Long-term median sales efficiency for growth-stage SaaS businesses is ~70%, according to ScaleVP. "SaaS Metrics: A Primer on SaaS Sales Efficiency." Accessed May 2, 2023. https://www.scalevp.com/blog/saas-metrics-a-primer-on-saas-sales-efficiency.
[73] Assumptions about revenue, EBITDA, and growth for the median search fund company are captured in Footnote #3. Exit multiple under all scenarios held at 11x TEV / TTM EBITDA, as in every other scenario presented in the present paper. Analysis shown assuming a taxable structure for the US-based company.

Exhibit 12(b) – Base Case

The Impact of Reinvesting Tax Savings Assuming 75% Sales Efficiency in the Median Pass-Through Search Company[74] ($ in thousands, x & %)[75]

	6-Yr. Hold Period		10-Yr. Hold Period		Delta vs. Pass-Through Search OpCo	
	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	6-Yr. Hold Period	10-Yr. Hold Period
Post-Tax Net IRR to Pref. Equity Investors						
10% CAGR	23.5%	27.6%	18.8%	22.4%	4.2%	3.6%
20% CAGR	33.5%	37.9%	28.3%	32.1%	4.5%	3.8%
30% CAGR	43.7%	48.5%	38.3%	42.3%	4.7%	4.0%
Post-Tax Net MOIC to Pref. Equity Investors						
10% CAGR	3.5x	4.3x	5.6x	7.5x	0.8x	1.9x
20% CAGR	5.7x	6.9x	12.1x	16.2x	1.2x	4.1x
30% CAGR	8.8x	10.7x	25.5x	34.0x	1.9x	8.5x
Pref. Equity Absolute Post-Tax $ Proceeds						
10% CAGR	$26,631	$32,528	$42,007	$56,610	$5,897	$14,602
20% CAGR	$42,528	$51,813	$91,043	$122,058	$9,285	$31,015
30% CAGR	$66,328	$80,572	$192,027	$255,842	$14,244	$63,815
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Pass-Through / US-Based Entrepreneur	US Pass-Through / PR-Based Entrepreneur	US Pass-Through / US-Based Entrepreneur	US Pass-Through / PR-Based Entrepreneur		
10% CAGR >>>>>>	$5,208	$6,593	$9,201	$11,647	$1,384	$2,446
20% CAGR	$10,507	$13,300	$25,546	$32,337	$2,793	$6,791
30% CAGR	$18,440	$23,342	$59,207	$74,946	$4,902	$15,739
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Pass-Through / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur	US Pass-Through / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur		
10% CAGR >>>>>>	$5,208	$9,081	$9,201	$17,808	$3,873	$8,607
20% CAGR	$10,507	$17,218	$25,546	$45,423	$6,711	$19,877
30% CAGR	$18,440	$29,352	$59,207	$101,872	$10,912	$42,665
Cummulative FCF (or Tax-Affected FCF) Generated						
10% CAGR	$7,227	$12,321	$15,465	$28,053	$5,094	$12,588
20% CAGR	$10,012	$17,392	$26,986	$50,342	$7,380	$23,356
30% CAGR	$13,732	$24,246	$47,059	$89,877	$10,514	$42,817

Note: (1) Unless otherwise stated in KPI subtitle.

[74] Long-term median sales efficiency for growth-stage SaaS businesses is ~70% according to ScaleVP. "SaaS Metrics: A Primer on SaaS Sales Efficiency." Accessed May 2, 2023. https://www.scalevp.com/blog/saas-metrics-a-primer-on-saas-sales-efficiency.
[75] Assumptions about revenue, EBITDA, and growth for the median search fund company are captured in Footnote #3. Exit multiple under all scenarios held at 11x TEV/TTM EBITDA, as in every other scenario presented in the present paper. Analysis shown assuming a taxable structure for the US-based company.

Exhibit 12(c) – Upside Case

The Impact of Reinvesting Tax Savings Assuming 100% Sales Efficiency in the Median Pass-Through Search Company[76] ($ in thousands, x & %)[77]

	6-Yr. Hold Period		10-Yr. Hold Period		Delta vs. Pass-Through Search OpCo	
	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	Pass-Through US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	6-Yr. Hold Period	10-Yr. Hold Period
Post-Tax Net IRR to Pref. Equity Investors						
10% CAGR	23.5%	28.4%	18.8%	23.0%	4.9%	4.2%
20% CAGR	33.5%	38.8%	28.3%	32.9%	5.3%	4.6%
30% CAGR	43.7%	49.4%	38.3%	43.1%	5.7%	4.8%
Post-Tax Net MOIC to Pref. Equity Investors						
10% CAGR	3.5x	4.5x	5.6x	7.9x	0.9x	2.3x
20% CAGR	5.7x	7.1x	12.1x	17.2x	1.5x	5.1x
30% CAGR	8.8x	11.1x	25.5x	36.0x	2.3x	10.5x
Pref. Equity Absolute Post-Tax $ Proceeds						
10% CAGR	$26,631	$33,680	$42,007	$59,665	$7,049	$17,657
20% CAGR	$42,528	$53,734	$91,043	$129,051	$11,206	$38,008
30% CAGR	$66,328	$83,651	$192,027	$270,975	$17,323	$78,948
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Pass-Through / US-Based Entrepreneur	US Pass-Through / PR-Based Entrepreneur	US Pass-Through / US-Based Entrepreneur	US Pass-Through / PR-Based Entrepreneur		
10% CAGR >>>>>>	$5,208	$6,593	$9,201	$11,647	$1,384	$2,446
20% CAGR	$10,507	$13,300	$25,546	$32,337	$2,793	$6,791
30% CAGR	$18,440	$23,342	$59,207	$74,946	$4,902	$15,739
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Pass-Through / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur	US Pass-Through / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur		
10% CAGR	$5,208	$9,567	$9,201	$19,097	$4,359	$9,896
20% CAGR >>>>>>	$10,507	$18,029	$25,546	$48,374	$7,521	$22,828
30% CAGR	$18,440	$30,652	$59,207	$108,257	$12,211	$49,050
Cummulative FCF (or Tax-Affected FCF) Generated						
10% CAGR	$7,227	$12,698	$15,465	$29,391	$5,470	$13,925
20% CAGR	$10,012	$17,958	$26,986	$52,965	$7,947	$25,979
30% CAGR	$13,732	$25,080	$47,059	$94,877	$11,348	$47,818

Note: (1) Unless otherwise stated in KPI subtitle.

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[76] Best-in-class cloud companies achieve sales efficiency >100%, here according to Bennett, Kent, Adam Fisher, Michael Droesch, Sisi Song, Aleeza Hashmi, Caty Rea, and Christine Deakers. "State of the Cloud 2022." Accessed May 2, 2023. https://www.bvp.com/atlas/state-of-the-cloud-2022. Published 5 October 2022.

[77] Assumptions about revenue, EBITDA, and growth for the median search fund company are captured in Footnote #3. Exit multiple under all scenarios held at 11x TEV/TTM EBITDA, as in every other scenario presented in the present paper. Analysis shown assuming a taxable structure for the US-based company.

Exhibit 13: Impact of Reinvesting Chapter 3's Tax Savings on the Cumulative Cash Flow Profile and Post-Tax Proceeds for the Median Taxable Search Company

Exhibit 13(a) – Conservative Case

The Impact of Reinvesting Tax Savings Assuming 50% Sales Efficiency in the Median Taxable Search Company[78] ($ in thousands, x & %)[79]

	6-Yr. Hold Period		10-Yr. Hold Period		Delta vs. Taxable Search OpCo	
	Taxable US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	Taxable US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	6-Yr. Hold Period	10-Yr. Hold Period
Post-Tax Net IRR to Pref. Equity Investors						
10% CAGR	24.3%	26.9%	19.4%	21.7%	2.5%	2.2%
20% CAGR	34.3%	37.1%	28.9%	31.3%	2.8%	2.4%
30% CAGR	44.6%	47.5%	38.8%	41.4%	2.9%	2.6%
Post-Tax Net MOIC to Pref. Equity Investors						
10% CAGR	3.7x	4.2x	5.9x	7.1x	0.5x	1.2x
20% CAGR	5.9x	6.6x	12.7x	15.3x	0.8x	2.6x
30% CAGR	9.1x	10.3x	26.6x	32.0x	1.2x	5.4x
Pref. Equity Absolute Post-Tax $ Proceeds						
10% CAGR	$27,762	$31,358	$44,424	$53,481	$3,596	$9,056
20% CAGR	$44,147	$49,862	$95,397	$114,893	$5,715	$19,495
30% CAGR	$68,610	$77,443	$199,830	$240,329	$8,833	$40,499
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Taxable / US-Based Entrepreneur	US Taxable / PR-Based Entrepreneur	US Taxable / US-Based Entrepreneur	PR Taxable / US-Based Entrepreneur		
10% CAGR >>>>>>	$5,585	$7,070	$10,006	$12,666	$1,485	$2,660
20% CAGR	$11,047	$13,983	$26,997	$34,174	$2,936	$7,177
30% CAGR	$19,201	$24,305	$61,808	$78,238	$5,104	$16,430
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Taxable / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur	US Taxable / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur		
10% CAGR >>>>>>	$5,585	$8,587	$10,006	$16,488	$3,002	$6,481
20% CAGR	$11,047	$16,395	$26,997	$42,400	$5,348	$15,402
30% CAGR	$19,201	$28,032	$61,808	$95,326	$8,831	$33,518
Cummulative FCF Generated						
10% CAGR	$9,136	$11,941	$19,545	$26,689	$2,805	$7,144
20% CAGR	$12,744	$16,817	$34,334	$47,665	$4,074	$13,330
30% CAGR	$17,584	$23,401	$60,229	$84,769	$5,817	$24,540

Note: (1) Unless otherwise stated in KPI subtitle.

[78] Long-term median sales efficiency for growth-stage SaaS businesses is ~70% according to ScaleVP. "SaaS Metrics: A Primer on SaaS Sales Efficiency." Accessed May 2, 2023. https://www.scalevp.com/blog/saas-metrics-a-primer-on-saas-sales-efficiency.
[79] Assumptions about revenue, EBITDA, and growth for the median search fund company are captured in Footnote #3. Exit multiple under all scenarios held at 11x TEV/TTM EBITDA, as in every other scenario presented in the present paper. Analysis shown assuming a taxable structure for the US-based company.

Exhibit 13(b) – Base Case

The Impact of Reinvesting Tax Savings Assuming 75% Sales Efficiency in the Median Taxable Search Company[80] ($ in thousands, x & %)[81]

	6-Yr. Hold Period		10-Yr. Hold Period		Delta vs. Taxable Search OpCo	
	Taxable US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	Taxable US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	6-Yr. Hold Period	10-Yr. Hold Period
Post-Tax Net IRR to Pref. Equity Investors						
10% CAGR	24.3%	27.6%	19.4%	22.4%	3.3%	2.9%
20% CAGR	34.3%	37.9%	28.9%	32.1%	3.6%	3.2%
30% CAGR	44.6%	48.5%	38.8%	42.3%	3.9%	3.5%
Post-Tax Net MOIC to Pref. Equity Investors						
10% CAGR	3.7x	4.3x	5.9x	7.5x	0.6x	1.6x
20% CAGR	5.9x	6.9x	12.7x	16.2x	1.0x	3.5x
30% CAGR	9.1x	10.7x	26.6x	34.0x	1.6x	7.4x
Pref. Equity Absolute Post-Tax $ Proceeds						
10% CAGR	$27,762	$32,528	$44,424	$56,610	$4,766	$12,185
20% CAGR	$44,147	$51,813	$95,397	$122,058	$7,667	$26,661
30% CAGR	$68,610	$80,572	$199,830	$255,842	$11,962	$56,012
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Taxable / US-Based Entrepreneur	US Taxable / PR-Based Entrepreneur	US Taxable / US-Based Entrepreneur	US Taxable / PR-Based Entrepreneur		
10% CAGR >>>>>>	$5,585	$7,070	$10,006	$12,666	$1,485	$2,660
20% CAGR	$11,047	$13,983	$26,997	$34,174	$2,936	$7,177
30% CAGR	$19,201	$24,305	$61,808	$78,238	$5,104	$16,430
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Taxable / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur	US Taxable / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur		
10% CAGR	$5,585	$9,081	$10,006	$17,808	$3,496	$7,801
20% CAGR >>>>>>	$11,047	$17,218	$26,997	$45,423	$6,171	$18,426
30% CAGR	$19,201	$29,352	$61,808	$101,872	$10,151	$40,064
Cummulative FCF Generated						
10% CAGR	$9,136	$12,321	$19,545	$28,053	$3,185	$8,508
20% CAGR	$12,744	$17,392	$34,334	$50,342	$4,648	$16,008
30% CAGR	$17,584	$24,246	$60,229	$89,877	$6,662	$29,648

Note: (1) Unless otherwise stated in KPI subtitle.

[80] Long-term median sales efficiency for growth-stage SaaS businesses is ~70% according to ScaleVP. "SaaS Metrics: A Primer on SaaS Sales Efficiency." Accessed May 2, 2023. https://www.scalevp.com/blog/saas-metrics-a-primer-on-saas-sales-efficiency.
[81] Assumptions about revenue, EBITDA, and growth for the median search fund company are captured in Footnote #3. Exit multiple under all scenarios held at 11x TEV/TTM EBITDA, as in every other scenario presented in the current paper. Analysis shown assuming a taxable structure for the US-based company.

Exhibit 13(c) – Upside Case

The Impact of Reinvesting Tax Savings Assuming 100% Sales Efficiency in the Median Taxable Search Company[82] ($ in thousands, x & %)[83]

	6-Yr. Hold Period		10-Yr. Hold Period		Delta vs. Taxable Search OpCo	
	Taxable US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	Taxable US-Based Search OpCo	Taxable Chapter 3 PR-Based Search OpCo(1)	6-Yr. Hold Period	10-Yr. Hold Period
Post-Tax Net IRR to Pref. Equity Investors						
10% CAGR	24.3%	28.4%	19.4%	23.0%	4.1%	3.6%
20% CAGR	34.3%	38.8%	28.9%	32.9%	4.5%	4.0%
30% CAGR	44.6%	49.4%	38.8%	43.1%	4.9%	4.3%
Post-Tax Net MOIC to Pref. Equity Investors						
10% CAGR	3.7x	4.5x	5.9x	7.9x	0.8x	2.0x
20% CAGR	5.9x	7.1x	12.7x	17.2x	1.3x	4.5x
30% CAGR	9.1x	11.1x	26.6x	36.0x	2.0x	9.5x
Pref. Equity Absolute Post-Tax $ Proceeds						
10% CAGR	$27,762	$33,680	$44,424	$59,665	$5,918	$15,240
20% CAGR	$44,147	$53,734	$95,397	$129,051	$9,588	$33,654
30% CAGR	$68,610	$83,651	$199,830	$270,975	$15,041	$71,145
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Taxable / US-Based Entrepreneur	US Taxable / PR-Based Entrepreneur	US Taxable / US-Based Entrepreneur	US Taxable / PR-Based Entrepreneur		
10% CAGR >>>>>>	$5,585	$7,070	$10,006	$12,666	$1,485	$2,660
20% CAGR	$11,047	$13,983	$26,997	$34,174	$2,936	$7,177
30% CAGR	$19,201	$24,305	$61,808	$78,238	$5,104	$16,430
Mgmt. Carry Absolute Post-Tax $ Proceeds	US Taxable / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur	US Taxable / US-Based Entrepreneur	PR Taxable / PR-Based Entrepreneur		
10% CAGR	$5,585	$9,567	$10,006	$19,097	$3,982	$9,090
20% CAGR >>>>>>	$11,047	$18,029	$26,997	$48,374	$6,982	$21,376
30% CAGR	$19,201	$30,652	$61,808	$108,257	$11,451	$46,449
Cummulative FCF Generated						
10% CAGR	$9,136	$12,698	$19,545	$29,391	$3,562	$9,846
20% CAGR	$12,744	$17,958	$34,334	$52,965	$5,215	$18,631
30% CAGR	$17,584	$25,080	$60,229	$94,877	$7,496	$34,648

Note: (1) Unless otherwise stated in KPI subtitle.

[82] Best-in-class cloud companies achieve sales efficiency >100%, according to Bennett, Kent, Adam Fisher, Michael Droesch, Sisi Song, Aleeza Hashmi, Caty Rea, and Christine Deakers. "State of the Cloud 2022." Accessed May 2, 2023. https://www.bvp.com/atlas/state-of-the-cloud-2022. Published 5 October 2022.

[83] Assumptions about revenue, EBITDA, and growth for the median search fund company are captured in Footnote #3. Exit multiple under all scenarios held at 11x TEV/TTM EBITDA, as in every other scenario presented in the present paper. Analysis shown assuming a taxable structure for the US-based company.

Exhibit 14

Case Study on a Real-World, Fully Remote Software Company

To illustrate the potential impact of Puerto Rico's Act 60 incentives in a real-world context, we selected one real-world example of a fully remote software company and calibrated our model to reflect the same conditions at "year 0" that were present at acquisition.

Without disclosing identifying information, the company was between $2M and $5M of annual recurring revenue (ARR) at acquisition and growing at around ~30%. The searcher's model was built to be conservative, with projected growth of 20–30% over a ~5-year hold. The company was structured as a C-Corp at acquisition, so the below calculations compare a taxable PR entity under Chapter 3 to a taxable US entity.

Pretax Returns Projected by the Searcher as a US Tax Resident Operating a US Entity

The searcher's base case projected a ~5.6x gross MOIC, ~4.6x net MOIC to investors (post searcher carry), and estimated pretax proceeds to the searcher of ~$9.5M at exit.

Assuming a federal capital gains rate of 21%, this implies a personal capital gains tax liability of ~$2.0M for the searcher, resulting in ~$7.5M of post-tax take-home pay at exit.

We then asked the following: What would be the impact if the searcher could relocate their company to Puerto Rico and operate it from Puerto Rico as a bona fide resident under Act 60 Chapters 2 and 3, respectively?

Adjusted Returns, Assuming 0% Sales Efficiency

The same company achieves a ~5.7x pretax gross MOIC when headquartered in Puerto Rico as a PR Act 60, Chapter 3 taxable entity. The incremental ~0.1x pretax gross MOIC is driven by accumulated cash in the entity's balance sheet resulting from the tax savings.

Assuming the searcher operated the company from Puerto Rico and was able to obtain an individual investor decree under Chapter 2, the searcher would effectively save ~$2.0M in capital gains taxes. Said in another way, the searcher gets to deposit ~$2.0M they would otherwise have paid in capital gains taxes back in their own bank account, which translates to ~$0.5M per year of personal tax savings over a 5-year hold period.

Adjusted Returns, Assuming 100% Sales Efficiency

Using the same model and only adjusting our sales efficiency assumption from 0% (as described above) to 100%, the gross pretax MOIC increases to a ~6.9x, or ~1.3x incremental turns of gross pretax MOIC. On a net basis to investors (postsearcher carry), the impact of the higher sales efficiency results in an incremental ~1.0x net pretax MOIC return.

This more meaningful increase in pretax MOIC reflects the power of compounding the same amount of capital more efficiently over the same hold period.

Assuming the searcher operated the Chapter 3 company as a bona fide Puerto Rican resident under Chapter 2, their post-tax take-home pay will have increased to ~$12.5M, representing ~$5.0M additional dollars of personal tax savings compared with operating the business as a US tax resident. This translates into roughly $1.0M of personal tax savings per year over a 5-year hold period.

The 2022 GSB search fund study shows that the average value of equity earned by searchers who have exited their businesses equates to $1.45M per year of operation.[84]

Although pursuing an Act 60 tax strategy is not a perfect fit for all searchers or all business models, we would argue that a potential $0.5–1.0M of equity value per year of operating represents a compelling opportunity for geographically agnostic searchers who are open to remote-forward companies.

[84] Peter Kelly, and Sara Heston. "2022 Stanford GSB Search Fund Study Selected Observations." Stanford Graduate School of Business. Accessed May 2, 2023. https://www.gsb.stanford.edu/faculty-research/case-studies/2022-search-fund-study-selected-observations., p. 13

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- Andy Lock, Partner, Goodwin Procter
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