

**PUERTO RICO ACT 154:
THE BEGINNING OF THE END?
EFFECTS OF ACT 154 ON FUTURE ECONOMIC DEVELOPMENT**

ARTICLE

FELIPE RODRÍGUEZ LAFONTAINE*

I. Introduction	217
A. Puerto Rico’s Primary Taxing Power: The Fiscal Autonomy of the Island	218
B. Puerto Rico and Industrial Development Incentives: Past and Present.....	221
II. General Background Information: International Taxation	223
III. Puerto Rico Act 154.....	224
A. Alternatives Analyzed.....	224
B. The Approval Process and Immediate Concerns.....	226
C. Technical Aspects: Discussion of the Mechanics of Act 154.....	229
1. Approval of the Internal Revenue Code for a New Puerto Rico.....	229
2. Modified Effectively Connected Income and Source Rule.....	230
3. Excise Tax on the Acquisition of Property and Services from Related Parties.....	233
4. Relevant Concepts found in the Regulations applicable to the Excise Tax.....	234
5. Creditability of Act 154 Excise Tax	237
D. Unanswered Concerns: The “Twilight Zones” in Act 154	237
IV. Conclusions: Are We at the Border of the Cliff?.....	240

I am pleased to announce our plan to fulfill the promise that we made you of a tax reform that leaves you with More Money in Your Pockets . . . that gives a real tax relief to all and every single Puerto Rican . . . that rewards our workers . . . and stimulates savings and job creation.

The tax reform that will be presented . . . is, without a doubt, the largest, most comprehensive, fairest and that returns the most money to the pockets of our people, in all of our history. Because as we said before and proudly repeat today: 'a dollar in your hands yields much more than a dollar in the government’s hands'.

* Certified Public Accountant; Tax Senior working for Deloitte Tax LLP in San Juan, Puerto Rico and J.D. Candidate, University of Puerto Rico Law School, 2012.

Governor of the Commonwealth of Puerto Rico, Luis G. Fortuño¹

Good friend, this event (Act 154), may be the last nail in the coffin.

Email by an anonymous top executive of the pharmaceutical industry²

I. INTRODUCTION

When the Governor of Puerto Rico, Luis G. Fortuño, pronounced the above-mentioned statement— given during his special message before a joint session of the Puerto Rico Senate and House of Representatives on October 25, 2010— he conveniently failed to mention which would be the revenue source that would be implemented to finance this new tax reform. However, just a couple of hours before announcing this new tax reform, the Governor had enacted into law Puerto Rico Act 154 of 2010 (hereinafter Act 154),³ which modified several provisions of the Puerto Rico Internal Revenue Code of 1994⁴ with the purpose of increasing income tax revenues. In contraposition, when the Governor expressed his view, he basically summed the worst fears of the manufacturing industry in Puerto Rico. Therefore, the wise words of Benjamin Franklin couldn't have had more relevance: "in the world nothing can be said to be certain except death and taxes."⁵

In summary, Act 154 modified the source of income rules in order to treat certain non-resident alien individuals, foreign corporations or partnerships as engaged in trade or business within Puerto Rico in order to tax them on certain transactions.⁶ Act 154 also enacted a new excise tax on the acquisition of personal property and services. This article studies the technical aspects and effects of Act 154 on the tax incentives scheme that

¹ LUIS G. FORTUÑO, GOVERNOR OF THE COMMONWEALTH OF PUERTO RICO, Mensaje Especial sobre La Reforma Contributiva, Salud para Todos y Más Dinero en tu Bolsillo [Special message regarding the Tax Reform, Healthcare for All and More Money in your Pockets], October 25, 2010, http://www.fortaleza.gobierno.pr/mensaje_gobernador/pdf/mensaje.pdf.

² Joanisabel González, *Píldora que atraganta la economía (The Pill that Chokes the Economy)*, EL NUEVO DIA, October 31, 2010,

<http://www.elnuevodia.com/Xstatic/endi/template/imprimir.aspx?id=808566&t=3> (informing about the general provisions of PR Act 154, the lack of transparency in the approval process and the general discontent amongst the manufacturers in Puerto Rico).

³ 2010 P.R. Laws No. 154; as amended by 2010 P.R. Laws No. 157.

⁴ P.R. LAWS ANN. tit.13 § 8006 §§ 9750 (LexisNexis 2007).

⁵ BENJAMIN FRANKLIN, LETTER TO JEAN-BAPTISTE LEROY (Nov. 13, 1789) *available at* <http://www.scmidnightflyer.com/benf.html>.

⁶ 2010 P.R. Laws No. 154.

existed, which served as a stimulus for the Island's economic development. In light of these new developments, we analyze Puerto Rico's long history of tax driven incentives for economic development, the possible effects of Act 154 on our ability to further economic development derived from foreign investment in order to propose refocusing and restructuring our tax revenue polices in these times of global uncertainty.

Finally, it is extremely important to bear in mind that the new Source Rule and the Excise Tax are unusual statutory provisions. These were structured by a consulting firm hired by the local Government to be specifically applied to corporate and business structures, which resulted from the tax incentives schemes promoted by the Government for decades. The Source Rule and the Excise Tax effectively impose a tax on income earned as a result of production in Puerto Rico, instead of focusing on the income derived from the sale transactions of those products. In essence, the *Source Rule* does this by attributing to Puerto Rico, and thus subjecting to tax, a portion of the income earned by purchasing entities that resell goods manufactured in its jurisdiction. Consequently, the *Excise Tax* directly imposes a tax on the acquisition of goods by the purchasing entities from related entities that manufacture in Puerto Rico. This is an unusual practice, because most states seek to encourage local production while discouraging imports by imposing fewer taxes on local production and heavier taxes on sales within the state.⁷

Therefore, Act 154 was designed to pay for a tax reduction for Puerto Rican residents (individuals and corporations). As such, we will discuss the peculiarities of its relationship with the United States, which has in turn facilitated its establishment as a top destination for manufacturing, the specific technical provisions of Act 154, its possible impact on foreign manufacturing companies that operate in Puerto Rico, and the possibilities for future economic development, after the implementation of Act 154.

A. Puerto Rico's Primary Taxing Power: The Fiscal Autonomy of the Island

⁷ *Tax And Business Incentives Overview The Lowest Effective Corporate Income Tax*, Puerto Rico Industrial Development Company, PRIDCO.COM (Jan. 26, 2011, 7:45 PM), http://www.pridco.com/english/tax_and_business_incentives/3.0tax_bus_incentives_overview.html#TaxModels (explaining that this was the logic followed previously by the Government when it stated that Puerto Rico provides unparalleled value that no other location can match. It is a United States community with a foreign tax structure. Here you can enjoy the benefits and protections of operating within a U.S. jurisdiction with the added tax benefits of operating under a Controlled Foreign Corporation (CFC) structure. Profits from sales to the U.S. mainland are free from U.S. taxation and goods enter the U.S. market duty-free. In addition, Puerto Rico offers a highly attractive incentives package that includes 100% exemption from multiple taxes; special treatment for pioneer industries and much more).

As exemplified by this section's title, Puerto Rico exercises a powerful tool in the form of primary taxing power. It is the primary taxing entity of the wealth generated within the Island. This primary taxing power arises from the constitutional developments that have characterized its relationship with the United States for more than a century.

As described by International Tax Professor Juan C. Méndez-Torres “on April 12, 1900, Congress approved an Organic Act for Puerto Rico, also known as the Foraker Act, which ended the military regime that had ruled the island and established a civil government. It also declared that the people of Puerto Rico were 'citizens of Puerto Rico.’”⁸ Additionally, Tax Law Professor Carlos Díaz-Olivo has stated that:

The Foraker Act itself established that the tariff of the Dingley Act would not be collected on any product interchanged between Puerto Rico and the United States as soon as the Legislative Assembly of Puerto Rico had put into operation a system of local taxation and would have notified the President of the United States. He, in turn, would issue a proclamation, thereof, terminating the said collection of duties. Acting according to the dispositions of the Organic Act, the Legislative Assembly of the Island established and put into operation on March 31, 1901, a system of local tax to defray the expenses of the Government upon the enactment of a law entitled: Act to Provide Income to the Government of Puerto Rico and for other purposes. The sources of income established by the Island Legislature when exercising for the first time its power to levy taxes were essentially three: a real and personal property tax, an inheritance tax, and a tax on tobacco, alcoholic beverages and other consumer products.⁹

Henceforth, “soon after the enactment of the Foraker Act, the United States Supreme Court held that, unlike Hawaii, Puerto Rico was not to be considered an incorporated territory in the formal sense as defined in the U.S. system of government.”¹⁰ The United States (hereinafter U.S.) Supreme Court further held that the tax uniformity clause of the U.S. Constitution is not applicable to the territory of Puerto Rico.¹¹

⁸ Juan Carlos Méndez Torres, *The Internal Revenue Code's Role in Puerto Rico's Economic Development*, 15 J. INT'L TAX'N 22, 2 (2004), (commenting Act of March 24, 1900, ch. 91, 31 Stat. 51 (1900)).

⁹ Carlos Díaz Olivo, *The Fiscal Relationship Between Puerto Rico and the United States: an Historical Analysis*, 51 Rev. Col. Abog. P.R. Núm. 2-3, 32 (1990).

¹⁰ Méndez, *supra* note 6, at 2 (citing *Downes v. Bidwell*, 182 U.S. 244 (1901)).

¹¹ *Downes v. Bidwell*, 182 U.S. 244.

Thereafter, the U.S. “Congress on March 2, 1917, adopted another Organic Act for Puerto Rico, the Jones Act. It maintained the same relationship between the U.S. and Puerto Rico, but it granted U.S. citizenship to all persons born in Puerto Rico.”¹² Looking at the statutory provision of the Jones Act, Professor Díaz-Olivo has indicated that:

With the enactment of the Jones Act and the Revenue Act of 1917 a new chapter was begun in the history of the fiscal relationship between the United States and Puerto Rico. It is precisely during this period that the tax pattern, which has characterized our fiscal relations with the United States for the last 90 years, was fully established. Such pattern has been the fundamental basis of our aspirations for economic development. A special tax treatment exempting Puerto Rico from the application and extension of federal legislation regarding this matter, and the concession of authority to the Government of Puerto Rico for the enactment and application of its own tax laws assured a degree of fiscal autonomy.¹³

For this reason, only 10 years after the approval of the Jones Act, the U.S. Congress enacted The Butler Amendment:

In 1927, the United States Congress expressly gave the Legislature of Puerto Rico the power to enact its own income tax law by adding the words 'income taxes' after the phrase 'taxes and assessments on property' in the first sentence of Section 301 of the Jones Act. After this amendment, Section 3 reads so far as pertinent: 'That no export duties shall be levied or collected on exports from Puerto Rico, but taxes and revenue, and license fee, and royalties for franchises, privileges, and concessions may be imposed for the purposes of the insular and municipal government, respectively, as may be provided and defined by the Legislature of Puerto Rico.'¹⁴

The next transcendental event took place “[o]n July 3, 1950, [when] Congress adopted Public Law 600 [stating] 'in the nature of a compact so that

¹² Méndez, *supra* note 8, at 2 (citing 39 Stat. 951 (1917)).

¹³ Díaz Olivo, *supra* note 7, at 44 (citing Romero, *The History of Federal Inconsistencies in the Treatment of Taxation of Income Derived from Puerto Rico by Individuals*, 53 REV. JUR. UPR 446, 455 (1984)).

¹⁴ *Id.* at 53 (referencing Act of March 4, 1927, Ch. 503, §I, 44 Stat. 1418 (1927), 48 U.C.S. §741 (known as the Butler Amendment)).

the people of Puerto Rico may organize a government pursuant to a constitution of their own adoption.¹⁵ The importance of this Act was that it “established that, once effective, the new constitution would automatically repeal the sections of the Jones Act that dealt with local affairs. The remaining sections would remain effective and, together with Public Law 600, would be known as the Puerto Rico Federal Relations Act.”¹⁶ Specifically, “[t]he Federal Relations Act provides that federal internal revenue laws do not apply to Puerto Rico.”¹⁷ However, it is very important to note that this Act also established that “[t]he government of Puerto Rico is not allowed to enter into any kind of treaty with foreign countries and most, if not all, U.S. tax treaties and conventions with foreign countries specifically exclude Puerto Rico from their application.”¹⁸

B. Puerto Rico and Industrial Development Incentives: Past and Present

As of today, “currently in Puerto Rico there are three different schemes of corporate taxation: (i) the scheme applicable to exempt corporations under the Incentives Acts, (ii) the scheme applicable to the so-called special corporations, such as hotels and agricultural businesses (iii) the scheme applicable to regular corporations, taxed at a maximum rate of 39 percent.”¹⁹

We will take a look at the conditions that helped Puerto Rico establish itself as one of the fastest growing, high-tech industrial development centers in the world.²⁰ Basically, the system of tax incentives it put into place resulted from “the nature of the political relationship between the U.S. and Puerto Rico, Congress was willing for many years to enact tax incentive statutes to promote U.S. investment in the island.”²¹

Throughout the years, the U.S. Congress set forth Internal Revenue Code “sections 931, 936, and 30A [which] provide tax incentives for domestic corporations engaged in business in Puerto Rico.”²² These were particularly useful to economic development efforts; they stimulated the development of

¹⁵ Méndez, *supra* note 8, at 2 (citing Act No. 600 of July 3, 1950, ch 446, 64 Stat. 319(1950)).

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ CENTER FOR THE NEW ECONOMY (“C.N.E.”), *Commentaries given at the public hearings of the Joint Treasury Commissions of the Puerto Rico Senate and House of Representatives on January 11, 2011*, p. 3-4, (discussion of Puerto Rico House of Representatives Project 3070 proposed PR Internal Revenue Code of 2010), available at

http://www.grupocne.org/publications/Ponencia_Proyecto_Reforma_Contributiva.pdf.

²⁰ Puerto Rico Industrial Development Company, The Manufacturing Powerhouse, http://www.pridco.com/english/overview/2.1pr_overview_powerhouse.html (last visited Jan. 27, 2011),

²¹ Méndez, *supra* note 8, at 24.

²² *Id.* (addressing the I.R.C of 1954 § 931(a)(repealed in part 1976), I.R.C of 1976 § 936(a)(as amended in 1982) and I.R.C § 30A(2006)).

labor-intensive manufacturing, which, in turn, helped ease the workforce's transition from agriculture, and prevented massive unemployment.²³ Hence, Puerto Rico enacted specific legislation affording industrial tax exemptions, which took advantage of the U.S. Internal Revenue code sections mentioned above. Since its first Industrial Development Act, enacted in 1953, Puerto Rico has had a history of over 60 years of capital investment promoted by its industrial development program.²⁴ Using this legislation, the Government established industrial tax exemption grant agreements with many corporations, which tended to be members of affiliated groups containing both, U.S. and non-U.S. subsidiaries.²⁵ At this point in time, the valid industrial tax exemption grants should have been granted pursuant to the Tax Incentives Act of 1998²⁶ and its successor, the Economic Incentives for the

²³ Steven J. Davis & Luis A. Rivera-Batiz, *The Climate for Business Development and Employment Growth* in THE ECONOMY OF PUERTO RICO: RESTORING GROWTH 283 (Susan M. Collins et al. eds., 2006).

In practice, section 936 tax subsidies proved most attractive to capital-intensive manufacturing industries that produce proprietary products with big price markups over marginal costs. Products of this type facilitate tax minimizing transfer process and profit shifting between jurisdictions with different effective tax rates.

According to a study by the U.S. General Accounting Office...section 936 tax subsidies to U.S. corporations with Puerto Rican operations amounted to \$2.6 billion in 1989, or 13 percent of Puerto Rico's GDP. One view is that subsidies of this magnitude profoundly influenced Puerto Rico's economy and industrial structure. Another view is that section 936 subsidies mainly reflect paper transactions with little impact on the Puerto Rican economy but with a high cost to the U.S. treasury.

²⁴ The first Industrial Incentives Act was 1953 P.R. Laws No. 6 of December 15, 1953, as amended, known as the "Industrial Tax Incentives Act of Puerto Rico of 1954" followed by 1978 P.R. Laws No. 26 of June 2, 1978, as amended, known as the "Industrial Tax Incentives Act of Puerto Rico of 1978", 1987 P.R. Laws No. 8 of January 24, 1987, as amended, known as the "Tax Incentives Act of Puerto Rico", 1997 P.R. Laws No. 135 of December 2, 1997, as amended, known as the "Tax Incentives Act of 1998" and the most recent installment of the Industrial Incentives chapter in Puerto Rico 2008 P.R. Laws No. 73 of May 28, 2008, as amended, known as the "Economic Incentives Act for the Development of Puerto Rico".

²⁵ Puerto Rico Industrial Development Company, Recommended Tax Structures, http://www.pridco.com/english/tax_&_business_incentives/tax_incentives/3.11rec_tax_structures.html (last visited Jan. 27, 2011, 1:15 PM) (stating that "many companies have established their operations in Puerto Rico as profit centers to take advantage of special tax provisions". It is explained that a "U.S. Parent, under the Controlled Foreign Corporation ("CFC") structure, the Puerto Rico subsidiary, which will generate a maximum corporate income tax rate of 7% with no withholding tax, may use these profits to fund their foreign operations including the Puerto Rico operations". In the case of the European Union Parent under the European parent model, the European Union ("EU") parent has an affiliate in the Netherlands who in turn owns the Puerto Rico Corporation).

²⁶ 1997 P.R. Laws No. 135.

Development of Puerto Rico Act of 2008.²⁷ In general, the tax exemption agreements made pursuant to these acts provide, among other incentives, a low, flat rate of income tax on specific types of income and reduced rates and exemptions with respect to certain Puerto Rico and municipal property taxes, license fees, and excise taxes.²⁸

As informed by the Government, with respect to the macroeconomic indicators, Puerto Rico's "economy is centered on high value-added services and manufacturing. During 2009, the gross domestic product was nearly \$95.7 billion, with a GDP per capita of over \$24,000. As of February 2010, the labor force was around 1.3 million strong, of which some 1.1 million were employed."²⁹ Thus, it could be argued that one of the biggest drivers of these indicators is the industrial tax incentive scheme. Furthermore, the importance of the tax incentives scheme in Puerto Rico's development is illustrated by Mr. David P. Lewis', Chief Tax Executive of Eli Lilly & Company, remarks stating that Puerto Rico's taxation regime was a fundamental factor in his company's decision to invest in the Island.³⁰

II. GENERAL BACKGROUND INFORMATION: INTERNATIONAL TAXATION

It is extremely important to note that "[a]t its most general, United States [and also Puerto Rico] international income tax law is a question of jurisdiction, specifically the questions of whether and to what extent the United States [and Puerto Rico] will assert income tax jurisdiction over items of income with respect to which another sovereign also could assert income tax jurisdiction."³¹ As explained by the distinguished Professor Meade Emory:

[U]nder United States [and Puerto Rico] tax law, international economic connections are broadly divided into two categories. The United States economic activities of foreign individuals and entities are classified as 'inbound' transactions while the foreign economic activities of U.S. individuals (based on

²⁷ 2008 P.R. Laws No. 73.

²⁸ See generally Department of Economic Development and Commerce of the Government of Puerto Rico, A Guide to Doing Business in Puerto Rico (2010), <http://www.pridco.com/pdf/aguidepr.pdf>.

²⁹ *Id.* at 8. Puerto Rico Coastal Management Program, Draft Assessment and Strategies FY 2011-2015, 2-3, available at <http://www.drna.gobierno/pr/oficinas/arn/recursosvivientes/costasreservasrefugios/pmz/>.

³⁰ Davis P. Lewis, Vice President Global Taxes, Eli Lilly & Company, Remarks at the Conference of the Historical Foundation of the Supreme Court of Puerto Rico, the Foundation of the Federal Bar Association and its Fellows, and the Center for the New Economy: Economic Development and the Judicial Branch (Mar. 18, 2010).

³¹ Meade Emory et al., *U.S. Tax Overview: Structure of the Federal Tax System of the United States*, 949 Tax Mgmt. (BNA) Foreign Income, (January 27, 2011).

citizenship or residence) and U.S. corporations are classified as 'outbound' transactions. The United States imposes very different taxing regimes on these two classes of transactions. In general, the United States asserts broader taxing authority over the latter taxpayers (generally, 'U.S. persons') than it does over the former taxpayers (generally, 'foreign persons').

Outbound transactions are generally subject to the principle of worldwide taxation under which the United States asserts the authority to tax all of the income of U.S. taxpayers from whatever source derived, subject to a foreign tax credit to mitigate double taxation. In contrast, inbound transactions — transactions in which foreign taxpayers earn U.S. source income — are subject largely to source-based taxation, under which the United States asserts jurisdiction over only U.S. source income. This regime is not the only alternative available; for example, France maintains a territorial system under which it asserts taxing jurisdiction over only domestic source income for all taxpayers.³²

This statement illustrates how the fiscal taxing autonomy possessed by both, the U.S. and Puerto Rico, can be used to reach all sorts of income generated by their residents and non-residents. As such, on the forefront of the approval of Act 154, Puerto Rico decided to explicitly wield its fiscal taxing autonomy to reach new taxpayers that, until now, had been beyond its taxing reach. Imagine, for an instant, an enormous leviathan –not unlike the Greek Scylla—³³ reaching out from the Island, with huge tentacles towards the U.S. and other foreign jurisdictions, in order to seek out those³⁴ who are not located abroad and were thought as not having a direct presence in Puerto Rico.

III. PUERTO RICO ACT 154

A. Alternatives Analyzed

On February 4, 2010, a tax reform commission was appointed by the Governor and charged with the task of examining different alternatives to

³² *Id.*

³³ Homer, Book XII, The Odyssey, (Mar. 25, 2011, 2:04 p.m.), <http://homer.classicauthors.net/odyssey/odyssey12.html>.

³⁴ This pronoun includes natural and juridical persons (corporations, partnerships, estates and trusts).

quickly reform the Island's tax system.³⁵ Amongst the considerations appraised by the Commission, was whether Puerto Rico could change its corporate income tax in order to adopt a unitary system of combined reporting using some kind of apportionment formula.³⁶ It was thought that combined reporting could be applied to related corporations, which composed a group of related entities engaged in the same, single business.³⁷ The Commission concluded that combined reporting treated the group of corporations as one unitary business and calculated the income of that single business which would be subjected to tax, using an apportionment formula.³⁸

Thus, the Commission preliminarily concluded that Puerto Rico could implement such a combined reporting for unitary groups and stated that its purposes would be to require the inclusion of an affiliate's portion of the income of such non-resident affiliate to taxation.³⁹ It stated that it was aware that such a system would enable imposing income tax on the group in its entirety, instead of on each corporation, as it was currently being applied.⁴⁰ This new alternative would result in applying Puerto Rico's current corporate income tax provisions to the groups of corporations, which operated as a unitary business. Its result would be subjecting to taxation part of the affiliate corporations' income generated while doing business in Puerto Rico, even when these had no physical presence or direct involvement in its jurisdiction.⁴¹

The Commission considered that if a unitary system was imposed, the corporations manufacturing products in Puerto Rico and their U.S. or foreign affiliates who were purchasing and reselling those products, would all be considered as part of a single business and the income subject to tax would be determined based on a series of factors computed by reference to the group as a whole.⁴² However, the Commission concluded that the combined reporting and formulary apportionment methods contained inherent complexities and, as such, the impact of implementing it, given the limited enforcement resources of the Department of the Treasury of the

³⁵ Yanira Hernández Cabiya, *Configurado el comité que redactará la reforma contributiva*, EL NUEVO DIA, February 4, 2010, <http://www.elnuevodia.com/Xstatic/endi/template/imprimir.aspx?id=667979&t=3> (informing that such committee was composed of "attorney Xenia Vélez as Director of the Executive Committee . . . Representative Antonio Silva, Senator Migdalia Padilla; Secretary of the Treasury Juan Carlos Puig; the President of the Government Development Bank, Carlos García; Secretary of Economic Development, José Ramón Pérez Riera, and the Governor's Chief of Staff Marcos Rodríguez Ema).

³⁶ See generally 2010 P.R. Laws No. 154, Statement of Motives, at 1.

³⁷ *Id.* at 2.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.* at 3.

⁴² *Id.*

Commonwealth of Puerto Rico (hereinafter Department of the Treasury) would be detrimental to its tax system.⁴³ In particular, the Commission was concerned that its Department of the Treasury would be unable to locate and gather the information needed to apply such taxing methods in an effective manner, and that it would potentially create uncertainty regarding the amount and timing of the tax revenues to be collected.⁴⁴

Based on these considerations, the Commission determined that instead of establishing a combined reporting and formulary apportionment system, Puerto Rico should tax the income of company's affiliates that did business and engaged in substantial transactions with manufacturers in Puerto Rico.⁴⁵ Therefore, instead of adopting a system of corporate income tax, which took on the group as a whole, it purported to change the way individual corporations that performed certain activities as members of a unitary business structure were being taxed.⁴⁶ To accomplish this, Puerto Rico would have to adopt a modified income source rule and a new excise tax that would apply in certain situations in lieu of the new modified source rule.⁴⁷

B. The Approval Process and Immediate Concerns

“The Government of Puerto Rico kept the contents of this legislation strictly confidential until October 22, 2010, when the Legislature of Puerto Rico unveiled a substitutive bill to House Bill 2526.”⁴⁸ Shortly thereafter, “[o]n October 23, 2010, the Government of Puerto Rico, represented by [various high ranking officials], and the Government's external counsel on this matter [the Washington DC law firm of Steptoe & Johnson LLP], held a meeting with a small group of Puerto Rico tax practitioners, . . . to explain the new statute.”⁴⁹ From the get-go, it seems that the principal strategy followed by the Government was to sell the idea that the newly legislated tax could qualify as credit against U.S. federal income tax by arguing that it could meet the requirements of an *in lieu of tax* under section 903 of the Internal Revenue Code of 1986.⁵⁰ However,

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at 4.

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *New Puerto Rico Taxes on Certain Foreign Corporations*, MCCONNELL VALDÉS TAX ALERT, (McConnell Valdés LLC, San Juan, P.R.), Oct. 25, 2010, at 3, <http://www.mcvpr.com/CM/McValerts/New-Puerto-Rico-Taxes-on-Certain-Foreign-Corporations.pdf>.

⁴⁹ MCCONNELL VALDÉS TAX ALERT, *supra* note 47, at 3.

⁵⁰ *Id.* at 3. *See also* Steptoe & Johnson LLP, Legal Opinion: Creditability of Excise Tax requested by The Government of Puerto Rico (October 25, 2010) (on file with author).

[t]he big picture is that the tax is intended for local manufacturers, but since the government cannot tax local manufacturers because the tax treatment of those entities is frozen under a tax exemption grant, the only way to raise taxes is to tax through mechanisms which impose the tax on affiliates who are purchasing the local production.⁵¹

The backlash generated by the general public, industry and private practitioners quickly followed once it was made public that House Bill 2526 was enacted into law roughly two (2) days after its submission and just in time for the Governor's special message regarding tax reform. The President and CEO of the National Association of Manufacturers indicated

[w]e are alarmed by the actions taken by the Puerto Rican government to impose a new excise tax on multinational manufacturers. Over the years, U.S.-based manufacturers have invested in Puerto Rico, most notably in the chemical, pharmaceutical and biotechnology industries. They represent approximately 80 percent of all the manufacturing jobs in Puerto Rico and nearly 26 percent of Puerto Rico's gross domestic product (GDP). The imposition of this tax could jeopardize the jobs of over 100,000 people and could damage business relationships that have taken years to develop between the affected companies and the government of Puerto Rico.

Even more concerning was that this law was passed in a period of 48 hours with no public hearings. By increasing costs for these manufacturers, the Puerto Rican government is jeopardizing jobs and economic growth at a time when our global economy is struggling to recover from a crippling recession.⁵²

⁵¹ Liz Bearese, *Manufacturing tax in Puerto Rico to discourage US and EU investments*, International Tax Review (Nov. 5 2010) (citing CPA Felipe Mariani from Zaragoza and Alvarado), available at <http://www.internationaltaxreview.com/Article/2712087/Manufacturing-tax-in-Puerto-Rico-todiscourage-US-and-EU-investments.html>.

⁵² The National Association of Manufacturers (NAM), *Manufacturers Oppose Puerto Rico's New Tax Increase on Multinational Companies*, Press Release, (Oct. 27, 2010), <http://www.nam.org/Communications/Articles/2010/10/Manufacturers-Oppose-Puerto-Rico.aspx>.

Furthermore, John Castellani, president of Pharmaceutical Research and Manufacturers of America (hereinafter PhRMA), released a statement expressing opposition to the law because it “could significantly reduce the ability of PhRMA’s members to operate in the Commonwealth.”⁵³ PhRMA’s press release also highlighted that “[t]he biopharmaceutical research sector has supported a total of 94,217 jobs and \$3.6 billion in output in Puerto Rico, according to the latest survey conducted in 2006.”⁵⁴

Local criticisms were also very specific, regarding the lack of public participation in the development and subsequent adoption of Act 154. For example, the Puerto Rico Society of Certified Public Accountants expressed:

[w]e further understand, as has been reported in the press and by the Government of Puerto Rico, that the proposed tax reform will be financed primarily, by the revenues generated by Act 154, which imposes a special tax on certain foreign companies that meet specific requirements. We would like to point out that during the legislative process for approval of this Act 154 the Puerto Rico State Society of CPAs was not offered the opportunity to thoroughly analyze the particularities of the Act and its impact on Puerto Rico, however we understand prudent to point out our concern (which is the same for many other organizations in Puerto Rico) on the impact that the Act might have on one of the most important economic sectors of our country, manufacturing.⁵⁵

Also, Mr. Pedro Watlington, President of the Puerto Rico Manufacturers Association denounced that

the imposition of 4% excise tax to corporations is a measure that poses a serious detriment to the competitiveness of businesses in Puerto Rico and results in a critical situation that will lead to halt expansion plans, the exit of some companies from the island, and serious impact on the supply chain

⁵³ Press Release, Pharmaceutical Research and Manufacturers of America (PhRMA), PhRMA Statement Regarding Puerto Rico Law 154, Press Release, (Oct. 27, 2010), <http://www.phrma.org/node/356>.

⁵⁴ *Id.*

⁵⁵ Puerto Rico Society of Certified Public Accountants, Recommendations given at the public hearings of the Joint Treasury Commissions of the Puerto Rico Senate and House of Representatives on December 21, 2010 (discussion of Puerto Rico House of Representatives Project 3070 proposed PR Internal Revenue Code of 2010), *available at* <http://www.colegiocpa.com/download.php?id=2691>.

composed of local Puerto Rican manufacturing companies and service providers.⁵⁶

Moreover, it was cautioned that “[w]ithout having collected the first penny of the excise tax, Act 154 ‘accelerated’ any decision-making process connected with the local manufacturing operations [established in Puerto Rico]. The Government ‘has gone around’ the contracts and tax exemption decrees signed or renegotiated with dozens of multinational corporations.”⁵⁷ The unfortunate thing, according to Edgardo Fábregas, is that Act 154 and its precipitated adoption denote a Puerto Rico that decided to *opt out*, as the measure casts a shadow over the Government's commitment to the sector and virtually ends the industrial promotion strategy.⁵⁸

The purpose of this section was to highlight the enormous backlash — from industry executives and private practitioners— that ensued immediately after the approval of Act 154 was announced. However, this counter-blast was more than mere bickering from industry leaders and private practitioners. This up-spur of public opinion exemplifies the degree of discomfort and instability that continues to impact the general business environment in Puerto Rico. What were once viewed as unchangeable, *e.g.* income tax exemption decrees, have now become mere legal texts that can be side stepped through the use of loophole legislation, such as Act 154.

C. Technical Aspects: Discussion of the Mechanics of Act 154

1. Approval of the Internal Revenue Code for a New Puerto Rico

On January 31, 2011, a new Internal Revenue Code for Puerto Rico was signed into law and became known as the Internal Revenue Code for a New Puerto Rico (hereinafter the 2011 Internal Revenue Code for Puerto Rico Code). With certain exceptions, the 2011 Internal Revenue Code for Puerto Rico Code came into effect as of January 1, 2011 (i.e. for taxable years commenced after December 31, 2010). However, section 1035.05 of the 2011 Internal Revenue Code for Puerto Rico Code specifically sets forth that, for purposes of determining the income, gain or loss to be treated as effectively connected with the operation of a trade or business in Puerto Rico, the rules provided in subsection (f) and the definitions established in subsection (h) of

⁵⁶ Puerto Rico Manufacturers Association, Industriales Presentan Recomendaciones Sobre Reforma Contributiva, Press Release, (Oct. 27, 2010), *available at* <http://www.prma.com/pages/LegislationNews/RECOMENDACIONESSOBREREFORMACONTRIBUTIVA.aspx>.

⁵⁷ Joanisabel González, *supra* note 2, at 3 (referencing comments made by Carlos Serrano, ex Assistant Secretary for Internal Revenue for the Puerto Rico Treasury Department).

⁵⁸ *Id.*

Section 1123 of Act No. 120 of October 31, 1994, as amended, known as the "Puerto Rico Internal Revenue Code of 1994," in effect as of the date of enactment of this Code, shall apply. Additionally, section 3070.01 of the 2011 Internal Revenue Code for Puerto Rico Code states that the provisions related with excise tax on the acquisition of personal property and services made after December 31, 2010 among related persons shall be provided in Sections 2101, 2102, 2103, 2104 and 2105 of Act No. 120 of October 31, 1994, as amended, effective on the date of enactment of the 2011 Internal Revenue Code for Puerto Rico Code.

2. Modified Effectively Connected Income and Source Rule

The most important concept introduced by the modified effectively connected income and source rule is that it treats the activities of those related to a nonresident individual, foreign corporation, or partnership as an office or fixed place of business of a nonresident individual, foreign corporation or partnership in Puerto Rico.⁵⁹ This is an enormous change from previous provisions of the Puerto Rico Internal Revenue Code. Up to this point, the activities of a related person in Puerto Rico had been treated as an office or fixed place of business of a nonresident individual, foreign corporation, or partnership when that related person regularly exercised the authority to negotiate and conclude contracts or had a stock of merchandise from which he regularly filled orders, on behalf of the nonresident individual, foreign corporation, or partnership.⁶⁰ As a result, the modified effectively connected income and source rule broadens the situations when a related person shall be regarded as an office of fixed place of business of a nonresident individual, foreign corporation, or partnership. Specifically, it establishes additional conditions under which certain transactions between the related party and the nonresident individual, foreign corporation, or partnership are considered as occurring in an office or fixed place of business.⁶¹ When the requirements are satisfied, the modified effectively connected income and source rule treats a portion of the income of certain activities of the nonresident as Puerto Rico source income.⁶² Consequently, a portion of the income is treated as effectively connected with the execution of a trade or business in Puerto Rico and is subject to its taxation.⁶³

⁵⁹ 2010 P.R. Laws No. 154 (amending P.R. I.R.C. §1123(f) by adding §1123(f)(1)(A) and subsequent §§). These new sections set forth the new rules for the application of amended §1123(f).

⁶⁰ Puerto Rico Revenue Code (P.R.I.R.C.), P.R. LAWS ANN. tit. 13 § 8523(f)(3)(B) (LexisNexis 2007).

⁶¹ 2010 P.R. Laws No. 154 (P.R. I.R.C. §1123(f)(4)(A)).

⁶² *Id.*

⁶³ *Id.*

In practice, the modified effectively connected income and source rule strives to achieve two things. First of all, the source rule expands the scope of *office or fixed place of business* by providing that a nonresident alien individual, corporation, or partnership will be treated as having an office or fixed place of business in Puerto Rico as a result of transactions above a certain threshold with a related party.⁶⁴ Second, the modified effectively connected income and source rule expands the scope of source income to provide that a portion of the income earned by the nonresident alien individual, corporation, or partnership shall be treated as Puerto Rico source income, and therefore be subjected to taxation as income effectively connected with the conduct of a trade or business in Puerto Rico.⁶⁵

The modified effectively connected income and source rules provide that the office or fixed place of business of a person in Puerto Rico will be considered as the office or fixed place of business of a foreign entity when it: (i) has authority to negotiate and conclude contracts on behalf of the foreign entity, provided it is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of his business,⁶⁶ or; (ii) is a member of the same controlled group as the foreign entity, and for the taxable year or any of the three (3) preceding taxable years satisfies one of following thresholds:⁶⁷

(i) Total Gross Receipts: If at least ten percent (10%) of the gross receipts of the person in Puerto Rico arises from the sale of personal property manufactured in Puerto Rico to, or from the performance of services in Puerto Rico for or on behalf of, the foreign entity.⁶⁸

(ii) Total Cost: If the sales of personal property manufactured in Puerto Rico, or the performance of services in Puerto Rico for or on behalf of, the foreign entity, account for at least ten percent (10%) of the cost of the total personal property or services purchased by the foreign entity.⁶⁹

(iii) Total Commissions and Fees: If the commissions or fees earned by the foreign entity from transactions related to personal property manufactured in Puerto Rico or services

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.* at P.R. I.R.C. §1123(f)(4)(A)(i)(I).

⁶⁷ *Id.* at P.R. I.R.C. §1123(f)(4)(A)(i)(II).

⁶⁸ *Id.* at P.R. I.R.C. §1123(f)(4)(A)(ii)(a).

⁶⁹ *Id.* at P.R. I.R.C. §1123(f)(4)(A)(ii)(b).

performed by the other person in Puerto Rico represent at least ten percent (10%) of the total commissions or fees earned from similar transactions.⁷⁰

(iv) Facilitation Analysis: If the foreign entity facilitates the sale of personal property manufactured in Puerto Rico or the performance of services by the person in Puerto Rico, and such sales or services, when considered with the activities described above, account for at least: (a) ten percent (10%) of the total gross receipts of the person in Puerto Rico; or (b) ten percent (10%) of the total gross receipts of the foreign entity from similar facilitation services.⁷¹

If the aforementioned thresholds are met, the foreign entity will be deemed as engaged in a trade or business in Puerto Rico and a portion of its income, gains, and profits will be treated as Puerto Rico source effectively connected income.⁷² The portion of source effectively connected income will be determined based on a formula that considers four (4) factors: payroll, property, sales, and purchases.⁷³

The percentage is computed by taking an average of four fractions: (i) property in Puerto Rico divided by total property;⁷⁴ (ii) Puerto Rico payroll divided by total payroll;⁷⁵ (iii) sales in Puerto Rico divided by total sales;⁷⁶ and (iv) purchases in Puerto Rico divided by total purchases.⁷⁷ The resulting sum of these fractions is divided by four and multiplied by the purchaser's total income in order to determine the Puerto Rico source income.⁷⁸ Act 154 provides that, if any taxpayer believes that the apportionment to Puerto Rico determined under the formula results in a greater portion of its total income than is reasonably attributable to business or sources within it, the purchaser may file a statement of objections proposing an alternative method of apportionment it considers appropriate, under the circumstances.⁷⁹ Additionally, Act 154 provides a simpler calculation for cases in which a purchaser is unwilling or unable to adequately document the required information for the application of the four factors and if he is unable to

⁷⁰ *Id.* at P.R. I.R.C. §1123(f)(4)(A)(ii)(c).

⁷¹ *Id.* at P.R. I.R.C. §1123(f)(4)(A)(ii)(d).

⁷² *Id.* at P.R. I.R.C. §1123(f)(4)(B)(i).

⁷³ *Id.* at P.R. I.R.C. §1123(f)(4)(B)(v).

⁷⁴ *Id.* at P.R. I.R.C. §1123(f)(4)(B)(v)(I).

⁷⁵ *Id.* at P.R. I.R.C. §1123(f)(4)(B)(v)(II).

⁷⁶ *Id.* at P.R. I.R.C. §1123(f)(4)(B)(v)(III).

⁷⁷ *Id.* at P.R. I.R.C. §1123(f)(4)(B)(v)(IV).

⁷⁸ *Id.* at P.R. I.R.C. §1123(f)(4)(B)(v).

⁷⁹ *Id.* at P.R. I.R.C. §1123(f)(4)(B)(vi).

demonstrate a viable alternative formula or method.⁸⁰ The alternative calculation treats 50 percent (50%) of the income from the sale or exchange of property manufactured or produced in whole or in part within Puerto Rico as sourced where it is manufactured or produced; in this case, Puerto Rico.⁸¹

It is important to note that, for the very first time in history, the Puerto Rico Internal Revenue Code has been amended to include an *anti-abuse rule* that restricts a taxpayer's discretion to structure transactions in order to limit their tax consequences. The modified effectively connected income and source rule contains an anti-abuse rule stating that any transaction or series of transactions, where one of their principal purposes is the avoidance of any of the 10 percent (10%) tests described above, will be disregarded.⁸² Therefore, this *anti-abuse rule* was adopted in hopes of limiting taxpayer's discretion in structuring transactions so as to avoid the application of the modified effectively connected income and source rule. Thus, Act 154 ensures a fixed stream of tax revenues.

The modified effectively connected income and source rule, as stated by Act 154, applies to income accrued after December 31, 2010,⁸³ but these do not contain any expiration or *sunset* provision. Hence, we understand that both of these methods will become a permanent change to Puerto Rico's taxation laws.

3. Excise Tax on the Acquisition of Property and Services from Related Parties

The Commission explained that the idea behind adopting a separate excise tax on the acquisition of personal property and services among related parties responds to the concern that the Department of Treasury would lack sufficient resources to effectively enforce the modified effectively connected income and source rule.⁸⁴ Additionally, it concluded that the inability to correctly enforce the modified effectively connected income and source rule would result in a significant revenue loss from taxpayers with substantial volumes of purchases from Puerto Rico related parties engaged in manufacturing.⁸⁵

The new excise tax applies, in lieu of the income tax that would otherwise result from the application of the amended effectively connected income and source rule, when gross receipts from the sale of personal property manufactured in or services performed in Puerto Rico exceed

⁸⁰ *Id.* at P.R. I.R.C. §1123(f)(4)(B)(vii).

⁸¹ *Id.*

⁸² *Id.* at P.R. I.R.C. §1123(f)(4)(B)(iv).

⁸³ 2010 P.R. Laws No. 154, article 5.

⁸⁴ *See generally* 2010 P.R. Laws No. 154, Statement of Motives, at 4.

⁸⁵ *Id.*

\$75,000,000 for any of the three (3) preceding taxable years.⁸⁶ The base amount for imposing the excise tax will be the value of the personal property and services acquired in Puerto Rico by the foreign entity after December 31, 2010.⁸⁷ Such value will be determined according to the invoice rendered for such items and, in the absence of an invoice, the tax shall be based on the fair market value of the items.⁸⁸ The excise tax is imposed on, and will be a liability of, the person acquiring such personal property and services, and the Secretary of the Department of Treasury (hereinafter Secretary) has the authority to prescribe regulations to prevent duplicative collection of such tax.⁸⁹

However, the person receiving any consideration for personal property or services in a transaction must collect the tax and deposit it with the Secretary or any authorized financial institution on or before the fifteenth (15th) day of the month after the transaction took place.⁹⁰ Furthermore, such person must file quarterly returns with the Department of Treasury and penalties apply in case of non-compliance.⁹¹

The excise tax is temporary and it encompasses a period of six (6) years that will phase out as follows: four percent (4%) for acquisitions occurring after December 31, 2010 and before January 1, 2012; three and three quarters percent (3.75%) for acquisitions occurring after December 31, 2011 and before January 1, 2013; two and three quarters percent (2.75%) for acquisitions occurring after December 31, 2012 and before January 1, 2014; two and one half percent (2.5%) for acquisitions occurring after December 31, 2013 and before January 1, 2015; two and one quarter percent (2.25%) for acquisitions occurring after December 31, 2014 and before January 1, 2016; and one percent (1%) for acquisitions occurring after December 31, 2015 and before January 1, 2017.⁹²

4. Relevant Concepts found in the Regulations applicable to the Excise Tax

The tax applies to the acquisition of personal property and services by one member of a controlled group of corporation⁹³ from another member with manufacturing operations in Puerto Rico and with gross receipts in excess of \$75,000,000 for any of the three (3) preceding tax years.⁹⁴

⁸⁶ P.R. I.R.C. §1123(f)(4)(B)(iii)(I).

⁸⁷ 2010 P.R. Laws No. 154 (P.R. I.R.C. §2101(a)(1)).

⁸⁸ *Id.* at P.R. I.R.C. §2101(a)(1).

⁸⁹ *Id.* at P.R. I.R.C. §2101(a)(2).

⁹⁰ 2010 P.R. Laws No. 154 (P.R. I.R.C. §2102(a)).

⁹¹ *Id.* at P.R. I.R.C. §2102(b).

⁹² 2010 P.R. Laws No. 154 (P.R. I.R.C. §2102(b)(4)).

⁹³ P.R. LAWS ANN. tit. 13 § 8428 (P.R. I.R.C. §1028 defining the term "corporations or partnerships controlled groups").

⁹⁴ Puerto Rico Regulation 7970, P.R. I.R.C. Regulation § 2101(a)-1(a).

Additionally, the regulation defines personal property and services as tangible property manufactured or produced in whole or in part and services performed in Puerto Rico in connection with the manufacture or production of tangible property.⁹⁵ A person is treated as having manufactured or produced tangible property in Puerto Rico if: (i) the assembly or conversion costs account for twenty percent (20%) or more of the total sale price;⁹⁶ (ii) employees or contractors substantially transform the property in Puerto Rico;⁹⁷ (iii) the product is produced or manufactured under industrial incentives legislation, including the Puerto Rico Economic Development Incentives Act of 2008, the Tax Incentives Act of 1998, the Tax Incentives Act of 1987, or the Industrial Incentives Act of 1978.⁹⁸

The regulation also defines *acquisition* as “any action, transaction, or series of actions or transactions by which any person or enterprise (i) obtains or procures legal ownership or physical possession of tangible property, or (ii) obtains or procures the benefit of services.”⁹⁹ It includes the electronic transmission or communication of a computer program from a location in Puerto Rico.¹⁰⁰ It further establishes that an acquisition occurs on the day on which the tangible property is acquired, transmitted, communicated, or first loaded onto a vehicle or placed in the custody of a common carrier for transportation from the manufacturer or producer in Puerto Rico.¹⁰¹ The value of personal property and services is determined by the regulations. These consider the following factors: (i) bill for property or services: the price it shows, assuming other bills do not reflect different prices for the same good or service;¹⁰² (ii) fair market value: the value established for tax reporting purposes (if no bill exists);¹⁰³ (iii) exclusion of separately priced publicly traded components: the value recorded in financial records;¹⁰⁴ (iv) acquisition of services: the value of the personal property to which the services relate, not the services themselves;¹⁰⁵ (v) transfer pricing adjustments: allowable, if they reflect fair market value.¹⁰⁶

The regulation allows for credits that could be used to provide partial relief from the excise tax or, in some cases, eliminate the tax in its entirety.¹⁰⁷

⁹⁵ *Id.* at P.R. I.R.C. Regulation § 2101(a)-1(c).

⁹⁶ *Id.* at P.R. I.R.C. Regulation § 2101(a)-1(c)(3)(i).

⁹⁷ *Id.* at P.R. I.R.C. Regulation § 2101(a)-1(c)(3)(ii).

⁹⁸ *Id.* at P.R. I.R.C. Regulation § 2101(a)-1(c)(3)(iii).

⁹⁹ *Id.* at P.R. I.R.C. Regulation § 2101(b)-1(a)(1).

¹⁰⁰ Puerto Rico Regulation 7970, P.R. I.R.C. Regulation § 2101(b)-1(a).

¹⁰¹ *Id.* at P.R. I.R.C. Regulation § 2101(b)-1(b).

¹⁰² Puerto Rico Regulation 7970, P.R. I.R.C. Regulation § 2101(b)-2(a)(1).

¹⁰³ *Id.* at P.R. I.R.C. Regulation § 2101(b)-2(a)(2).

¹⁰⁴ *Id.* at P.R. I.R.C. Regulation § 2101(b)-2(a)(3).

¹⁰⁵ *Id.* at P.R. I.R.C. Regulation § 2101(b)-2(a)(4).

¹⁰⁶ *Id.* at P.R. I.R.C. Regulation § 2101(b)-2(a)(5).

¹⁰⁷ Puerto Rico Regulation 7970, P.R. I.R.C. Regulation § 2102(a)-2(a).

Credits that may offset the excise tax include: (1) a general credit against the excise tax of \$4,000,000.00 in 2011; after 2011, the excise tax rate is divided by 4% times \$4,000,000.00. Unused credits may not be carried forward, backward, or refunded;¹⁰⁸ (2) an alternative credit based on gross receipts, in lieu of the general credit; a controlled group may elect this credit and, if it meets certain conditions, the credit begins at \$7,000,000.00 in 2011, but reduces each year thereafter;¹⁰⁹ (3) an alternative credit in cases where taxable acquisitions exceed certain thresholds. Some controlled groups with taxable acquisitions of \$4,000,000,000.00 or more and that employ 500 employees or more with a payroll of \$20,000,000.00 may elect this credit. For 2011, the amount of the credit varies from \$20,000,000.00 to \$80,000,000.00, based on the dollar amount of taxable acquisitions.¹¹⁰ In addition to alternative credit for incremental increase in employees, the regulation provides an additional credit that may apply if the number of persons employed by the controlled group in Puerto Rico exceeds 500 by at least 100. This credit applies for companies with taxable acquisitions in excess of \$4,000,000,000.00.¹¹¹ Also, the regulations state that a controlled group that has members engaged in manufacturing and production or manufacturing services in facilities located in three or more municipalities and employing more than 50 people, may be eligible for a credit of \$3,000,000.00 per municipality, up to a maximum of \$15,000,000.00.¹¹²

The two last credits set forth by the regulation include a credit for minority suppliers and a credit for knowledge corridor and research and development investment. The first credit applies if a controlled group directly purchases seventy-five percent (75%) or more of its goods or services from an approved minority business, it may be eligible for a credit based on how much of these exceeded the average annual amount purchased from minority businesses during the preceding two years.¹¹³ For the second credit, a controlled group may be eligible based on its contributions to the Puerto Rico Science, Technology and Research Trust or to the Special Economic Development Fund. A cap of one or two percent (1 or 2%) of the excise tax would apply.¹¹⁴

Finally, the regulation states that the maximum excise tax amount imposed by Section 2101 for a calendar year, on all of the members of a controlled group that make taxable acquisitions, shall not exceed \$375,000,000.00, except for the Economically Disadvantaged or Critical

¹⁰⁸ *Id.* at P.R. I.R.C. Regulation § 2102(a)-2(b).

¹⁰⁹ *Id.* at P.R. I.R.C. Regulation § 2102(a)-2(c).

¹¹⁰ *Id.* at P.R. I.R.C. Regulation § 2102(a)-2(d).

¹¹¹ *Id.* at P.R. I.R.C. Regulation § 2102(a)-2(e).

¹¹² *Id.* at P.R. I.R.C. Regulation § 2102(a)-2(f).

¹¹³ *Id.* at P.R. I.R.C. Regulation § 2102(a)-2(g).

¹¹⁴ *Id.* at P.R. I.R.C. Regulation § 2102(a)-2(h).

Industry Suppliers credit and the Knowledge Corridor and Research and Development Investment credit.¹¹⁵

5. Creditability of Act 154 Excise Tax

The Internal Revenue Service (hereinafter I.R.S.) issued Notice 2011-29 aiming on addressing the creditability of the excise tax enactment by Act 154.¹¹⁶ The IRS explained through Notice 2011-29 that “it has been the position of the Government of Puerto Rico that the excise tax is a tax imposed in substitution of the generally imposed income tax and that, as such, under Section 903 of the US Code, US taxpayers can claim a foreign tax credit for amounts paid.”¹¹⁷

Consequently, the I.R.S. stated in notice 2011-29 that “the determination of the creditability of the excise tax requires the resolution of a number of legal and factual issues.”¹¹⁸ Furthermore the notice states that “pending the resolution of these issues, the I.R.S. will not challenge a taxpayer’s position that the excise tax is a tax in lieu of an income tax under section 903.”¹¹⁹ Additionally the I.R.S. stated that the notice is effective for excise tax paid or accrued on or after January 1, 2011 and that any change in the foreign tax credit treatment of the excise tax after resolution of the pending issues will be prospective, and will apply to excise tax paid or accrued after the date that further guidance is issued.”¹²⁰

It must be noted that the language used by the I.R.S. in Notice 2011-29 is extremely vague and conditional. In essence, the I.R.S. will stand down and allow the excise tax to be credited as a foreign tax paid “in lieu of income tax” until the courts and other administrative agencies review the provisions of Act 154 and issue their rulings on this matter. Therefore, acknowledging the uncertainty that this notice creates, the I.R.S. agreed to allow the excise tax paid to be claimed as a credit and consequently, any changes in this position will be enforced prospectively. Thus, this issue continues to be unresolved and open to numerous challenges in the courts of Puerto Rico and the United States, where Act 154’s constitutionality can be questioned in several ways.

D. Unanswered Concerns: The “Twilight Zones” in Act 154

Since there were no public hearings or debates regarding Act 154, there remain many unanswered questions about its new rules. Firstly,

¹¹⁵ Puerto Rico Regulation 7970, P.R. I.R.C. Regulation § 2102(a)-3(a).

¹¹⁶ Puerto Rican Excise Tax Notice 2011-29, 2011-16 I.R.B 663-664.

¹¹⁷ *Id.* at 663.

¹¹⁸ *Id.* at 664.

¹¹⁹ *Id.*

¹²⁰ *Id.*

[t]his is a new tax that is not in accord with international norms. Taxpayers that have subsidiaries that manufacture in Puerto Rico were disappointed that Puerto Rico even considered such a tax. The government of Puerto Rico apparently believed the tax would be funded through the U.S. foreign tax credit system.¹²¹

Therefore, we can conclude that the creditability of the tax will not even be considered, for some taxpayers with manufacturing subsidiaries in Puerto Rico. For these, the tax will simply be deemed as an additional direct cost of manufacturing in Puerto Rico.¹²²

Secondly, it is yet to be seen how the U.S. Treasury and the Internal Revenue Service will view the creditability of the tax as a foreign tax credit for U.S. tax purposes or, in the case of the excise tax, as a section 903 *tax in lieu* of an income tax.¹²³ Also, we must be vigilant of any lawsuits presenting issues regarding the tax's constitutionality. Thus, questions could arise regarding nexus, due process, and the inter-state commerce clause.¹²⁴

Thirdly, the creditability of the tax as a foreign tax credit may be of little interest to taxpayers, when the tax is imposed on a non-U.S. corporation such as a foreign parent company or the Controlled Foreign Corporations (CFC) of a U.S. parent company that purchases goods from a manufacturing company in Puerto Rico.¹²⁵ For those companies, the tax will simply be a direct cost of manufacturing in Puerto Rico. Additionally, "numerous collateral issues can also arise, such as constructive dividends and section 956 investments, when the company on whom the tax is imposed fails to reimburse the company that manufactured the products in Puerto Rico and then paid the excise tax."¹²⁶

As a fourth consequence, it is unclear whether the new source rule and excise tax are consistent with tax grants that companies had previously negotiated with the Puerto Rico Government.¹²⁷ Entities currently operating

¹²¹ JAMES P. FULLER, et al., U.S. International Tax Developments, (2011) at 32, *available at* <http://www.ifausa.org/dman/Document.phx/Events/%5Eeman.208/Conference+Handouts/US+International+Tax+Developments?folderId=Events%2F%25Eeman.208%2FConfere%2BHandouts&cmd=download>.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ JAMES P. FULLER, *supra* note 118. (In reference to constructive dividends and section 956 investments). *See also* I.R.C § 956 (2006) (dealing investment of earnings in United States property).

¹²⁷ PRICEWATERHOUSECOOPERS LLP, *Puerto Rico enacts new temporary excise tax on offshore manufacturers, permanent change in source-of-income rule*, INDUSTRIAL PRODUCTS & SERVICES TAX ALERT (Nov. 30, 2010) *available at*

in Puerto Rico that enjoy tax exemptions should not see their tax benefits affected. The new excise tax and sourcing rules should apply only to related foreign corporations. However, at the consolidated level, the tax could represent a significant increase in effective tax rate for the Puerto Rico jurisdiction.¹²⁸

In fifth place, “Act 154 does not address the effect and treatment of transfer pricing adjustments introduced at year-end related to the new excise tax”.¹²⁹ Neither does it specifically address the compliance requirements applicable to foreign corporations deemed to be engaged in a trade or business in Puerto Rico by virtue of the amended provisions related to sources of income. Furthermore, the effect that the Act might have on other Puerto Rico filing requirements is yet to be determined.¹³⁰ Additionally, Act 154 fails to address the volume of business tax implications that could result from the new effectively connected rules.

Finally, it is relevant to bear in mind that there are various tax accounting and financial reporting complications that must be addressed if Act 154 is to be imposed. Specifically, “[t]he key accounting question surrounding this new tax is determining whether it is within the scope of ASC 740, *Taxes*, or other accounting guidance.”¹³¹ As such, it must be noted that:

The principles of ASC 740 are applicable to ‘taxes based on income.’ However, authoritative literature under US GAAP does not clearly define the term ‘tax based on income’ or differentiate taxes based on income from taxes that are not. In practice, the general rule is that a tax would qualify as ‘tax based on income’ when revenues or receipts are reduced by at least one category of expense. Thus, implicit in ASC 740 is the concept that taxes on income are determined after revenues and gains are reduced by expenses, and losses respectively. A

<http://www.publications.pwc.com/DisplayFile.aspx?Attachmentid=3968&Mailinstanceid=18824>.

¹²⁸ *Id.* at 3.

¹²⁹ *Id.* at 4.

¹³⁰ *Id.*

¹³¹ PRICEWATERHOUSECOOPERS LLP, *Puerto Rico’s Excise Tax: New Regulations and Accounting Considerations*, PHARMA AND LIFE SCIENCES TAX NEWS, Vol. 9, No. 13 (Oct. 13, 2010) available at http://www.pwc.com/gx/en/pharma-life-sciences/pdf/ptn_vol9no18.pdf. Regarding XXX, refer to Generally Accepted Accounting Principles (GAAP), Accounting Standards Codification 740 Income Taxes Topic addresses financial accounting and reporting for the effects of income taxes that result from an entity’s activities during the current and preceding years.

tax solely based on gross amounts such as revenue/receipts or purchases would generally not qualify as an income tax.¹³²

IV. CONCLUSIONS: ARE WE AT THE BORDER OF THE CLIFF?

It is amazing to see how much things can change in a relatively short amount of time. Just a couple of months ago, the following statement made sense: “[t]he competition to attract companies setting up new manufacturing facilities is also rising. Ireland and Puerto Rico have established particularly strong manufacturing bases, thanks to corporate income tax rates of 12.5% and 20%, respectively.”¹³³ A description that’s offered, for example, about Ireland’s tax incentives is that “[w]ith its 12.5% corporate tax rate and highly educated populace, Ireland has attracted numerous pharmaceutical companies.”¹³⁴ Whereas Puerto Rico has been described as “low corporate tax rate and off-shore status have stimulated a large pharmaceutical manufacturing presence. Most of the big players, including AstraZeneca, GlaxoSmithKline, Johnson & Johnson, Lilly, Merck & Co. and Pfizer have plants there.”¹³⁵

This statement came from a report, which also states that “for the past 20 years, Pharma has benefited from a benign legislative and commercial environment that has enabled it to report low and stable tax rates.”¹³⁶ It also emphasizes that “Governments have permitted the use of low-tax jurisdictions, and the industry has been able to demonstrate that a large portion of the profit it earns comes from the intellectual property it creates – much of which is located in low-tax countries.”¹³⁷ Furthermore, the report proclaims that the economic prospects of the pharmaceutical industry are fast changing, because “many governments are trying to curb the use of low-tax jurisdictions in an effort to repair their damaged finances.”¹³⁸ As such, the report foreshadows that companies based in high-tax jurisdictions will have lower returns on capital over the long term and will thus be at a significant competitive disadvantage, compared to those based in low-tax jurisdictions. Consequently, these companies will have to evaluate potential transfers to a more favorable regime.¹³⁹

¹³² *Id.*

¹³³ PRICEWATERHOUSECOOPERS LLP, *Pharma 2020: Taxing times ahead Which path will you take?*, PHARMA AND LIFE SCIENCES (2010), at 11 available at http://www.pwc.com/en_GX/gx/pharma-life-sciences/pdf/ph2020_tax_times_final.pdf.

¹³⁴ *Id.*, figure 6.

¹³⁵ *Id.*

¹³⁶ *Id.* at 21.

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.*

The actions of the Government of Puerto Rico have had the effect of accelerating the omens warned in the industry reports. Desperate for revenues in the midst of a recession, the Government blitzed foreign pharmaceutical and manufacturing industries with a \$6,000,000,000.00 tax. As stated by William Riefkohl, “this tax changes the basis on which the companies that were invited to invest in Puerto Rico made their commitment. For the first time, it sends the world a message that Puerto Rico can change its rules at any moment without previous prior notice.”¹⁴⁰ Puerto Rico decided to explicitly exert its fiscal taxing autonomy to reach new taxpayers that, until this point, had not been reached by Puerto Rico’s taxing arm. This was partly due to the practice of designing corporate structures, which would elude taxation in Puerto Rico. Through tax exemption grants, Puerto Rico specifically agreed to allow and enable the establishment of manufacturing in exchange for the economic activity these spurred. Now, Puerto Rico has explicitly circled around the conceded tax exemption grants and wielded its enormous fiscal taxing autonomy arm to stab at taxpayers and their income located in the United States and other foreign jurisdictions in order to reach taxpayers and their income that, up until then, were not thought to be located nor to have any direct presence in Puerto Rico. Additionally, to set up and defend the creditability of the modified effectively connected income and source rule and the related excise tax against United States income tax is to request a backdoor bailout for Puerto Rico from the United States Treasury Department. In essence, what has been done is to request that the United States Government assume at least a significant chunk of the bill.

Puerto Rico’s economic feasibility requires swift, decisive steps towards promoting industrial, manufacturing, and knowledge-based economic activities. The Island is suffering the consequences of a lack of foresight and an inability to develop institutions that can drive its economy. The approval of Act 154 goes completely against the economic plan, as forged from the early 1950’s, and which had the effect of raising the Puerto Rican economy up to its current state of development. Approving Act 154 to fund the related Individual and Corporate income tax reform is not sound fiscal policy; it’s just shifting the responsibility from one side to another. Puerto Rico’s economic recovery requires that politicians, private practitioners, and the men and women of industry focus on collaborative efforts that promote self-sustaining job creation and well-being, while ensuring fair tax rates for all stakeholders. In conclusion, it is tragic that Puerto Rico has used its current fiscal autonomy powers in a way that has affected the general welfare of its people and economy.

¹⁴⁰ *Id.* (citing William Riefkohl, vice president of the Puerto Rico Manufacturers Association).