

Establishing a Branch in Puerto Rico: An Often Neglected Tax Structure

When moving to Puerto Rico to participate in the Act 60 program,¹ many taxpayers establish a Puerto Rico LLC to conduct operations. In our experience, this is not always the most efficient tax structure, and many times can lead to a multitude of nasty U.S. tax issues that a taxpayer and their advisor have not contemplated. Many times, having your current U.S. company establish a branch in Puerto Rico is the optimal structure and something that should be considered.

The article will use a fictional case study to explain and address the issue of establishing a branch operation in Puerto Rico.

Background

Matt is a U.S. citizen who lives in Nevada and owns 100% of a Nevada corporation (“NevCo”). NevCo has elected to be taxed as an “S” corporation.

Matt and NevCo provide consulting services. Over the years Matt and NevCo have developed software (the “Software”) that they use in providing the consulting services. Use of the Software allows Matt and NevCo to charge premium prices to clients. Thus, NevCo is very profitable.

Although Matt participated in developing the Software, NevCo is the legal and beneficial owner of the Software. Matt receives a salary from NevCo in an amount that is considered reasonable compensation.

Matt has heard about the potential for significant tax savings if he moves his business to Puerto Rico. He is considering becoming a bona fide resident of Puerto Rico and having the NevCo business operate from Puerto Rico. However, Matt is concerned that shutting down NevCo and opening up a new company in Puerto Rico may: (1) trigger the [anti-inversion rules of Code](#)

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.



[§7874](#),² causing the new Puerto Rican company to be taxed as a U.S. company or (2) trigger the [deemed royalty rules under Code §367\(d\)](#) on outbound transfers of intangible property. In addition, Matt is concerned that if he works partly from the U.S. during the year, the U.S. profits of the Puerto Rican company could be subject to [triple U.S. taxation](#).

Because of these concerns, Matt decides to keep NevCo and to have NevCo open a branch in Puerto Rico.³ Matt becomes a bona fide resident of Puerto Rico, and he continues to receive his salary from NevCo. However, he now works full time from Puerto Rico. The Software has also been moved to NevCo's branch in Puerto Rico.

Definition of Branch

There is no single definition of the term "branch." One definition of "foreign branch" is found in Treas. Reg. §1.367(a)-6T(g)(1), which provides in part:

[T]he term foreign branch means an integral business operation carried on by a U.S. person outside the United States. Whether the activities of a U.S. person outside the United States constitute a foreign branch operation must be determined under all the facts and circumstances. Evidence of the existence of a foreign branch includes, but is not limited to, the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by employees or officers of the U.S. person in carrying out business activities outside the United States. * * *

General Description of the Taxation of S Corporations

The First Circuit Court of Appeals in *Benenson v. Commr.*, 887 F.3d 511, n.1 (1st Cir. 2018) had a concise summary of the taxation of C corporations and S corporations:

A C corporation is a corporate entity that is required to pay taxes on the income it earns. If a C corporation decides to issue dividends to its shareholders, the shareholders must pay income tax on these dividends. This arrangement exposes shareholder dividends to double taxation - a C corporation's income is taxed at

² All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

³ The U.S. company would apply for the Act 60 grant. No separate Puerto Rico company would need to be established.



the corporate level and the portion of the C corporation's income that is passed on to shareholders is taxed again at the shareholder level. An S corporation, by contrast, is not taxed at the corporate level. Instead, the responsibility for the payment of taxes owed by the S corporation "passes through" to its shareholders, who pay the tax liability in proportion to each shareholder's pro rata share of the S corporation. An S corporation avoids double taxation on dividends because S-corporation income is only taxed once - at the shareholder level.

Source of the Income Earned by NevCo

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.⁴

To the extent Matt and NevCo perform services in Puerto Rico, they will generate income that is Puerto Rican-source income. The source of NevCo'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."⁵ In many cases, the facts and circumstances will be such that an apportionment on the time basis is acceptable.⁶ Therefore, if NevCo generates all of its income from Puerto Rican activities, all of NevCo's income would be Puerto Rican-source income.

Flow Through of NevCo's Income to Matt

Because NevCo is an S corporation, all of its income will flow through to, and be taxable to, Matt.⁷ NevCo should not pay any Federal income tax.⁸

The income flowing through from NevCo to Matt will retain its character.⁹ Thus, the nature of NevCo's income as Puerto Rican-source income will be retained when the income is included on Matt's U.S. tax return.

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).

⁵ Treas. Reg. §1.861-4(b)(1)(i).

⁶ *Id.*

⁷ Code §1366(a)(1).

⁸ Code §1363(a).

⁹ Code §1366(b).

Income from sources within Puerto Rico is excludable from an individual's U.S. gross income if the individual is a bona fide resident of Puerto Rico.¹⁰ Correspondingly, any deductions related to such excluded income are disallowed.¹¹

The Forms K-1/K-3 that Matt receives from NevCo will need to identify the portion of its gross income that was earned from Puerto Rican sources.¹² In addition, the Forms K-1/K-3 will need to identify what portion of its deductions are related to the Puerto Rican-source income. If Matt or other employees of NevCo work partially from within the U.S., then NevCo will need to perform an analysis (similar to a transfer pricing analysis) to determine the portion of its income that was earned in Puerto Rico and the portion of its income that was earned in the U.S.

If all of NevCo's gross income is Puerto Rican-source income, then Matt can exclude all of NevCo's gross income from his U.S. taxable income and he will not be able to claim any of NevCo's business expenses and deductible business expenses. If only a portion of NevCo's gross income is Puerto Rican-source income, then Matt will use the information on the Forms K-1/K-3 to determine how much of NevCo's gross income flowing through to him can be excluded from his gross income and how much of NevCo's expenses must be disallowed.

Matt's Salary

Matt is an employee performing services on behalf of NevCo. 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.¹³ Thus, if Matt's total work days 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, Matt could not exclude 32% of his salary from U.S. taxable income under Code §933(1). Only 68% of his salary could be excluded from U.S. taxable income.

¹⁰ Code §933(1) and Treas. Reg. §1.933-1(a)(1).

¹¹ Code §933(1) and Treas. Reg. §1.933-1(c).

¹² Treas. Reg. §1.6031(b)-1T(a)(1) and (3)(ii).

¹³ Treas. Reg. §1.861-4(b)(2)(ii)(A) and (E).

Form 8858

NevCo will be required to annually file Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs)*. On the Form 8858, NevCo will disclose the activities of its Puerto Rican branch.

Benefits of the Puerto Rican Branch Structure

Under the Puerto Rican branch structure, Matt must be a bona fide resident of Puerto Rico. The branch structure allows Matt to avoid the anti-inversion rules of Code §7874 because he has not caused a foreign corporation to acquire substantially all of the assets of a domestic corporation.

The deemed royalty rules of Code §367(d) are avoided because the Software has not been transferred to a foreign corporation.

If Matt works partly from the U.S. during the year, NevCo's U.S.-source profits are not subject to triple U.S. taxation. In contrast, if Matt had formed a Puerto Rican corporation and worked partly from within the U.S., the portion of the Puerto Rican corporation's profits attributable to the U.S. activities could be subject to triple U.S. taxation (U.S. corporate income tax, U.S. branch profits tax, and U.S. individual income tax on the receipt of U.S.-source dividends).

Lastly, Matt and NevCo are able to avoid various U.S. tax information reporting obligations. U.S. citizens that own certain foreign corporations are required to file Form 5471 with respect to the foreign corporation. Foreign corporations that are doing business in the U.S. generally must file Form 1120-F and Form 5472. The penalties for failing to file these forms can be substantial. By avoiding the requirement to file these forms, the risk of penalties is removed.

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



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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.

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