A CLOSER LOOK AT US FEDERAL TAX FISCALIZATION OVER PUERTO RICO BUSINESSES AND RESIDENTS SEEKING INCENTIVES

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In the infamous insular cases, the United States (US) Supreme Court upheld that territories such as Puerto Rico (PR) belong but are not part of the US.[1] Such differences have resonated within the US federal tax code provisions. In light of this, the present article discusses the US federal tax authority over PR businesses and residents. This writing contains an overview of its political status to situate the reader on where PR's legal and economic system currently stands. It is divided into the following sections:
i. Background
ii. PR General Tax & Incentives Regime
iii. Interplay between PR and US Federal Tax Rules
iv. IRS Audit Campaign
v. Conclusions and Recommendations

I. BACKGROUND

Since 1898, PR has been an unincorporated territory of the United States of America (US). In 1952, PR formally established its Commonwealth status by the enactment of its own Constitution. Thereafter, PR residents and businesses are under the protection of both the US and PR constitutions. The people born in PR are granted US citizenship. In addition, PR utilizes the same merchant marine, currency, financial, and banking system as the US. As a commonwealth, PR has legal authority over its internal affairs to the extent that the US laws do not preempt local laws on the subject matter.[2]

During the last decades, the island's economy has undergone financial distress which has led to a long-lasting recession. This situation has precluded PR from being compliant with its fiscal plan and meeting its creditors' commitments.
On June 30, 2016, Act 114-187, commonly known as "PROMESA"[3] was enacted by the US Government to allow PR to restructure its debt and achieve fiscal responsibility. The US Congress appointed a Financial Oversight and Management Board ("FOMPR") to address PR's public finances and ensure that PR restores its credibility on the credit markets after being in default for its first time ever in the repayment of its public debt. As part of its oversight prerogatives, the FOMPR requested the filing of the PR Government's fiscal plan for their review and approval. Moreover, while in place, the FOMPR requires that PR laws and certain rules, regulations, and executive orders are submitted for its approval.[4]

In terms of its tax autonomy, PR has its own tax code which governs the fiscal imposition of revenues derived in PR. Similar to the US, PR follows a worldwide tax regime. However, as further explained later, the US Internal Revenue Code provides that PR bona fide residents are not subject to US federal taxation on their income from PR sources. Nonetheless, it is paramount to note that US tax laws have overarching jurisdiction over foreign or US-sourced income derived by US citizens.

As US citizens, Puertorricans generating foreign-sourced revenues will be taxed on this income in both jurisdictions and may claim a credit in PR for the foreign and US income taxes paid limited to the PR liability corresponding to such income.

Historically, the island's economy has been strongly driven by economic tax incentives granted by the PR government to foster employment and attract foreign investment. With this goal in mind, a myriad of local legislation has been approved to bestow local incentives to certain industries. On July 1, 2019, PR's legislature enacted Act 60, as amended, known as the "PR Incentives Code", to compile, reshape, and streamline all incentives formerly scattered in separate incentives laws such as Acts 20-2012 and 22-2012. These incentives have the potential of highly increasing business returns if they are properly structured. As discussed below, adequate planning is crucial before moving out of the mainland to enter PR.

II. REGULAR PR TAX & TAX INCENTIVES REGIME

Legal entities formed in PR are considered foreign and thus are not generally subject to US federal tax unless they are engaged in a US trade or business or receive US effectively connected income.
Likewise, US entities conducting business in PR or deriving PR effectively connected income will be subject to PR tax.

- Regular PR Tax Regime

PR is a tax-intensive jurisdiction with impositions pouring from the central government and municipalities upon different streams of revenue. A business will be directly taxed at the state level by its net income and by the locality by its gross income. Its personal and real property will be taxed by the municipality and its purchases and imports by a combination of central and local authorities.

Individuals are subject to progressive income tax rates that top at 33%. Long-term capital gains and dividends may be subject to a preferential rate of 15%. The regular PR corporate tax rate is 18.5% plus a progressive surtax that can escalate it to a maximum tax of 37.5%. For both, individuals and corporations, a minimum alternate or basic tax may apply. In the case of partnerships, the distributive share of the operations of a partnership will be subject to the partner's income tax rate.

- PR Tax Incentives Regime

- Industries incentivized under Act 60

Under the PR Incentives Code, many eligible industries are granted state and local tax incentives. Among the most popular qualified industries incentivized in the PR Incentives Code are:
- Individual Resident Investors
- Exportation of goods or services
- International financial entities (IFEs)
- International insurers and reinsurers
- Private equity funds
- Tourism
- Manufacturing
- Film and creative industries
- Priority Projects for qualified opportunity zones (OZs)

- General Tax Incentive Benefits

The following are some of the general benefits conferred by Act 60 to exempt businesses:
- 4% fixed income tax rate on eligible income;
- 100% exemption on dividend distributions arising from eligible income;
- 75% exemption on municipal property taxes; [5]
- 50% exemption on municipal volume of business taxes; [6]
- tax exemption grant period standardized to 15 years, with an extension of 15 additional years;
- research and development tax credits for exempt businesses that incur in eligible expenses.

These benefits are generally applicable irrespective of the form of business chosen by the taxpayer (i.e., corporation, partnership). Until recently, US disregarded entities doing business in PR were treated by default as partnerships[7] for PR tax purposes since the disregarded entity treatment was not available under Act 1 of January 31, 2011, as amended, known as the "PR Internal Revenue Code" ("PR Code"). With the approval of Act 52 of June 30, 2022, the disregarded entity treatment is now recognized for PR tax purposes.

Individual Resident Investors' incentives grant a total exemption on capital gains derived by the appreciation of securities accrued after becoming a PR bona fide resident. In addition, these benefits confer PR tax exemptions on passive income, such as interest and dividends. For these reasons, high-net-worth US residents are attracted to moving to the Island to benefit from available tax exemptions at the individual and business level. The relocation of these individuals has increased the demand for export of goods tax incentives, as many of them seek to move their businesses to the Island.

III. INTERPLAY BETWEEN PR AND US FEDERAL TAX RULES

US citizens are subject to US federal tax on worldwide income. However, pursuant to §933 of the US Internal Revenue Code of 1986, as amended, ("US Code") PR bona fide residents are entitled to exclude their income attributable to PR sources from US taxation. For this reason, it is crucial to have a general knowledge of US sourcing rules and PR residency requirements.

- US General Sourcing Rules

The following table presents a summary of the most common income types and their general sourcing rules per the US Code:

TYPE OF INCOME	FACTOR DETERMINING SOURCE
Salaries/compensation for labor or personal services	Location where the service was performed
Rents	Location of property
Real Property	Location of property
Personal Property	Seller's tax home (special rules apply)
Interest	Residence of payer
Dividends	Where corporation was created or organized

- Special Sourcing Rule in the US for the Sale of Personal Property

In general, income from the sale of personal property is attributed to the residency of the seller. Nonetheless, there are Special Rules under §1.937-2(f) of the US Code Regulations ("US Regs") for gains from dispositions of certain investment property (e.g., debt and equity securities) owned by a US citizen or resident alien prior to becoming a bona fide resident of a US territory (such as PR). Under the Special Rules, such gains will generally be treated as US-sourced.

The Special Rule is applicable to a taxpayer that meets the following conditions:
1. For the tax year in question, he/she was a bona fide resident of the possession,
2. Had a gain from certain investment property that was acquired before the move to the possession,[8] and
3. For any of the 10 years preceding the year of sale, he/she was a citizen or resident of the US (other than a bona fide resident of the possession).

Notwithstanding said Special Rule, §1.937-2(f)(1)(vi) of the US Regs allows taxpayers to elect to bifurcate the gain between the US and the possession according to the individual's holding period. The cutoff for the commencement of the possession holding period lies when the individual has fully attained bona fide residency in such possession. This election is most beneficial when the holding period allocable to the US is shorter than the period allocable to PR, as more gain can be brought to PR. The allocation of gains will be computed differently depending on the classification of the security held (i.e., marketable, or non-marketable).

- PR bona fide residency requirements

Individuals claiming PR bona fide residency seeking to exclude PR source income will have to comply with the tests of §937 of the US Code and the regulations thereunder as well as the requirements of the PR Code.

§1.937-1 of the US Regs has the following three-prong test that individuals must annually meet to be considered PR Bona fide residents: (1) the presence test, (2) tax home test, and (3) closer connection test. The presence test generally is met when individuals are physically present in PR for at least 183 days. The tax home test requires the main place of business for the taxpayer to be PR. Lastly, the closer connection is a circumstantial test that requires the individual to prove their personal and family life is grounded in PR. The PR Code has a general presumption that the individual is a bona fide resident if he or she is present in PR for 183 days or more.[9] PR Case law points out that the intention of the individual to permanently reside in PR is another factor to be considered when determining if PR bona fide residency has been attained.[10]

- Controlled Foreign Corporation Implications

In general, US shareholders of a foreign corporation are not subject to tax until it makes a dividend distribution. However, an exception applies to foreign corporations that fall into the Controlled Foreign Corporation (CFC) regime. Under the CFC rules, US shareholders are taxed on the corporation's income at US regular income tax rates. A foreign corporation will be considered a CFC if more than 50% of its stocks' total combined voting power or value is owned directly, indirectly, or constructively by US shareholders.[11] Constructive attribution rules are highly technical and must be carefully examined in light of the taxpayer's circumstances.

As explained, entities created in PR are considered foreign entities for US tax purposes and thus may fall into the CFC regime. Nevertheless, PR bona fide residents are exempted from this regime if the following conditions are met: (a) such individual is a bona fide PR resident during his entire taxable year in which the taxable year of the foreign corporation ends, and (b) dividends received from said foreign corporation are treated as derived from PR sources.[12] There are other US anti-deferral regimes (e.g., Passive Foreign Investment Company and Accumulated Earnings Tax) that may apply.

IV. IRS AUDIT CAMPAIGN

In January 2021, the IRS formally established the "Puerto Rico Act 22, Individual Investors Act" Campaign by adding it to the list of active audit areas targeted by its Large Business and International division. The IRS has publicly expressed this campaign will address the following matters through examinations, outreach, and soft letters.[13]

- Act 22 Individuals that relocated to PR without meeting the residency requirements of Section 937 of the US Code that allow PR source income exclusion under Section 933, and
- Assess if such individuals that are availing themselves from the exclusion of Section 933 are inappropriately claiming non-PR source income as PR source income to escape US federal taxation.

As a result of this campaign, there will be heightened scrutiny of these individuals' US federal compliance filings. Individuals should be prepared to present solid evidence to decimate IRS worries of a wrongfully claimed residency status or any erroneous reporting of income. Maintaining residency in PR goes beyond buying a house or apartment, it requires individuals to comply with the three PR bona fide residency requirements previously mentioned. Special emphasis must be placed on the closer connection test which requires individuals to move their personal, social, cultural, and family lives to the island. The burden of proof will be on the taxpayer's hands if the IRS chooses to conduct an audit.

Although not directly mentioned, it could also be inferred that the IRS will be closely monitoring and examining the export businesses held by these individuals. In this sense, potential targets for IRS examination would be to assess if the PR business activities conducted are a continuation of a former US business, if it engages in US business activities, or if there have been any transfers of property from the US to PR, among others. Strong documentation will be key to supporting that the business has been completely developed and its operations are fully conducted locally. Finally, the IRS may also analyze the complete business structure to assess if there are CFCs that are not compliant in the US federal arena or if other anti-deferral implications apply.

V. CONCLUSIONS AND RECOMMENDATIONS

Due to the intricacies involved within the PR and US tax framework, securing proper tax planning is paramount for any individual relocating and structuring a business on the Island. There are many moving pieces that can turn a successful investment into a defective structure ultimately subject to unintended tax consequences.

Focal points of assessment before moving and commencing a business on the island are:

- Individuals

- Explore the island, study the culture, and evaluate if PR fits your family's social, professional, and educational needs.
- On the technical side, seek counsel from a US tax advisor that works in conjunction with a PR firm to plan ahead, ensure an understanding of the sourcing rules, residency, US and PR tax. filings, and tax grant requirements that must be complied with, and weigh if the move is convenient tax-wise, and if pre-steps need to be taken before jumping the ocean.
- One key consideration is to analyze pre-emigration appreciation of assets and compare it with expected yield after relocation to have a general estimate of the potential savings after the move.

- Businesses

- Pursue PR tax counsel to assess if the proposed business is viable and eligible to benefit from PR tax incentives. Furthermore, insights from local advisors should be obtained to build a business structure that maximizes PR tax benefits. Also, it is important to be aware of local business requirements, tax and grant compliance filings to ensure a deadline is not overlooked.
- Simultaneously, it is recommended taxpayers consult with US tax counsel to be certain of the US tax implications that must be considered as part of the analysis, especially, if other US investors or US-related entities are part of the structure. These last two factors can unfold in US tax consequences for the business. US investors may serve as agents that cause the unintended result of engaging the PR business in a US trade or business. Transactions with US affiliates may require the preparation of a transfer pricing report to deduct the expenses for income tax purposes. A parallel requirement is present in the PR Code for PR operations that are not covered under a tax grant.
- Caution must be exercised with functions performed by the business outside of PR, as they will not be covered by the grants and may prompt tax consequences for the entity in the foreign country.

- Bringing a US business to PR may entail an outbound transaction of intangibles (e.g., intellectual property) triggering a US tax imposition on such transfer. In addition, if certain circumstances are met, moving a US corporation to the Island may activate US anti-inversion rules by deeming the new PR entity to be taxed as a US domestic corporation, thereby, frustrating the end goal of the incentives.

In recent times where the IRS has turned the spotlight on Act 22 incentives, the first course of action if the taxpayer has been established in PR should be to perform a compliance readiness assessment of the individual and business structure. This can shed light on areas that should be addressed prior to facing an audit to pass the tests without major inconveniences. Planning and remaining compliant are the key priorities.

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[1] Downes v. Bidwell, 182 U.S. 244, 282 (1901); Dorr v. United States, 195 U.S. 138, 24 S. Ct. 808, 49 L. Ed. 128 (1904); Balzac v. Porto Rico, 258 U.S. 298 (1922); Examining Bd. Of Engineers, Architects & Surveyors v. Flores de Otero, 426 U.S. 572, 96 S. Ct. 2264, 49 L. Ed. 2d 65 (1976); Califano v. Torres, 435 U.S. 1, 98 S. Ct. 906, 55 L. Ed. 2d 65 (1978).

[2] This requirement hinges on the preemption doctrine, derived from the Supremacy Clause of the US Constitution. Under this doctrine, the US legislative arm has the authority to effectuate congressional occupation of a specific field which translates into state law being displaced by US laws on the specific subject matter. Ryan Patton, Federal Preemption in an Age of Globalization, 37 Case W. Res. J. Int'l L. 111 (2005) Available at: https://scholarlycommons.law.case.edu/jil/vol37/iss1/7 In these cases, US courts will have jurisdiction over the matters occupied by US laws.

[3] The Puerto Rico Oversight, Management, and Economic Stability Act.

[4] Section 204 of PROMESA requires that PR laws and certain rules, regulations, and executive orders are submitted for approval to the FOMPR.

[5] Municipalities impose a property tax on the appraised value of all taxable personal property of up to 10.33% per annum and on taxable real property of up to 12.33% per annum. Tax Rates for Real and Personal Property for Fiscal Year 2022-2023 published by Puerto Rico Municipal Revenue Collection Center, available at: https://portal.crim360.com/crimpr/CMS/DOCUMENTOS/download/269.pdf

[6] The volume of business tax is another tax levied by municipalities, with varied tax rates that cannot exceed 0.5% for nonfinancial businesses and 1.50% for financial businesses. Article 7.202 of Act 107 of August 14, 2020, as amended, known as the "Puerto Rico Municipal Code".

[7] There is an exception to this rule for certain businesses under the Incentives Code. Exempt businesses that are Priority Projects grantees under the Incentives Code which are treated as disregarded entities under the US Code are conferred equal treatment in PR and thus are treated as disregarded entities for PR tax purposes.

[8] US Code §731(c)(3)(C)(i) property and §954(c)(1)(B) property; further clarified by US Regs §1.954-2(e)(1). Includes money, stock in a corporation, notes, bonds, debentures and similar debt instruments, foreign currencies, property that yields dividends, interest, rent, royalties, or annuities among others.

[9] PR Code §1010.01(a)(30).

[10] Fiddler v. Srio. de Hacienda, 85 DPR 316 (1962).

[11] US Code §951(b) defines a U.S. shareholder, with respect to any foreign corporation, as a US person (as defined in US Code §957(c)) that owns 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10% or more of the total value of shares of all classes of stock of the foreign corporation. US Code §957(c) adheres to the meaning of §7701(a)(30) under which a US person is defined generally as any domestic corporation, domestic partnership, domestic trust or estate, or US individual citizen or resident.

[12] US Code §957(c)(1).

[13] Large Business and International Active Campaigns are listed in the following IRS website: https://www.irs.gov/businesses/corporations/lbi-active-campaigns