

# Puerto Rico's Act 60 Tax Incentive Program Attracting Heightened IRS Scrutiny of Sourcing and Transfer Pricing

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### Background

Since their passage in 2012, Puerto Rico's Acts 20 and 22, known together as Act 60 since 2019, have encouraged many individuals and businesses, especially from the U.S. mainland, to relocate to Puerto Rico. The tax benefits that Act 60 provides encourage taxpayers outside Puerto Rico to boost the Puerto Rican economy by investing in, doing business in, and living in Puerto Rico. As with any tax benefit, though, Act 60 is vulnerable to abuse. The Internal Revenue Service ("IRS") and the Department of Justice ("DOJ") over the past two years publicized their intention to devote substantial enforcement resources to addressing potential abuse of Act 60 by U.S. taxpayers.

Act 60 operates against the background of U.S. law, under which a *bona fide* resident of Puerto Rico is not subject to U.S. income taxes on income derived from sources within Puerto Rico. Instead, *bona fide* residents of Puerto Rico only pay Puerto Rican income taxes. Thus, Act 60's Puerto Rican tax incentives reduce a *bona fide* resident's only income taxes: those of Puerto Rico.

Puerto Rico's Export Services Act of 2012, also known as Act 20, offered tax incentives to service providers in Puerto Rico that exported their services to other jurisdictions. The tax benefits included a tax rate of four percent for eligible export services, a 100-percent tax exemption on dividends from earnings and profits, and a 60-percent tax exemption on local municipal taxes, all

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with a 20-year decree guaranteeing these rates. These tax incentives applied only to income that Puerto Rican companies earned from performing services in Puerto Rico for customers outside Puerto Rico. In addition to boosting local Puerto Rican export businesses, Act 20 was also intended to induce foreign service providers to relocate to Puerto Rico.

Puerto Rico's Individual Investors Act of 2012, also known as Act 22, offered tax incentives to individuals who relocated to Puerto Rico. Beneficiaries of Act 22 received a 100-percent tax exemption on all dividend and interest income, in addition to all capital gain income accrued after establishing *bona fide* residences in Puerto Rico.

In 2019, Puerto Rico's Act 60 absorbed Act 20 and Act 22. Act 60 is a comprehensive tax incentive code that includes a variety of tax decrees, incentives, subsidies, and tax benefits. Pursuant to Act 60, an individual "resident investor" is required to pay an annual fee of \$5,000 and make annual contributions of \$10,000 to certified Puerto Rican nonprofits.

Although many taxpayers have been taking advantage of these programs since their inception, the past few years have seen a sharp increase in the number of people moving to the island. Fueled by expanding opportunities for remote work caused by the coronavirus disease 2019 ("COVID-19") pandemic, investors, attorneys, hedge fund managers, and, most famously, cryptocurrency traders, have flocked to Puerto Rico. Communities and support systems for the new residents abound, including the 20/22 Act Society. Founded by one of the first and best-known individuals to relocate to the island to take part in the incentive programs, the Society was established to aid and guide individuals who wish to relocate or have relocated to Puerto Rico. The resulting dramatic rise in real estate prices on the island reflects the newcomers' enthusiasm for the tax incentive programs, since establishing *bona fide* residency requires owning a home within the first two years of the move.

## Enforcement

Americans' increased interest in Act 60 as a means of lowering their tax obligations has logically led to heightened government enforcement efforts. While Congress briefly foreshadowed perceived abuses in the 2004 American Jobs Creation Act by outlining rules for obtaining Puerto Rican *bona fide* residence, the

U.S. Government's first major public efforts to ramp up enforcement in this space occurred only within the past three years. In an October 21, 2020 press release, the IRS promised to "*vigorously pursue any individuals and professionals that fraudulently enrich themselves by abusing government tax incentive programs,*" specifically Act 20.<sup>1</sup>

On January 29, 2021, the IRS added Puerto Rico Act 22 to its list of compliance campaigns in response to concerns of abusive tax avoidance, noncompliance, and fraud committed by decree holders.<sup>2</sup> The IRS pointed to two potential cases of abuse of the Acts: falsely claiming *bona fide* residency in Puerto Rico and establishing *bona fide* residency in Puerto Rico but falsely reporting U.S.-source income as Puerto Rico-source income.

Accompanying these warnings are active efforts to increase Act 60 monitoring. The IRS has started to send information document requests ("IDRs") to recent residents who have engaged with the incentive program. They have made these residents easier to spot, too, by requiring them to disclose their recent expatriation on Form 8898, *Statement for Individuals Who Begin or End Bona Fide Residency in a U.S. Possession*.

This increased monitoring led to the indictment and arrest of Puerto Rican CPA Gabriel F. Hernández in October 2020. As the former Tax Manager and Partner-in-Charge of the now defunct accounting firm BDO Puerto Rico, Hernández was indicted and arrested on 10 counts of wire fraud, in violation of Title 18, U.S. Code, Section 1343. According to the press release, Hernández's scheme to defraud the IRS involved the submission of false information to the Puerto Rican government in an attempt to fraudulently provide a company with federal tax relief *via* the provisions of Act 20.<sup>3</sup>

The IRS' and DOJ's investigation of Hernandez used an undercover IRS Special Agent who, beginning in 2018, contacted Hernandez posing as a wealthy U.S. taxpayer from Arizona. According to the indictment, the undercover Special Agent told Hernandez that he wanted to take advantage of Act 20 to reduce his taxes by "creat[ing] a business within Puerto Rico to move the [Special Agent's] profits from the mainland United States to Puerto Rico."

Although the indictment is quite spare, it appears to allege that Hernandez created a shell Puerto Rican company for the agent, willfully filed false tax returns with Puerto Rico's Treasury Department ("Departamento de Hacienda") reporting U.S.-source income of \$500,000

as the shell company's Puerto Rico-source income, and told the agent to file a false U.S. tax return omitting that \$500,000 of U.S.-source income. The indictment charges Hernandez with wire fraud in violation of 18 USC §1343 and alleges that the IRS was the victim of Hernandez's fraud. But instead of alleging that Hernandez defrauded the IRS of tax dollars, the indictment alleges that the "money" at issue was the "substantial fees" that Hernandez charged his taxpayer clients. This appears to run afoul of the Supreme Court's holding that "[t]he wire fraud statute ... prohibits only deceptive 'schemes to deprive [the victim of] money or property.'"<sup>4</sup> It is unclear how the government will prove that Hernandez deprived the IRS of his clients' fees. Presumably, the government chose not to allege that Hernandez deprived his clients of fees because they knowingly participated in the scheme.

## Sourcing of Income and Transfer Pricing

This indictment also highlights that establishing *bona fide* residency in Puerto Rico is only the first step in taking advantage of the Act 60 tax program. Just as important is establishing that one's income was earned in Puerto Rico, making it foreign-source income. Even after one becomes a foreign person by establishing his or her *bona fide* residency in Puerto Rico, his or her income is still subject to U.S. tax if the income comes from sources within the United States. Thus, benefiting from Act 60 is not as simple as uprooting oneself and moving to Puerto Rico.

Unsurprisingly, the IRS has rules governing the determination of whether income is U.S. sourced or foreign sourced. These sourcing rules are mostly contained in Code Secs. 861–865 and their regulations are complicated. The rules depend in large part on the type of income at issue, for example, interest, dividends, income from personal services, and rentals and royalties.

For taxpayers who seek to enjoy the benefits of Act 60, the income in question is often rentals or royalties in the form of licensing fees for the use of the intellectual property. In these circumstances, the IRS's transfer pricing rules under Code Sec. 482 typically come into play. For example, when a U.S. taxpayer decides to move to Puerto Rico to take advantage of the Act 60 regime, he or she may also relocate his or her company's intellectual property to a related Puerto Rican company. Typically, the U.S. company would

then pay licensing fees to the Puerto Rican company for the privilege of using the intellectual property. These licensing fees may then be considered Puerto Rico sourced, as they would be "rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties" under Code Sec. 862(a)(4).

Of course, the amount of the licensing fees on which the two related companies agree will attract the IRS's interest. To establish that the amount of the licensing fees complies with Code Sec. 482's arms-length transfer pricing principle, many taxpayers obtain a transfer pricing study to document that the pricing complies with the arms-length principle. Of course, these transfer pricing studies will only be valuable in defending against a future IRS audit if the taxpayer has conveyed full and accurate information to the accounting firm that he or she hires to produce the study.

If the taxpayer is not fully honest with the accounting firm that produces the transfer pricing study, the study will not only fail as a shield against an IRS audit, but it may well become a sword for the IRS to use against the taxpayer both civilly and criminally. While the *absence* of a transfer pricing study may make substantiating arms-length pricing more difficult, the *presence* of a fraudulently obtained study makes civil fraud penalties or a criminal investigation far more likely. A fraudulent transfer pricing study would be the kind of affirmative act of tax evasion that would cause an IRS Criminal Investigation and the DOJ to pursue criminal charges.

The IRS and DOJ rarely bring criminal charges involving complicated tax concepts like income sourcing and transfer pricing, but a fraudulent transfer pricing study greatly simplifies the issues. Instead of having to educate a criminal jury on complicated tax concepts, the DOJ would only have to persuade a jury that the facts underlying the transfer pricing study were false. Further, the DOJ's greatest ally in making this case to the jury would be the very accounting firm that produced the study. Any reputable accounting firm would want nothing to do with defending a study that was the result of the taxpayer being untruthful with the accounting firm. Being on trial for a tax crime with one's own accounting firm as the prosecution's star witness is not an enviable position.

Through increased civil audits and criminal enforcement, the IRS and DOJ are moving aggressively to crack down on what they see as abuse of Puerto Rico's Act 60 tax program. Anyone who has taken advantage of these tax incentives or is considering doing so should carefully

consider their risks. Anyone who believes that he or she may not be in full compliance with the requirements of the program should consult with counsel about how to address the problem before the IRS or the DOJ come calling.

## ENDNOTES

<sup>1</sup> [www.irs.gov/compliance/criminal-investigation/puerto-rico-cpa-indicted-and-arrested-on-wire-fraud-charges-in-relation-to-act-20-and-act-22-scheme](http://www.irs.gov/compliance/criminal-investigation/puerto-rico-cpa-indicted-and-arrested-on-wire-fraud-charges-in-relation-to-act-20-and-act-22-scheme).

<sup>2</sup> [www.irs.gov/businesses/corporations/lbi-active-campaigns](http://www.irs.gov/businesses/corporations/lbi-active-campaigns).

<sup>3</sup> [www.justice.gov/usao-pr/pr/puerto-rico-cpa-indicted-and-arrested-wire-fraud-charges-relation-act-20-and-act-22](http://www.justice.gov/usao-pr/pr/puerto-rico-cpa-indicted-and-arrested-wire-fraud-charges-relation-act-20-and-act-22).

<sup>4</sup> *Kelly*, S Ct, 590 US \_\_\_, 140 S Ct 1565, 1571 (2020) (quoting *McNally*, S Ct, 483 US 350, 358, 107 S Ct 2875 (1987)).

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