GUIDE

THE TAX CUTS AND JOBS ACT
EFFECTS ON PUERTO RICO TAXES

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The Tax Cuts and Jobs Act effects on Puerto Rico Taxes

Disclaimer:

This paper is prepared for the only purpose of presenting an overview of tax issues on U.S. shareholders owning 10% or more of a Puerto Rico corporation. The information provided in these materials must be used as guidance rather than as a source of legal or tax opinion reference. To ensure compliance with requirements imposed by IRS Circular 230, we inform you that any US federal tax advice contained in this paper (including any attachments) is not intended, or written, to be used, and cannot be used, for the purposes of: (i) avoiding penalties under the United States Internal Revenue Code of 1986, as amended, or (ii) promoting, marketing or recommending to another party any transaction or matters addressed herein.

Overview

Overview of The Tax Cuts and Jobs Act (Act) concerning entities taxed as a corporation organized under the laws of the Commonwealth of Puerto Rico owned by a bona fide resident of Puerto Rico and U.S. shareholders.

One of the more perplexing aspects of the recent U.S. tax reform effort is that lawmakers did not start from scratch and construct an entirely new tax code. Instead, they chose to layer a few sets of highly complex new rules on top of the convoluted regime already in place. Patchwork systems often lack a distinct internal logic, as we have learned. The IRS has issued no ruling or guidance, so in this context it feels like uncharted waters.

Puerto Rico Tax Provisions Effects

A shareholder who is a bona fide resident of Puerto Rico is not a US person concerning an entity taxed as a corporation organized under the laws of the Commonwealth of Puerto Rico if a dividend received by such shareholder is treated as income derived from sources within Puerto Rico.

A Puerto Rico resident is not subject to GULTI nor Transition Tax on earnings of a Puerto Rico entity owned 50% or more by Puerto Rico by resident investors.

A Puerto Rico corporation owned by 50% or more by Puerto Rico residents is not subject new provision of GULTI or Transition Tax.

US resident Corporation or US resident individuals investors owning more than 10% of a Puerto Rico entity owned by over 50% by US investors are subject to GILTI and Transition Tax.

The Senate Finance Committee report dealing with the Tax Reform Act stated: "The special exemption provided in conjunction with investment incentive programs established by possessions of the United States, especially the Commonwealth of Puerto Rico, has been used as an inducement to U.S. corporate investment in active trades and businesses in Puerto Rico and the possessions.... The committee after studying the problem concluded that it is inappropriate to disturb the existing relationship between the possessions investment incentives and the U.S. tax laws because of the important role it is believed they play in keeping investment in the possessions competitive with investment in neighboring countries".

New Tax Reform Provisions

Individual Tax Rates: The seven marginal tax rates for individuals are modified, with a top rate of 37% for income of more than $500,000 for individuals and $600,000 for married couples. The Act's modified rate structure does not apply to taxable years beginning after December 31, 2025, and rates will revert to the rates in effect during 2017 after that date.

Corporate Tax Rate to 21%: The maximum corporate tax rate is reduced from 35% to 21%, effective for taxable years beginning after December 31, 2017, and with no sunset provision.

"U.S. Shareholder" of a Controlled Foreign Corporation: The Act broadens the definition of "U.S. Shareholder" to include a person who owns 10% or more of a foreign company's stock by value (in addition to those who own 10% or more by vote, which was the test under prior law) for the purposes of determining whether a foreign corporation is a "controlled foreign corporation".

From "Worldwide" Taxation to "Territorial" Taxation: A U.S. corporation that owns 10% or more of a foreign corporation will be entitled to a 100% dividends-received deduction for the foreign-source portion of dividends paid by such foreign corporation.

Deduction for Pass-through Qualified Business Income:

The Act allows a taxpayer other than a corporation to deduct the lesser of (i) 20% of that taxpayer's share of any "domestic qualified business income" of a pass-through (e.g., a partnership, S corporation, or sole proprietorship) and (ii) the greater of (a) 50% of the domestic wages paid with respect to the trade or business and (b) the sum of 25% of such wages and 2.5% of the unadjusted basis of all qualified property used in such trade or business. Assuming the full 20% deduction, the effective marginal rate is 29.6% in respect of such income for the highest earners. The deduction does not apply to income from specific services businesses (e.g., accounting, law, health, financial services, and other businesses for which the skill or reputation of the owner or employees is the principal asset), except in the case of individuals whose taxable income does not exceed $207,500.

Elimination of 30-Day Minimum Holding Period for CFC:

For tax years of foreign corporations that begin after Dec. 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end, a U.S. parent is subject to current U.S. tax on the CFC's subpart F income even if the U.S. parent does not own stock in the CFC for an uninterrupted period of 30 days or more during the year.

Transition Tax

Imposition of a tax on certain previously undistributed and un-taxed foreign earnings of certain specified foreign corporations. These specified foreign corporations include controlled foreign corporations as well as foreign corporations with one or more U.S. corporate shareholder. Thus, the Transition Tax generally applies to U.S. persons owning 10% or more by vote or value of either CFCs or foreign corporations with certain domestic corporations as shareholders.

The Transition Tax is base on the inclusion of the specified foreign corporation's undistributed, post-1986 net earnings. A participation exemption deduction effectively reduces the rate of tax imposed on those earnings; the deduction calculation depends on the foreign corporation's asset composition, with foreign earnings reflected in cash and cash equivalents subject to a higher, though still beneficial, rate than net earnings invested in non-cash assets (15.5% versus 8%).

The Transition Tax is payable by the United States Shareholder, or in the case of United States Shareholders that are pass-through entities, by the partners, shareholders, or beneficiaries. A partial foreign tax credit is available to individual taxpayers to offset the computed liability and net operating losses can, unless the taxpayer elects otherwise, reduce the inclusion. Note that for the calendar year foreign corporations, the 965 integration and associated tax are, along with the various elections, items reportable (and payable) on 2017 returns.

GILTI

Global Intangible Low Taxed Income (affectionately known in the tax practitioner community as "GILTI", pronounced "guilty").

Effective for the first tax year of a controlled foreign corporation (CFC) beginning after December 31, 2017, any US person who is a US shareholder of a CFC and directly or indirectly owns stock in the CFC on the last day of the CFC's tax year is subject to US federal income tax on the owner's share of the CFCs' Global Intangible Low Taxed Income (GILTI).

GILTI is defined to include most business income of a CFC, reduced by 10 percent of the adjusted tax basis of the CFC's depreciable tangible personal property (generally, plant and equipment, but not real estate property).

The new GILTI rule, which is intended to subject all of a CFC's above-routine income to a minimum tax, results in a significantly higher tax cost to US shareholders that are not C

corporations (non-C corporation US shareholders) than to US shareholders that are C corporations (C corporation US shareholders).

C corporation US shareholders are entitled to reduce their GILTI by 50 percent; and are subject to a US federal corporate tax rate of only 21 percent; they are also entitled to claim a credit for up to 80 percent of the foreign taxes paid or accrued by the CFC on the GILTI. As a result, the GILTI rules generally impose a US corporate minimum tax of 10.5 percent (50% x 21%); and to the extent, 80% foreign tax credits are available to reduce the US corporate tax, may result in no additional US federal income tax being due.

In the case of non-C corporation US shareholders, however, the effective rate imposed on GILTI is much higher. The reason for this is that non-C corporation shareholders are not entitled to deduct 50 percent of their GILTI; are subject to a US federal income tax rate of up to 37 percent; and cannot generally claim a credit for the foreign taxes paid or accrued by the CFC on GILTI. As a result, non-C corporation US shareholders will generally be subject to US federal tax on GILTI at a 37 percent rate plus any foreign taxes imposed on the CFC's GILTI.

Prior to the GILTI rules, the active business income of a CFC owned by a non-C corporation US shareholder generally qualified for deferral from US tax and, when distributed, may have qualified for a reduced qualified dividend rate of 20 percent, resulting in an overall effective US regular federal income tax rate of 20 percent on such income on a fully repatriated basis. As a result of the GILTI rules, however, an active business income of a CFC is generally subject to full US individual regular federal income tax at a 37 percent rate, so GILTI not only eliminates deferral but also increases the effective tax imposed on the GILTI attributable to non-C corporation US shareholders of CFCs.

The income subject to **GILTI excludes** effectively connected income from a corporate operation of Subpart F income and related party dividends.

Foreign Credit: A Foreign tax credit is available on foreign income tax paid concerning GILTI but limited to an 80%, without carrying back or carry forward.

Section 962 Election by non-C Corp

The elective Section 962 allows individuals investing in CFCs the same tax treatment they would have had if they had funded through domestic corporations Creating Parity between Corporate Taxation and Individual Taxation.

By making an election under Section 962, individual shareholders, including shareholders who own CFCs through trusts, partnerships and S corporations, are treated as corporations eligible to claim the foreign tax credits associated with GILTI inclusions. However, as in corporations, individuals making this election are subject to a second tax on subsequent distributions of corporate earnings. It is unclear whether this election entitles individuals to claim the deduction described above on GILTI income; therefore we did not consider the 50% GILTI credit. A distribution of GILTI for which a 962 election is made will be subject to US tax upon distribution to the extent that the distribution exceeds the amount of US tax previously imposed on such income under the GILTI rules and such amount will not be treated as PTI.

"Blockers" or "Stoppers" Corporations

A blocker or stopper is an entity inserted within a structure to change the character of the underlying income or assets, or both, to address entity qualification issues, to improve the method of reporting, or otherwise to get a result that would not be available without the use of more than one entity.

The most significant change in the law brought by the TCJA is the reduction in the corporate tax rate to 21%. U.S. individual investors or pass-through entities may want to consider whether it is efficient to own the foreign company stock through a U.S. corporate blocker eligible for the reduced rate on GILTI.

A blocker will allow taxpayers to claim credits and deductions associated with the GILTI inclusions that they would not ordinarily be permitted to take. Taxpayers should take care, however, to avoid the personal holding company rules that could potentially subject this strategy to additional US tax. Moreover, actual shareholder distributions of earnings will draw a second tax on the dividend itself.

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Check the Box Election

The GILTI tax only applies to income earned by foreign entities considered corporations under U.S. tax rules. U.S. taxpayers can elect to treat eligible foreign entities as pass-through entities or disregarded entities for U.S. tax purposes.

The ability to check or not check the box and choose the U.S. tax treatment of a foreign eligible entity provides U.S. taxpayers the powerful option of selecting how to treat their foreign entities.

It may also make sense to have non-C corporation US shareholders set up new foreign operations through true foreign branches or through foreign entities that they elect to treat as pass-through for US federal income tax purposes under the check-the-box rules, in order to avoid the application of the GILTI rules (and get the benefit of foreign tax credits) going forward.

Entity Classifications

The default classification rule for non-U.S. entities is different. Taxpayers and their domestic tax advisers often assume that a foreign entity that is similar to a U.S. L.L.C. will by default be treated as a partnership or disregarded entity. However, foreign L.L.C.s almost always will be treated as corporations by default.

When an entity is initially formed, it will obtain an "initial classification." This initial classification can be determined under the default rules, or it can be established as a result of a check-the-box election. Check-the-box elections can generally only be retroactive 75 days from the date of filing (certain late elections may also be allowed). Thus, if no election is made within 75 days of establishing an entity, the default classification will apply using the following criteria:

1. A corporation if all of its owners have limited liability.

2. A partnership, if it has two or more owners and at least one owner, does not have limited liability.

3. A disregarded entity if it has a single owner that does not have limited liability.

Change in Classification

It is important for the taxpayer to understand the tax implications of changes in an entity's classification. If an entity changes its designation from a corporation to either a partnership or a disregarded entity, the transaction will often be a taxable liquidation. A taxable liquidation triggers gain or loss to both the corporation and the shareholder(s). For a foreign entity, gains at the corporate level can trigger Subpart F Income and gains at the shareholder level are often taxed as ordinary income.

Estimated Effective USA Income Tax Rate USA Investors operating in USA on Income Source in USA

USA Corporation, 40%

A USA individual resident investors a, 37%

Estimated Effective Income Tax Rate Puerto Rico Resident Entities and Individuals Under Act 20 of Puerto Rico Income Source

An active Act 20 Company with a 100% Puerto Rico resident shareholders ownership is are **NOT subject to GILTI**, an estimated effective tax of 4%.

An active Act 20 Company that has (50% or less) of a U.S. Shareholder ownership is not subject to GILTI, an estimated effective tax of 4% for Puerto Rico Investors and a estimated effective tax of 24% for USA investors.

Effective Tax rate includes Puerto Rico Tax and USA Dividend Tax

Estimated Effective Income Tax Rate Owned by more that 50% by USA Shareholders under Act 20 Puerto Rico Income Source Subject to GILTI

Ownership thought Individual Investor, 31%%.

Ownership through a Blocker USA Domestic C Corporation, of 33%.

Individual US shareholder making the election of 962 section, 41%:

A US investor ownership using the check the box election option as a USA Domestic C Corporation, 41%.

A US Partnership ownership is taking the option of check the box election as a disregarded entity, 32 %%.

A US Individual Investor ownership is taking the option of check the box election as a disregarded entity, 32 %%.

Effective Tax rate includes Puerto Rico Tax, USA Corporate Tax ,USA Dividend Tax, GILTI tax and Investment Tax, net of applicable foreign tax credits.