

Tax Alert: Wages limitation to officer-owners rendering services to an eligible export services

On October 13, 2015, the Secretary of the Treasury (the “Secretary”) issued Administrative Determination 15-22 (“AD 15-22”) which provides guidance on the imputation of wages to stockholders or partners that receive income for services rendered to a company that benefits from a tax exemption grant under the Act to Promote the Export of Services (Act 20-2012), the Act Regulating International Financial Entities (Act 273-2012) and the International Insurers and Reinsurers Act (Act 399-2004), collectively known as the Exportation of Services Legislation.

Previous to AD 15-22, the only reference to what constituted a “reasonable annual salary” attributable to a stockholder or partner of a Company under a tax exemption grant was Administrative Determination 10-06 (“AD 10-06”), which was issued before the approval of the above mentioned Acts. AD 10-06 dictated that the compensation of employees of service units benefiting from a tax exemption decree under Act 135-1997 or Act 73-2008, who hold a proprietary interest of at least 5% in the service units, will be the lower of \$250,000 annually or 30% percent of the shareholder or partner share in the earnings and profits of the service unit for the taxable year.

By offering a preferential income tax rate (among other incentives), the Exportation Services Legislation aims to transform Puerto Rico into an International Services Centre by enticing the establishment of foreign services

companies and job creation in the Puerto Rico economy.

Nonetheless, compensation for the rendering of services for markets outside of Puerto Rico under these exemption vehicles has often been problematic since the same officers who render the services are usually shareholders or partners of the company, and their compensation is designed to include basic salary, commissions and profit sharing, as well as the distribution of dividends or profits that are exempt from income tax.

For this reason, the Secretary has set forth the parameters it will follow for the imputation of wages to stockholders and partners who are at the same time officers (i.e. “Officer-Owner”) of a company whose operations are covered by a tax exemption grant under Exportation of Services Legislation, in case it is deemed necessary.

AD 15-22 defines an **Officer-Owner** as any stockholder or partner who, at the end of the taxable year, maintains a proprietary interest on an Eligible Export Services Company and meets the following requirements:

1. Devotes no less than 80% of its time to the eligible activity covered under the Exportation of Services Legislation; and
2. Is a resident of Puerto Rico, as such term is defined on Section 1010.01(a)(30) of the Puerto Rico Internal Revenue Code of 2011, as amended (the “Code”), during the applicable taxable year.



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Meanwhile, an **Eligible Export Services Company** is defined as any export services company where more than 80% of all its gross income is derived from the rendering of eligible export services that are covered under any of the Exportation of Services Legislation, including its Controlled Group or Related Entities, as defined in Sections 1010.04 and 1010.05 of the Code.

AD 15-22 states that an Officer-Owner should receive a reasonable annual salary that is commensurate with the services he/she renders to an Eligible Export Services Company in which he/she maintains a proprietary interest at the end of the taxable year.

To that end, AD 15-22 sets forth a \$350,000 ceiling on the annual wages attributable to an Officer-Owner; one hundred thousand dollars (\$100,000) more than the ceiling established back in 2010 for officers under Acts 73-2008 and 135-1997.

Therefore, pursuant to these guidelines, and under the Secretary's sole discretion, an Officer-Owner that earns less than \$350,000 for services rendered to an Eligible Export Services Company in which he/she maintains **a proprietary interest at the end of the taxable year**, may be subject to an evaluation of the reasonableness of the income received from services rendered to the Eligible Export Services Company.

The evaluation will take into consideration the facts and circumstances of each case, the functions performed by the Officer-Owner within the hierarchy of the organization and the market trends as they relate to wages in comparable positions. As a result, the Secretary may impose additional wages up to a maximum of \$350,000 in order to clearly reflect the income of said Officer-Owner.

All tax exemption grants issued under the Exportation of Services Legislation at the issuance date of AD 15-22 and thereafter will be subject to the provisions established therein.

Nonetheless, please note that in contradistinction to AD 15-22, AD 10-06 established both a dollar (i.e. \$250,000) as well as a percentage threshold (i.e. 30%). Though the Treasury Department has not commented on this difference, it stands to reason that AD 10-06's \$250K or 30% formula could be extrapolated to benefit industries under the Exportation of Services Legislation, with the only difference being the higher dollar amount contemplated on AD15-22.

We highly recommend a proper and careful analysis of the Officer-Owners' compensation structure within the Eligible Export Services Company's operations, in light of these guidelines set forth by the Secretary in AD 15-22.

Please contact our Tax Department should you require additional information regarding this or any other tax issue; we will be glad to assist you.