taxnotes®

Volume 152, Number 8 ■ August 22, 2016

Puerto Rico: A Tax Haven for Hedge Fund Managers

By Fernando Goyco Covas

Reprinted from *Tax Notes*, August 22, 2016, p. 1131

Puerto Rico: A Tax Haven for Hedge Fund Managers

by Fernando Goyco Covas

Fernando Goyco Covas is of counsel with Pietrantoni Méndez & Alvarez LLC.

In this article, Goyco Covas examines how a hedge fund manager who becomes a bone fide resident of Puerto Rico may enjoy reduced or zero U.S. and Puerto Rican tax rates on his management fee and incentive allocation.

A hedge fund manager who is a citizen or resident of the United States is generally subject to federal income taxes of up to 39.6 percent, plus applicable state and local income taxes, on the net management fee paid by the hedge fund. Also, the manager's carried interest or performance allocation, consisting of his distributive share of the fund's capital gains from the sale of securities (the incentive allocation), is generally subject to federal income taxes of up to 43.4 percent for short-term capital gains (39.6 percent maximum federal income tax on ordinary income + 3.8 percent Medicare tax on net investment income) and 23.8 percent for long-term capital gains (20 percent maximum federal income tax on long-term capital gains + 3.8 percent Medicare tax on NII), plus applicable state and local income tax.

On March 11, 2013, the financial community learned that a manager who becomes a bona fide resident of Puerto Rico (BFR-PR) may enjoy a management fee that is exempt from U.S. federal income tax and subject only to a reduced 4 percent Puerto Rican income tax, and that his incentive allocation of short- and long-term capital gains from the sale of securities may be exempt from both U.S. federal and Puerto Rican income taxes.[1]

This seems too good to be true, but a manager who becomes a BFR-PR can enjoy those tax savings if specific requirements are met. The news in 2013 triggered a lot of interest, and reportedly about 500 individuals, including securities traders, investment advisers, and managers, have since moved to Puerto Rico for the tax benefits.

The tax benefits stem from the interplay between sections 933 and 937 and two Puerto Rican laws: the Act to Promote the Transfer of Investors to Puerto Rico, as amended (act 22),[2] and the Act to Promote the Exportation of Services, as amended (act 20).[3]

From a U.S. federal income tax perspective, the tax benefits result from how the IRC treats individuals who are BFR-PRs and how it sources capital gains and fees for services. While U.S. citizens are generally subject to U.S. federal income tax on their worldwide income regardless of where they reside,[4] a BFR-PR, within the meaning of the term under section 937, is not subject to U.S. federal income tax on income from sources within Puerto Rico that is not effectively connected with a U.S. trade or business.[5] Moreover, under the IRC's source rules, capital gains from the sale of securities are generally sourced in the country where the seller of the security resides, and fees for services rendered are sourced in the country where the services are rendered.[6] Consequently, short- and long-term capital gains from the sale of securities and fees for services rendered from Puerto Rico by a BFR-PR, such as the management fee, are generally sourced in Puerto Rico and are thus not subject to U.S. federal income tax.

Under Puerto Rican income tax law, act 20 and act 22 allow a manager[7] who becomes a BFR-PR to enjoy an exemption from Puerto Rican income tax for specific short- and long-term capital gains from the sale of securities that form part of the manager's incentive allocation, as well as a reduced 4 percent Puerto Rican income tax on the management fee.

---

[1]Katherine Burton, Stephanie Ruhle, and Zackary Mider, "Paulson Said to Explore Puerto Rico as Home With Low Tax," Bloomberg, Mar. 11, 2013. *See also* Mark Leeds and Gabriel Hernandez, "U.S. and Puerto Rican Tax Incentives for Bona Fide Residents," *Tax Notes*, May 13, 2013, p. 790.

[2]P.R. Laws Ann. tit. 13, sections 10851 et seq.

[3]P.R. Laws Ann. tit. 13, sections 10831 et seq.

[4]Section 61 and reg. section 1.1-1(b).

[5]Sections 933 and 937(b)(2).

[6]Reg. section 1.937-2(b), -2(f)(1), and -2(f)(2); and sections 862(a)(3), 865(a), and 865(e).

[7]Those tax benefits are available regardless of whether the manager is a U.S. citizen or an alien. However, a manager who is an alien must obtain the relevant U.S. visa to be able to reside and work in Puerto Rico and must check the tax implications under the laws of his country. This article will focus on managers who are U.S. citizens.

Accordingly, by becoming a BFR-PR, the manager will save U.S. federal income taxes of up to 43.8 percent and 23.8 percent (plus state and local income taxes, if applicable) on the incentive allocation of short- and long-term capital gains from the sale of securities, respectively, and the 39.6 percent maximum federal income tax rate on the management fee (plus state and local income taxes, if applicable) will be reduced to 4 percent.

A. IRC and Acts 20 and 22 Requirements

1. IRC requirements. The incentive allocation is exempt from U.S. federal income tax if during the tax year that the capital gains are realized, the manager is a BFR-PR and his distributive share of the fund's short- and long-term capital gains constitutes Puerto Rican-source income that is not effectively connected with a U.S. trade or business, according to the source of income rules of the IRC and the regulations thereunder.[8] Likewise, the management fee is not subject to U.S. federal income tax as long as the investment advisory services are rendered from Puerto Rico by an entity that is a partnership, a disregarded entity, or a foreign corporation under the IRC.

Notably, if the investment advisory services are rendered by a foreign corporation, the dividends of the corporation must constitute Puerto Rican-source income for the manager; otherwise, they will be subject to U.S. federal income taxes. If the corporation is organized under the laws of Puerto Rico and the manager owns at least 10 percent of its voting power, the dividends will be from Puerto Rican sources if, during a specific three-year lookback period, (1) at least 80 percent of the corporation's gross income is from Puerto Rican sources or is effectively connected with a Puerto Rican trade or business and (2) at least 50 percent of its gross income is derived from the active conduct of a trade or business in Puerto Rico.[9] If this test is not met, the portion of the dividend that will qualify as Puerto Rican-source income will be an amount equal to the product of the dividend and a fraction with a numerator equal to the gross income of the corporation from Puerto Rican sources during the period and a denominator equal to the total gross income of the corporation during the period.

If other U.S.-resident managers are also shareholders of the Puerto Rican corporation, they will also enjoy U.S. federal income tax benefits. The dividends paid to them by the Puerto Rican corporation will be subject to U.S. federal income tax at the capital gains rate (maximum of 20 percent), and thus their combined Puerto Rican and U.S. federal income tax rate will be 23.2 percent (4 percent payable by the corporation to Puerto Rico plus 20 percent on the remaining amount payable by the managers to the United States). If the operations had been conducted in the United States, the managers would generally be subject to a 39.6 percent U.S. federal income tax rate; thus the tax arrangement represents income tax savings of 16.4 percent, plus the applicable state and local income taxes. If the managers are subject to the U.S. 3.8 percent Medicare tax, the combined rate increases to 26.8 percent, and the tax savings are reduced to 12.8 percent, plus the applicable state and local income taxes.

2. Act 22 requirements. Under act 22, the manager's distributive share of the fund's short- and long-term capital gains from the sale of securities is exempt from Puerto Rican income tax[10] if the manager (1) was not a resident of Puerto Rico at any time during the six-year period immediately before January 17, 2012; (2) becomes a resident of Puerto Rico and is a resident of Puerto Rico during the tax year that the gains are realized; and (3) obtains a grant of tax exemption under act 22 that is in full force and effect during that tax year.[11]

3. Act 20 requirements. Under act 20, the manager is subject to a 4 percent Puerto Rican income tax on the management fee during a 20-year period (which may be extended for 10 more years) if the manager provides the investment advisory services to the fund through a passthrough entity that obtains a grant of tax benefits under act 20.[12] Conversely, if the act 20 company is a corporation for Puerto Rican income tax purposes, the corporation will be subject to the tax, and the dividends distributed to the manager will be exempt from Puerto Rico income tax.[13]

---

[8]Sections 933 and 937(b)(2).

[9]Reg. section 1.937-2(g). If the manager owns directly or indirectly less than 10 percent of the Puerto Rican corporation's voting stock, the dividend will be Puerto Rican-source income if less than 25 percent of the Puerto Rican corporation's gross income during the three-year lookback period is effectively connected with a trade or business in the United States. *See* reg. section 1.937-2(b) and section 861(a)(2)(B).

[10]Act 22 also grants an exemption to Puerto Rican income tax for interest and dividends, but it is generally meaningless from a U.S. federal income tax standpoint (except in the case of interest and dividends paid by specific Puerto Rican issuers) because the interest and dividends generally do not constitute Puerto Rican-source income and are thus subject to U.S. federal income taxes. Accordingly, for U.S.-source interest and dividends, the tax savings are generally limited to state and local income taxes.

[11]P.R. Laws Ann. tit. 13, sections 10851(a), 10852, and 10853.

[12]P.R. Laws Ann. tit. 13, sections 10832(a) and 10836(a).

[13]P.R. Laws Ann. tit. 13, section 10834(a).

B. The Puerto Rican Residency Requirement

1. IRC bona fide residency requirement. To qualify as a BFR-PR under the IRC, the manager must meet the presence test, tax home test, and closer connection test.

To meet the presence test, the manager must meet any of the following: (1) be present in Puerto Rico for at least 183 days during the calendar year; (2) be present in the United States for no more than 90 days during the calendar year; (3) have no earned income from sources within the United States (that is, compensation for labor or personal services rendered by the manager in the United States exceeding $3,000) and be present in Puerto Rico for more days than in the United States; (4) be present in Puerto Rico for a minimum of 549 days during the three-year period that includes the current tax year and the two preceding calendar years, as long as he is also present in Puerto Rico for a minimum of 60 days during each of those three years; or (5) have no ''significant connection'' to the United States.[14]

The manager will have no significant connection to the United States and thus will meet the presence test, regardless of the number of days spent in Puerto Rico or in the United States, if the manager does not have any of the following: (1) a permanent home in the United States (which includes any accommodation, house, apartment, or a furnished room available to the manager at all times, continuously, and not only for stays of short duration), regardless of whether it is owned or rented by the manager or otherwise made available to him; (2) a spouse or child who has not attained the age of 18 whose principal place of abode is in the United States (unless the spouse is legally separated under a decree of divorce or separate maintenance, the child lives in the United States with a custodial parent, or the child is in the United States as a student); or (3) current registration to vote in the United States.

The manager does not have to be present in Puerto Rico during the calendar year to meet the presence test if he spends no more than 90 days in the United States or has no significant connection to the United States. However, to meet the tax home test, the manager's regular (or principal, if more than one) place of business that he claims for purposes of determining income tax deductions for traveling expenses while away from home in the pursuit of a trade or business must be in Puerto Rico.[15] Thus, to meet the tax home test, the manager must spend substantially more time working from his office in Puerto Rico than from an office in the United States or a foreign country.

Lastly, the manager must have more significant connections with Puerto Rico than he does in the aggregate with the United States and any foreign country. For that determination, the following factors are taken into account: (1) the location of the manager's permanent home; (2) the location of the manager's family; (3) the location of the manager's personal belongings, such as automobiles, furniture, clothing, and jewelry; (4) the location of social, political, cultural, or religious organizations with which he has relationships; (5) the location where the manager conducts routine personal banking activities; (6) the location where the manager conducts business activities (other than those that constitute the manager's tax home); (7) the location where the manager holds a driver's license; (8) the location where the manager votes; and (9) the country of residence designated by the manager on all official government forms, documents, and tax returns. The significant connections analysis can also take into account similar factors[16] that attempt to show that the manager is no longer living in the United States.[17]

Bona fide residency in Puerto Rico must be for the entire calendar year.[18] Accordingly, the manager must meet the tax home and closer connection tests on or before December 31 of the year preceding the calendar year for which the manager intends to qualify as a BFR-PR and must meet the presence test during the calendar year for which he wishes to qualify as a BFR-PR. If the manager is not a BFR-PR during the entire calendar year, the manager may nonetheless qualify as a BFR-PR as long as he (1) was not a BFR-PR for any of the three calendar years immediately preceding the year of the move to Puerto Rico; (2) meets the presence test for the calendar year; and (3) complies with the tax home test and the closer connection test for at least each of the last 183 days of the calendar year in which he moved to Puerto Rico. However, under this alternative, the manager must continue qualifying as a BFR-PR for each of the three calendar years immediately following the calendar year of the move to Puerto Rico.[19] If the manager fails to qualify as a

[14]Sections 933 and 937(b)(2) and reg. section 1.937-2. Note that only one of those requirements must be met to comply with the presence test.

[15]Reg. section 1.937-1(d).

[16]Reg. section 1.937-2(e).

[17]''The conferees believe that the various exemptions from U.S. tax provided to residents of possessions should not be available to individuals that continue to live and work in the U.S.'' American Jobs Creation Act of 2004, P.L. 108-357.

[18]Section 933.

[19]Reg. section 1.937-1(f).

BFR-PR in the following three calendar years, the manager will not qualify as a BFR-PR for the year of the move to Puerto Rico, and the incentive allocation and management fee (or if the act 20 company is a corporation, the dividend from the act 20 company) for that year will be subject to U.S. federal income tax.

It is important to note that the three additional years of bona fide residency in Puerto Rico are required only if the manager is not a BFR-PR during the entire calendar year. If the manager is a BFR-PR during the entire calendar year (that is, the tax home and closer connection tests are met on or before December 31 of the preceding calendar year, and the presence test is met during the calendar year), the three-year requirement does not apply.

Finally, a manager that becomes a BFR-PR must notify the IRS of his Puerto Rico residency by filing Form 8898 on or before the due date of his U.S. income tax return for the calendar year when he became a BFR-PR.[20]

2. Resident of Puerto Rico requirement. To qualify as a resident of Puerto Rico under act 22, the manager must be a ''resident individual,'' as the term is defined in section 1001.01(a)(30) of the Puerto Rico Internal Revenue Code of 2011 (the PR-IRC), as amended. Section 1001.01(a)(30) provides that a resident individual is one domiciled in Puerto Rico. It further states that it shall be presumed that an individual is a resident of Puerto Rico if he has been present in Puerto Rico for a period of 183 days during the calendar year. Lastly, it says that the Treasury secretary shall adopt regulations establishing the factors that will be taken into account in determining whether an individual is domiciled in Puerto Rico.

Because no regulations have been adopted, it is unclear what requirements must be met to qualify as a resident of Puerto Rico under act 22. To eliminate that uncertainty, the tax exemption grant issued under act 22 contains a clause stating that if the individual qualifies as a BFR-PR by meeting the presence test, tax home test, and closer connection test of section 937, as expanded by reg. section 1.937-1, the individual will qualify as a resident individual for purposes of act 22. Accordingly, if the manager qualifies as a BFR-PR, he will be entitled to the Puerto Rican income tax exemption under act 22 for interest, dividends, and capital gains from the sale of securities.

C. The Act 20 and Act 22 Tax Grants

The tax grants under acts 20 and 22 are treated as contracts between the government of Puerto Rico and the manager or the act 20 company, as applicable.[21] Treating the grants as contracts is intended to protect managers and act 20 companies from any revocation of the acts by future Puerto Rico legislation, under the provision in Puerto Rico's constitution that bars the impairment of contractual obligations.[22]

The act 22 tax grant exempts from Puerto Rican income tax the manager's short- and long-term capital gains from the sale of securities, as well as interest and dividends, until December 31, 2035. The act 20 tax grant, however, provides that the act 20 company (or the manager, if the act 20 company is a passthrough entity) is subject to a 4 percent Puerto Rican income tax rate, in lieu of any other Puerto Rican income tax, during a 20-year period commencing on the date operations begin and may be extended for an additional 10 years.[23] Moreover, the act 20 grant provides that dividends distributed by the act 20 company are exempt from Puerto Rican income tax and that the act 20 company is 60 percent exempt from a municipal tax of 0.5 percent of gross receipts (1.5 percent for specific financial businesses) during that period.[24]

Applications must be filed with the Puerto Rico Office of Industrial Tax Exemption.[25] A $750 fee must be paid with each application. Upon its approval, the act 22 grant is retroactive to the first day of the calendar year during which the manager became a resident of Puerto Rico. A $5,000 fee is payable to the Department of Economic Development and Commerce upon the approval of the act 22 grant, but no fee is payable upon the approval of the act 20 tax grant.[26] To obtain the act 22 grant, the manager is also required to acquire a residence in Puerto Rico within a two-year period commencing on the date of the move to Puerto Rico. Copy of the deed of purchase evidencing the acquisition must be submitted to the Office of Industrial Tax Exemption on or before the expiration of the two-year period.

Act 20 tax grants are made retroactive to the date the act 20 company commenced operations, as long as the application was filed on or before that date.[27] Thus, once an application is filed, the act 20 company may commence operations in Puerto Rico, and

[20]Reg. section 1.937-1(h)(1).

[21]P.R. Laws Ann. tit. 13, sections 10838(a) and 10851a(a).

[22]Section 7 of Article II of Puerto Rico's constitution provides in relevant part: ''No laws impairing the obligation of contracts shall be enacted.''

[23]P.R. Laws Ann. tit. 13, sections 10852, 10853(a), 10853(b), and 10836(a).

[24]P.R. Laws Ann. tit. 13, sections 10834 and 10833(a).

[25]P.R. Laws Ann. tit. 13, sections 10837(a) and 10851a(a).

[26]P.R. Laws Ann. tit. 13, section 1084(b).

[27]P.R. Laws Ann. tit. 13, section 10836(b)(1).

once approved, the 20-year exemption period will begin as of the date of commencement of operations, and all the act 20 company's income derived from the investment advisory services will enjoy the 4 percent Puerto Rican income tax, 60 percent municipal gross receipts tax exemption, and dividend exemption.

To qualify for the tax grant, the act 20 company must employ a minimum of five full-time employees (or full-time equivalents) who are residents of Puerto Rico. Three of those individuals must be hired within six months from the date of commencement of operations and the other two within two years of that date.

D. Exemption on the Incentive Allocation

1. U.S. income tax exemption. As previously stated, short- and long-term capital gains from the sale of securities are generally sourced in the jurisdiction where the seller resides (that is, the seller's tax home).[28] U.S. citizens and resident aliens are not treated as nonresidents for this purpose unless an income tax of at least 10 percent is paid on the gains to the country where they reside.[29] However, section 865(j)(3) authorizes regulations to provide that this 10 percent tax requirement does not apply to a BFR-PR, and in Notice 89-40, the IRS stated it would adopt regulations to that effect.[30] Thus, even though capital gains are exempt from Puerto Rican income tax, the gains may still qualify as Puerto Rican-source income, and if the manager is a BFR-PR, the short- and long-term capital gains from the sale of securities that form part of the incentive allocation will constitute Puerto Rican-source income not subject to U.S. federal income tax.[31]

However, if the capital gains are attributable to an office or other fixed place of business of the manager in another jurisdiction and a tax of at least 10 percent is payable to that jurisdiction on the gains, the source of the gains is the jurisdiction where the office or fixed place of business is located.[32] Thus, if the capital gains of the fund are attributable solely to the trading activities that the manager conducts from his Puerto Rican office, the incentive allocation should constitute Puerto Rican-source income not subject to U.S. income tax, but if other traders continue trading from the United States or a foreign country on behalf of the fund, an issue arises as to whether the incentive allocation is attributable to an office outside Puerto Rico and will be subject to U.S. income tax.

While there is no IRS guidance or other authority on this issue, it seems that if the activities conducted outside Puerto Rico are limited to trading in securities on behalf of the fund, the manager should not be considered as having an office or other fixed place of business outside Puerto Rico to which the gains are attributable, and thus the capital gains that form part of the incentive allocation should constitute Puerto Rican-source income exempt from U.S. income tax.[33]

Importantly, for securities owned by a an individual on the date that he becomes a BFR-PR, generally the only portion of the capital gains derived from the sale of those securities that will qualify as Puerto Rican-source income consists of the appreciation in value of the securities commencing on the first day that the individual ceased to have a tax home in the United States.[34] This rule could apply to securities of the fund that are indirectly owned by the manager in his capacity as a partner of the fund if the manager is deemed to own them for this purpose. No legal authority addresses this issue, but the better view seems to be that the securities of the fund should not be treated as owned by the manager and thus the full amount

---

[28]Section 865(a) and reg. section 1.937-2(b). Note also that in the case of partnerships such as the fund, section 865(i)(5) provides that the tax home of the partner determines the source of the partner's gain.

[29]Section 865(g)(2).

[30]Notice 1989-90, 1989-1 C.B. 681.

[31]Section 865(a) and reg. section 1.937-2(b).

[32]*Id.*

[33]Under section 865(e)(3), the "principles" of section 864(c)(5) apply to determine whether a taxpayer has an office or other fixed place of business and whether the sale is attributable to that office. Reg. section 1.864-7(b)(1) under section 864(c)(5) provides as follows: "As a general rule an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility through which a nonresident alien or foreign corporation *engages in a trade or business*" (emphasis added). Reg. section 1.864-6(b)(1) states that income, gain, or loss is attributable to an office or other fixed place of business that a nonresident alien individual or a foreign corporation has in the United States only if that office or other fixed place of business is a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the *trade or business carried on through that office or other fixed place of business*. Accordingly, it seems reasonable to conclude that a trade or business must be conducted in the office or other fixed place of business for there to be an office or other fixed place of business to which the gain may be attributable. Under section 864(b)(2)(A)(ii), trading in stocks or securities for the taxpayer's own account, whether by the taxpayer, his employees, or specific agents, does not constitute a trade or business within the United States; thus, it seems that if the U.S. or foreign-country activities are limited to trading in securities for the account of the fund, the gains should not be attributable to that office, and the short- or long-term gains that form part of the incentive allocation should be Puerto Rican-source income.

[34]Reg. section 1.937-2(f)(1)(i), -2(f)(1)(vi), and -2(f)(1)(vii)(B).

of the capital gains of the fund that form part of the incentive allocation should qualify as Puerto Rican-source income.[35]

2. Puerto Rican income tax exemption. Act 22's exemption for capital gains from the sale of securities applies to the portion of the gain that represents the appreciation in value of the securities owned by the qualifying individual during the period that he is a resident of Puerto Rico.[36] Initially, it was unclear whether the exemption would apply if the capital gains were realized by a passthrough entity such as the fund. A clause was added to the act 22 tax grants to clarify this issue, saying, in essence, that the exemption does apply even if the capital gains are realized by a passthrough entity, including partnerships, such as the fund. Accordingly, the portion of short- and long-term capital gains from the sale of securities that form part of the incentive allocation that represents the appreciation in value of the fund's securities during the period that the manager is a BFR-PR should be exempt from Puerto Rican income tax if the manager obtains the tax grant under act 22 and the capital gains are derived from the sale of securities.[37]

Conversely, the portion of the fund's capital gains representing the appreciation in value of the securities before the individual's residency in Puerto Rico is arguably not exempt from Puerto Rican income tax. Nevertheless, because the gains should not be subject to U.S. federal income tax, it may be possible to persuade the secretary of economic development and commerce to include a provision in the act 22 tax grant stating that the gains are also exempt from Puerto Rico income tax.

As previously stated, if the incentive allocation or any portion thereof consists of interest or dividends from non-Puerto Rican issuers, the income will be exempt from Puerto Rican income tax under act 22, but the interest and dividends will not be Puerto Rican-source income and will be subject to U.S. income tax.[38]

E. The Management Fee Exemption

1. U.S. income tax exemption. Generally, an act 20 company is a corporation organized in Puerto Rico (a foreign corporation under the IRC)[39] to avoid the imposition of U.S. income tax on the management fee derived from services rendered from Puerto Rico or outside Puerto Rico and to allow its dividends to qualify as Puerto Rican-source income not subject to U.S. income tax.[40] The act 20 company should not render investment advisory services from the United States; if those services are rendered from the United States by the manager, employees of the company, or specific agents of the company, the company will be deemed to be engaged in a trade or business in the United States, and the net income derived from the management fee attributable to those services will be subject to U.S. federal income tax at the regular U.S. corporate income tax rates of up to 35 percent and to a U.S. branch profits tax of 30 percent.[41] Also, if the gross fees for those services anywhere outside Puerto Rico exceed a 20 percent threshold[42] or the gross fees for those services in the United States exceed a 25 percent threshold,[43] a portion of the dividends distributed by the act 20 company to the manager will not constitute Puerto Rican-source income and will be subject to U.S. federal income tax.[44]

Likewise, if the act 20 company is a Puerto Rican limited liability company that elects to be treated under the IRC as a disregarded entity or partnership and the services are rendered from the United States or elsewhere outside Puerto Rico, the portion of the management fee attributable to those services will not constitute Puerto Rican-source income.[45]

Thus, to avoid U.S. income taxes, for an act 20 company that is a corporation or is subject to U.S. income tax as a corporation, no services should be rendered from the United States, and the services rendered outside Puerto Rico should not exceed the 20 percent threshold. Similarly, in the case of an act 20 company that is a partnership or a disregarded

[35]Under reg. section 1.937-2(f)(1)(ii)(B), the appreciation in value rule is applicable to securities the manager owns before becoming a BFR-PR. Other provisions of reg. section 1.937-2 refer to property owned directly or indirectly, but reg. section 1.937-2(f)(1)(B) refers solely to property "owned" by the individual and does not include property "indirectly" owned. Reg. section 1.937-2(f)(1)(B)'s failure to include indirectly owned property supports the view that the portion of the investment allocation consisting of capital gains from the sale of securities owned by the fund before the manager becomes a BFR-PR should constitute Puerto Rican-source income.

[36]Laws P.R. Ann. tit. 13, section 10853(b).

[37]Laws P.R. Ann. tit. 13, section 10853. While the term "securities" is not defined by act 22, the tax grant issued to the manager states that the capital gains exemption granted by the act applies to gains from the sale of "investment assets." Thus, the exemption should apply to capital gains from the sale or other disposition of shares of stock, bonds, and other securities and also to capital gains from the sale or other disposition of commodities, commodity futures, and other similar investment assets.

[38]Section 861(a)(1) and (a)(2) and reg. section 1.937-2(b).

[39]Section 7701(a)(4), (a)(5), and (a)(9).

[40]Sections 11(a), 11(d), 61, and 861(a)(2)(A) and reg. section 1.937-2(b).

[41]Sections 864(b), 882(a)(1), and 884.

[42]Reg. section 1.937-2(g)(1)(ii).

[43]Sections 861(a)(2)(B) and 862(a)(2).

[44]This conclusion assumes that the manager owns at least 10 percent of the issued and outstanding shares of stock or other equity interests of the act 20 company.

[45]Sections 861(a)(3) and 862(a)(3).

entity, no services should be rendered outside Puerto Rico to avoid the imposition of U.S. federal income tax on the manager on the portion of the management fee attributable to those services.

If the act 20 company is a Puerto Rican corporation, the controlled foreign corporation or passive foreign investment company provisions of the IRC may be applicable. However, if the manager is a BFR-PR, the CFC regime will not be applicable, and the PFIC regime should not result in adverse tax consequences to the manager as long as the company's gross income does not exceed the 25 percent threshold. Moreover, if the manager owns at least 10 percent of the issued and outstanding voting rights of the act 20 company, the CFC and PFIC provisions will not adversely affect him, as long as the company does not exceed the 20 percent threshold.[46]

2. Four percent income tax. As previously stated, act 20 imposes a 4 percent Puerto Rican income tax, in lieu of any other Puerto Rican income tax, on the income that an act 20 company derives from providing specific services, including investment advisory services, to nonresidents of Puerto Rico. The exemption also covers dividends that the act 20 company distributes from earnings and profits derived from that income. Thus, if the manager creates a Puerto Rican corporation or LLC subject to Puerto Rican income tax as a corporation to provide the investment advisory services to the fund or to act as a sub-adviser to the fund's U.S. investment adviser and the entity obtains the tax grant under act 20, the corporation or LLC will be subject to the 4 percent Puerto Rican income tax, and the dividends out of E&P derived from the investment advisory services will be exempt from Puerto Rican income tax. Conversely, if the act 20 company is a Puerto Rican partnership or LLC that is treated as a partnership for Puerto Rican income tax purposes, the act 20 company will not be subject to Puerto Rican income tax, and the 4 percent Puerto Rican income tax will be imposed on the manager.

In determining the tax savings for the management fee, it should be noted that a manager who is an equity holder of the act 20 company and also a service provider must have a salary that is fully taxable in Puerto Rico at the ordinary income tax rates of up to 33 percent. Under a public ruling issued by the Puerto Rican Department of Treasury, the salary should be a market salary of up to a maximum of $350,000.[47]

F. Puerto Rico Operations & the Fund's Investors

Because the fund is a partnership and the act 20 company will be its exclusive agent, under the PR-IRC, the fund could be engaged in a trade or business in Puerto Rico. If so, the investors of the fund will be deemed to be engaged in the operations that the act 20 company conducts in Puerto Rico.[48]

Fund investors who are U.S. citizens and nonresidents of Puerto Rico, including passthrough and disregarded entities owned by those U.S. citizens, will not be subject to Puerto Rican income tax as a result of the Puerto Rican operations of the act 20 company. Under the PR-IRC, income from sources outside Puerto Rico of U.S. citizens who are nonresidents of Puerto Rico is not subject to Puerto Rican income tax.[49] Because those U.S. citizens' distributive share of the fund's income will generally consist of interest, dividends, or capital gains from the sale of securities from sources outside Puerto Rico,[50] the operations of the act 20 company in Puerto Rico should not result in the imposition of Puerto Rican income taxes upon them.

Conversely, corporate investors of funds (or entities treated as corporations under the PR-IRC) organized outside Puerto Rico will be subject to Puerto Rican income tax on their distributive shares of the fund's capital gains from the sale of securities and interest and dividends from sources outside Puerto Rico if the company engages in a trade or business in Puerto Rico and the income is effectively connected with the active conduct of a banking, financing, or similar business of that corporation in Puerto Rico or is received by a corporation whose principal business is trading in securities for its own account.[51] Accordingly, because the manager trades in securities as an agent of the fund, the fund could be deemed to be trading in securities in Puerto Rico for its own account. If the trading activities constitute a trade or business in Puerto Rico, the fund's corporate investors will be deemed to engage in a trade or business in Puerto Rico, and their distributive share of the fund's

---

[46]Section 957(a), prop. reg. section 1.1291-1(f), and reg. section 1.937-2(g)(1)(ii).

[47]Administrative Determination dated Oct. 10, 2015. *But see Krueger v. Secretary of the Treasury*, 89 D.P.R. 345 (1963), which

(Footnote continued in next column.)

supports the position that the salary may be lower than market. Regrettably, *Krueger* does not establish a bright line to determine the amount of the salary.

[48]*Adda v. Commissioner*, 10 T.C. 273 (1948). P.R. Laws Ann. tit. 13, section 1071.01.

[49]P.R. Laws Ann. tit. 13, section 1031.01(a)(35).

[50]P.R. Laws Ann. tit. 13, section 1035.02(a)(1), 1035.01(a)(1), 1035.02(a)(2), 1035.01(a)(2), 1035.03(a)(2), and 1035.03(a)(3).

[51]P.R. Laws Ann. tit. 13, sections 1092.01(b)(2), 1123(f)(1)(A), and 1123(f)(3)(B)(ii).

interest, dividends, and capital gains could be subject to Puerto Rican income tax.[52]

Reg. section 1231-1(d)(2) under the Puerto Rican Internal Revenue Code of 1994, as amended (which is still applicable under the PR-IRC), provides that the phrase ''engaged in business in Puerto Rico'' does not include transactions in stock, securities, or commodities (including hedging transactions) through a broker, agent, or resident custodian. The predecessor of this regulatory provision (which had identical wording) was article 231-2(c) of the regulations under the Puerto Rico Income Tax Act of 1954, as amended, promulgated on July 11, 1957, which in turn was based on section 211(b) of the U.S. Internal Revenue Code of 1939, as amended.

U.S. court cases[53] have held that a similar provision of the IRC, before its amendment by the U.S. Foreign Investors Tax Act of 1966, did not preclude foreign corporations that traded in securities for their own account through a U.S. agent from being considered to be engaged in a trade or business in the United States for income tax purposes. Specifically, in *Liang*,[54] the Tax Court held that trading in securities constituted a U.S. trade or business even if conducted for the trader's own account because those provisions were intended to be applicable to mere incidents of investment and not to transactions that constituted carrying on a trade or business. According to the Tax Court, the frequency of the transactions and the length of the holding period were relevant to determining whether the investor was a ''trader.'' The court stated that whether the investor engaged in short sales, puts, calls, or hedging was also relevant. Similarly, in *Nuba*,[55] the Fourth Circuit held that trading in commodities for one's account for profit could constitute a trade or business if sufficiently extensive. However, upon the enactment of section 864(b)(2) as part of the Foreign Investors Tax Act of 1966, Congress clarified that trading in securities or commodities through a U.S. agent with discretionary authority to carry out transactions in the United States regarding stock, securities, or commodities did not warrant treating the foreign person acting on his account as engaging in a trade or business in the United States. Congress further indicated that individuals who trade in U.S. stocks and commodities are not thereby treated as being engaged in the business of buying and selling stocks and commodities even if the volume of their activity is large.[56] Accordingly, given the explanatory nature of section 864(b)(2), it seems that the Puerto Rican treasury and the Puerto Rican courts should not treat the corporate investors of the fund as engaged in a trade or business in Puerto Rico as long as the act 20 company's activities are limited to trading in securities or commodities. Nevertheless, to ensure that the fund's corporate investors will not be adversely affected by the Puerto Rican operations of the company, a provision should be included in the act 20 tax grant expressly stating that the fund's investors will not be treated as engaged in a trade or business in Puerto Rico because of the company's Puerto Rican operations. The government of Puerto Rico has already agreed to that clause in several tax grants. ■

[52]Interestingly, for the corporate investors to be subject to Puerto Rican income tax, their principal business must be trading in securities for their own account, but the PR-IRC does not specify whether that analysis takes into account solely the business's imputed Puerto Rican operations or also its worldwide operations.

[53]U.S. court cases construing provisions of the IRC or regulations that are equivalent to provisions of the PR-IRC or the regulations thereunder are very persuasive and are generally followed by the Puerto Rican Department of Treasury and the Puerto Rican courts.

[54]*Liang v. Commissioner*, 23 T.C. 1040 (1955).

[55]*Commissioner v. Nuba*, 185 F.2d 584 (4th Cir. 1950).

[56]S. Rep. 1707 (P.L. 89-809), at 16.