



PUERTO RICO CHANGES INCOME TAXATION RULES FOR DISTRIBUTIONS BY US ORGANIZED MUTUAL FUNDS¹

By: Ricardo Muñiz

The Puerto Rico (“PR”) income tax treatment of distributions by US organized entities that are considered Regulated Investment Companies (“RICs”) under the US Internal Revenue Code (“US-IRC”), has been substantially modified. Hereinafter these RICs are referred to as “US Mutual Funds”. These changes are applicable to distributions made by US Mutual Funds after December 31, 2013.

In this article we use the term “US Mutual Funds” to describe the following broad types of investment vehicles, which qualify for and are entitled to the special tax treatment prescribed by the US-IRC for RICs²: US organized Municipal Bond Funds, US organized Fixed Income Mutual Funds, and US organized Equity Mutual Funds (including those US organized funds that invest solely or principally in foreign equity or debt securities, and closed-end funds). The term “US Mutual Funds” also includes US organized Index Funds and US organized ETFs (e.i. Exchange Traded Funds) that elect to be treated as RICs under the US-IRC.

Prior to these changes to the PR Internal Revenue Code (“PR-IRC”)³, distributions by US Mutual Funds that were considered “exempt dividends” and “capital gains distributions” for US income tax purposes, were generally subject to an equivalent PR income tax treatment. Thus, “tax exempt dividends” (for US-IRC purposes) paid by US organized Municipal Bond Funds, which are exempt from US income taxation, were generally treated as “tax exempt dividends” for PR income tax purposes, and also exempt from the PR alternative basic tax (“ABT”). Likewise, “capital gains distributions” (for US-IRC purposes) paid by US Mutual Funds were treated as net long term capital gains for PR income tax purposes.

Distributions of “Ordinary Dividend” and “Qualified Dividends”⁴ by US Mutual Funds (as these terms are defined in the US-IRC), were, and will continue to be after December 31, 2013, subject to the regular PR income tax rates of the PR-IRC (e.i. ordinary income for individuals, trust, estates and corporate taxpayers in PR).

All distributions after December 31, 2013 of dividends by US Mutual Funds (including those considered “tax exempt dividends” or “capital gain distributions” for US income tax purposes) will be taxed in PR as ordinary income, thus they will be subject to the PR-IRC’s regular income tax rates. The PR-IRC’s maximum marginal income tax rate for 2014 and years thereafter is 33% for individuals, and 39% for corporations.

The PR Secretary of the Treasury is authorized to issue regulations that provide different rules for those US Mutual Funds that comply with the requirements of the PR Investment Company Act of 2013 (the “2013 PR Investment Company Act”); however, it may be far fetched to expect any US Mutual Fund to comply with the requirements of the 2013 PR Investment Company Act, particularly the requirement that 20% of its assets be invested in PR. (See AMG Puerto Rico Business Law Notes 2013-Corp-01).

Alternatives to Avoid Additional PR Income Taxation on Distribution by US Mutual Funds

Of all these changes, the most negative for PR investors is the repeal of the exemption on “Tax Exempt Dividends” paid by US Mutual Funds, mainly US organized Municipal Bond Funds. The after-tax return to an individual investor in these funds will be reduced by up to 33% for individuals, trusts and estates, and up to 39% for corporations. For example, if an individual subject to the maximum PR income tax rate had been earning a 3.9% annual return on his US organized Municipal Bond Fund investment, the annual return will be reduced to 2.6% on an after-tax basis.

PR investors need to carefully consider the alternatives available to completely eliminate, or reduce, the above described increased exposure to PR income taxation.

By investing directly in bonds issued by the States and their political subdivisions, in lieu of investing in US organized Municipal Bond Funds, PR investors will be able to generate income that is 100% exempt in PR. Likewise, gains from the sale or exchange of direct investments by individuals in shares of stock of US or foreign corporations, that if sold after a six (6) month holding period generate long term capital gains in PR, will continue to be entitled to the 10% preferential PR capital gains tax rate (with possible exposure, depending on your income level, to the PR-IRC’s 15% or 24% ABT)⁵, while gains derived through “capital gain distributions” from US Mutual Funds (particularly US organized Equity Mutual Funds) will now be fully taxable in PR. However, direct investments in US municipal bonds and shares of stock of specific US or foreign corporations (except for large volume investments that can be handled by professional management), do not have the advantages of broad diversification and professional management that are provided by US Mutual Funds.

PR investors in US organized Equity Mutual Funds who wish to reduce their PR income tax exposure on “dividends” and “capital gain distributions” may consider (in addition to direct investment in shares of stock of US or foreign corporations) investing in “tax managed” US Mutual Funds, as these utilize various portfolio management strategies to minimize the dividends and/or capital gains distributions paid to their shareholders. The objective of these funds is that a large portion of the income/rate of return generated by their shareholders be realized upon the redemption of shares of the fund; which is favorable to PR investors as gains realized upon redemption of shares will not be subject to US income taxes, and, if such shares were held for more than 6 months, the gains are considered long term capital gains in PR. Likewise, US organized Index Funds and US organized ETFs, due to their structure, are generally understood to offer tax efficiencies that may allow them to generate less capital gains, and less “capital gain distributions”, while taxation of the appreciation in value is deferred until the sale of shares of the fund.

Caution With US Estate Tax Exposure: If upon the death of a PR resident who acquired his/her US citizenship solely by reason of birth or residence in PR, he/she owns investments in US Mutual Funds, obligations of States of the US, and stock issued by US organized corporations (among other types of US located properties), the estate of such PR resident may have a substantial exposure to US estate taxes, as these estates are generally only entitled to exclude \$60,000 of the market value of such investments from the US estate tax. The US estate tax is very onerous for these PR residents, as the tax starts at 26% when the aggregate value of the assets of such an estate that are considered “US located property” is between \$60,000 to \$80,000, and increases to 40% on the value of such assets in excess of \$1,000,000.

PR investors that have utilized PR organized corporations, special partnerships and LLCs to invest in US Mutual Funds (particularly US organized Municipal Bond Funds) also need to be particularly concerned, as after December 31, 2013 the income derived from these funds will be subject to full PR income taxation. The PR shareholders of these entities also need to be concerned with their exposure to additional US income taxation due to the complex, and unfortunately frequently misunderstood, source rules of the Regulations issued under US-IRC Section 937.

The Regulations under Section 937 of the US-IRC can result in full or partial US income taxation, at the shareholder/partner/member level (in addition to the US income tax applicable at the entity level), on a PR corporation's, special partnership's or LLC's income that is derived from US organized Municipal Bond Funds and other US Mutual Funds. Puerto Rico will now also fully tax such income at the corporate level, and if these entities are taxed as corporations in PR, when such income is distributed as dividends it will be further taxed in PR.

The ideal income and estate tax structure for the ownership of US municipal bonds, and stock of US corporations, by PR resident investors that were born or naturalized in PR, would be one that: (i) avoids or minimizes the exposure to US and PR income taxes; (ii) avoids or minimizes the negative implications of the US income attribution rules of the Regulations under US-IRC §937; and (iii) avoids any US estate tax exposure. **At AMG we can help you design such ideal structure to the extent your investments in US organized Municipal Bond Funds, US municipal obligations and/or stock of US organized corporations are large enough to justify the costs and expenses of setting up and monitoring such a structure.**

¹ This article supersedes and replaces a prior Article (AMG Puerto Rico Business Law Notes 2013-TAX-07 dated September 17, 2013 "Puerto Rico Taxation of Distributions by PR and US Organized Registered Investment Companies (Mutual Funds)"), as the changes described in such Article to the PR-IRC income tax treatment of taxable distributions by PR organized Mutual Fund were repealed by Act No. 137 of November 27, 2013.

² Generally, RICs are not subject to US income taxation during any year on its income (including net capital gains) that it distributes to its shareholders, provided that it distributes at least 90% of its "investment company taxable income" (generally, its taxable income other than net capital gain) for such taxable year. In addition, if the RIC distributes during each calendar year substantially all of its ordinary income and capital gains, it will not be subject to US excise tax.

³ These changes were introduced by Act No. 93 of July 30, 2013, and became effective on January 1, 2014.

⁴ "Qualified Dividends", including those distributed by US Mutual Funds, are entitled under the US-IRC to the preferential 15% and 20% tax rates prescribed therein for long term capital gains. However, the PR-IRC has and will continue treating "Qualified Dividends" as ordinary income for PR income tax purposes.

⁵ The PR ABT for individuals, trusts and estates, for 2014 and years thereafter, is: 10% when "net income subject to ABT" is between \$150,000 to \$250,000; 15% when "net income subject to ABT" is over \$250,000, and does not exceed \$500,000; and 24% when "net income subject to ABT" exceeds \$500,000.

Should you have any questions with respect to the above, please contact any of the following members of our Tax Department: Fernando Goyco-Covas, Esq. at 787-281-1802; Caridad Muñiz, Esq. at 787.281.1817 or; Ricardo Muñiz, Esq. at 787.281.1818.

The above summary is intended for information purposes only. It cannot be considered a legal opinion, and it does not intend to consider all the tax and legal considerations that could be relevant to any particular person or entity. It should also be noted that the changes discussed herein were recently enacted, and that the PR Treasury has not yet issued regulations, tax forms or interpretative announcements on such changes.

IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

The contents of PUERTO RICO BUSINESS LAW NOTES may not be reproduced, transmitted, or distributed without the express written consent of Adsuar Muñiz Goyco Seda & Pérez-Ochoa, P.S.C. ("AMG"). The material contained herein is intended for information purposes only and is not to be considered legal advice. Qualified counsel should be consulted based on individual circumstances.