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Inbound and Outbound U.S. Tax Planning for Bona Fide Residents of Puerto Rico

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Since Puerto Rico enacted the "Individual Investors Act" (Act 22) and the "Export Services Act" (Act 20) in 2012, much press has been devoted to the number of high-net worth U.S. taxpayers (including citizens and green card holders) who have relocated to Puerto Rico and become "bona fide residents" of such U.S. possession. The primary tax benefits available to such persons that have received the most attention are (i) the 100-percent exclusion of Puerto Rican-source interest and dividends from both U.S. and Puerto Rican income tax; and (ii) the 100 percent exclusion of worldwide capital gains, to the extent such gains accrue after the person becomes a resident of Puerto Rico, from both U.S. and Puerto Rican income tax. In addition, Puerto Rico corporations providing "export services" to non-Puerto Rican persons are only subject to a 4 percent corporate income tax in Puerto Rico. It should be noted that these benefits are available to bona fide residents of Puerto Rico even though they remain U.S. taxpayers and therefore are not subject to the expatriation rules.

What has not received as much attention, however, and possibly just as significant as the benefits described above, are the provisions of the U.S. Internal Revenue Code and relevant Treasury Regulations that specifically do not apply to bona fide residents of Puerto Rico who own shares of corporations organized in Puerto Rico. For example, bona fide residents of Puerto Rico may be exempt from the U.S. controlled foreign corporation (CFC) rules, and the passive foreign investment company (PFIC) rules with respect to their ownership of Puerto Rican corporations. Furthermore, as a result of the "check the box" rules and proper planning, these exemptions may be extended to income derived in foreign jurisdictions other than Puerto Rico (including U.S.-source treaty benefitted income), without that income being subject to tax in the United States or Puerto Rico.

Bona Fide Residents of Puerto Rico and the U.S. Anti-Deferral Rules

As noted above, a U.S. taxpayer who becomes a bona fide resident of Puerto Rico is able to exclude under Section 933(1)[1] Puerto Rican source interest and dividends, and (possibly) worldwide capital gains. This income also would be excluded from Puerto Rican income tax. To become a bona fide resident of Puerto Rico, an individual must satisfy (i) the presence test; (ii) the "tax home" test; and (iii) the closer connection test.

Assuming the individual satisfies these three tests, that person may be eligible for U.S. income tax benefits relating to Puerto Rican corporations that would not otherwise be available to foreign corporations organized in other jurisdictions. In particular, "U.S. shareholders" who own more than 50 percent of the stock of a foreign corporation (which, for this purpose, includes Puerto Rican corporations) generally are subject to current U.S. federal income tax on any "subpart F" income earned by such CFC, even if the income is not distributed to the shareholder in the form of a dividend.[2] Similarly, U.S. shareholders are also subject to current U.S. federal income tax on their pro rata share of the average of the amounts of "United States property" held by a CFC at the close of each quarter of a taxable year.[3]

A U.S. taxpayer who is a bona fide resident of Puerto Rico, however, will not be treated as a "U.S. shareholder" for purposes of determining whether a Puerto Rican corporation is a CFC, if a dividend received by such individual from the Puerto Rican corporation would be treated, for purposes of Section 933(1), as Puerto Rican-source income.[4] Generally, for purposes of Section 933(1), the source of a dividend paid by a corporation organized in a U.S. possession will be treated as derived from sources within that possession based on the "possession source ratio" of such dividend.[5] A different rule applies with respect to a possession corporation that is engaged in the active conduct of a trade or business in such possession. In that case, the entire dividend will be treated as income derived from that possession if (i) 80 percent or more of the gross income of the corporation during the prior three years was derived from sources within such possession; and (ii) 50 percent or more of the gross income during the prior three years was derived from the active conduct of a trade or business within such possession.[6]

These sourcing rules do not apply, however, to dividends paid by Puerto Rican corporations.[7] Instead, dividends paid by a Puerto Rico corporation typically are treated as Puerto Rican source income for purposes of Section 933(1), so long as less than 25 percent of the Puerto Rican corporation's gross income is comprised of income effectively connected to a U.S. trade or business.[8] Accordingly, unless a Puerto Rican corporation derives at least 25 percent of its income from income effectively connected to a U.S. trade or business, that corporation will not be treated as a CFC with respect to a U.S. taxpayer who is a bona fide resident of Puerto Rico.

Similar favorable provisions also apply to bona fide residents of Puerto Rico who are shareholders of PFICs. Typically, a U.S. taxpayer that owns shares of a PFIC will be subject to adverse U.S. federal income tax consequences when they receive certain distributions from a PFIC, as well as when they sell their PFIC shares. Proposed regulations, however, provide an exception to the PFIC rules for a bona fide resident of Puerto Rico for the year in question.[9]

Structuring to Take Advantage of Puerto Rican Tax Incentives

A U.S. taxpayer who owns shares in a Puerto Rican corporation that qualifies for benefits under the Export Services Act generally would not be concerned about the CFC or PFIC rules because income derived from the performance of services in Puerto Rico should not be treated as subpart F income under the CFC rules or passive income under the PFIC rules. Where a bona fide resident of Puerto Rico would benefit significantly from the lack of application of the CFC and PFIC rules would be with respect to income (including passive income) earned outside of Puerto Rico through foreign disregarded entities owned by a Puerto Rican corporation.[10] By having the Puerto Rican corporation own foreign subsidiaries that, for U.S. federal income tax purposes, are treated as branches of the Puerto Rican entity, the CFC and PFIC exceptions noted above continue to apply to income (including U.S.-source treaty benefitted income) earned by those foreign subsidiaries, regardless of whether it is connected to Puerto Rico.[11]

For example, assume a U.S. citizen taxpayer ("T") owns an operating business in the United States. T wishes to relocate to Puerto Rico and form a Puerto Rican corporation to provide export services, such as investment management services or R&D. Also assume there is valuable intellectual property involved, which T wants to license back to the U.S. operating business. T forms a Puerto Rican company, and then causes the Puerto Rican corporation to in turn form an Irish company (Irish Co) to own the IP.[12] T causes Irish Co to elect to be treated as a disregarded entity for U.S. tax purposes. Irish Co then licenses the IP, on a royalty-free basis, to a Luxembourg subsidiary (Lux Co), also owned by the Puerto Rican corporation and also a disregarded entity for U.S. tax purposes. Lux Co in turn sub-licenses the IP to the U.S. company, in exchange for royalty payments.

The royalties should be exempt from U.S. withholding tax under the U.S.-Luxembourg income tax treaty. Lux Co should qualify for treaty benefits in this case. The treaty's limitation of benefits (LOB) provision allows U.S. citizens (regardless of where they are resident) who are the ultimate beneficial owners of a Luxembourg company to qualify the company for treaty benefits.[13]

When Lux Co receives the royalty payment, it should be entitled to a deemed deduction for Luxembourg tax purposes due to the royalty-free license with Irish Co.[14] Therefore, Lux Co only will be taxable on a minimal spread. Furthermore, while Ireland does have transfer pricing rules, these rules only apply to income derived from a trading activity, which would not include a single license. Therefore, this structure allows for the payment of U.S.-source royalties that are deductible and exempt from withholding for U.S. federal income tax purposes, and are only subject to minimal foreign income tax.[15] In addition, despite the passive nature of the income, neither the CFC nor the PFIC rules should apply because the foreign subsidiaries are treated as branches of a Puerto Rican corporation.[16]

The non-Puerto Rican source profits ultimately can be repatriated to the shareholder resident in Puerto Rico either by way of a direct loan from Lux Co,[17] or by way of a loan from Lux Co to the Puerto Rican corporation, followed by the payment of a dividend to the shareholder. The dividend will be completely exempt from U.S. federal income tax under Section 933(1), so long as 80 percent or more of such amount is attributable to Puerto Rican source income.[18] If more than 20 percent of the dividend is attributable to non-Puerto Rican source income, the Puerto Rican source portion will be exempt from U.S. federal income tax under Section 933(1), whereas the remaining portion of the dividend that is attributable to non-Puerto Rican source income will be subject to U.S. federal income tax at qualified dividend rates (i.e., 23.8 percent) under Section 1(h)(11).[19] Finally, any gain realized from the disposition of the shares of the Puerto Rican corporation (including the foreign branches and their untaxed earnings) will be completely exempt from U.S. federal income tax under Section 933(1), so long as the shares were not owned at any time during the 10-year period prior to the U.S. taxpayer becoming a bona fide resident of Puerto Rico.[20]

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[1] *All references to "Section" refer to Sections of the Internal Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.*

[2] *Section 951(a)(1)(A)(i).*

[3] *Sections 951(a)(1)(B) and 956.*

[4] *Section 957(c)(1).*

[5] *Treas. Reg. 1.937-2(g)(1)(i).*

[6] *Treas. Reg. 1.937-2(g)(1)(ii).*

[7] *Treas. Reg. Section 1.957-3(b)(2). These sourcing rules still apply to determine whether the dividend is excludable from U.S. federal income tax under Section 933(1). To the extent the dividend is excludable only in part, the portion of the dividend that is attributable to non-Puerto Rican source income will be subject to U.S. federal income tax at qualified dividend rates (i.e., 23.8 percent). Section 1(h)(11)(C)(i)(I).*

[8] *Section 861(a)(2)(B).*

[9] *Prop. Treas. Reg. Section 1.1291-1(f).*

[10] *In order for a dividend received by a bona fide resident of Puerto Rico from a Puerto Rican corporation that is engaged in a trade or business in Puerto Rico (e.g., under Act 20) to be completely excludable from U.S. federal income tax under 933(1), no more than 20 percent of the income can be attributable to income earned outside of Puerto Rico.*

[11] *It should be noted that Puerto Rico treats foreign LLCs that are disregarded for U.S. tax purposes as flow-through entities for Puerto Rican tax purposes. Therefore, in order for this planning to apply, and avoid Puerto Rican corporate income tax, the foreign subsidiaries need to be organized as entities other than LLCs but are still* non-*"per se" entities under the check-the-box rules. See Treas. Reg. Section 301.7701-2(b)(8)(i).*

[12] *Care should be structured when transferring the IP to Ireland. While capital gain derived by a bona fide resident of Puerto Rico generally would be exempt from U.S. federal income tax under Section 933(1), an exception applies for gain triggered on the sale of property within 10 years of the U.S. taxpayer becoming a bona fide resident of Puerto Rico if such property were owned prior to relocating to Puerto Rico. Treas. Reg. Section 1.937-2(f)(1).*

[13] *Despite the fact that Lux Co and Ireland Co are disregarded for U.S. tax purposes, Section 894(c) will not deny treaty benefits because the income is treated as "derived" in Luxembourg for Luxembourg tax purposes. Finally, the conduit financing regulations should not apply because, if the royalties were paid directly to Irish Co, they would be eligible for 0% withholding under the U.S.-Ireland income tax treaty. See Treas. Reg. Section 1.881-3(b)(2)(i).*

[14] *The base erosion provision of the LOB article should be satisfied because the deductible amounts accrued in Luxembourg are owed to another EU-country member.*

[15] *This planning may be affected at some point by the Base Erosion and Profits Shifting (BEPS) initiative and the proposed U.S. Model Treaty (especially the "special tax regime" provision).*

[16] *In addition, Puerto Rico does not have CFC rules.*

[17] *It should be noted that any such loan will not be treated as "United States property" under Section 956 because the Puerto Rican corporation and its disregarded subsidiaries will not be treated as CFCs for U.S. tax purposes. If a loan were made directly to the Puerto Rican corporation, interest payments may be*

subject to Puerto Rican withholding tax.

[18] *Treas. Reg. Section 1.937-2(g)(1)(ii). Interesting issues arise under the Section 367(b) regulations if an existing CFC is re-domiciled into a Puerto Rican corporation.*

[19] *It should be noted that a dividend paid by Lux Co to the Puerto Rican corporation likely would be subject to Puerto Rican corporate income tax at regular corporate tax rates.*

[20] *The gain will be treated as Puerto Rican-source income and thus exempt under Section 933(1), so long as more than 50 percent of the Puerto Rican corporation's income is attributable to an active trade or business in Puerto Rico. Treas. Reg. Section 1.937-2(f)(2)(i)(A) and Section 865(g)(3). Section 1248 should not apply if the Puerto Rican corporation was never a CFC for U.S. federal income tax purposes.*

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