

# A CONSTITUTIONAL AND TECHNICAL ANALYSIS: THE IMPOSITION OF PUERTO RICO'S EXCISE TAX ON THE MANUFACTURING INDUSTRY

ANA DELIA MONTAÑEZ MORALES\*

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*“No government can exist without taxation ...  
the grand art consists of levying so as not to oppress.”  
Frederick the Great  
18th Century Prussian King*

## I. INTRODUCTION

A tax is a “compulsory monetary contribution to the state’s revenue, assessed and imposed by a government on the activities, enjoyment, expenditure, income, occupation, privilege, property, etc., of individuals and organizations.”<sup>1</sup> Taxes are used as tools for economic and social policies. Their main purposes are to generate income, encourage or discourage certain types of activities, redistribution of wealth, and economic control. An effective tax system must generate steady stream of government revenue, ensure fairness, be administratively feasible, and neutral.

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\* Certified Public Accountant; Tax Senior working for Deloitte Tax LLP in San Juan, Puerto Rico and fourth year student at the University of Puerto Rico Law School.

<sup>1</sup> Tax Definition, WebFinance, Inc., <http://www.businessdictionary.com/definition/tax.html> (last visited: Nov. 15, 2011).

The taxing power of Puerto Rico arises in Article 6, Section 2 of the Constitution.

The power of the Commonwealth of Puerto Rico to impose and collect taxes and to authorize their imposition and collection by municipalities shall be exercised as determined by the Legislative Assembly and shall never be surrendered or suspended.<sup>2</sup>

The rule of taxation in Puerto Rico shall be uniform<sup>3</sup> and shall originate in the House of Representatives, but the Senate may propose or concur with amendments as on other bills. The taxing power of the Commonwealth of Puerto Rico is exercised through the Internal Revenue Code, which embodies domestic statutory tax law.

In fact, on October 25, 2010 the governor of Puerto Rico enacted Act No. 154<sup>4</sup>, which amends several provisions of the Internal Revenue Code. The Act modifies the sourcing rules to treat certain nonresident alien individuals and foreign entities as engaged in a trade or business within Puerto Rico. It also sets forth a new excise tax on the acquisition of personal property manufactured in Puerto Rico and services related to the manufacturing of tangible property. In particular, throughout this paper I will examine the industry perspective towards the excise tax, evaluate its creditability as a foreign tax in other jurisdictions and analyze some constitutional aspects related to the imposition of the excise tax.

## II. THE MANUFACTURING INDUSTRY IN PUERTO RICO

Since the 1950s, American pharmaceutical companies have invested heavily in Puerto Rico, encouraged by duty free access to the United States and tax incentives. As a result, the pharmaceutical industry has become one of the leading manufacturing industries in Puerto Rico. This industry has improved Puerto Rico's economy by helping to exponentially increase its exports and imports between fiscal years 1987 and 1997.<sup>5</sup>

The Commonwealth of Puerto Rico has a unique political and economic relationship with the United States which has allowed companies to manufacture products free from the Federal Income Tax imposed in the

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<sup>2</sup> P.R. CONST. Art. VI § 2.

<sup>3</sup> P.R. CONST. Art. VI § 3.

<sup>4</sup> Act to Amend Section 1123 and add a new Chapter 7 to Subtitle B – “Excise Tax”, to Act No. 20 of 1994: Internal Revenue Code of Puerto Rico of 1994, Act No. 154 of October 25, 2010, P.R. LAWS ANN. tit. 13 § 8523, §§9085-89 (2010).

<sup>5</sup> WELCOME TO PUERTO RICO, Economy; <http://www.topuertorico.org/economy.shtml> (last visited: Nov. 15, 2011).

United States and, either, exempt from Puerto Rican income tax, or, subject to a reduced Puerto Rican income tax rate.<sup>6</sup> As such, the government of Puerto Rico has been actively campaigning to promote the island as a manufacturing destination.

The Puerto Rico Industrial Development Company ("PRIDCO") is the primary government agency charged with promoting Puerto Rico as an investment destination for companies and industries worldwide.<sup>7</sup> The following is the statement of invitation to companies to do business in Puerto Rico:

Here you can enjoy the benefits and protection of operating within a U.S. jurisdiction with the added tax benefits of operating under a foreign tax structure. There are no federal income taxes and goods enter the U.S. market duty-free.

In addition, Puerto Rico offers a highly attractive incentives package that includes maximum corporate income tax rates with a low percent, various tax exemptions and deductions, training reimbursement and special tax treatment for pioneer industries.

Such a unique business proposition, coupled with a highly skilled workforce and flexible financing alternatives can only maximize your company's profitability.<sup>8</sup>

Many articles have been written to enhance the tax benefits offered by Puerto Rico to the manufacturing industry. For example, Fernando Goyco Covas expressed the following regarding the advantages of doing business in Puerto Rico:

Given that essentially the entire spectrum of products may be manufactured, assembled or produced in Puerto Rico enjoying the Puerto Rican tax incentives, and products manufactured in Puerto Rico are not subject to US custom duties, companies organized outside of the US may obtain significant tax and US custom duties savings from manufacturing in Puerto Rico the products that they sell in the US market. . . .

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<sup>6</sup> Fernando Goyco Covas, How Puerto Rico is a Tax Haven for the US, INT'L TAX REV., available at <http://www.internationaltaxreview.com/Article/2608678/How-Puerto-Rico-is-a-tax-haven-for-the-US.html>

<sup>7</sup> PUERTO RICO INDUSTRIAL DEVELOPMENT COMPANY, Guide to Doing Business in Puerto Rico 71, available at <http://www.pridco.com/pdf/aguidepr.pdf>.

<sup>8</sup> PUERTO RICO INDUSTRIAL DEVELOPMENT COMPANY, Overview Incentives, available at [http://www.pridco.com/index.php?option=com\\_content&task=view&id=37&Itemid=119](http://www.pridco.com/index.php?option=com_content&task=view&id=37&Itemid=119).

The distribution of products from Puerto Rico to the US, the Caribbean and Latin America could also be used to shift income from high-tax jurisdictions to Puerto Rico. If the distribution operations are conducted by a corporation organized outside of Puerto Rico, and the products are manufactured by the corporation or an affiliate outside of Puerto Rico, the foreign-source income derived from the sale of the products with title passing outside of Puerto Rico will not be effectively connected with the Puerto Rico trade or business of the corporation and, therefore, will be exempt from Puerto Rico income tax.<sup>9</sup>

### III. PUERTO RICO TAX INCENTIVES

A company is considered resident of Puerto Rico if it is created or organized in Puerto Rico- also known as a domestic corporation- or if it is a foreign corporation engaged in a trade or business in Puerto Rico. A foreign corporation engaged in trade or business in Puerto Rico is subject to tax only on its Puerto Rico source income and income effectively connected with the conduct of the trade or business in Puerto Rico, and will be able to claim as deduction those expenses connected with or properly allocable to income that is effectively connected with its Puerto Rico business.<sup>10</sup>

Several laws have been passed to provide tax incentives through tax grants between the Government of Puerto Rico and eligible businesses. The latest act focused on tax incentives for the manufacturing industry is Act No. 73 of 2008, the Economic Incentives for the Development of Puerto Rico.<sup>11</sup> The tax benefits include a 90% exemption from property tax, a 60% exemption from municipal gross receipts tax, and reduced income tax rates on the income derived from the eligible activity. In addition, exemption is granted from excise taxes on raw materials, machinery and equipment used in the exempt manufacturing operations. However, on October 25, 2010, the Governor of Puerto Rico enacted Puerto Rico Act No. 154, hereinafter Act 154, which could potentially impact the landscape of the manufacturing industry of the island.

### IV. PUERTO RICO ACT 154: OVERVIEW

“All was done in one weekend with no hearings, no input from anyone and no chance to submit any testimonials or comments”, expressed

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<sup>9</sup> Goyco Covas, *supra* note 6.

<sup>10</sup> P.R. CODE REGS. ART. 1234-1(b)

<sup>11</sup> Puerto Rico Economic Development Incentives Act of 2008, Act No. 73 of July 2, 2010, P.R. LAWS ANN. tit. 13 §§ 8046, 8050, 8052, 8099 (2010).

William Riefkohl, Vice President of the Puerto Rico Manufacturers Association.<sup>12</sup> In fact, Act 154, formerly House Bill 2526, was filed on Friday, October 22<sup>nd</sup> by the Treasury Commission of the House of Representatives and was signed by the Governor on October 25<sup>th</sup>, establishing that the Act's main purpose is to finance upcoming tax reform legislation.

As explained on the previous section, the Puerto Rico tax system provides that sales by a non-Puerto Rico affiliate outside of Puerto Rico are not subject to tax in Puerto Rico to the extent that such entity is not engaged in business in Puerto Rico. However, Act 154 modifies the sourcing rules in order to treat certain nonresident alien individuals, and foreign entities as engaged in trade or business within Puerto Rico in order to subject them to Puerto Rico tax on certain transactions. Act 154 establishes specific rules with respect to sales made by a non- Puerto Rico entity of products manufactured by its Puerto Rico affiliate. It also sets forth a new excise tax on the acquisition of personal property and services to any non-Puerto Rico entity whose Puerto Rico affiliate has gross receipts from products manufactured or services rendered in Puerto Rico in excess of \$75,000,000 for any of the three (3) preceding taxable years.

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

The new Internal Revenue Code for Puerto Rico was signed into law on January 31, 2011, and became known as the Internal Revenue Code for a New Puerto Rico (hereinafter the 2011 Internal Revenue Code for Puerto Rico Code). Specifically, section 1035.05 of the 2011 Internal Revenue Code for Puerto Rico Code 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 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. Furthermore, 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.

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<sup>12</sup> Fernando Goyco Covas, Manufacturing Tax in Puerto Rico to Discourage US and EU Investments, *INT'L TAX REV.*, Nov. 5, 2010, available at <http://www.internationaltaxreview.com/Article/2712087/Manufacturing-tax-in-Puerto-Rico-to-discourage-US-and-EU-investments.html>.

### B. Effectively Connected Income Rules<sup>13</sup>

Act 154 expands the scope of the *office or fixed place of business* concept. It provides 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 the person in Puerto Rico: 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; or 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:<sup>14</sup>

If at least ten percent (10%) of the gross receipts of the person in Puerto Rico arise 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.

If the sales of personal property manufactured in Puerto Rico to, 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.

If the commissions or fees earned by the foreign entity from transactions related to personal property manufactured in Puerto Rico or services performed by the other person in Puerto Rico represent at least ten percent (10%) of the total commissions or fees earned from similar transactions.

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:

Ten percent (10%) of the total gross receipts of the person in Puerto Rico; or,

Ten percent (10%) of the total gross receipts of the foreign entity from similar facilitation services.

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<sup>13</sup> See P.R. Internal Revenue Code § 1123(f).

<sup>14</sup> P.R. Internal Revenue Code § 1123(f)(4).

If the aforementioned thresholds are met, the foreign entity will be considered to be engaged in trade or business in Puerto Rico and, consequently, a portion of its income, gains, and profits will be treated as Puerto Rico source effectively connected income. The portion of Puerto Rico source effectively connected income will be determined based on a formula that considers four (4) factors: payroll, property, sales, and purchases. Accordingly, "the effect of the new source rule will be to treat income from the resale of purchases from Puerto Rico affiliates by a foreign entity, in part, as Puerto Rico source income effectively connected with the conduct of a Puerto Rico trade or business."<sup>15</sup>

### C. Excise Tax

The new excise tax applies when gross receipts from the sale of personal property manufactured in Puerto Rico or services performed in connection with the manufacture of tangible property by the person in Puerto Rico exceed seventy-five million (\$75,000,000) dollars for any of the three (3) preceding taxable years.

The terms personal property and service are defined as tangible property manufactured or produced in whole or in part in Puerto Rico, and services performed in Puerto Rico in connection with the manufacture or production of tangible property.<sup>16</sup>

The proposed regulations for Act 154 specify that a person is treated as having manufactured or produced tangible property in Puerto Rico if one or more of the following provisions apply:

Employees or contractors substantially transform the property in Puerto Rico

The assembly or conversion costs account for 20% or more of the total sale price.

The product is produced or manufactured under industrial incentives legislation, including the Puerto Rico Economic Development Incentives Act of 2008 (Act 73), the Tax Incentives Act

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<sup>15</sup> PricewaterhouseCoopers, Puerto Rico enacts new temporary excise tax on offshore manufacturers, permanent change in source-of-income rule, Pharma and life sciences tax news: Vol. 9, No. 13, available at [http://www.pwc.com/gx/en/pharma-life-sciences/pdf/ptn\\_vol9-no13-final.pdf](http://www.pwc.com/gx/en/pharma-life-sciences/pdf/ptn_vol9-no13-final.pdf).

<sup>16</sup> P.R. Internal Revenue Code § 2101(b)(1).

of 1998 (Act 135), the Tax Incentives Act of 1987 (Act 8), or the Industrial Incentives Act of 1978 (Act 26).<sup>17</sup>

The excise tax is temporarily implemented for six years, 2011 through 2016, at a rate of 4% but will phase out gradually at 1% for 2016. It will not be imposed upon net income, but on the value of the personal property and services acquired in Puerto Rico by the foreign entity after December 31, 2010. Such value will be determined according to the invoice rendered for such items. In absence of an invoice, the tax shall be based on the fair market value of the items.<sup>18</sup>

The excise tax shall apply only where the person acquiring personal property or services acquires such personal property or services directly or indirectly from another member of the same controlled group, or where a person provides distribution or facilitation services for or on behalf of another member of the same controlled group, including services on a commission or commissionaire basis, provides such services, that account during the three (3) preceding taxable years for at least:<sup>19</sup>

10% of the gross receipts of the Puerto Rico affiliate from the sale of personal property manufactured or produced, and services performed in Puerto Rico;

At least 10%, by cost, of the total amount of personal property and services acquired by the affiliate subject to the excise tax;

At least 10% of the total amount of commissions or other fees earned by such person; or in the case of transactions facilitated by the taxpayer, such transactions together with the activities previously mentioned account for at least 10% of the total gross receipts of the Puerto Rico affiliate or the total gross receipts of nonresident affiliate from facilitation services.

The Puerto Rico affiliate, the person receiving any consideration for personal property or services in a transaction, must collect the tax and deposit the aforesaid with the Secretary or any authorized financial institution on or before the fifteenth (15<sup>th</sup>) day of the following month.<sup>20</sup> Furthermore, such person must file quarterly returns with the Puerto Rico

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<sup>17</sup> See P.R. Internal Revenue Code Reg. 2101(a)-(1)(c) available at <http://www.hacienda.gobierno.pr/pdf/reglamentos/7970.pdf>.

<sup>18</sup> P.R. Internal Revenue Code § 2101(b)(2).

<sup>19</sup> P.R. Internal Revenue Code § 2101(c)(1).

<sup>20</sup> P.R. Internal Revenue Code § 2102.



Treasury Department.<sup>21</sup> Penalties will apply in case of non-compliance with the collection or timely deposit of the tax.<sup>22</sup>

Act 154 also provides for a tax credit mechanism.<sup>23</sup> A credit shall be granted for taxes paid by the nonresident affiliate to any of the states of the United States on the acquisition of personal property and service subject to the excise tax; and for excise tax imposed to another person that is a member of the controlled group on personal property and services that are subsequently acquired by the taxpayer. The amount of the credit shall be the lesser of the tax paid by the Puerto Rico affiliate to a state by reason of the imposition of a similar tax on the acquisition of the personal property and services, or the excise tax imposed by Act 154 with respect to such personal property and services.

#### V. MANUFACTURING INDUSTRY PERSPECTIVE

Many of the manufacturing plants operating in Puerto Rico were directly invited by the Government of Puerto Rico through the offer of significant tax incentives. Therefore, the enactment of an excise tax specifically applicable to the manufacturing industry, without the opportunity of public hearings, and effective almost immediately, was contradictory to the previous actions by the Government of Puerto Rico, and subsequently caused great uproar within the reaction of the manufacturing industry.

Government officials estimated that forty (40) through fifty (50) multinationals with operations in Puerto Rico will be subject to Act 154.<sup>24</sup> At the very least, 50% of the multinationals in Puerto Rico are in the pharmaceutical industry.<sup>25</sup> In fact, Pharmaceutical Research and Manufacturers of America (PhRMA) President John Castellani released the following statement about Act 154:

PhRMA member companies have long had a strong presence in Puerto Rico, providing thousands of stable, high-paying jobs and investment in local economies in the search for new medicines.

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<sup>21</sup> P.R. Internal Revenue Code § 2103.

<sup>22</sup> *Id.*

<sup>23</sup> P.R. Internal Revenue Code § 2104.

<sup>24</sup> New tax in Puerto Rico to proceed despite extreme opposition, *INT'L TAX REV.*, Dec. 1, 2010, available at <http://www.internationaltaxreview.com/Article/2730131/New-tax-in-Puerto-Rico-to-proceed-despite-extreme-opposition.html>.

<sup>25</sup> *Id.*

Law 154 will dramatically hinder these companies' positive efforts within Puerto Rico. The measure imposes special taxes on certain activities and transactions conducted by non-resident individuals and companies in Puerto Rico. This could significantly reduce the ability of PhRMA's members to operate in the Commonwealth and to continue to make significant investments in researching and developing innovative new medicines for patients. In addition, we are concerned that this significant new tax increase was developed and enacted without the opportunity for public input and comment. Transparent and predictable tax policies are critical to helping foster innovation in Puerto Rico. These policies should be developed and vetted through a public process involving all relevant stakeholders, including PhRMA member companies.<sup>26</sup>

In addition, the U.S. Chamber of Commerce established its 'strong opposition' to the Puerto Rico excise tax. "This new tax increase makes drastic changes to longstanding tax law, may have unintended consequences, and is potentially detrimental to new and existing foreign investment in Puerto Rico."<sup>27</sup> "By imposing a discriminatory new tax, without notice or the benefit of public hearings, a negative message is sent to new and existing investment in Puerto Rico. A strong incentive is created for foreign companies to look elsewhere for their manufacturing and distribution."<sup>28</sup>

Additionally, the National Association of Manufacturers (NAM) President and CEO John Engler also issued a statement related to Act 154:

We 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

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<sup>26</sup> See Press Release, John Castellani, PhRMA Statement Regarding Puerto Rico Law 154 (Oct. 25, 2010), <http://www.phrma.org/media/releases/phrma-statement-regarding-puerto-rico-law-154>.

<sup>27</sup> Letter from R. Bruce Josten, Executive Vice President, Government Affairs of the U.S. Chamber of Commerce to Raúl Gayá Nigaglioni, Chairman of the Puerto Rico Chamber of Commerce, Letter opposing Puerto Rico's newly enacted 4 percent tax on foreign corporations (Oct. 26, 2010), available at <http://www.uschamber.com/issues/letters/2010/letter-opposing-puerto-ricos-newly-enacted-4-percent-tax-foreign-corporations>.

<sup>28</sup> *Id.*

taken years to develop between the affected companies and the government of Puerto Rico.

Even more concerning is 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.<sup>29</sup>

These declarations are, without a doubt, detrimental to the island's reputation as an investment destination. Companies seeking to invest capital diligently search for jurisdictions with political, economic and social stability. The companies affected by the excise tax were directly invited by the Government of Puerto Rico and the way that such an important act was enacted, without public hearings on a weekend, affects the stability perception and trust that these entities had in the jurisdiction. "Once a popular destination for multinationals, Puerto Rico's future as a favorable tax regime for foreign investment is now at stake."<sup>30</sup> Consequently, Puerto Rico's capability of attracting foreign investment has significantly declined. In order to ease the tension and improve its perception, the Government of Puerto Rico declared that the excise tax could be used as a Foreign Tax Credit for American companies.

## VI. CREDITABILITY OF EXCISE TAX

To mitigate or eliminate the risk of double taxation of the same income, Puerto Rico corporations have the option of either deducting or crediting the income and excess profit taxes paid or accrued during the taxable year to the United States, any possession of the United States, or any foreign country.<sup>31</sup>

First, it has to be determined whether a foreign tax imposed is a creditable tax. Section 901 of the US Internal Revenue Code ("US IRC") limits the credit to foreign taxes imposed on "income, war profits or excess profits." Section 903 of the US IRC provides that the term "income, war profits, and excess profits taxes"

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<sup>29</sup> Press Release, John Engler, National Association of Manufacturers (NAM) President and CEO, Manufacturers Oppose Puerto Rico's New Tax Increase on Multinational Companies (Oct. 27, 2010), <http://www.nam.org/Communications/Articles/2010/10/Manufacturers-Oppose-Puerto-Rico.aspx>.

<sup>30</sup> Goyco Covas, *supra*, note 12.

<sup>31</sup> P.R. Internal Revenue Code § 1023(c) and §1131(a)(1).

shall include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country.

The regulations provide that in order for an in-lieu-of tax to qualify under Section 903:<sup>32</sup>

the in-lieu-of tax need not be imposed because of administrative difficulty in determining the base of the generally imposed income tax;

the base of the in-lieu-of tax need not bear any relation to realized net income; and

the tax burden resulting from the in-lieu-of tax need not be the same as or less than the tax burden resulting under the generally imposed income tax.

The two basic requirements that must be satisfied in order for a foreign levy to be creditable under Section 903 are: (1) it must be a tax; and (2) it must meet the substitution requirement of the §903 regulations.<sup>33</sup>

“The term ‘income, war profits, and excess profits taxes’ shall include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise *generally imposed* by any foreign country or by any possession of the United States.”<sup>34</sup>

The regulations do not contain any definition of ‘generally imposed income tax’. It is clear, however, that the term has a narrower meaning than under earlier versions of the regulations. The regulations note, for example, that a tax on only one industry (banks) cannot be considered a generally imposed income tax. The regulations make it clear, however, that a tax imposed on all foreign residents doing business within a foreign jurisdiction is a generally imposed income tax, even if residents and locally owned enterprises are not taxed.<sup>35</sup>

The excise tax established in Act 154 is specifically imposed upon the manufacturing industry. In fact, it is established to forty or fifty multinationals, as estimated by government officials. As such, it cannot be

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<sup>32</sup> U.S. I.R.C. Regs. §1.903-1.

<sup>33</sup>Id.

<sup>34</sup> See I.R.C. § 903.

<sup>35</sup> See C. Dupy and K. Dolan, THE CREDITABILITY OF FOREIGN TAXES-GENERAL ISSUES, BNA TaxManagement Portfolio 901-2nd, p. A-29 (2005).

determined that it is classified as a 'generally imposed tax' since it is imposed to specific companies that are engaged in a specific industry. It is not a tax imposed on all foreign residents doing business in Puerto Rico. Accordingly, if it is not considered 'a generally imposed tax' it fails to meet the first requirement to be considered a creditable tax under section 903 of the U.S. Internal Revenue Code, and, consequently, should not be allowed to be taken as a foreign tax credit. Therefore, the analysis of the creditability could be ended here. However, I will proceed to analyze the second requirement.

The regulations provide that, in order for a tax to meet the substitution requirement, it has to operate as a tax imposed in substitution for, and not in addition to, a generally imposed income tax. The substitution requirement is not met if the foreign tax in question merely supplements an income tax without a reduction or exemption for those subject to the tax in question. In addition, the regulations require an exemption from the generally imposed income tax with respect to items subject to the substitute tax and not merely a reduction in the income tax.<sup>36</sup>

The excise tax is imposed to the affiliates acquiring personal property manufactured in whole or in part in Puerto Rico or services performed in Puerto Rico in connection with the manufacture or production of the tangible property. Such business entities were not subject to any tax before Act 154. The Act imposes the tax based on the value of the property or services; and after the temporary period of six years, it has been established that those companies will be subject to the new source rules that Act 154 added to the PR Internal Revenue Code. In fact, the proposed regulations establish that if the excise tax does not apply, then the Puerto Rico tax of the nonresident affiliated entity will be determined based on the sourcing rules.

However, since the excise tax is not considered an income tax, the tax will represent a 4% increase in cost of the products. Therefore, the resale of such products will create a multi-level of tax that will impact business entities without any contact with the Puerto Rico jurisdiction, and finally will have an effect on the individual consumers.

The excise tax is technically imposed on each related purchaser of the personal property or services. Thus, it may impose multiple levels of tax on a series of sales between related parties. The law provides for a credit intended to prevent multiple layers of taxation. However, as currently drafted the law may not accomplish this goal in many cases.<sup>37</sup>

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<sup>36</sup> Id.

<sup>37</sup> Damon L. Lyon, David G. Noren, Lowell D. Yoder, Rachel E. Aaronson, Robert A. Clary II, Puerto Rico Enacts New Excise Tax that Impacts US Companies, LEXISNEXIS COMMUNITIES, TAX

Those taxpayers affected by the multiple level of tax will not necessarily be subject to the new effectively connected income source rules. As a result, the tax cannot be considered a substitution of an income tax.

Moreover, treasury regulations provide that, in order for a foreign tax to qualify as a creditable tax, the foreign levy must be a tax.<sup>38</sup> A foreign levy is actually a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes, the payment must not be in exchange for a specific economic benefit, as defined by the Regulations, and the payment must not be refunded or credited. "An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven."<sup>39</sup> It is important to highlight that the proposed regulations allow for credits that could provide partial relief from the excise tax or even wipe out the tax in some cases. Credits that may offset the excise tax include:<sup>40</sup>

General credit against tax: \$4 million in 2011; after 2011, the excise tax rate is divided by 4% times \$4 million. No unused credit may be carried forward or back or refunded.

Alternative credit based on gross receipts: In lieu of the general credit, a controlled group may elect this credit if it meets certain conditions. The credit begins at \$7 million in 2011 but reduces each year thereafter.

Alternative credit where taxable acquisitions exceed certain thresholds: some controlled groups with taxable acquisitions of \$4 billion or more that employ 500 employees or more with a payroll of \$20 million may elect this credit. For 2011, the amount of the credit varies from \$20 million to \$80 million, based on the dollar amount of taxable acquisitions.

Addition to alternative credit for incremental increase in employees: An additional credit may apply if the number employed by the controlled group in Puerto Rico exceeds 500 by at least 100. The credit ranges from \$750,000 to \$3.75 million, depending on the number employed. This credit applies for companies with taxable acquisitions in excess of \$4 billion.

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LAW COMMUNITY, PRACTITIONERS CORNER (Nov. 7, 2010, 01:58 PM), <http://www.lexisnexis.com/Community/taxlaw/blogs/practitionerscorner/archive/2010/11/07/puerto-rico-enacts-new-excise-tax-that-impacts-u-s-companies.aspx>.

<sup>38</sup> See U.S. Internal Revenue Code Regs. § 1.901-2.

<sup>39</sup> U.S. Internal Revenue Code Regs. § 1.901-2(e)(2)(i).

<sup>40</sup> PricewaterhouseCoopers, *supra*, note 15.

Controlled groups with manufacturing and production facilities in multiple municipalities in Puerto Rico: A controlled group that has members engaged in manufacturing and production or manufacturing services in facilities located in three or more PR municipalities and employing more than 50 may be eligible for a credit of \$3 million per municipality, up to a maximum of \$15 million.

Minority suppliers: A controlled group that makes direct purchases of goods or services from an approved minority business equal to or in excess of 75% of its total purchases of goods and services may be eligible for a credit based on how much these purchases exceed the average annual amount purchased from minority businesses during the preceding two years.

Knowledge corridor and research and development investment credit: A controlled group may be eligible for a credit based on its contributions to the Puerto Rico Science, Technology and Research Trust or Special Economic Development Fund. A cap of either 1% or 2% of the excise tax would apply.<sup>41</sup>

Accordingly, these credits could have the effect of eliminating the tax in some circumstances. As a result, the excise tax will not be considered a 'tax' as defined by the regulations, since the credit may wipe out the levy. Consequently, if the foreign levy is not considered a tax, it fails to meet one of the requirements to be creditable as a foreign tax under the U.S. Internal Revenue Code. As such, for all the reasons explained above, it could be determined that the excise tax imposed by the Puerto Rico Act 154 is not creditable against U.S. taxes.

Furthermore, it is important to mention that on April 18, 2011, the IRS issued Notice 2011-29. The Notice provides that the determination of the creditability of the Excise Tax imposed by the Puerto Rico Act 154 requires the resolution of a number of legal and factual issues, and that pending the resolution of those issues, the IRS will not challenge a taxpayer's position that the Excise Tax is a tax in lieu of an income tax under section 903.

However, any non-US foreign business that purchases goods or services, as defined by Act 154, from a Puerto Rico affiliate could not take a foreign tax credit for the excise tax paid in Puerto Rico, as "tax credits do not apply to foreign sales, which account for a large proportion of what is manufactured in Puerto Rico."<sup>42</sup>

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<sup>41</sup> Id.

<sup>42</sup> Goyco Covas, *supra*, note 12.

## VII. CONSTITUTIONAL ASPECTS OF EXCISE TAX

### A. Export Taxes Prohibition

The Foraker Act, also known as the Organic Act of 1900, was enacted into law with the purpose of creating a civil government in Puerto Rico.<sup>43</sup> It also provided that the laws of the United States, that were not locally inapplicable, would be applicable to Puerto Rico. However, it expressly stated that the U.S. internal revenue laws were not applicable to Puerto Rico.<sup>44</sup> This section remained valid with the enactment of the Jones Act<sup>45</sup> and with the Federal Relations Act<sup>46</sup>.

On March 24, 1927, Section 3 of the Jones Act was amended to include what has been known as the Butler's Amendment. Section 3 of the Jones Act expressly forbids export taxes; however, the Butler's Amendment conferred the power to the Government of Puerto Rico to impose taxes on imports provided that no discrimination shall be made between local products and foreign products.

SEC. 3. That no export duties shall be levied or collected on exports from Porto Rico but taxes and assessments on property, income taxes, internal revenue, and license fees, and royalties for franchises, privileges, and concessions may be imposed for the purposes of the insular and municipal governments, respectively, as may be provided and defined by the Legislature of Porto Rico; and when necessary to anticipate taxes and revenues, bonds and other obligations may be issued by Porto Rico or any municipal government therein as may be provided by law, and to protect the public credit.

*And it is further provided,* That the internal-revenue taxes levied by the Legislature of Porto Rico in pursuance of the authority granted by this Act on articles, goods, wares, or merchandise may be levied and collected as such legislature may direct, on the articles subject to said tax, as soon as the same are manufactured, sold, used, or brought into the island: *Provided,* that no discrimination be made between the articles imported from the United States or foreign

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<sup>43</sup> Foraker Act, ch. 191, 31 Stat. 77 (1900).

<sup>44</sup> Foraker Act, ch. 191, 31 Stat. 77, § 14 (1900).

<sup>45</sup> Jones Act – Puerto Rico Federal Relations Act, ch. 145, 39 Stat. 951 (1917).

<sup>46</sup> 48 U.S.C. § 734 (1955).



countries and similar articles produced or manufactured in Puerto Rico.<sup>47</sup>

Clearly, the excise tax imposed on the purchase of products manufactured in Puerto Rico by nonresident businesses can be denominated as an export duty. The tax is imposed according to value of the personal property and services acquired in Puerto Rico by the foreign entity. Therefore, there is discrimination between the local entity and the foreign entity. This discrimination was made on purpose since the local entity usually has a tax grant that provides several tax reliefs and exemptions. As a result, the government imposes the tax on the foreign affiliate that does not have an agreement with the government. In *San Juan Trading v. Sancho*<sup>48</sup>, the Court established that the government may make *reasonable* classifications. It is arguable whether the excise tax imposed on the manufacturing industry, which specifically affects forty to fifty multinationals, is a reasonable classification. Butler's Amendment forbids the discrimination between local manufactured products and foreign products. However, the pertinent case law attacks taxes that discriminate in favor of local manufactured products, since in most cases the government imposes taxes to promote local products.

In this case, it can be argued that Act 154's excise tax discriminates against locally manufactured products. But still, it discriminates between local products and foreign products. Relevant case law has established that it can be discriminated when the local benefit is only incidental<sup>49</sup>, since there are reasonable categories, when it is a hypothetical discrimination<sup>50</sup>, and when it is expressly authorized by the U.S. Congress<sup>51</sup>. However, in this case we have an export duty, which is expressly forbidden, that discriminates between the Puerto Rico affiliates and the foreign entities without any reasonable classification.

#### B. Due Process and the Privileges and Immunities Clause

The taxing power of Puerto Rico arises in Article 6, Section 2 of the Constitution. However, this power is limited by the Butler's amendment, as explained above, and by the constitutional disposition of the due process clause.

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<sup>47</sup> Jones Act – Puerto Rico Federal Relations Act, ch. 145, 39 Stat. 951, § 3 (1917).

<sup>48</sup> *San Juan Trading Co. v. Sancho*, 114 F.2d. 969 (1st Cir. 1940).

<sup>49</sup> See *U.S. Brewers Ass'n v. Srio. De Hacienda*, 109 P.R. Dec. 456 (1980).

<sup>50</sup> See *Texaco Puerto Rico v. Descartes*, 304 F.2d. 184 (1st Cir. 1962).

<sup>51</sup> See *Pan American Standard Brands v. United States*, 177 F. Supp. 769 (1st Cir. 1959)

No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.<sup>52</sup>

The Supreme Court of Puerto Rico established in *International Harvester v. Srio. De Hacienda*<sup>53</sup> the requirements to comply with the due process clause in the process of imposing any tax: there should be a nexus between the taxed activity and the state; and the taxable income must be reasonably linked to the activity that realizes the taxpayer in the state. There should be a reasonable nexus between the contribution to be paid and the benefits that are offered to taxpayers by the state.

The government of Puerto Rico has constantly promoted the island as an investment destination, and has even proposed organizational structures for the business entities to benefit from the tax incentives offered through tax grants. Puerto Rico has made direct invitations to manufacturing entities to create jobs in the island by manufacturing their products in Puerto Rico, and the government provides several tax incentives in exchange. The corporations that have accepted the invitation to produce in Puerto Rico have been organized in a way in which they can benefit from the tax incentives. As such, they have created a Puerto Rico Corporation to manufacture the products and several foreign affiliates to make business worldwide. It is clear that each affiliate is a separate taxpayer.

Act 154 imposes an excise tax to the purchaser of manufactured products in Puerto Rico through a Puerto Rico affiliate. The taxpayer is the purchaser not the manufacturer.<sup>54</sup> Therefore, the manufacturer has a nexus with the Puerto Rico jurisdiction, but the taxpayer -the purchaser- does not have any substantial nexus. The taxpayer does not have a reasonable nexus between the contribution to be paid and the benefits that are offered to taxpayers by the state, since all the benefits of the state are provided to the PR affiliate not the foreign affiliate. In addition, the taxpayers affected by this multi-level tax do not have any contact with the jurisdiction.

Furthermore, the Privileges and Immunities Clause has been expressly extended to Puerto Rico by the Congress<sup>55</sup>. In *Postley v. Srio. De Hacienda*<sup>56</sup> the Puerto Rico Supreme Court established that Puerto Rico cannot treat United States citizens as foreign taxpayers. This case discusses

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<sup>52</sup> U.S. CONST. amend. XIV, § 1.

<sup>53</sup> *Int'l Harvester v. Srio. De Hacienda*, 114 P.R. Dec. 281 (1983).

<sup>54</sup> P.R. Internal Revenue Code § 2101(a)(2).

<sup>55</sup> 48 U.S.C. § 737 (1950).

<sup>56</sup> *Postley v. Srio. De Hacienda*, 75 P.R. Dec. 874 (1954).

the constitutionality of a 29% tax imposed to citizens of the United States that are non-residents of Puerto Rico. The Supreme Court declared the tax unconstitutional because it was arbitrary. Similarly, the excise tax imposed by Act 154 treats U.S. affiliates as foreign affiliates. Consequently, after discussing the provisions and case law regarding the privileges and immunities clause, one cannot help but reach the conclusion that Act 154's excise tax should be declared unconstitutional.

### C. Commerce Clause

In *Sea Land Services, Inc. v. The Municipality of San Juan*<sup>57</sup>, the Federal District Court for the District of Puerto Rico held that the Dormant Commerce Clause is applicable to Puerto Rico. The reasons that led Congress to adopt a commerce clause also apply to Puerto Rico. Furthermore, the prohibition placed upon individuals to prevent the flow of interstate trade by imposing tax barriers is applicable to Puerto Rico. The Court expresses the following requirements for a tax to be in compliance with the Commerce Clause:

The Commerce Clause "requires 'some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax' "

The tax must be allocated in a fair and equitable way

The tax must not discriminate against the interstate commerce

The tax must be related to significant services provided by the tax jurisdiction

In terms of the substantial link, the federal Supreme Court held in *Quill Corp. v. North Dakota*<sup>58</sup>, that the test of nexus for the due process is different from the nexus required for the commerce clause. The former is related to the minimum contacts and reasonable notice, while the latter is related to the interstate commerce and the national economy. As such, the nexus under the commerce clause must be stronger than that for due process. The Court explained that a business must have physical presence in the jurisdiction in order for the state to impose a tax burden. Consequently, the excise tax imposed by Act 154 must be declared unconstitutional, since

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<sup>57</sup> *Sea-Land Services v. Municipality of San Juan*, 505 F. Supp. 533 (D.P.R.1980).

<sup>58</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

the tax liability is imposed on foreign affiliates that do not have physical presence in Puerto Rico.

The 'nexus' is supplied if the corporation avails itself of the 'substantial privilege of carrying on business' within the State. The corporations that have physical presence in Puerto Rico are the Puerto Rico affiliates, a separate entity from the purchaser, and they are not considered the taxpayers. The Puerto Rico affiliates are the business entities that have the privilege of carrying business within the island. Another requirement is that the tax must be related to significant services provided by the tax jurisdiction. But, as explained, these taxpayers do not have any substantial nexus with the jurisdiction, and, therefore, do not receive any service from the jurisdiction. They receive the products from the manufacturer company in Puerto Rico, but do not receive any benefit or service from the state.

The other requirement is that the tax must be allocated in a fair and equitable way, and must not discriminate against the interstate commerce. The excise tax is imposed on the value of the product, and will be collected by the Puerto Rico affiliate. The fairness of the tax is questionable, since it is imposed to specific taxpayers (forty to fifty multinationals). The tax was effective almost immediately without the opportunity of any public hearing and any reasonable notice. The companies were unable to plan for the impact of the additional production costs, which included a substantial addition of 4%. The tax rates are phased down gradually, but the greatest impact of 4% was effective immediately. Additionally, the excise tax penalizes the purchase of products from Puerto Rico, which have a direct effect against the interstate commerce.

Therefore, the excise tax should be considered unconstitutional as it violates the commerce clause.

### VIII. CONCLUSION

The Government of Puerto Rico has actively promoted the island as an investment destination for manufacturing plants. Puerto Rico offered tax incentives that functioned in such a way that, if the distribution operations were conducted by a corporation organized outside Puerto Rico and the products were manufactured and purchased by an affiliate outside Puerto Rico, the foreign-source income derived from the sale of products with title passing outside Puerto Rico would not be considered as effectively connected with the Puerto Rico trade or business of the corporation and, therefore, would be exempt from Puerto Rico income tax. Therefore, many companies utilized the jurisdiction as its main manufacturing plant for tax incentives in exchange of creating jobs. These corporations searched for a stable and trustworthy tax jurisdiction. However, Act 154 eliminated the benefits of such corporate structures and developed uncertainty and disappointment

within the manufacturing industry, which is the primary industry of our economy.

The Government of Puerto Rico, in order to control the expressions of the manufacturing industry, has emphasized that the excise tax applies to the foreign affiliates of the eligible business that have a tax grant with the government. However, it has been expressed that

the grant of tax benefits to manufacturing and eligible services is statutorily characterized as a contract with the government of Puerto Rico in an effort to constitutionally shield the tax benefits from future legislation impairing such benefits before the holiday period expires.<sup>59</sup>

Therefore, Act 154 is a legislation that impairs the benefits of such companies, since it imposes an excise tax that increases production costs without adding value.

In addition, the government has declared that the excise tax should be creditable as a foreign tax credit in the United States. However, after analyzing the tax, it can be concluded that it does not meet the requirements to be creditable as a foreign tax under the U.S. Internal Revenue Code, since it is not a 'generally imposed tax' nor is it considered a tax as defined by the regulations, since the proposed credits could have the effect of completely eliminating it.

Furthermore, Act 154 expressly establishes that the taxpayer is the purchaser of the products manufactured in Puerto Rico, which creates a constitutional issue. For such reason, we analyzed the constitutional aspects under the Puerto Rico statutes and case law. First, under the Jones Act, the excise tax is considered unconstitutional since it is an export duty, which is expressly forbidden. Under the due process analysis, the excise tax is also unconstitutional, because the taxpayer does not have a reasonable nexus between the contribution to be paid and the benefits that are offered to taxpayers by the State. By analyzing the tax under the privileges and immunities clause, it must also be deemed unconstitutional seeing as it treats US business entities as foreign entities. Finally, under the commerce clause, it is also unconstitutional, because the excise is imposed on taxpayers that do not have physical presence in the jurisdiction and it penalizes the purchase of products from Puerto Rico.

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<sup>59</sup> Goyco Covas, *supra* note 6.

Consequently, the excise tax created by Act 154 is an unconstitutional tax that cannot be creditable as a foreign tax in other tax jurisdictions and one that has detrimentally impacted the manufacturing industry as well as Puerto Rico's economy.