

CORPORATE BUSINESS TAXATION MONTHLY

Published Monthly by CCH, a Wolters Kluwer business

**Manhattan's Silicon Alley Federal & State R&D Tax
Credit Opportunity**

**New Car Fuel Rules Drive Product Innovation and R&D
Tax Credits**

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"You Can't Have Your Cake and Eat It Too!"**

Officer and Owner Liability for Corporate Tax

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Vol. 13, No. 8 May 2012

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New Tax Incentives Legislation in Puerto Rico

By Jose R. Perez-Riera

Jose Perez-Riera, Secretary of Economic Development and Commerce of Puerto Rico, discusses two new acts that create tax incentives to boost the territory's economy by attracting new residents and to establish and develop in Puerto Rico an international export services center.

On January 17, 2012, the Legislative Assembly of Puerto Rico approved new legislation to promote the economic development of Puerto Rico:

- Act No. 22, also known as the Act to Promote the Relocation of Individual Investors to Puerto Rico (the "Individual Investors Act"), and
- Act No. 20, also known as the Act to Promote the Exportation of Services (the "Export Services Act").

The Individual Investors Act seeks to attract new residents to Puerto Rico by providing a total exemption from Puerto Rico income taxes on all passive income realized or accrued after such individuals become *bona fide* residents of Puerto Rico. This relocation should result in new local investments in real estate, services and other consumption products and in capital injections to the Puerto Rico banking sector, all of which will accelerate the economy of Puerto Rico.

The purpose of the Export Services Act is to establish and develop in Puerto Rico an international export services center. This Act seeks to encourage local service providers to expand their services to persons outside of Puerto Rico, promote the development of new businesses in Puerto Rico and stimulate the inbound transfer of foreign service providers to Puerto Rico. The Act also creates a special fund for the continuous development of new tax incentives

that will promote export services and the establishment of new businesses in Puerto Rico.

Individual Investors Act—Applicability

The Individual Investors Act applies to any individual investor that becomes a *Puerto Rico resident* on or before the tax year ending on December 31, 2035 (hereinafter referred to as "Resident Individual Investor"), provided that such individual was not a resident of Puerto Rico at any time during the 15-year period preceding the effective date of the Individual Investors Act.

A *Puerto Rico resident* is an individual who is domiciled in Puerto Rico. Physical presence in Puerto Rico for a period of 183 days during the tax year will create a presumption of residence in Puerto Rico for tax purposes.

Special Tax Rule Under the U.S. Code for Puerto Rico *Bona Fide* Residents

Pursuant to Code Sec. 933 of the Internal Revenue Code ("the Code"), income derived from sources within Puerto Rico by individuals who are *bona fide residents of Puerto Rico* during the entire tax year is not included in gross income and is exempt from taxation under the Code (the "Code Sec. 933 Exclusion").

Jose R. Perez-Riera is Secretary of Economic Development and Commerce of Puerto Rico.

The term "*bona fide* resident of Puerto Rico" means a person who:

- (1) is present in Puerto Rico for at least 183 days during the tax year;
- (2) does not have a tax home outside of Puerto Rico during the tax year; and
- (3) does not have a closer connection to the United States or a foreign country than to Puerto Rico.

Tax Exemption on Interest and Dividend Income

Under the Individual Investors Act, Resident Individual Investors will enjoy a 100-percent tax exemption from Puerto Rico income taxes on interest and dividend income derived during the tax exemption period (as defined below).

Pursuant to the Code Sec. 933 Exclusion, interests and dividends received by Resident Individual Investors that qualify as Puerto Rico source income will not be subject to federal income tax under the Code.

Resident Individual Investors may be able to reduce the tax rate applied on interest and dividend income coming from sources outside of Puerto Rico (including the source country taxation) to zero percent or 10 percent, respectively, by investing through certain Puerto Rico investment vehicles.

Tax Exemption on Capital Gains

Long-term capital gains (LTCG) derived by Resident Individual Investors for investment appreciation accruing after becoming a Puerto Rico resident will be 100-percent exempted from Puerto Rico income taxes, if such gain is recognized prior to January 1, 2036.

On the other hand, LTCG derived by Resident Individual Investors will be subject to preferential income tax rates in certain circumstances, as follows:

- LTCG for investment appreciation that accrued prior to becoming a Puerto Rico resident (the "Non-PR Gain") will be taxed at: (a) 10 percent, if such gain is recognized within 10 years after the date residence is established in Puerto Rico and prior to January 1, 2036, and (b) five percent, if such gain is recognized after said 10-year period but prior to January 1, 2036. Any taxes paid in Puerto Rico with respect to any Non-PR Gain may be used as a tax credit in another jurisdiction that taxes the same Non-PR Gain. As such, the Resident Individual Investor will not pay any additional taxes on the Non-PR Gain.

- A similar rule applies under the Code with respect to *United States Investors*, regardless of the Code Sec. 933 Exclusion, since any Non-PR Gain recognized within said 10-year period by investors formerly subject to the United States taxing jurisdiction (the "United States Investor") will be taxed in accordance to the applicable provisions of the Code. The *United States Investor* may elect to apportion to Puerto Rico any part of the LTCG related to investment appreciation that accrued after becoming a Puerto Rico resident and, therefore, be entitled to the Code Sec. 933 Exclusion for such portion.

- The United States Investor qualifying as a Resident Individual Investor which recognizes a Non-PR Gain after 10 years of becoming a *bona fide* Puerto Rico resident would not be subject to federal income tax on any portion of the Non-PR Gain and to a five-percent tax in Puerto Rico. As stated before, any part of a LTCG attributable to the period of Puerto Rico residence would qualify for zero-percent United States federal income tax and zero-percent Puerto Rico income tax, if recognized prior to January 1, 2036.

Any LTCG for investment appreciation not described above will be taxed in accordance with the applicable provisions of the Puerto Rico Internal Revenue Code of 2011, under which LTCG derived by Puerto Rico residents is subject to a 10-percent preferential income tax rate.

In light of the above, Resident Individual Investors may be able to reduce the tax rate applied on LTCG in their former domicile to zero percent, five percent or a maximum 10 percent.

Tax Exemption Period

The tax exemption granted under the Individuals Investors Act will expire on December 31, 2035 (the "Tax Exemption Period").

Export Services Act—Applicability

The Export Services Act applies with respect to any entity with a *bona fide* office or establishment located in Puerto Rico that is or may be engaged in an eligible service (the "Eligible Business").

The term "eligible service" includes

- research and development;
- advertising and public relations;
- economic, environmental, technological, scientific, management, marketing, human re

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- sources, information and audit consulting;
- advisory services on matters relating to any trade or business;
- commercial arts and graphic services;
- production of construction drawings, architectural and engineering services and project management;
- professional services such as legal, tax and accounting;
- corporate headquarters;
- electronic data processing centers;
- development of computer programs;
- voice and data telecommunications between persons located outside of Puerto Rico;
- call centers;
- shared services centers ("shared services") including, but not limited to, accounting, finance, taxes, auditing, marketing, engineering, quality control, human resources, communications, electronic data processing and other centralized management services;
- storage and distribution centers ("hubs");
- educational and training services;
- hospital and laboratory services;
- investment banking and other financial services; and
- any other service that the Government of Puerto Rico later determines must be treated as an eligible service (collectively, the "Eligible Service").

An Eligible Service must also qualify as either a *service for exportation* or a *promoter service*. *Services for exportation* are services performed for nonresident individuals and/or

foreign entities that have no nexus with Puerto Rico (that is the Eligible Service is not, and will not be, related to the conduct of a trade, business or other activity in Puerto Rico).

Promoter services are services rendered to nonresidents individuals and/or foreign entities related to the establishment of a new business in Puerto Rico, as defined by the Export Services Act.

Tax Exemption Decree

To enjoy the benefits granted under the Export Services Act the services provider must request and obtain a tax exemption decree under said Act (the "Tax Exemption Decree"). Such decree will have a term of 20 years, renewable for 10 additional years, provided certain conditions are satisfied.

The Tax Exemption Decree will constitute a contract with the Puerto Rico Government not subject to subsequent legislative changes.

Tax Incentives

Service providers operating under a Tax Exemption Decree will enjoy the following tax incentives during the term of such decree:

- A four-percent flat income tax rate will apply to Export Services Income (as defined below). This rate may be reduced to three percent when more than 90 percent of the Eligible Business's gross income is derived from export services, and such services are considered strategic services, according to the criteria established in the Export Services Act.
- Distributions from earnings and profits derived from the Export Services Income will receive one-hundred-percent tax exemption.

- One-hundred-percent exemption from property taxes will apply during the first five years of operations in the case of Eligible Services described above. After said five-year period, a 90-percent exemption will apply during the term remaining under the Tax Exemption Decree.

Export Services Income

The term "Export Services Income" means net income derived by an Eligible Business subject to the following:

- in the case of new Puerto Rico businesses, all net income derived from an Eligible Service;
- in the case of existing Puerto Rico businesses, only that portion of net income derived from an Eligible Service that exceeds the average net income generated by such business during the three tax years preceding the date a request for a Tax Exemption Decree is filed by such business; and
- in the case of service promoters, only the net income derived from Eligible Services performed within the 12-month period ending on the day preceding the day the new business takes any of the following actions:
 - begins construction of the facilities to be used in Puerto Rico;
 - commences operations in Puerto Rico; or
 - executes a contract to acquire or lease facilities in Puerto Rico.

ENDNOTES

¹ For more information about these incentives, you may contact the Department of Economic Development and Commerce of Puerto Rico at 787-765-2900 or visit our website: <http://puertoricodoesitbetter.com>.