

Puerto Rico Tax Break Controversy: IRS Targets Crypto Traders, Hedge Fund Managers, and other Wealthy Individuals

by PHILIPP BEHRENDT

Puerto Rico has been offering tax incentives to wealthy individuals, hedge fund managers, and cryptocurrency traders since 2012. These tax incentives have allowed them to legally avoid paying federal income tax and certain other taxes. However, recent developments have brought these tax breaks under scrutiny, with US prosecutors and IRS agents launching criminal and civil investigations into their potential abuse. In this blog post, we will explore the controversies surrounding Puerto Rico's tax incentives and the increasing scrutiny faced by those who have taken advantage of them.

I. The Tax Incentives in Puerto Rico:

Puerto Rico's tax incentives have attracted thousands of individuals and businesses, providing them with significant tax advantages. Under these incentives:

- Individuals can avoid federal income tax and pay no taxes on dividend, interest, and capital gains income.
- Businesses enjoy tax exemptions on earnings and profits and pay only a 4% tax on export services.

To qualify for these incentives, individuals must meet strict residency requirements, including demonstrating a "closer connection" to Puerto Rico than the US and establishing the island as their "tax home."

II. Increasing Scrutiny and Investigations:

Recent investigations have shed light on potential abuses of these tax incentives. According to a Bloomberg article,¹ US prosecutors and IRS agents are actively deploying undercover agents and meticulously examining records to build criminal and civil cases against wealthy individuals suspected of illegally exploiting Puerto Rico's tax breaks. Authorities are specifically investigating whether individuals misrepresented the amount of time spent in Puerto Rico and the source of their income. Moreover, promoters, attorneys, and accountants who facilitated participation in the program are also facing scrutiny. At least two criminal investigations, including one involving a US lawyer, may result in charges soon.

One case involving potential abuses of tax incentives in Puerto Rico mentioned in the Bloomberg article is that of Gabriel F. Hernandez, an accountant at BDO Puerto Rico. In October 2020, Hernandez was indicted on wire fraud charges for allegedly offering to help an undercover IRS agent falsely claim he earned \$500,000 on the island to qualify for the tax incentives. Hernandez pleaded not guilty, and his case is pending.

III. The IRS and Residency Investigations:

¹ <https://www.bloomberg.com/news/articles/2023-07-12/irs-probes-puerto-rico-tax-breaks-that-lured-crypto-traders-fund-managers>.

The IRS initiates its investigations by reviewing Form 8898, a crucial document required to establish or terminate "bona fide residence" in Puerto Rico or other US territories. This form prompts individuals to provide detailed information about their time spent in the territory, their permanent home, vehicle location, voter registration, and income sources. To navigate the complexities of Puerto Rico's tax incentives and ensure compliance, individuals are strongly advised to maintain meticulous records of their movements and seek professional legal advice on residency obligations.

IV. Broader Implications and Recent Developments:

The IRS has intensified its focus on individuals who may be erroneously reporting US source income as Puerto Rico source income to evade US taxation. In January 2021, the IRS launched a campaign targeting such taxpayers. Similarly, other US territories, such as the US Virgin Islands, offer similar tax incentives to US citizens and businesses. Consequently, it is essential for individuals to be aware of their obligations, understand the potential legal risks associated with non-compliance, and seek professional advice to ensure compliance with tax laws and regulations.

Additional Points to Consider:

- Act 83-2010: The Green Energy Incentives Act promotes green energy and provides tax benefits for businesses investing in this sector, including a 4% fixed income rate of their "Green Energy Income", 100% tax-exempt distributions, and exemptions on real property taxes, personal property taxes, municipal license tax, and state excise tax for raw materials and machinery used in green energy production.
- Act 74-2010: The Tourism Development Act of Puerto Rico aims to boost tourism projects on the island. It offers incentives such as a 90% exemption on income tax and property tax, 100% exemption on municipal licenses and construction excise tax, and tax credits based on project cost or cash from investors.
- Act 73-2008: The Economic Incentives Act for the Development of Puerto Rico supports the manufacturing industry by providing a 4% income tax rate on industrial development income, tax rates from 0% to 1% on income from pioneer or novelty products manufactured in Puerto Rico, tax credits on purchases of locally manufactured or recycled products, and job creation incentives.

V. Conclusion:

As investigations into potential abuses of tax breaks in Puerto Rico continue, individuals and businesses must be mindful of their obligations and comply with the residency requirements. Seeking professional advice, maintaining accurate records, and staying informed about any policy changes or enforcement efforts by tax authorities are crucial to mitigate potential legal risks and ensure a clean tax record. Compliance with tax laws and regulations is essential for individuals and businesses to maintain their financial stability and uphold their integrity in the tax system. By navigating the complexities of Puerto Rico's tax incentives responsibly, taxpayers can protect their interests and avoid legal pitfalls in the ever-evolving landscape of tax controversy.

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