Longing To Spend a Summer in Europe? Tax Consequences of Working Outside of Puerto Rico for Owners of Act 60 Companies.

As the COVID-19 pandemic begins to wind down and various countries throughout the world begin to open up, many of us are ready to resume overseas travel. A frequent question arises in my practice regarding the tax consequences to an Act 60 owner who desires to spend a summer in Europe with his or her family and work remotely. The results are interesting and for many taxpayers, surprising. This article will use a fictional case study to explain and address the issue of working in a foreign country as an Act 60 company owner. And it will highlight that proper planning is key to avoiding those potentially disastrous tax and legal implications.

Background

Julie is a U.S. citizen who is a bona fide resident of Puerto Rico. Julie owns a Puerto Rican company ("PRCo") that qualifies for Puerto Rican "Act 60" tax benefits.[1] PRCo is an LLC that is taxed as a corporation for both U.S. and Puerto Rican tax purposes.[2] Under these rules, PRCo is taxed in Puerto Rico at a 4% income tax rate, and distributions from PRCo to Julie are exempt from Puerto Rican income tax.

PRCo performs services for customers outside of Puerto Rico. Julie is an employee of PRCo, and her time and effort are the driving force behind PRCo's business operations. PRCo also has 3 other employees (the "Other Employees"), who are similarly bona fide residents of Puerto Rico.

Julie is a workaholic, and she works 7 days a week. As an employee of PRCo, Julie is paid an arm's length salary for her services. PRCo consistently generates gross revenue of $15 million per year. After payment of all expenses, PRCo generates a consistent profit of $10 million a year. PRCo annually distributes a dividend to Julie of $10 million.

Julie and PRCo contracted to have a transfer pricing study prepared to determine what portion of PRCo's revenue is created due to Julie's time and effort, as compared to revenue generated by the

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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.

2 It should be noted that the vast majority of Act 60 companies are established as LLCs. 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. See Treas. Reg. §301.7701-3(b)(2)(i)(B). All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

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Other Employees. The transfer pricing study concluded that 90% of PRCo's revenue was attributable to Julie's activities. In other words, it was determined that $13.5 million of the gross revenue was attributable to Julie, and that $1.5 million of the revenue was attributable to the services performed by the Other Employees.

In the past, Julie and the Other Employees have spent all of their workdays in Puerto Rico. However, Julie is now considering spending her summers in France. She would continue to work for PRCo while in France.[3]

Julie is unpleasantly surprised when her U.S. tax advisor informs her that the time she spends working in France may trigger a little-known rule that causes a portion of the PRCo dividends to be taxable to her in the U.S. at qualified dividends rates, which reach as high as 23.8%.

Source of Services Income Earned By PRCo

Personal services income is sourced to 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.[4]

Up until now, Julie and the Other Employees have spent all of their workdays in Puerto Rico. Consequently, all of PRCo's services have been performed in Puerto Rico, and all of PRCo's gross income has been Puerto Rican-source income.

Source of Julie's Dividend Income from PRCo

There are two dividend sourcing rules found in the Internal Revenue Code applicable to Julie and PRCo:

1. The 861/862 Dividend Sourcing Rule, and
2. The 937 Dividend Sourcing Rule.

3 This article does not discuss the French tax consequences to Julie or to PRCo as a result of her activities in France. A French tax advisor should be consulted to consider the French tax implications.

4 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).

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861/862 Dividend Sourcing Rule

The 861/862 Dividend Sourcing Rule, in the context of PRCo, is important in determining whether PRCo is a controlled foreign corporation ("CFC").[5] If the entire dividend from PRCo is treated as Puerto Rican-source income under the 861/862 rule, Julie is not considered a U.S. person and PRCo is therefore not considered a CFC.[6]

Under Code §§861(a)(2) and 862(a)(2), dividends paid by a foreign corporation are treated entirely as foreign-source income if less than 25% of the foreign corporation's total gross income for the past 3 years is effectively connected with the conduct of a trade or business within the U.S. Income that is effectively connected with the conduct of a trade or business within the U.S. is generally referred to as "effectively connected income" or "ECI".

As described above, all of PRCo's gross income is from services, and it all has been foreign-source income (i.e., Puerto Rican-source income). Because none of PRCo's gross income has been from services performed in the U.S., none of PRCo's gross income has been U.S.-source income.

Income from services that is foreign-source income is not ECI.[7] Therefore, none of PRCo's gross income has been ECI. Stated another way, since less than 25% of PRCo's gross income has been ECI, dividends paid by PRCo should be treated entirely as foreign/Puerto Rican-source income to Julie under the 861/862 Dividend Sourcing Rule.

This means that Julie has not been considered a U.S. person for purposes of determining whether PRCo is a CFC, and PRCo should not be a CFC. Because PRCo is not a CFC, the Subpart F Income and GILTI rules do not apply to PRCo and Julie.[8]

The CFC status of PRCo should not change if Julie starts working in France for part of the year. All of PRCo's gross income will continue to be earned outside the U.S., meaning that none of PRCo's gross income will be ECI. Therefore, PRCo should continue to avoid CFC status, even if Julie will be working for part of the year in France.

5 Code §957(c)(1) and Treas. Reg. §1.957-3.
6 *Id.*
7 Code §864(c)(2), (c)(3), and (c)(4).
8 Code §§951 and 951A.

<u>937 Dividend Sourcing Rule</u>

The 937 Dividend Sourcing Rule is important for purposes of determining whether Julie is able to exclude the dividends she receives from PRCo from her U.S. taxable income.[9] Under the 937 Dividend Sourcing Rule, dividends paid by PRCo are sourced entirely to Puerto Rico if PRCo meets both an "80% Test" and a "50% Test".[10] The 80% and 50% Tests are performed with respect to a 3-year period, consisting of the current year and the preceding two years.[11] This period is referred to as the "testing period".[12] The testing period to use for a corporation that has been in existence for less than three years is calculated using the period the corporation has been in existence.[13]

The 80% Test requires that "80 percent or more of the gross income of the corporation for the testing period was derived from sources within [Puerto Rico] * * * or was effectively connected with the conduct of a trade or business in [Puerto Rico] * * *."[14]

The 50% Test requires that "50 percent or more of the gross income of the corporation for the testing period was derived from the active conduct of a trade or business within [Puerto Rico]."[15]

If PRCo fails the either the 80% Test or the 50% Test, dividends paid by it to Julie are treated as Puerto Rican-source income only to the extent of the "possessions source ratio."[16] PRCo's possessions source ratio is a fraction, the numerator of which is PRCo's gross income from sources within Puerto Rico for the testing period and the denominator of which is PRCo's total gross income for the testing period.[17]

Thus, if PRCo fails either of these tests, only a portion of the $10 million dividend paid to Julie each year can be excluded from her U.S. taxable income.

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9 Code §933(1) and Treas. Reg. §1.933-1.
10 Treas. Reg. §1.937-2(g)(1)(ii).
11 Treas. Reg. §1.937-2(g)(1)(iii).
12 *Id.*
13 *Id.*
14 Treas. Reg. §1.937-2(g)(1)(ii)(A).
15 Treas. Reg. §1.937-2(g)(1)(ii)(B).
16 Treas. Reg. §1.937-2(g)(1)(i).
17 Treas. Reg. §1.937-2(g)(1)(i)(A).

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Source of PRCo Dividends (Under Code §937) Until Now

Up until now, PRCo has only generated Puerto Rican-source gross income. Thus, up until now, PRCo has met both the 80% Test and the 50% Test. The entire amount of the dividends paid by PRCo to Julie have been properly excluded from Julie's U.S. taxable income.

Source of PRCo Dividends (Under Code §937) After Spending Summers in France

Once Julie starts to spend her summers in France, a portion of PRCo's gross income will be earned outside of Puerto Rico. If more than 20% of PRCo's gross income (over the 3-year testing period) is generated from Julie's activities in France, then only a portion of the dividends from PRCo to Julie can be excluded from Julie's gross income under Code §933.

As an example, if Julie consistently spends 25% of the year in France, then 25% of PRCo's income attributable to Julie's activities will be generated from sources outside of Puerto Rico. As indicated above, PRCo generates total gross income each year of $15 million, and $13.5 million of that gross income is attributable to Julie's efforts.

If Julie spends three summers in France, the total gross income earned by PRCo over the 3-year testing period will be $45 million ($15 million x 3), and the portion of PRCo's gross income earned outside of Puerto Rico will be $10.125 million ($13.5 million x 25% x 3). In other words, the portion of PRCo's gross income earned inside Puerto Rico will be $34.875 million ($45 million - $10.125 million). Because $34.875 million is less than 80% of $45 million (34.875 / 45 = 77.5%), PRCo will fail the 80% Test.

The possession source ratio will be 77.5% (the portion of PRCo's gross income earned inside Puerto Rico / PRCo's total gross income during the 3-year testing period). Thus, only $7.75 million of the $10 million dividend PRCo pays to Julie will be excludable from her U.S. taxable income, and $2.25 million of the dividend will be taxable to Julie in the U.S.

Failing the 80% Test Also Triggers a Form 5471 Filing Requirement

Form 5471 is required to be filed if a person falls within the definition of one or more of the "category of filers." Category 2 and 3 filers are defined in Code §6046 and the regulations thereunder. Category 4 filers are defined in Code §6038(a)(1) and the regulations thereunder. Category 5 filers are defined in Code §6038(a)(4).[18]

[18] There is no statutory or regulatory definition of a Category 1 filer. See the instructions to Form 5471 for the definition of Category 1 filers.

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As discussed above, if the entire dividend from PRCo is treated as Puerto Rican-source income under the 861/862 Dividend Sourcing Rule, Julie is not considered a U.S. person for purposes of determining whether PRCo is a CFC. However, if PRCo does not meet either the 80% Test or the 50% Test, Julie is considered a U.S. person for purposes of filing Form 5471 as a Category 2, 3, or 4 filer.[19] Category 2 and 3 filers only need to file Form 5471 in certain years. However, Category 4 filers need to file Form 5471 annually. For each year that PRCo fails the 80% Test or the 50% Test, Julie will be required to file Form 5471 as a Category 4 filer.

The penalty for failure to file Form 5471 is generally $10,000.[20] **It is also important to note that the statute of limitations for the IRS to collect tax from Julie or audit her individual tax return (Form 1040) does not begin to run until she files this form.[21]**

Puerto Rico Tax Consequences [22]

In our above example, the first two summers that Julie spends working from France will not cause her to fail the 80/50 Tests. Julie is very excited and believes she has hit a home run for tax purposes. She is planning to spend less time working in France in her 3rd year so that she can continue to pass the dreaded 80/50 Tests. Unfortunately, Julie forgot one very important detail. Although she may have found a way to legally avoid U.S. taxes on the dividends from PRCo, the income attributable to her services provided from France on behalf of PRCo likely does not qualify as "export services income" for Puerto Rico tax purposes. A plain reading of the Puerto Rico Incentive Regulations[23] appear to indicate that working "outside of Puerto Rico" can qualify as an eligible export service, but only when specific requirements are met. Article 2031.01(a)-1[24] reads as follows:

> *For purposes of this Article 2031.01(a)-1 and the [Puerto Rico Internal Revenue] Code, the phrase "outside of Puerto Rico" means that an Eligible Activity will not be disqualified*

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19 Treas. Reg. §1.6046-1(f)(3)(ii)(A) (for Category 2 and 3 filers) and Treas. Reg. §1.6038-2(d)(2)(i) (for Category 4 filers). Julie would not be a Category 5 filer because this category only applies to U.S. shareholders of CFCs. PRCo would continue to avoid CFC status.

20 Treas. Reg. §1.6038-2(k)(1)(i)

21 Code §6501(c)(8).

22 Special thanks to Diego Perdomo of the Puerto Rico-based CPA firm of Perdomo Ferrer, LLC for providing helpful input regarding the Puerto Rico tax consequences discussed in this section.

23 Regulations on Incentives, MO-DEC-013, which interprets in its articles, the subtitles, chapters, subchapters and sections of Act No. 60-2019, as amended, known as the "Puerto Rico Incentive Code".

24 *Id.*

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> *when by nature of the Eligible Activity, and because it is not possible, the Licensee must relocate outside of Puerto Rico to conduct part of such activity. Under this scenario, the Eligible Activity conducted outside of Puerto Rico will be incidental to the main Eligible Activity, which must be conducted from Puerto Rico. [Emphasis added]*

Julie's choice to spend her summers working in France[25] certainly doesn't appear to meet these requirements. It doesn't appear there is any legitimate business reason as to why Julie must work outside of Puerto Rico; nor does it appear that her services conducted outside of Puerto Rico would be viewed by the Puerto Rico taxing authority as "incidental to the main Eligible Activity." As of today, we are unaware of any formal guidance from the Department of Economic Development and Commerce Office for Business in Puerto Rico ("DDEC"), the Puerto Rico Treasury, or any Puerto Rico governmental agency for that matter that provides any additional insight or clarification that expands on this issue of working outside of Puerto Rico. In fact, the Article 2031.01(a)-1 language cited above is included verbatim on page 1 of every Act 60 Export Services grant issued by the DDEC. It will be interesting to see if DDEC clarifies this issue with formal guidance in the near future. It is certainly needed.

The 4% tax rate offered through Act 60 only applies to eligible export activities. The portion of the income generated by PRCo from services provided outside of Puerto Rico and not qualifying as eligible export activity will likely be taxed at the full Puerto Rico corporate tax rates, which are the second highest in the world, reaching a top marginal rate of 37.5%.[26]

If Julie spends 25% of her time working from France, this means that 25% of the $13.5 million in income PRCo earns in any given year may be subject to full Puerto Rico corporate tax rates. This could result in a potential Puerto Rico corporate tax liability as high as $1,212,000.[27] This equates to $13,466[28] in Puerto Rico tax for every day Julie works from France. Certainly not the tax-savings home run that Julie had in mind when planning her summer getaway.

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25 Although outside the scope of this article, a taxpayer who decides to work from the U.S. (versus a foreign country) runs the same risk of having that income not qualified as "export services income" for Puerto Rico purposes, as well as the income also being subject to U.S. tax. See attached article for a discussion of the US tax consequences of working from the U.S. https://tomduffycpa.com/wp-content/uploads/2019/09/Puerto-Rican-Residents-Working-From-The-US-Final-Version.pdf

26 https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/

27 37.5% (18.5% base rate + 19% surtax on income over USD 275,000). https://www.pf-cpa.com/domestic_corporation.html.

28 $1,212,000/ 90 days.

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Potential U.S. Criminal Implications of Failing to Pay Tax to a Foreign Jurisdiction (i.e., Puerto Rico)

In addition to the tax liability that might result from Julie's work during her summer abroad, Julie should consider whether she is stumbling into potential criminal liabilities as a result of her tax position. While we are not attorneys, and this article is not legal advice, it is worth asking: Is Julie properly reporting and calculating the Puerto Rico corporate tax liability as a result of her remote work in France? Or is she choosing instead to play the audit lottery and assuming the Puerto Rican taxing authorities will never select her company for audit? If Julie and her tax preparer are signing a Puerto Rico tax return under penalties of perjury, and claiming that all the income generated for the year is eligible for the reduced Puerto Rico tax rate of 4%, when the facts don't support that position, are they both at risk of potential criminal prosecution by the U.S. government if they knew the tax reporting position was not supported by the facts? It is certainly an interesting question. Some advisors might suggest (erroneously) that the IRS and the U.S. Department of Justice are not interested in the non-U.S. tax liability. The U.S. courts appear to have a different position.

In *Pasquantino et al. v. United States*[29], the defendants were caught employing various individuals to smuggle large amounts of alcohol from the United States into Canada in order to evade the Canadian excise tax on alcohol. Canada's excise tax on alcohol at the time was well in excess of the rates imposed by the U.S. They were arrested and ultimately convicted in a U.S. court of wire fraud for devising a scheme to smuggle alcohol into Canada and deprive Canada of tax revenue. Their prison sentences were substantially augmented due to the calculated tax revenue loss to the Canadian and Ontario government.[30]

The lower courts held that, "a plot to defraud a foreign government of tax revenue violates the federal wire fraud statute." On appeal, the Fourth Circuit affirmed the convictions. The Fourth Circuit also held that Canada's right to receive tax revenue was "money or property" within the wire fraud statute's meaning. This case made its way to the U.S. Supreme Court, where Justice Clarence Thomas wrote the opinion affirming the Fourth Circuit's holding that defrauding a foreign government of tax revenue violates the federal wire fraud statute.

Because we are not attorneys, we do not give legal advice. But based on the above, Julie should check with a licensed attorney and CPA who are familiar with the tax consequences of this situation to determine how to properly calculate and report her tax liability. It is critical that

29 *See Pasquantino et al. v. United States*, 544 U.S. 349 (2005).

30 Jason S. Friedman, Whiskey and the Wires: The Inadvisable Application of the Wire Fraud Statute to Alcohol Smuggling and Foreign Tax Evasion, 96 J. Crim. L. & Criminology 911 (2005-2006)

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taxpayers like Julie and PRCo pay particular attention to the specific requirements for their situation and get professional advice tailored to their facts and circumstances. As demonstrated above, there can be a domino effect of seemingly unrelated and innocuous decisions (such as living abroad and working remotely), and guidance from reputable tax and legal experts is important in order to maintain compliance with the laws of the U.S., Puerto Rico and other foreign jurisdictions. In some situations, requesting a clarification or interpretation of the Puerto Rico Incentive Regulations as it relates to the Taxpayer's particular situation might be appropriate.

Planning Opportunities

Before Julie books her flights for France, she should consult her tax advisors to discuss her specific situation. In addition to an analysis of the amount and type work she plans to perform in France, she should also inquire whether it is possible to request an amendment to the Act 60 Export Services grant from DDEC to treat work performed outside of Puerto Rico as an eligible activity subject to the reduced Puerto Rico tax rate of 4%. Can a Puerto Rico tax advisor request an amendment to a tax grant to include a specific threshold number of days of remote performance of services that qualify as incidental to the main Eligible Activity described in the tax grant?

Conclusion

As international travel normalizes post-COVID, the Puerto Rican and U.S. tax rules with respect to remote work are even more important and impactful. Given the IRS Campaign and recent activity arising from the IRS-Criminal Investigation Division on the island, and the DDEC's declared intention to continue their residency audits of tax grant recipients,[31] 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.

Although some Act 22 individuals who received their tax grants prior to 2019 are currently going through residency correspondence audits with the DDEC, our experience indicates that it is a very straightforward and non-stressful process for those taxpayers who kept good records and met the applicable requirements. For those who have not, the failure to comply with Puerto Rico tax laws can result in Puerto Rico civil and/or criminal penalties, as well as a revocation of a tax grant by DDEC in the most egregious situations. Puerto Rico tax attorneys who are well-versed in these issues can make all the difference.

31 https://newsismybusiness.com/govt-revokes-121-tax-incentives-decrees-under-act-22/

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Luckily for Julie, and our readers, all hope is not lost. With proper tax planning and structuring, many of these undesirable and sometimes surprising tax implications are preventable. Don't let your relaxing summer abroad turn into a nightmare trip.

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. He is licensed to practice in Florida, Illinois, and Puerto Rico.

For more information and tax-related articles on Puerto Rico's Act 60 program, please visit us at www.tomduffycpa.com

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