U.S. TAX CONSEQUENCES OF WORKING IN THE U.S. ON BEHALF OF YOUR ACT 60 COMPANY

As the IRS Campaign in Puerto Rico kicks off, now would be a good time for taxpayers to assess their past U.S. tax filings and prepare for the very real event of an IRS audit or soft letter. In our experience, there are two main areas of U.S. federal tax noncompliance that are overlooked or misunderstood by many, if not most, Act 60[1] residents and companies, that will likely be a serious focus of the IRS Campaign:

1) Puerto Rico residents working for their Act 60 companies while present in the U.S. mainland, and
2) Act 60 companies being engaged in a U.S. trade or business and generating income that is effectively connected with such trade or business.

Many owners of Puerto Rico Act 60 companies are frequently traveling to the U.S. mainland. There seems to be a sense among some of these owners that, if they spend 183 days a year in PR and qualify as PR residents, they are free to spend the rest of their time in the U.S. mainland working on behalf of their Act 60 companies without incurring any U.S. federal tax consequences for either themselves or their Act 60 companies. We are not sure why this line of thinking is so prevalent on the island, but it is certainly erroneous.

With the IRS primed and ready to identify and address these issues, we anticipate that the activity will not be limited to tax liability. In addition to the taxes, interest and penalties that will be owed once the IRS focuses in on these taxpayers and issues assessments, we believe this will be an area that may even see criminal penalties assessed in the most egregious situations. However, the good news is that for most taxpayers, it is not too late to remedy these issues, even for past years of noncompliance.

The article will use a fictional case study to explain and address the issues and tax consequences of working from the U.S. mainland on behalf of your Act 60 company.

---

[1] Act 60–2019, known as the Puerto Rico Incentives Code, was signed into law on July 1, 2019, with an effective date of January 1, 2020 ("Act 60"). Act 60, among other things, consolidated various tax decrees, including Act 20, the Promotion of Export Services Act, and Act 22, the Act to Promote the Relocation of Individual Investors to Puerto Rico.

Tom Duffy CPA, P.A. & P.C.
225 N. Arlington Heights Rd., Suite 109, Elk Grove Village, IL 60007
tduffy@tomduffycpa.com

Puerto Rican Residents Working Partly in The U.S.

The following example illustrates the rules related to bona fide residents of Puerto Rico working part of the year in the U.S.

Joe is a U.S. citizen who is a bona fide resident of Puerto Rico. During the year Joe spent 200 days in Puerto Rico and 160 days in the U.S. The remaining 5 days were spent traveling outside the U.S. and Puerto Rico.

About half of Joe's time in the U.S. (roughly 80 days) is truly vacation time, where he is spending holidays with his family or traveling to tourist destinations. The other 80 days in the U.S., Joe works remotely from wherever he happens to be that day. For example, on the workdays Joe checks his work emails and drafts emails replies. He also makes and receives business-related phone calls.

Joe's Puerto Rican Act 60 company ("PRCo") receives $6 million in management fees for performing export services. Joe owns 100% of PRCo, and he is an employee of PRCo. Joe receives a salary of $300,000 from PRCo for his services. After paying Joe's salary and other expenses, PRCo's profit is $5 million. (Note: It should be noted that the vast majority of Act 60 companies are established as LLC's. A Puerto Rico LLC that has not elected to be treated as a flow-through entity for U.S. purposes is treated as a corporation for U.S. purposes.)

Joe and PRCo are Separate "Persons"

Both Joe and PRCo are separate taxpayers. Generally, a corporation, including one wholly owned by one shareholder, is a taxpayer separate and distinct from that shareholder.[2]

Thus, both Joe and PRCo, in their separate capacities, are potentially subject to U.S. income tax. Puerto Rico is not considered part of the United States for most U.S. income tax purposes. [3] [4] Therefore, PRCo is treated as a foreign corporation. Generally, foreign corporations doing business in the U.S. are subject to U.S. corporate income tax.

---

2 *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 442 (1934).

3 All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

4 Code §7701(a)(5) and (a)(9).

Joe's Activities in The U.S. are PRCo's Activities in The U.S.

A corporation can act only through its authorized agents.[5] Joe is an employee of PRCo. If Joe is working for PRCo while he is in the U.S., then PRCo (through Joe) is operating in the U.S.

Performing Services in The U.S. Generates U.S.-Source Income

Personal services income is sourced where the services are performed, without regard to the location of the payor, the residence of the taxpayer, the place of contracting, or the place of payment.[6]

For employees, the general rule is that the source of compensation is determined by comparing the number of days of performance of the personal services within the U.S. to his or her total number of days of performance of personal services during the year.[7] Thus, if Joe's total workdays during the year was 250, and he worked from the U.S. during 80 of those days, then 32% (80 / 250) of his total compensation for the year would generally be treated as U.S.-source income. Thus, Joe could not exclude $96,000 (300,000 x 32%) of his salary from U.S. taxable income under Code §933(1). Only $204,000 (300,000 x 68%) of his salary could be excluded from U.S. taxable income. If we assume that Joe's U.S.-source salary of $96,000 is taxed at the highest rate of 37%, Joe's individual income tax on the U.S.-source salary would be $35,520.

The source of PRCo's income "is determined on the basis that most correctly reflects the proper source of the income under the facts and circumstances of the particular case."[8] In many cases, the facts and circumstances will be such that an apportionment on the time basis, similar to that described above for Joe, is acceptable.[9] Therefore, if PRCo primarily generates its income from Joe's activities, perhaps as much as 32% of PRCo's income would be U.S.-source income. Thus, perhaps $1,600,000 (5,000,000 x 32%) of PRCo's profits would be U.S.-source income.

It is possible that Joe does not generate all of the income earned by PRCo. For example, if PRCo has a support staff of employees performing services in Puerto Rico, then perhaps less than 32% of PRCo's income should be treated as U.S.-source income due to Joe's activities in the U.S. In

[5] *General Information Associates Partnership v. Commr.*, T.C. Memo 1992-583.

[6] Code §§861(a)(3), 862(a)(3); Treas. Reg. §1.861-4(a); *Francisco v. Commr.*, 119 T.C. 317 (2002); *Dillin v. Commr.*, 56 T.C. 228, 244 (1971).

[7] Treas. Reg. §1.861-4(b)(2)(ii)(A) and (E)

[8] Treas. Reg. §1.861-4(b)(1)(i).

[9] *Id.*

this case, an analysis would need to be performed (such as a transfer pricing analysis) to determine the portion of PRCo's income earned by Joe as compared to the portion of PRCo's income earned by the staff of employees. However, if the IRS were to assert that 32% of PRCo's income was U.S.-source income, PRCo would bear the burden of proving that the IRS's determinations are erroneous.[10]

Bright-Line Test For Being Engaged In U.S. Business – Performing Services In The U.S.

As a foreign corporation, PRCo is subject to U.S. corporate income tax only if it is engaged in a U.S. trade or business.[11] In many circumstances it is unclear whether a foreign corporation has sufficient activity in the U.S. to be considered engaged in a U.S. trade or business. However, with respect to services, the statute is clear:

> [T]he term "trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year * * *. Code §864(b).

Because PRCo is in the business of performing services and because Joe (PRCo's employee) is acting on behalf of PRCo while he works from the U.S., it is clear that Joe's activities in the U.S. would cause PRCo to be engaged in a U.S. trade or business.

Because PRCo is engaged in a U.S. trade or business and has U.S.-source services income, its U.S. earnings would be subject to U.S. corporate income tax. Thus, as much as $1,600,000 (5,000,000 x 32%) of PRCo's profits would be subject to U.S. corporate income tax. With the U.S. federal corporate income tax imposed at a rate of 21%, the federal corporate income tax would be as much as $336,000. The after-tax U.S. earnings would be $1,264,000 (1,600,000 – 336,000). State corporate income taxes may also apply.

Second Level Branch Profits Tax

Not only would PRCo's U.S. income be subject to U.S. corporate income tax, but it would also be subject to a 30% branch profits tax.

To understand the branch profits tax, it is helpful to first understand how a foreign-owned U.S. corporation is taxed. The U.S. corporation is first subject to U.S. corporate income tax. Second, when dividends are paid to the foreign shareholders, the dividends are subject to a 30% U.S. withholding tax. The 30% rate may be reduced pursuant to an income tax treaty.

---

10 *Welch v. Helvering*, 290 U.S. 111, 115 (1933)

11 Code §§11(d), 882(a), and 864(b)

The branch profits tax is a substitute for the 30% dividend withholding tax. It is imposed on the U.S. earnings of a foreign corporation that are shifted out of the U.S. branch. In our example, because PRCo is a foreign corporation that has U.S. earnings (due to Joe's activities in the U.S.) the branch profits tax will apply to PRCo's U.S. earnings. Although the rate of 30% is often reduced pursuant to income tax treaties, there is no income tax treaty between the U.S. and Puerto Rico. Therefore, the full 30% rate would apply to the U.S. earnings of PRCo.

Continuing the example above, if PRCo had after-tax U.S. earnings of $1,264,000, the branch profits tax would be $379,200.

Dividends from PRCo to Joe

Because more than 25% of PRCo's gross income is effectively connected with the conduct of a U.S. business, dividends paid by PRCo to Joe will be partly U.S.-source income.[12] The U.S.-sourced portion of the dividend will be based on a ratio of PRCo's gross U.S.-sourced income and its total gross income.[13] In the example above, as much as 32% of the dividend would be U.S.-source income.

After the U.S. corporate income tax and the U.S. branch profits tax, PRCo's earnings would be $4,284,800 (5,000,000 – 336,000 – 379,200). When these earnings are paid as a dividend to Joe, $1,371,136 (4,284,800 x 32%) would be U.S.-source income. If we assume that all of the earnings of PRCo ($4,284,800) are distributed to Joe in the current year, $1,371,136 of the dividend would be taxable to Joe in the U.S. Assuming a tax rate of 23.8%,[14] Joe's individual income tax on the U.S.-source dividend would be as much as $326,330 (1,371,136 x 23.8%).

---

12 Code §861(a)(2)(B).

13 Notably, a proportionate amount of dividends paid by PRCo would be non-Puerto Rican sourced if more than 20% of PRCo's gross income was from sources outside Puerto Rico. Treas. Reg. §1.937-2(g)(1).

14 The 23.8% rate is the sum of 20%, the highest rate on qualified dividend income, plus 3.8%, the rate imposed by the net investment income tax under Code §1411. Possessions corporations are generally treated as qualified foreign corporations and dividends from qualified foreign corporations are generally treated as qualified dividend income. Code §1(h)(11)(B) and (C).

Summary of Estimated U.S. Taxes

The total estimated U.S. tax owed by PRCo and Joe would include:

PRCo U.S. corporate income tax	$336,000
PRCo U.S. branch profits tax	379,200
Joe U.S. income tax on salary	35,520
Joe U.S. income tax on dividend	326,330
Estimated total	**$1,077,050**

The total estimated combined corporate and individual income taxes would be $1,077,050. Consequently, each day that Joe worked in the U.S. cost him $13,463 ($1,077,050/80) in tax. (Note: This estimate is conservative as it does not include interest and penalties that would be assessed by the IRS. Penalties range from 20%-75% and are assessed on the total amount of underpaid tax. We anticipate the IRS to be very aggressive in imposing penalties on taxpayers in the upcoming IRS Campaign.)

U.S. Tax Filings for PRCo

Form 1120-F

In general, every foreign corporation that is engaged in trade or business in the U.S. at any time during the taxable year is required to file a U.S. tax return (Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*).[15] Thus, PRCo will be required to file Form 1120-F for the year.

If PRCo is required to file a U.S. tax return but does not file, the IRS can disallow all deductions.[16] Treas. Reg. §1.882-4 provides in part:

> A foreign corporation shall receive the benefit of the deductions and credits otherwise allowed to it with respect to the income tax, **only if it timely files** * * * a true and accurate return * * * for the taxable year with the conduct of a trade or business in the United States by that corporation. [Emphasis added]

15 Treas. Reg. §1.6012-2(g)(1).

16 Code §882(c)(2).

Thus, if PRCo does not file Form 1120-F with the IRS, it may be subject to U.S. corporate income tax on its gross income, rather than on its net income. Generally, deductions are disallowed only if the tax return is filed more than 18 months after the original due date for filing Form 1120-F.[17]

Failing to timely file U.S. tax returns may also cause PRCo to be subject to various penalties, such as the failure to file penalty and the failure to pay penalty.[18]

It is also important to note that the statute of limitations for the IRS to collect the tax from PRCo does not begin to run until PRCo files its U.S. tax return.[19]

It would be highly advisable for Act 60 companies taking the position that they do not believe a U.S. tax return filing to be necessary because they were not engaged in a U.S. trade or business during the tax year to nonetheless file a protective Form 1120-F. This election protects the right to receive the benefit of the deductions and credits attributable to gross income if it is later determined, after the return was filed, that the original determination was incorrect.[20] More importantly, it begins the running of the statute of limitations, which limits the time period for the IRS to assess tax for that year.[21]

Form 5472

As a foreign corporation that is engaged in a U.S. trade or business, PRCo would be considered a "reporting corporation" for purposes of filing Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*.[22]

---

17 Treas. Reg. §1.882-4(a)(3)(i).

18 Code §6651(a).

19 Code §6501(a).

20 Treas. Reg. §1.882-4(a)(3)(vi).

21 Under IRC §6501(c)(1) and (2), if a return is false or fraudulent, or is filed as part of a willful attempt to evade taxes, there is no statute of limitations on assessment of tax for that tax year.

22 Code §6038C and Treas. Reg. §1.6038A-1(c), 2nd sentence.

A "reporting corporation" must generally file Form 5472 if it had a "reportable transaction" with a foreign or domestic related party.[23]

PRCo's payment of a salary to Joe would be considered a reportable transaction. Consequently, PRCo would need to include a Form 5472 with the filing of its Form 1120-F. The dollar amounts of reportable transactions with foreign related parties generally must be reported in Part IV of Form 5472. Here, Joe is a U.S. person. Although the monetary transactions with Joe would not need to be reported in Part IV, Part III would need to be completed, listing Joe as the domestic related party with which PRCo had reportable transactions during the year.

The penalty for failing to file Form 5472 is generally $25,000.[24]

Additional U.S. Tax Filings for Joe

As described above, because more than 25% of PRCo's gross income is effectively connected with the conduct of a U.S. business, dividends paid by PRCo to Joe will be partly U.S.-source income. This means that Joe will be treated as a U.S. person for purposes of testing whether PRCo is a controlled foreign corporation ("CFC"), and that PRCo will be considered a CFC (because it is owned 100% by a U.S. person).[25]

As a U.S. shareholder of a CFC, Joe will be required to annually file Form 5471, and he will be required to pick up any Subpart F Income and/or GILTI inclusions.[26] The U.S. income earned by PRCo should not be Subpart F Income or tested income (a component of GILTI).[27] [28] [29]

---

23 Treas. Reg. §§1.6038A-1(b) and 1.6038A-2(a)(1).

24 Code §§6038A(d) and 6038C(c)(1).

25 Code §957(c)(1) and (a).

26 Code §§6038, 951, and 951A.

27 Code §§952(b) and 951A(c)(2)(a)(i)(I).

28 If more than 20% of PRCo's gross income was from sources outside Puerto Rico but less than 25% of its gross income was effectively connected with the conduct of a U.S. business, PRCo would not be a CFC, but Joe would need to annually file Form 5471 as a Category 4 filer. Treas. Reg. §1.6038-2(d)(2)(i).

29 Joe's Subpart F Income and/or GILTI inclusions with respect to PRCo would likely be considered Puerto Rican-source income, meaning that it could be excluded from Joe's U.S taxable income. Prop. Treas. Reg. §1.861-3(d) ("For purposes of [the sourcing rules], the amount included in gross income of a United States person under [the Subpart F Income

The penalty for failure to file Form 5471 is generally $10,000.[30] It is also important to note that the statute of limitations for the IRS to collect tax from Joe or audit his individual tax return (Form 1040) does not begin to run until he files this form.[31]

Conclusion

Given the impending IRS Campaign and recent activity emanating from the IRS-Criminal Investigation Division on the island, taxpayers should act now to assess past years' filings for areas of noncompliance and seek appropriate tax advice on how to minimize or remedy potential civil and/or criminal exposure. For ideas on how to work from the U.S. while minimizing U.S. taxes, please refer to a previous article on the topic. http://tomduffycpa.com/puerto-rico-companies-mitigate-us-task-risks/

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

Tom Duffy C.P.A., 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. Tom Duffy is a member in good standing with the American Institute of CPAs and the Puerto Rico Society of CPAs.

For more information and tax-related articles on Puerto Rico, please visit us at www.tomduffycpa.com

and GILTI rules] * * * are treated as dividends received directly by the United States person from the foreign corporation that generated the inclusion.").

30 Treas. Reg. §1.6038-2(k)(1)(i)

31 Code §6501(c)(3).