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Alert: Act 20/22 Taxpayers Asking Questions Following Indictment and Arrest of BDO Tax Division Head

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The Department of Justice ("DOJ") indicted and arrested the head of BDO Puerto Rico's Tax Division for allegedly flouting rules surrounding Puerto Rico's Act 20/22/60 tax incentive program ("Act 60").[1] The DOJ may now possess a list of BDO's Act 60 clients.

What could P.R. residents who are utilizing the Act 60 regime do now? As detailed below:

- P.R. Residency: Reassess whether you satisfy the three-part P.R. residency test, and understand the consequences if you do not.

- U.S. Taxation of Your P.R. Company: Reevaluate U.S. positions for your Act 60 company:

    - Did you take all required steps when you formed your Act 60 company, including filing Form 926 identifying assets transferred to the entity? If not, what penalties may apply and will the normal time limit on IRS audits be suspended?

    - Is your on-going transfer pricing defensible or could you face adjustments and penalties?

    - Is your P.R. company engaged in a U.S. trade or business and what are the consequences?

    - Will your P.R. company be taxed as a U.S. company under very technical "inversion" rules?

- Defending against potential penalties: If you are uncertain about your compliance, you should consult with experienced tax counsel. Key issues are whether (and how) to act preemptively before the Internal Revenue Service ("IRS") approaches you.

I. Meeting the 3-Part P.R. Residency Requirement

The rules governing eligibility for federal tax relief under the Internal Revenue Code (the "U.S. Tax Code") and tax incentives under Act 60 can be complicated, but they must be followed. Eligibility for the incentives turns on whether a U.S. citizen is a "bona fide resident" of Puerto Rico. To qualify as a bona fide Puerto Rican resident, a U.S. citizen must satisfy three tests: (1) the presence test; (2) the tax home test; and (3) the closer connection test.

Though the presence and tax home tests require detailed recordkeeping, they are relatively straightforward. The required analyses generally involve quantitative, numerical data — *e.g.*, day counts, income figures, and business details. The closer connection test, conversely, requires a more nuanced and difficult facts

[1] Act 60–2019, was signed into law on July 1, 2019, with an effective date of January 1, 2020. The Act, among other things, consolidated various tax decrees, including Act 20, the Promotion of Export Services Act, and Act 22, the Individual Investors Tax Act.

and circumstances analysis involving an array of qualitative data — *e.g.*, personal relationships and affiliations. In Caplin & Drysdale's experience, these subjective factors and analysis often make or break a residency dispute and require careful and up-to-date analysis. It is imperative that U.S. citizens claiming bona fide residency status in Puerto Rico know whether they meet these tests, and, if not, obtain advice as to how to remedy any shortcomings.

If the residency test is not met, the U.S. may tax all of your P.R. income. In addition, your Act 60 company will likely be a "controlled foreign corporation," making it subject to current U.S. income taxation under subpart F or the "GILTI" (the Global Intangible Low-Taxed Income) regime.

II. Analyzing Cross-Border Issues

Even if taxpayers satisfy the residency test, key cross-border issues remain important, including: (1) whether the Act 60 company was properly formed; (2) whether the Act 60 company's transfer pricing is compliant, (3) whether the Act 60 company has a U.S. presence because its owners or employees perform work for it while in the United States, and (4) whether the Act 60 company might be considered an "inverted" U.S. company and taxed on all of its income by the United States.

1. **Formation.** When you formed your Act 60 company, you may have transferred assets to that company, including customer lists, know-how, cash, etc. These formation transactions are subject to a U.S. "exit" tax under section 367 of the U.S. Tax Code. In addition, the transaction must be reported on Form 926. Failure to file the form may result in penalties, and, critically, causes the statute of limitations on assessment to stay open permanently, even many years after the Act 60 entity was formed. If you have not filed Form 926, you should consider doing so now.

2. **Transfer Pricing.** Most Act 60 situations involve on-going transactions between the P.R. entity and a related U.S. entity, such as regular payments of consulting fees for services provided by the P.R. company to the U.S. company. Those transactions must satisfy U.S. transfer pricing rules, which require that the transactions be priced at "arm's length." Determining arm's length pricing — for both formation and on-going transactions — is as much art as science and normally benefits from the involvement of transfer pricing counsel, with trained economist support. Caplin & Drysdale works with economists under "Kovel" arrangements which allow discussions to be under the umbrella of the attorney-client privilege.

3. **U.S. Presence.** An Act 60 company may become subject to U.S. taxation if it engages in a "U.S. trade or business." This may occur if an owner or employee devotes time to company matters while personally in the United States. In our experience, even short-term presence or a single transaction in the United States can be problematic as the extent of activity required in the United States for a trade or business to exist is both low and legally ambiguous. The presence of an owner or employee of an Act 60 company in the United States therefore may not only cause residency and personal income tax issues for that owner or employee (see above), but it may also subject the Act 60 company to not one, but three levels of U.S. tax: (1) corporate income tax, (2) branch profits tax, and (3) dividends tax. These results can be disastrous, but can be defended and are avoidable with proper counsel and planning.

4. **Inversions.** If a preexisting U.S. corporation or U.S. partnership migrates substantially all of its assets to a P.R. entity classified as a corporation, the "inversion" rules can be triggered. If these inversion rules apply, the P.R. entity is taxed as a U.S. corporation. U.S. corporations are subject to U.S. corporate income tax on their worldwide income. In this case, even if the P.R. entity genuinely earns income from P.R. sources, the income is subject to U.S. corporate income tax. If no U.S. corporate income tax returns have been filed, the statute of limitations remains open.

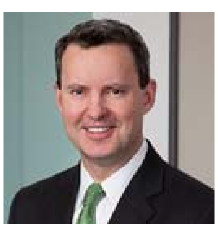
III. Assessing and Mitigating Exposure

If the IRS determines a tax deficiency exists from an improper claim of P.R. residency, transfer pricing, or Act 60 company presence in the United States, or inversion, standard civil penalties, which can amount to 20%, 40%, or even 75% of the unpaid tax, and interest could apply. Because certain IRS information forms may not have been filed, statutes of limitation could remain open for far more than the standard 3 or even 6 years. If an audit occurs, counsel must be experienced in how to navigate it, fully complying with IRS information and document requests while remaining sensitive to the pressure points.

Utilizing Act 60 and its predecessor was wise business planning for many. However, in the wake of DOJ's recent action some taxpayers are appropriately reviewing their tax positions. If a taxpayer has improperly claimed U.S. tax benefits under Act 60, it is not too late. Now is the appropriate time to consider a voluntary disclosure. In the IRS approved voluntary disclosure program, a taxpayer must file six years of accurate returns and pay exacting penalties in addition to tax and interest; however, taxpayers who complete the program are also granted criminal amnesty. And even if a voluntary disclosure program is not appropriate, or if the IRS has opened an audit or investigation, engage experienced counsel now.

IV. Conclusion

In light of recent enforcement activity, both U.S. persons residing in Puerto Rico and Act 60 companies are conducting a thorough review of their U.S. tax positions. For more information on this Alert or more general information on U.S. tax compliance with Act 60, please contact a member of Caplin & Drysdale's International, Tax Controversy, and Private Client groups, or Tom Duffy.



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The firm's reputation over the years has earned us the trust and respect of clients, industry peers, and government agencies. Moreover, clients rely on our broad knowledge of the law and our keen insights into their business concerns and personal interests. Our lawyers' strong tactical and problem-solving skills - combined with substantial experience handling a variety of complex, high stakes, matters in a boutique environment - make us one the nation's most distinctive law firms.

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About Tom Duffy C.P.A., P.C.

Tom Duffy C.P.A., P.C. is a Greater Chicago-based firm that specializes in international taxation with a particular focus on U.S. possessions. In addition, the firm is one of the few CPA firms in the country that specializes in representing residents of Puerto Rico during IRS examinations, specifically those taxpayers granted tax incentives under Puerto Rico's Act 60 (formerly Act 20/22).

Our foreign clients rely on our knowledge and expertise in complying with their U.S. tax obligations. Tom Duffy has over fifteen years of experience in international tax planning and associated U.S. tax return preparation. The firm services clients in the United States, its possessions, and throughout the world.

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