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So Very Hard to Go (Not)!

In Pursuit of Puerto Rican Tax Incentives

For any of you that have been reading my articles for any time, you know that I am a lover of horn bands, particularly the Tower of Power (TOP). I have seen them perform in different venues multiple times. I have reimagined another life following the Tower of Power from concert-to-concert in the same manner as a “Dead Head” minus the haze of smoke! It is clear when you hear the horns that the horn section has taken music lessons. Reading the group’s fan mail online, I noticed the group’s leader Emilio Castillo, paying homage to a fan that had died for having seen the band a thousand times in concert. I thought, “What an enviable life,” to hear such music so often. A life well lived!

One of the TOP’s soul classics from the early 1970’s is the song, *So Very Hard to Go*; however, to borrow a lyric from another TOP classic *What is Hip*, “*What is Hip Today may become passe!*” This article focuses on a planning strategy to minimize the impact of any potential tax increases in 2020.

So Very Hard to Go

The Commonwealth of Puerto Rico has had a hard time in the last ten years. PR has suffered a combination of devastating events including the Island’s bankruptcy, a hurricane and COVID-19. The Puerto Rican government introduced an incredible tax incentive program in 2012 to attract investment on the Island. All the unforeseen obstacles got in the way in my opinion. In my view, the Number 1 problem, is that the business owner or investor cannot make the sale to the spouse to move to Puerto Rico. No one would ever turn their back on significant tax incentive programs but for the dilemma, “How do I convince my spouse to move?”

Sophisticated tax planning has created a path to achieving this result. A taxpayer from Birmingham, Alabama or Dubuque, Iowa can benefit from a Puerto Rican tax incentive program by transferring key functions within his business to Puerto Rico without relocating to Puerto Rico (emphasis added). The Puerto Rican exempt company is taxed at only four percent with no Federal or state taxation. Furthermore, the business owner can repatriate the profits of the Puerto Rican exempt company without taxation. Let me repeat what I just wrote “The Puerto Rican exempt company is taxed at only four percent with no Federal or state taxation. Furthermore, the

business owner can repatriate the profits of the Puerto Rican exempt company without taxation.” No one had to learn Spanish, and no one had to learn to dance! More importantly, no one goes to jail! *So Very Hard to Go* (Not)!

Puerto Rico Me Encanta!

A business that relocates to Puerto Rico can significantly reduce its tax liability provided that the Puerto Rican entity is not engaged in a U.S. trade or business. The top U.S. corporate tax rate in 2018 is 21 percent at the Federal level. Assume another 5-8 percent at the state level. Many pass-through businesses will qualify for the new 20 percent business deduction under IRC Sec 199A. However, most professional service companies will not qualify for this deduction. These businesses might be well served to evaluate Act 20 status.

Under Puerto Rico’s Export Services Act, the corporate tax rate is flat four percent. Additionally, shareholders who relocate to Puerto Rico will have a 100 percent exemption on corporate distributions received from the Puerto Rican company.

Under the Export Services Act, services that are directed to foreign markets may generate income that will qualify for the special tax rate. Services for foreign markets include services performed for nonresident individuals and businesses. To qualify as “promoter services” under the Export Services Act, the net income must be earned, and service performed within the 12-month period ending on the day preceding the day the business commenced operations within Puerto Rico. The term “eligible services” includes a wide range of service-oriented businesses from research and development to investment management.

Significant changes were made to Act 20 on July 11, 2017. These changes eliminated the five-employee requirement and no minimum employee requirements for most businesses. In most cases, this will be the business owner. The new legislation added two new eligible services – (1) Hospital services and laboratories including medical tourism and telemedicine services; (2) Trading companies with no less than 80% of business in PR exporting business.

At least thirty percent of the of the doctors at medical tourism and telemedicine facilities should be Puerto Rican residents. International banks licensed in Puerto Rico under Act 273 also qualify for the special rate of four percent. Investment advisors, funds and family offices operating as international financial entities also qualify. Payday lenders with a hybrid licenses qualify as do fund managers with an offshore master/feeder structure.

Enjoying Puerto Rican Tax Incentives While Remaining on the Mainland

At the outset of this article, I cited as one of the biggest obstacles the fact that the business owner’s spouse is frequently unwilling to move to Puerto Rico. Under the *Doctrine of When Momma Ain’t Happy, Ain’t Nobody Happy*, most business owners just won’t make the leap from Sweet Home Alabama to San Juan. Clearly, it is not a question of resentment against reduced taxation. Nevertheless, the interplay of the Puerto Rican tax incentive regulations coupled with the taxation of trusts from a U.S. perspective along with fact that the controlled foreign corporation rules do not apply to Puerto Rican residents, provide the taxpayer with the ability to achieve four percent taxation as an Act 20 taxpayer without ever leaving the front porch on the Mainland.

Under this scenario, the taxpayer will be able to achieve significant accumulation in a Puerto Rican Act 20 Company without the imposition of Federal and state taxation. Funds do not have to be accumulated and can be repatriated on a tax-free basis with respect to U.S. taxation. So, it works like this, the taxpayer is taxed at a four percent rate without federal and state level taxation. The after-tax proceeds can then with planning be repatriated without Federal taxation.

The only taxation is the special incentive tax rate of four percent. The enhancements to the Act 20 legislation outlined above currently do not have a minimum employment requirement. Planning at the Trust level can avoid taxation on the PR and U.S. level for a future liquidation.

At the end of the day, the business owner will never have to take Salsa dancing lessons unless he wants to. Mrs. Business Owner will be able to stay home and not upset her current lifestyle and miss her grown children through any perceived hard duty in Puerto Rico.

Summary

Currently, most taxpayers on the Mainland have no interest in moving to Puerto Rico following the hurricanes and situation in Puerto Rico and lack of infrastructure. The strategy outlined in this article provides powerful tax benefits to all forms of businesses on the Mainland – service businesses or manufacturers or sellers of good services. Operating companies buying goods or services from a Puerto Rican Trade Company will create significant tax arbitrage. The Company will be able to provide management, administrative and marketing services from Puerto Rico. The Company will be able to achieve a four percent tax rate without any Federal or state taxation. The after-tax profits with careful planning can be repatriated with no Federal or state taxation to the business owner.

The potential tax and wealth accumulation benefits of the proposed strategy are exceedingly beneficial to business owners. All of this while remaining on the Mainland. Who said, there wasn't a clear view from Dubuque to San Juan!