

MAYER | BROWN

PUERTO RICO  
FINANCIAL SERVICES  
FORUM



# *Puerto Rico Financial Service Companies – Navigating US Tax Risks*

Mark Leeds

Partner

[mleeds@mayerbrown.com](mailto:mleeds@mayerbrown.com)

(212) 506 2499

Juan Lopez Valek

Associate

[jlopezvalek@mayerbrown.com](mailto:jlopezvalek@mayerbrown.com)

(212) 506 2471

October 18, 2022

# Today's Speakers



**Mark H. Leeds, Partner** - (212) 506 2499 ([mleeds@mayerbrown.com](mailto:mleeds@mayerbrown.com))

Mark 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. 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.



**Juan F. Lopez Valek, Associate** - (212) 506 2471 ([jlopezvalek@mayerbrown.com](mailto:jlopezvalek@mayerbrown.com))

Juan is a tax associate at the law firm of Mayer Brown. Juan's professional practice focuses on advising clients on corporate and international tax matters, the tax aspects of mergers and acquisitions, financing arrangements and working with US individuals and businesses that have moved to Puerto Rico. Prior to joining Mayer Brown, Juan worked as a senior tax associate in a public accounting firm based in New York and, prior to that, Juan was a senior associate in a boutique tax consulting firm in Mexico City. Juan is a native Spanish speaker and is fluent in Portuguese.

# The US Treats Puerto Rico Companies as Foreign

- “Doing Business in the US” Tax Risks
  - If a PR corporation is treated as engaged in the conduct of a US trade or business, interest income “effectively connected” to such trade or business will be subject to US net basis taxation
- Dividends are subject to a 10% withholding tax
- Interest Subject to 30% US Withholding
  - Participating Interest
  - Interest received from 10%-owned affiliates
- Withholding Tax Free Interest Income
  - Portfolio Interest
  - Short-Term Interest
  - Bank Deposit Interest

# Tax Code Source Rules Generally Apply

- General rule:
  - Rules for determining whether income is US-source income or ECI to a USTB apply for purposes of determining whether income is Puerto Rico source income or ECI with a Puerto Rico Trade or Business
  - Income treated as “US-source income” is excluded from Puerto Rico-source income even if it is earned in connection with a Puerto Rico Trade or Business
  - Office rule can stymie efforts to treat certain gains as Puerto Rico-source income
  - Interest and dividend income is sourced to the residence of the payer of such income.

# Business Income – General Rules

- 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 from US tax.
- 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 for patents and other IP look to where the IP is used.
  - Internet services may still look to where servers are located under specific circumstances.

# US Trade or Business Activities of Non-US Persons

- A non-US person is subject to tax on its income that is effectively connected with the conduct of a US trade or business under rules that are substantially similar to those applicable to a US person
  - Treas. Reg. § 1.882-5
  - Imputation of agent activities
- Lending money on a regular and continuous basis in the US will be treated as the conduct of a US trade or business
- Buying loans in secondary and tertiary market transactions should not be treated as trade or business activities

# Activities of Agents

- Authorities attribute activities of agents to the foreign person, when this imputation will occur is uncertain.
- If the agent is an independent agent, it is less likely that the agent's activities will be imputed to the non-US principal.
  - There have been instances in which the Internal Revenue Service has been successful in imputing an independent agent's activities to a principal. *De Amodio v. Comm'r*, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3rd Cir. 1962).
- If the agent is a dependent agent, its activities will be imputed to the non-US principal.

# Recent IRS Guidance

- Two non-binding authorities issued to date:
  - Generic Legal Advice Memorandum 2009-010 (Sept. 22, 2009) (the “GLAM”)
  - Internal Legal Memorandum 201501013 (Sept. 5, 2014) (the “ILM”)
- In the GLAM, the IRS determined that a foreign corporation was engaged in a USTB and recognized ECI as a result of lending activities (solicitation, due diligence, and negotiation with borrowers) attributed to the foreign corporation through an independent agent in the U.S.
- In the ILM, the IRS concluded that a foreign fund engaged in “lending” and “underwriting” activities that constituted a USTB not covered by the trading safe harbors.



# Guidelines for Loan Acquisitions

- Minimum waiting period (e.g., 24-48 hours) following original lender's funding/commitment before foreign person purchases, or commits to purchase (e.g., pursuant to a forward commitment), the loan.
- Special rules for loans that require later fundings and revolving loans
- Risks inherent in "vertical structures," in which the loan purchaser owns the loan originator
- No significant negotiation or other communication with borrower or lender.
- No fees should be payable to the loan purchaser (directly or through pricing)
- No relationship with original lender; offshore fund should not provide capital to the originator.
  - Additional restrictions apply if loans are originated by affiliates ("season and sell") in order to preclude agency attribution.

# Guidelines for Loan Acquisitions

- Originator sells participations to a significant number of investors (not selling the entire position to one off-shore fund).
- Originator has the ability hold the loan on its balance sheet.
- Price at which loan is sold reflects fair market value; sales do not occur at par value.
- Broad offering of loan participations.
- Distressed at purchase transactions
- Rules for loan extensions and amendments
  - Do substantial modifications constitute loan originations?
  - Do extensions constitute origination activities (roll-overs)?
  - Work-out considerations

# The IRS Adds Offshore Lending to Audit Campaign

- On June 10, 2021, the IRS added the acquisition of loans by non-US persons to its audit campaign stating:
  - This campaign addresses whether foreign investors were subject to U.S. tax on effectively connected income from lending transactions engaged in through a U.S. trade or business. In general, foreign investors who only trade stocks and securities for their own account are not engaged in a U.S. trade or business under the safe harbor rule set forth in 26 USC 864(b)(2). The safe harbor rule, however, is not available to dealers in stocks or securities, or to entities engaged in a lending business, or to foreign investors in partnerships engaged in such activities.

# PR Audit Campaign

- On January 29, 2021, the IRS added “Puerto Rico Act 22, Individual Investors Act,” to its audit campaign
- The audit campaign has three areas of focus:
  1. Identify individuals who have Act 22 decrees but do not satisfy the requirements
  2. Determine if individuals are inappropriately claiming non-Puerto Rico-source income as Puerto Rico-source income in order to avoid US tax
  3. Address non-compliance through examinations, outreach and soft letters

# Background – PR Audit Campaign

- **Congressional Letter.** In December 2019, members of Congress sent letter to Treasury secretary expressing concerns about benefits of US tax laws for taxpayers that become residents of Puerto Rico
- **IRS Report.** At the same time, Congress directed the IRS to determine the number of individuals that had relocated to Puerto Rico since 2012 and been granted tax exemptions under Act 22
  - IRS identified 2,331 individuals who had obtained Act 22 benefits from 2012-2019
- **Criminal Indictment.** In October 2020, a CPA with a large accounting firm was indicted on charges related to assisting clients fraudulently obtain benefits associated with Act 22

# Takeaways – Audits Are Coming

- **Tax Gap.** IRS Commissioner Charles Rettig recently testified before Congress that the amount of taxes uncollected in the US could be \$1 trillion or more per year
  - Previous estimates suggested uncollected taxes were much less (i.e., \$440 billion)
- **Budget Increase.** President Biden recently proposed a 10.4% increase to the IRS budget, which would increase resources for tax enforcement by \$900 million
- **Red Flag.** Individuals who received advice from the accounting firm involved in the indictment have an increased chance of an IRS audit as the IRS likely received the firm's list of clients who received advice

Thank You!