Growing Together

GUIDE

EFFECTIVELY CONNECTED INCOME (ECI) ISSUES

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PUERTO RICO TAX COMPLIANCE GUIDE

By Torres CPA Group
CifrasPR

Understanding the Puerto Rico tax system and its interrelation with United States is crucial for individuals and entities doing business in Puerto Rico. Puerto Rico is not a state; its's a territory, with its own Business and Payroll laws and regulations.

The following White Pater is designed to give an insight Tax Issues in Puerto Rico. It provides relevant background information, which will be of assistance to organizations considering establishing business in the Island. Nonetheless, it is highly recommended to seek advice and counsel from qualified professional sources before undertaking any business.

Certain exclusions and exemptions may apply and when specific problems occur in practice, it will often be necessary to refer to the laws and regulations of Puerto Rico, and to obtain appropriate accounting and legal advice.

It is understood that the following overview does not constitute any formal rendering of either legal, accounting, tax or professional services. If legal advice or other assistance is required, an attorney, CPA or tax adviser should be consulted.

Torres CPA Group is an Advice Certified Public Accounting Firm offering Audit, Tax, Consulting and Financial Outsourcing services for over 30 years. If you require any further information or help, please do not hesitate to contact us.

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EFFECTIVELY CONNECTED INCOME (ECI) ISSUES

General Source Rule

The general rule to determine the source of income from the sale of a property is that is made by reference to the taxpayer's residence. The income recognized by a U.S. resident is U.S. sourced. Any income received by a non-resident or a foreign entity is considered foreign sourced. To this purpose, an entity has been deemed a resident in the jurisdiction where it has been organized.

A starting point for determining whether income from the sale of a property is US Effectively Connected Income (ECI) is deciding whether the taxpayer is engaged in a U.S. Trade or Business (USTB) in the first place. In general, income cannot be effectively connected with a USTB unless the taxpayer is engaged in such a trade or business in the U.S.

ECI depends on its source. Thus, subject to a few exceptions, U.S. sourced income is ECI, and non-U.S. sourced income is not ECI.

One exception applies when the property sold constitutes a U.S. real estate property interest. In that event, the taxpayer is treated as though it is USTB, and the income is ECI, even if the taxpayer is not otherwise an USTB.

Foreign-sourced Income

Generally, foreign-sourced income is not ECI but there are exceptions to this rule.

One of those exceptions could be that it covers certain rents, royalties, dividends, and interest. According to the terms, it may apply to income on the sale of a property. It can also apply to the rent/royalty-sourcing rule, which signals to where the property will be used.

Interest looks to where the payor location is based.

Dividends looks to where the payor location is based; however, if ECI is US, even if it is USTB they are US sourced.

Another exception, which appears on its face to potentially apply to incomes on the sale of a property, is something of a red herring, and provides that foreign-sourced income from the sale of inventory outside the United States that is attributable to an office or fixed place of business in the United States is ECI.

However, if the property is sold for use, disposition, or consumption outside the United States, and the foreign office or the fixed place of business materially participated in the sale, it is not ECI.

The sale of any property, whether it is inventory and regardless of where the sale takes place, by a non-resident that is attributable to a U.S. office or fixed place of business is treated as U.S. sourced income. Thus, any income that otherwise would characterize that income as a U.S. sourced becomes then ECI under the unlimited force-of-attraction principle.

Force-of-attraction Principle

This proposition is frequently called the "unlimited force-of attraction principle," reflecting the idea that once a USTB exists, it attracts all U.S. sourced income, whether the operations of the company generated the revenue.

There are a few categories of U.S. sourced income not subject to the unlimited force-of-attraction principle. The Code provides that factors are considered in determining whether the income is ECI which could include:

(1) if the income is derived from assets used or held for use in the conduct of the trade or business ("asset use" test), or

(2) if the activities of the trade or business were a material factor in the realization of the income ("business-activities" test).

These rules do not mean that income on the sale of any capital asset will automatically be treated as ECI if the asset-use test or the business-activities test is satisfied. Analytically, these tests are reached only once it has been determined that income from the sale of a capital asset or another type of asset not subject to the unlimited force-of-attraction principle is U.S. sourced.

Sales of Inventory

Income from the sale of inventory is generally sourced where the sale takes place. Thus, an actual sale could give rise to either ECI or non-ECI, depending on where the sale occurs. However, the sale's location could be determined based on all the facts and circumstances if the sale is arranged in a particular manner for the primary purpose of tax avoidance.

Putting it all Together

Assuming a non-U.S. Taxpayer or a Foreign Entity

If the property is not a U.S. Real Estate, the inquiry is whether the taxpayer has USTB. If not, the sale is potentially subject to any of the exceptions to the general sale of property source rule. If no exceptions apply under the general source rule, the source of income is foreign since a non-U.S. taxpayer is assumed; hence, the income is not ECI.

If the property is intangible, the inquiry is whether the sale's consideration is contingent on the use, productivity, or disposition of the property. If so, the rent/royalty-sourcing rule applies, which looks to where the property will be used. If the user is outside the United States, the source is foreign, and the income is not ECI. If the user is within the United States, the original is the U.S.

Income from contingent sales of intangibles is one of the exceptions to the unlimited force-of-attraction rule. It is necessary to apply the asset use and business activity tests to determine whether the income is ECI.

If the sale's consideration is not contingent on use, productivity, or disposition, the question is whether the property is goodwill. If so, the source is determined based on where the goodwill was generated. If the source, is determined as such, it is foreign, and the income is not ECI.

As to sales of inventory, the first question is whether the property's income is subject to allocation and, if appropriate, those rules apply. If the income is not subject to allocation, fall through to the general inventory sourcing rule, applies to the place of sale. If the sale takes place outside the United States, the income is foreign sourced and is not ECI. If the sale occurs within the United States, the income is U.S. sourced.