Tax Alert: How Puerto Rico Companies Mitigate U.S. Tax Risks

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You moved to Puerto Rico (PR) and set up an Act 20 or Act 73 company.[1] The Company's income is taxed at 4%, a rate that's virtually impossible to match anywhere else (legally). But the costs to your personal mobility are significant. You generally must spend at least 183 days per year in PR. The last thing you want is to spend all that time, possibly away from your family, and not achieve the reduced tax rate.

For many Puerto Rico companies the biggest threat to the 4% rate is that the IRS will treat your company as doing business in the United States and attempt to tax it. This can happen, for example, if you personally spend time on company matters while in the U.S. (and this can also cause your Puerto Rico wages to be subject to U.S. tax).

The results can be disastrous. The IRS can disallow deductions and tax the company's <u>revenue</u> at 21%.[2] If the company leaves no funds in the U.S., an additional 30% "branch profits" tax will apply. Finally, dividends eventually paid by your Puerto Rico company may be treated as partly from U.S. sources and taxed by the United States. All of this is on top of potential penalties, which can be criminal in the worst circumstances.

There are solutions to all of these issues. Your U.S. activities can be structured and priced in a manner that appropriately minimizes U.S. tax. This article explains (1) when the IRS will tax your Puerto Rico company because it is doing business in the U.S.; (2) how much income the IRS may seek to tax; and (3) how appropriately to avoid or mitigate that outcome. We focus here on Puerto Rico operations that earn services income – such as hedge fund advisors. The risks and solutions differ depending on the facts and require a careful legal analysis.

When Will the IRS Tax Your Puerto Rico Company

The IRS regards a Puerto Rico company as a "foreign" corporation.[3] Foreign corporations are subject to U.S. tax if engaged in a U.S. trade or business.[4] A foreign corporation is engaged in a U.S. trade or business if its employees perform services in the U.S.[5]

The extent of services required for a trade or business to exist is both low and uncertain. Even the short-

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[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 73, Economic Incentives for the Development of Puerto Rico.

[2] The majority of Puerto Rico companies are formed as LLC's. A Puerto Rico LLC that has not elected to be treated as a flow-through entity for U.S. purposes is taxed as a corporation for U.S. purposes.

[3] Section 7701(a)(5) of the International Revenue Code of 1986, as amended (the "Code") defines a "foreign corporation" as any corporation that is not a "domestic corporation." Under Code Sections 7701(a)(4) and 7701(a)(10), a "domestic corporation" is a corporation created or organized in the United States, or under the laws of the District of Columbia or one of the fifty states. Thus, under these general definitions, a corporation organized under the laws of Puerto Rico is a foreign corporation and is subject to tax under Code Sections 881, 882, and 884.

[4] Code § 882(a).

[5] Code § 864(b).

term presence of employees – including you, the proprietor – may be enough.[6] Even a single transaction can constitute a business if significant relative to total activities. The presence of an agent or independent contractor may be enough.

For a company that provides services, the U.S. presence of an employee for a few days a year probably does not create a trade or business. Our experience, however, is that many Puerto Rico company proprietors spend a large number of days in the U.S. and act for the company while there.

Our Advice: If you spend even a small number of days in the U.S., it's best to structure a solution and mitigate or eliminate your risks. We identify options below.

How Will the U.S. Tax a Puerto Rico Company with a U.S. Trade or Business?

If your Puerto Rico company is engaged in a U.S. trade or business, there could be three levels of U.S. tax on the company:

1. Corporate Income Tax: The U.S. will tax the company on income that is "effectively connected" with the U.S. trade or business.[7] The IRS might apportion the company's income based on your time spent in the U.S.[8] The rate will be 21% plus state and local income tax. If the company fails to file U.S. returns, the IRS can penalize the company by disallowing deductions and apply the 21% rate to the company's U.S. revenue.

2. Branch Profits Tax: The IRS may then impose on the company a branch profits tax of 30%.[9] This tax is also referred to as the "dividend equivalent amount"[10] because it equates amounts returned to Puerto Rico as dividends from the U.S. operation. This tax typically applies because the Puerto Rico company's funds are never moved to the U.S. branch, but instead remain in Puerto Rico.

3. Dividends Tax: If the U.S. branch income exceeds certain levels (e.g., 20% of the company's gross income), a portion of dividends paid by the Puerto Rico company to you will be subject to U.S. tax.[11] In addition, if branch income exceeds 25% of the company's gross income, a bona-fide Puerto Rico resident may now be considered a U.S. person, making the company a controlled foreign corporation ("CFC"),[12] if it wasn't previously one. This can be especially painful for shareholders of the company who are U.S. persons not resident in Puerto Rico, who will now be

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[6] See Rev Rul. 70-424, 1970-2 C.B. 50; De Amodio, Inez, (1960) 34 TC 894, affd (1962, CA3).
[7] Code § 882(a)
[8] Treas. Reg. §1.861-4(b)(1)(i). Rules for apportioning based on time are provided in Treas. Reg. §1.861-4(b)(2)(ii)(E).
[9] Code § 884(a)
[10] In an effort to harmonize the treatment of a foreign corporation operating in the United States through a branch and a foreign corporation operating in the United States through a U.S. subsidiary (dividends from which would be subject to the flat 30 percent tax), Congress sought to create rules that would tax after-corporate income tax effectively connected earnings of a foreign corporation upon a deemed remittance of those earnings to the foreign corporation's head office. The result of these efforts is what is known as the "branch profits tax," which is contained in section 884.
[11] Treas. Reg. §1.937-2(g)(1)(ii)
[12] See Code § 957(c)(1) and Code § 861(a)(2)

subject to the GILTI and Subpart F tax regimes and taxed currently on their share of certain income earned by the Puerto Rico entity.[13]

In addition, the IRS may tax your wage income received from the Puerto Rico company for performing services while in the United States. This will generally be done on a time basis.[14]

Penalties can be 20%, 40% or even 75% of any tax underpayment. Criminal penalties for willful failure to file and pay can include jail time and monetary penalties.

The bottom line is that, if your company has a U.S. trade or business, failing to report U.S. income can be devastating on all fronts.

Potential Solutions

The best solution is to stay in Puerto Rico and away from the mainland United States. But our sense is that few Puerto Rico proprietors are able to do so.

Second best – and a typical structure we recommend and implement – is to form a pass-through U.S. entity that employs you and other staff when they work from the mainland. That entity should contract with the Puerto Rico company to provide services. If such an entity is formed, the trifecta listed above – corporate tax, branch profits tax and taxable dividends – likely would be avoided.

The downside is that the U.S. entity's income will be subject to U.S. tax, typically at 37% plus state and local. But the amount of U.S. income need not be based exclusively on the relative time you spend in the two locations. Instead, an inter-company agreement can spell out the relative assets, risks and functions of the Puerto Rico and U.S. companies and appropriately minimize U.S. income and tax. The pricing can be supported by a transfer pricing study (and based on accepted pricing conventions).

As an alternative to restructuring, a Puerto Rico company could file a U.S. return (Form 1120-F). Depending on the circumstances, this return could be merely protective (reporting zero income) or could report positive appropriate income. This will help preserve use of deductions and avoid or mitigate penalties, but could result in material U.S. income tax.

Conclusion

If you and your Puerto Rico company are operating in the U.S., ignoring the U.S. tax consequences is not an option. The downside is too great and solutions – that typically produce modest additional tax – are readily available.

[13] It should be noted that bona-fide residents of Puerto Rico may have relief from the GILTI regime in this particular instance.
[14] Treas. Reg. §1.861-4(b)(2)(ii)(E).

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