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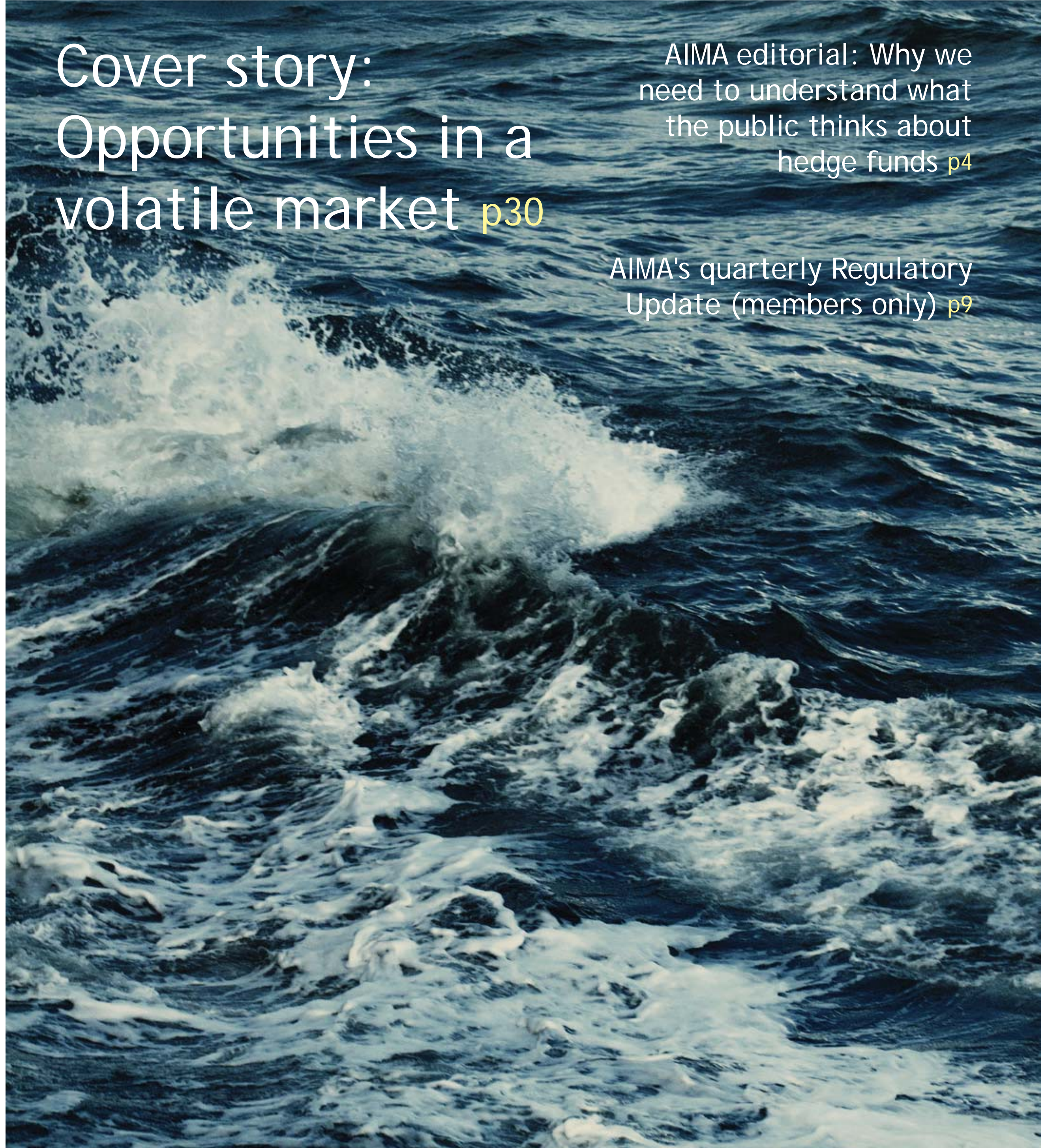

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Rum punch and taxes – Puerto Rico may serve as an island escape

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Significant press has been devoted to the benefits that US individual investment managers compensated with a "carried interest" are afforded when the allocations attributable to such "carried interest" are attributable to long-term capital gains.[2]

Often overlooked, however, is that the preferential tax rate attributable to long-term capital gains is typically reserved for private equity fund or other investment managers with long-term investment strategies (e.g., real estate funds and hedge funds with sporadic trading activities) because the preferential tax rates apply only with respect to long-term capital gains (i.e., gains attributable to capital assets held for more than one year).

US individual hedge fund managers who are compensated solely with management fees, performance fees, performance allocations attributable to short-term capital gains, or a combination of such compensation (such compensation is collectively referred to herein as "*ordinary income items*"), are often left out of the party and subject to US federal income tax at the rates applicable to ordinary income. Nonetheless, such hedge fund managers may be able to reduce their overall tax burden (and either achieve, or come close to achieving, the benefits available for long-term capital gain "carried interest" allocations, or, as described below, realise a better result) by restructuring their advisory operations to or initiating their advisory operations in Puerto Rico.

Specifically, individual hedge fund managers that become bona fide residents of Puerto Rico and own an ownership interest in a Puerto Rican investment advisory corporation that qualifies as an export service company under the Puerto Rico Export Services Act (an "*Act 20 Company*" and "*Act 20*", respectively) may be able to reduce their income tax burden on ordinary income items attributable to such advisory services to the extent such individual is compensated through the receipt of dividends from such corporation.

In addition, an individual hedge fund manager that does not become a bona fide resident of Puerto Rico but conducts his or her operations through an Act 20 Company may be able to significantly reduce his or her US federal income tax burden on ordinary income items attributable to his or her advisory activities to closely approximate the tax benefits afforded "carried interest" allocations of long-term capital gains.

Overview of relevant US tax considerations

In general, US individual taxpayers (i.e., for purposes of this article, US citizens and lawful permanent residents) are subject to US federal income tax on their worldwide income regardless of where such resident individual is domiciled.[3] A US individual taxpayer may be able to renounce his or her citizenship or otherwise expatriate and thereafter be subject to US federal

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2 The character of an item of income allocated from an entity treated as a partnership for U.S. federal income tax purposes is determined at the partnership level so that if a U.S. individual receives a "carried interest" allocation that is attributable to long-term capital gains, such "carried interest" will be considered long-term capital gains. Section 702(b). (Except as otherwise indicated herein, all section references are to the U.S. Internal Revenue Code of 1986, as amended (the "Code"), and all Regulation Section references are to the U.S. Treasury Regulations issued thereunder.)

3 Section 7701(a)(30) and Regulation Section 1.1-1(b).

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income tax only with respect to his or her US source income. An "exit tax" may apply[4], however, which generally imposes US federal income tax as if the expatriate sold all of his or her assets for their fair market value prior to the expatriation.[5] Nevertheless, the exit tax does not apply to a US individual who moves to Puerto Rico without renouncing his or her US citizenship or terminating his or her status as a lawful permanent US resident.[6]

The highest US federal income tax rate currently applicable to US resident individuals on ordinary income is 39.6%. The highest US federal income tax rate currently applicable to US resident individuals on long-term capital gain is 20%, and an additional tax of 3.8% may apply to some or all of a US resident individual's "net investment income".[7] "Qualified dividend income" received by a US resident individual generally is subject to US federal income tax at the rates applicable to long-term capital gains.[8] Dividends received by a US resident individual from a corporation organised in Puerto Rico generally are considered "qualified dividend income".[9]

Notwithstanding the general rule that a US resident individual is subject to US federal income tax on a worldwide basis, Section 933 generally provides that a US individual taxpayer "who is a bona fide resident of Puerto Rico" during the entire taxable year is not subject to US federal income tax with respect to such individual's Puerto Rican source income.[10] The Regulations provide a detailed set of rules regarding whether income will be considered to be derived from Puerto Rican sources.[11]

Very generally, (i) compensation income received by a "bona fide resident" of Puerto Rico for services performed in Puerto Rico is considered Puerto Rican source income[12]; (ii) dividends received by a US individual taxpayer who owns less than 10% of a Puerto Rican corporation are considered to be Puerto Rican source income; (iii) dividends received by any US individual taxpayer who owns 10% or more of the total voting stock of a Puerto Rican corporation are considered to be Puerto Rican source income if (a) 80% or more of the gross income of the corporation during the prior three years (or the period during which such corporation was in existence if less than three years) was derived from sources within Puerto Rico, and (b) 50% or more of the gross income during the prior three years (or the period in which such corporation was in existence if less than three years) was derived from the active conduct of a trade or business within Puerto Rico[13]; and (iv) dividends received by a US individual taxpayer who owns at least 10% of the total voting stock of a Puerto Rican corporation not described in (iii) will be considered Puerto Rican source income only to the extent of such corporation's Puerto Rican

4 Section 877A.

5 Section 877A. An inflation adjusted amount is excluded from an expatriate's gross income in determining such individual's taxable income resulting from expatriation.

6 Such an individual would not be considered an "expatriate" subject to Section 877A. Section 877A(g)(1) and (2).

7 Section 1411. "Net investment income" generally refers to passive income and gross income derived in a trade or business that constitutes a passive activity (within the meaning of Section 469) with respect to a taxpayer or a trade or business of trading in financial instruments or commodities. Section 1411(c).

8 Section 1(h)(11).

9 Section 1(h)(11)(B)(i), (C)(i); Section 936(d); Section 7701(d); Publication 570, *Tax Guide for Individuals with Income from U.S. Possessions*.

10 A U.S. resident individual generally will be considered to be a "bona fide resident" of Puerto Rico if (i) the individual is present in Puerto Rico during the taxable year for at least 183 days, (ii) the individual does not have a tax home outside of Puerto Rico during the taxable year, and (iii) the individual does not have a closer connection to the United States or a foreign country other than Puerto Rico during the taxable year. Section 937(a); Regulation Section 1.937-1(b)-(e). A further discussion of this "bona fide resident" test and the determination of whether a U.S. individual taxpayer may become a "bona fide resident" of Puerto Rico for the entire (or part of a) taxable year is beyond the scope of this article.

11 *See generally* Regulation Section 1.937-2.

12 Section 937(b)(1) generally provides that rules similar to determining whether income is from sources within the United States or is effectively connected with the conduct of a trade or business within the United States shall apply for purposes of determining whether income is from Puerto Rican sources.

13 Regulation Section 1.937-2(g)(1)(ii).

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source income.[14] While the source of capital gains generally is determined by reference to the residence of a taxpayer, a portion of capital gains realised with respect to property owned by a US individual taxpayer at the time of his or her move to Puerto Rico may remain subject to US federal income tax if realised within 10 years of emigration to Puerto Rico.[15]

Overview and relevant Puerto Rican tax considerations

Act 20 and the complementary Puerto Rico Individual Investors Act ("*Act 22*") were enacted in January 2012 with the objective of incentivising the emigration of businesses and individuals to Puerto Rico.

An Act 20 Company is not subject to graduated corporate tax rates in Puerto Rico but is instead subject to a flat tax of 4% with respect to export services performed by the company in Puerto Rico. Export services are services performed in Puerto Rico for service recipients located outside of and with no nexus to Puerto Rico. Investment management services performed by an Act 20 Company are considered export services for this purpose.

An Act 20 Company may be a start-up company or an existing business (although a new Puerto Rican entity generally must be established).[16] Transfer pricing issues must be considered if an Act 20 Company is part of a group business that operates both in and outside of Puerto Rico. In addition, Act 20 provides for a 100% dividend tax exemption (withholding or otherwise), a general 90% exemption from personal property tax for certain export service businesses and real property taxes, and a general 60% exemption from municipal taxes.

To qualify as an Act 20 Company, an entity must (i) provide qualified export services; (ii) employ at least three individuals residing in Puerto Rico (five individuals for applications filed on or after December 1, 2015); and (iii) submit an application to the Office of Industrial Tax Exemption of Puerto Rico. Upon approval, an Act 20 Company will receive a tax exemption decree from the government of Puerto Rico. The tax exemption decree is a 20-year binding contract between the government of Puerto Rico and the Act 20 Company providing that the Act 20 Company will be entitled to the aforementioned tax benefits for such 20-year period regardless of any changes in Puerto Rican tax laws.

In general, Act 22 provides an exemption for passive income (i.e., dividends, interest and post-migration source capital gains) realised by bona fide Puerto Rican residents. Built-in gains accrued while residing outside of Puerto Rico and realised within 10 years of becoming a Puerto Rican resident[17] are subject to Puerto Rican income tax at a rate of 15%, and such built-in gains realised after 10 years of becoming a Puerto Rican resident are subject to Puerto Rican income tax at a rate of 5%.

Thus, together with the application of Section 933, a US individual taxpayer who becomes a bona fide Puerto Rican resident should not be subject to US or Puerto Rican income tax with respect to Puerto Rican source dividends, interest, and post-migration capital gains. Notably, however, not all passive income realised by a US individual taxpayer after his or her emigration to Puerto Rico is free from both US and Puerto Rican taxes. As such, individuals who qualify under Act 22 are incentivised to invest in Puerto Rican businesses and real estate after emigration to Puerto Rico because passive income from these sources generally may be exempt from both US and Puerto Rican federal income taxes.

Compensation income received by a bona fide Act 22 Puerto Rican resident is subject to income tax in Puerto Rico at graduated rates, with the maximum rate being 33% for net taxable ordinary income exceeding $61,500. Double taxation of such income between the United States and Puerto Rico should not result because such income generally should not be subject to US federal income taxes under Section 933.

An individual who owns an Act 20 Company may choose

14 Regulation Section 1.937-2(g)(1)(i).

15 Regulation Section 1.937-2(f)(1)(ii); Notice 89-40, 1989-1 C.B. 681.

16 If an Act 20 Company relates to an existing business, certain outbound transfer rules must be considered, including Section 367 and the anti-inversion rules under Section 7874.

17 Such built-in gains generally also would be subject to U.S. federal income tax when recognized, but a U.S. foreign tax credit may be available to avoid double taxation.

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to limit the amount of compensation he or she receives from the Act 20 Company and instead receive dividend distributions from the Act 20 Company. In such a case, Puerto Rico may treat a dividend as compensation income to the extent that Puerto Rico deems the individual to have received less than reasonable compensation for his or her services.

Whether compensation is reasonable is based on the facts and circumstances in each case. Puerto Rico provides a safe harbor, however, under which it will not challenge an arrangement as providing for disguised compensation where an individual receives at least USD $350,000 of compensation from an Act 20 Company.

To qualify under Act 22, an individual must (i) not have been a resident of Puerto Rico at any time during the 6-year period prior to the enactment of Act 22 (i.e., January 17, 2012); (ii) apply to and gain approval of the Office of Industrial Tax Exemption of Puerto Rico; and (iii) change his or her domicile to Puerto Rico.[18]

The island vacation – putting it all together

On balance, Section 933, Act 20, Act 22 and the rules related to "qualified dividend income" may provide a US individual taxpayer with an opportunity to substantially reduce his or her aggregate tax burden where the taxpayer conducts investment advisory operations in Puerto Rico. The potential benefits of these provisions may be summarised as follows:

- A US-based individual investment manager who does not become a "bona fide" resident of Puerto Rico may be able to organize an Act 20 Company to conduct his or her investment management operations. In such a case, after accounting for the 3.8% tax on net investment income, the 4% Puerto Rican tax that would be imposed on the Act 20 Company, and assuming that the highest US federal income tax rates will apply, dividend income realised by a US individual taxpayer from an Act 20 Company will be subject to an effective combined US federal and Puerto Rican income tax rate of approximately 26.85%.[19] If the investment management business is operational prior to the formation of the Act 20 Company, the US individual taxpayer will need to consider certain rules relating to the outbound transfer of an existing US business (e.g., Section 367 and the anti-inversion rules under Section 7874), but the use of Act 20 is still possible.

- A US-based individual investment manager that becomes a "bona fide" resident of Puerto Rico may be able to organise an Act 20 Company to conduct his or her investment management operations and qualify for the Puerto Rican tax benefits afforded under Act 22. In that case (i) the Act 20 Company's income would be subject to Puerto Rican income tax of 4%; (ii) the individual would be subject to Puerto Rican (but not US) income tax with respect to Puerto Rican source compensation received from the Act 20 Company; (iii) the individual generally would not be subject to Puerto Rican or US income tax with respect to dividend distributions from the Act 20 Company; (iv) the individual generally would not be subject to Puerto Rican and US income tax with respect to gains realised upon the sale of the Act 20 Company, provided that the company was organised following the individual's emigration to Puerto Rico; and (v) the individual generally would not be subject to Puerto Rican or US income taxes with respect to Puerto Rican source capital gains recognised on capital assets acquired after becoming a bona fide Puerto Rican resident.

- In either case, transfer pricing issues must be considered if a group of companies under common control conducts investment management activities both in and outside of Puerto Rico. The relevant transfer pricing rules may require that a portion of the group's income be allocated to the United States and subject to US federal income tax.

18 Domicile refers to the intention of the individual to permanently reside in Puerto Rico and, therefore, this test is more subjective than the U.S. "bona-fide resident" test described in footnote 9 above.

19 For example, assume an Act 20 Company recognized income of $1,000 and distributed its after-tax income to its sole shareholder, a U.S. individual. The Act 20 Company would be subject to $40 of tax in Puerto Rico, leaving $960 available for distribution to its shareholder. Assuming the application of the highest U.S. federal income tax rate on "qualified dividend income" (20%) and the application of the 3.8% tax on "net investment income," the $960 dividend would be subject to U.S. federal taxes of $228.48 (23.8% * $960) with an aggregate U.S. federal and Puerto Rican income tax liability of $268.48, or an effective tax rate of approximately 26.85%.

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Conclusion

A US individual hedge fund manager who is not compensated with carried interest allocations of long-term capital gain generally is subject to US federal income tax on such compensation at ordinary income tax rates. In addition, a high net worth US individual generally cannot expatriate without potentially being subject to a US exit tax. Under current law, a US individual hedge fund manager may be able to take advantage of Act 20, Act 22, and certain US tax benefits related to ownership of a Puerto Rican corporation and/or Puerto Rican residency, with the result that the individual may be able to significantly reduce his or her aggregate income tax burden and/or redomicile without being subject to an exit tax. While organizing or reorganizing investment management operations to Puerto Rico may not be suitable for all US individual hedge fund managers, given these meaningful tax benefits a permanent vacation to the tropical island of Puerto Rico is certainly worth exploring.

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