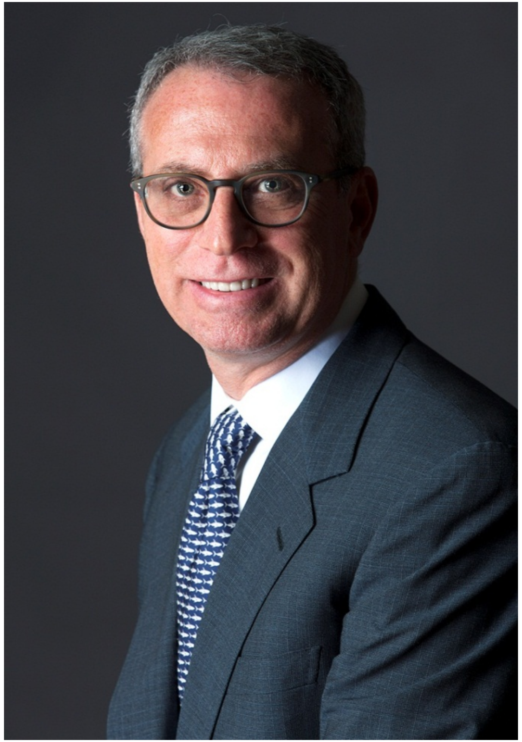
2018 PUERTO RICO INVESTMENT SUMMIT

Federal Income Tax Opportunities for US Individuals & Businesses in Puerto Rico After Tax Reform



Mark Leeds

Mark H Leeds (212) 506-2499 (mleeds@mayerbrown.com) is a tax partner at the law firm of Mayer Brown. Mark's professional practice focuses on the tax consequences of a variety of capital markets products and strategies, including over-the-counter derivative transactions, swaps, tax-exempt derivatives and working with US individuals and businesses that have moved to Puerto Rico.

Mark is also the editor-in-chief of Derivatives: Financial Products Report, a Thomson/RIA monthly publication. Prior to joining Mayer Brown, Mark was a partner at another International law firm, served as a Managing Director at Deutsche Bank, general counsel of a credit derivative company and, prior to that, Mark was a partner at Deloitte, where he led the Capital Markets Tax Practice.

Francisco Luis

Francisco Luis (787) 754-1915 (francisco.luis@pr.gt.com) a CPA and attorney- at-law, is a tax partner with Kevane Grant Thornton, with twenty five years plus of experience in public accounting, including the “Big Four” and private consulting practice.

He engages in the design and development of tax planning and consulting strategies. This includes tax services in the area of mergers and acquisitions, business reorganizations, partnership transactions, tax incentives and exemptions, individual and corporate tax issues, personal financial matters, and others.

Francisco has experience in assisting clients before the Internal Revenue Service, the Puerto Rico Treasury Department, among others. He also possesses extensive tax compliance experience. Francisco has extensive experience lecturing on local PR tax matters including various tax incentives (Acts 20 & 22, among others).

Overview of Impact of US Tax Reform

Overview of US Tax Reform

- Significant Changes to Tax Rates, & the top marginal rate for individuals is now 37% (down from 39.6%).
- Corporate tax rates have been slashed to 21%, but both of the accumulated earnings tax and the personal holding company rules serve as deterrents to leaving earnings in corporate solution.
- When the 20% tax on dividends is added to the corporate tax rate, business owners are basically in the same place using a C corporation structure as they as holding the business directly.
- Individual tax can be mitigated if the business generates qualified business income, but rate is still high & deduction is limited.

Puerto Rico Offers a Better Deal

- Even with US tax reform, individuals and businesses that can relate to Puerto Rico will still enjoy substantial tax savings.
- Making Puerto Rico work tax-wise involves the following steps:
  - Ensuring the local Puerto Rico tax can be mitigated to either zero or 4%.
  - Ensuring the income to be earned by the business or individual qualifies as Puerto Rico-source income.
  - Ensuring that the owners of the business or income meet the requirements to be treated as a *bona fide* resident of Puerto Rico.
  - Avoiding footfalls, such as earning qualifying income through a US office, not keeping sufficient records to establish day count, keeping a US residence available or too frequent trips back to the mainland.

Overview of Puerto Rico Tax Rules

Act 22 Overview

- Puerto Rico's Tax Exemption
  - tax exemption on dividends, interest and certain capital gains, granted in a tax exemption decree that lasts until 2035

- Requirements
  - Must meet the residency requirements under both jurisdictions (Puerto Rico and United States)

- US Federal Tax Implications
  - although US citizens remain subject to full federal income tax regardless of domicile, the US IRC provides special rules for an "individual who is a bona fide resident" of PR
  - the PR bona fide resident can exclude the income derived from sources within PR for US federal tax purposes

Puerto Rico Residency Rules

- To qualify for Act 22, must not have been a resident of PR at any time during the 6-year period preceding the effective date of the approval of Act 22 on January 17, 2012
- Facts and circumstances will determine if the individual is a resident of PR
  - Considered a resident of PR if it is domiciled in PR
  - It is presumed that an individual is a resident of PR if he/she has been present in PR for more than 183 days in a natural year
  - However, the intention of the taxpayer is the key factor and prevails over the 183 days presumption rule

Act 20 Overview

- Puerto Rico's Tax Rate
  - provides for a 4% maximum tax rate for the net income earned in certain eligible services performed in PR to markets outside of PR
  - the benefits are secured in a tax exemption decree for a period of 20 years with the option to extend them for 10 additional years

- Eligible Services
  - services have to be provided in PR, and the recipient of the service must be an outside of PR market

Act 20 Eligible Activities

- R&D
- Advertising and public relations
- Consulting
- Advise on matters related to trade or business
- Commercial arts and graphic services
- Production of construction, drawings, architectural and engineering services and project management
- Professional services
- Centralized management services
- Centers for electronic data processing
- Development of computer programs
- Telecommunications voice and data between persons outside of PR
- Call centers
- Shared services
- Storage and distribution services
- Educational and training services
- Hospitals and laboratories
- Investment banking and other financial services
- Creative industries (Act 173-2014)
- Distribution and logistics to centralized management services
- Industrial and commercial distribution of products manufactured in PR
- Packaging, assembly and bottling of products for exportation
- Marketing centers
- International trading company
- *Any other service that is later determined as an eligible service*

Compensation of the Officer-Owner

- If the owner of the Act 20 entity is also an employee – will need to have adequate compensation
  - During 2015, Puerto Rico Treasury Department issued Administrative Determination 15-22 to provide guidance on the imputation of wages to stockholders or partners that are also employees of an entity with an exemption grant under Acts 20-2012, 273-2012 and 399-2004
  - Given the problematic of properly determining the reasonable amount of taxable compensation versus the amounts to be received as tax free dividends, it states that an “Officer-Owner” should receive an annual reasonable compensation of up to $350,000
  - An “Officer-Owner” is defined as an individual that is a Puerto Rico resident and devotes no less than 80% of its time to the eligible activity under Act 20

Transfer Pricing Study Considerations

- If services are provided to a related entity in the US, the fee must be an arm's length fee that meets the requirement of US IRC Sec. 482; on this regard, the IRS has authority under Sec. 6662(e) and (h) to assess transfer-pricing penalties
- Such penalties will not be imposed if the taxpayer's controlled transactions satisfy the specified method and documentation requirements provided in the regulations
- The taxpayer must prepare a Transfer Pricing study in order to comply with the requirements of US IRC Sections 482 and 6662 enforceable on the US entity
- A benchmarking analysis may serve as a preliminary tool to determine the charges among related entities, but not to avoid penalties and sustain challenges from the IRS

Overview of US Tax Rules

Statutory Scheme

- A *bona fide* resident of Puerto Rico is exempt from US tax on income derived from sources within Puerto Rico. Code § 933(1).
- An individual who moves back to the US after having been a bona fide resident of Puerto Rico for at least the prior 2 years, may exclude Puerto Rico-source income from his federal taxable income after he has moved back.
- Only Puerto Rico-source income is exempt from US tax, not US-source income or foreign-source income.
- Purpose of exemption is to encourage economic growth in Puerto Rico. Purpose is not served if non-Puerto Rico source income were exempt from US tax.
- There is no expatriation tax due on a move to Puerto Rico.

Key Definitions

- The first key is definition is "*bona fide* resident of Puerto Rico. Basic rule is in Code § 937(a), but IRS regulations contain much more detailed rules.
- The second key definition is Puerto Rico-source income. US-source income is excluded from Puerto Rico-source income even if effectively connected with the conduct of a Puerto Rico trade or business. Code § 937(b).

Special Rules Apply for the Year of Move

- Special rules only apply if taxpayer was not a bona fide resident in any of the preceding 3 years
- In the second half of the year of move, taxpayer must not have a tax home in, or closer connection to, somewhere other than PR
- Taxpayer must satisfy all 3 residency tests for the 3 years following the year of move
- If requirements are met, tax home & closer connection do not apply to first half of year of move.

2018 PUERTO RICO INVESTMENT SUMMIT

The Rules for Becoming a Bona Fide Resident of Puerto Rico

Regulations Specify 3 Residency Tests

- Presence Test – Is the taxpayer present in Puerto Rico for enough time to allow him (her) to be treated as bona fide resident?
- Tax Home Test – If the taxpayer is working outside of Puerto Rico, then (s)he will not be treated as a bona fide resident of Puerto Rico.
- Closer Connection Test – Has the taxpayer demonstrated that (s)he really treats Puerto Rico as his or her permanent home?
- Tests (which apply to all possessions) were developed in response to abuses identified in the US Virgin Islands. *But see* Estate of Sanders, 144 TC No. 5 (Jan 29, 2015).

Rules for Green Card Holders

- A holder of a green card is treated as US individual & is subject to the same taxes as any other US person
- In order to become resident in Puerto Rico, an individual must be a US individual, a green card holder or hold a work visa
- An individual who does not hold a green card can still be taxed as a US person if (s)he satisfies a presence test:
  - Present in US for at least 31 days during the year &
  - Number of days present in US in current year & 2 preceding years exceeds 183 (1^{st} preceding year's days are multiplied by $1/3^{rd}$ and 2^{nd} preceding year's days are multiplied by $1/6^{th}$)
- If an individual is treated as a US individual, then in order not to be subject to tax on Puerto Rico-source income, the US individual must satisfy the 3 tests to be treated as a *bona fide* resident of Puerto Rico

2018 PUERTO RICO INVESTMENT SUMMIT

The Presence Test

The Presence Tests

- There are 5 separate presence tests. Satisfaction of any one test will suffice.
- Present in Puerto Rico for at least 183 days.
- Present in Puerto Rico for 549 days during 3-year period counting from 2nd preceding year to current year.
- Present in the US for no more than 90 days during the year.
- If earned income is less than $3,000, then was present in Puerto Rico more than in the US
- Had no significant connection to the US during the taxable year.

Days in Puerto Rico

- How to count a day present in Puerto Rico:
  - Physically present in Puerto Rico
  - Outside of Puerto Rico for or to accompany a child or parent receiving qualifying medical treatment
  - Days outside of Puerto Rico if failure to be present in Puerto Rico is attributable to any:
    - 14-day period when a major disaster occurs in Puerto Rico
    - Mandatory evacuation order is in effect for place of abode
    - Being a full-time student

Days in the United States

- How to count a day present in the United States:
  - Present in the US for any part of the day unless:
    - In the US for qualifying medical treatment or because of a disaster in Puerto Rico
    - In transit between 2 non-US destinations and presence in US is less than 24 hours
    - Temporarily present to compete in charitable sporting event
    - Temporarily present in the US as a student
    - Tie-breaker rule: if in the US & Puerto Rico on the same day, treat that day as a day in Puerto Rico.

The Tax Home Test

The Tax Home Test

- This test is a misnomer because it relates to where the individual works, not lives.
- Tax home is the individual's "regular or principal place of business."
- The individual may not have a tax home outside of Puerto Rico during any part of the taxable year.
- If the individual does not have a trade or business, then the tax home is "the individual's regular place of abode in a real & substantial sense."

2018 PUERTO RICO INVESTMENT SUMMIT

The Closer Connection Test

The Closer Connection Test

- Literally, this test asks whether the taxpayer has a closer connection to Puerto Rico than the United States or elsewhere.
- There have not been any reported cases in which a court has considered the application of this test.
- Most “touchy-feely” of the 3 tests and there are no bright lines as to when it will have been met.
- Under certain circumstances, the number of years spent in Puerto Rico could bear on whether test is satisfied in any particular year.

The Closer Connection Test

- Non-exclusive factors bearing on satisfaction of closer connection test:
  - Location of permanent home
  - Location of immediate family
  - Location of personal belongings
  - Location of social, political and religious organizations with which taxpayer has a current relationship
  - Location of business activities
  - Drivers license
  - Voter registration
  - Country shown on forms & documents

New York Case Law on Snowbirds

- Does the individual maintain significant ties to the US after the move?
- Has the home in the US been sold or rented or listed for sale in a manner that it is reasonable to expect that it will be sold?
- If business is continued in the US, does the individual attempt to manage the business from Puerto Rico?
- Where is correspondence sent?
- Safe deposit boxes location?
- Boat & airplane registration location?

2018 PUERTO RICO INVESTMENT SUMMIT

Puerto Rico – Source Income

Tax Code Source Rules Generally Apply

- Interest income: Where is obligor formed?
- Dividend income: Where is the payer formed?
- Special rules for Puerto Rico corporations:
  - If shareholder owns 10% or more of the voting stock of PR corporation, then look through PR corporation for source & allocate based on gross income.
  - If creditor owns 10% or more of the voting stock of the PR corporation, then look through PR corporation for source & allocate based on gross income.
  - Note that there are indirect ownership rules.

Business Income

- Service income is considered to be Puerto Rico-source income if the services are performed in Puerto Rico.
  - Income can be bifurcated if services are performed within and without Puerto Rico. Only PR-source income is excluded.
- Income from sale of goods traditionally has been sourced under title passage rule.
  - 2017 Tax Act relaxes title passage rule, provided that no US office is involved with the sale.
- Source rules patents and other IP look to where the IP is used. Internet services may still look to where servers are located.

Capital Gains from Securities Transactions

- Capital gains from securities sales generally are sourced to the residence of the seller. So, if seller is a bona fide resident of PR, then gain from securities sales will be PR-source. Code § 865(a).
- Swap income is also sourced to the residence of the payee. Treas. Reg. § 1.863-7(b)(1).
- If the sale is made from an office or other fixed place of business located outside of Puerto Rico, then the source of the sale is that office or fixed place of business.
- Notice 89-40: Source rules apply regardless of rate of Puerto Rico tax.

Special Situation Source Rules

- CFCs (Subpart F Income) – If shareholder owns at least 10% of PR corporation stock, subpart F inclusions are Puerto Rico-source only if CFC earned income from within Puerto Rico.
  - Special CFC rules apply to CFCs formed in Puerto Rico that exclude income earned through PR CFCs to the extent the income would have been treated as PR-source income if paid as a dividend.
- PFICs – Same as above.
- If shareholder owns less than 10% of voting stock, then look to country of formation of CFC or PFIC.
- Interest received from a PR partnership is Puerto Rico-source income only to the extent of the partnership's PR-source income.

Gain From Securities Brought into PR

- Special rules apply to stock, debt instruments, swaps, currencies, derivatives and options if sold within 10 years of becoming a bona fide resident of Puerto Rico.
- If property is publicly-traded only gain in excess of closing price on first day of possessions holding period is Puerto Rico-source income (snap shot approach).
- If property is not publicly-traded, only fraction that is attributable to holding period within Puerto Rico is PR-source income (day count approach).
- Possessions holding period begins when taxpayer does not have a tax home outside of Puerto Rico.

Tax Lien Income Can Be Capital Gain

- Neither the courts nor the IRS treat income from tax liens as interest income. Intercounty Operating Corp, (1944) 4 TC 55, acq.
- Rev Rul 70-63, 1970-1 CB 36 – No completed transaction occurs before the end of the redemption period
- IN PLR 9540006 , the IRS held that the holder of a tax lien certificate does not accrue income on the certificate.
  - Although the IRS would not rule that the certificates were capital assets in the hands of the taxpayer, if the certificates were not inventory, the clear implication is that the certificates are capital assets.

Notional Principal Contracts (Swaps)

- Definition: A financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Regs. § 1.446-3(c)(1)(i).
- Notional principal contracts include interest rate swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, and similar agreements.
- Section 1256 contracts, debt instruments, options and forward contracts do not constitute notional principal contracts. Regs. § 1.446-3(c)(1)(ii).

Thank You