



ASSOCIATION FOR  
FINANCIAL  
PROFESSIONALS

Puerto Rico

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# Federal Initiatives to Jumpstart the Local Economy

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# Presenter

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# Economic and Historic Background

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# US Internal Revenue Code Section 936

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- Creation
- Concept and Example
- Economic Analysis
- Termination

# Local Economic Status (1948)

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- Section 936 was adopted in 1948
  - Original Version Section 262 was adopted in 1921
- Intended to help compete with Philippines
  - Philippines was a possession until 1946 when it was granted independence
  - World War 2
- Coordinate with Operation Bootstrap (“Manos a la Obra”) - Tansill, PR: Independence or Statehood, Revista Colegio de Abogados 41 (1980); 93
  - Cheap Labor
  - Income Tax Exemption for 25 years (along with federal exemption)
  - Assistance in Building Plants

# 936 Basic Requirements

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- A 100% income tax credit was granted
- Must comply with:
  - 80% of the income must be derived in the possession
  - 75% must be from an active trade or business in Puerto Rico
- Credit was granted for Qualified Possession Source Investment Income (QPSII)
  - Local tollgate taxation was imposed

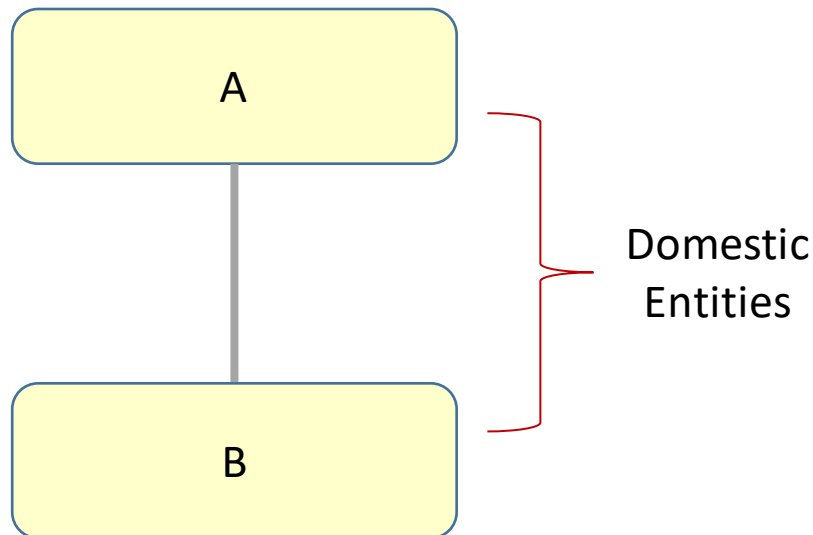
# Puerto Rico's Reaction

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- Tax Incentive Acts of
  - Act of 1948
    - 10 year extension (1954)
  - Industrial Incentives Act of 1963
  - Industrial Incentive Act of 1978
  - Tax Incentive Act of 1987
  - Tax Incentive Act of 1998
  - Economic Incentives Development Act of 2008
    - Act 20-2012

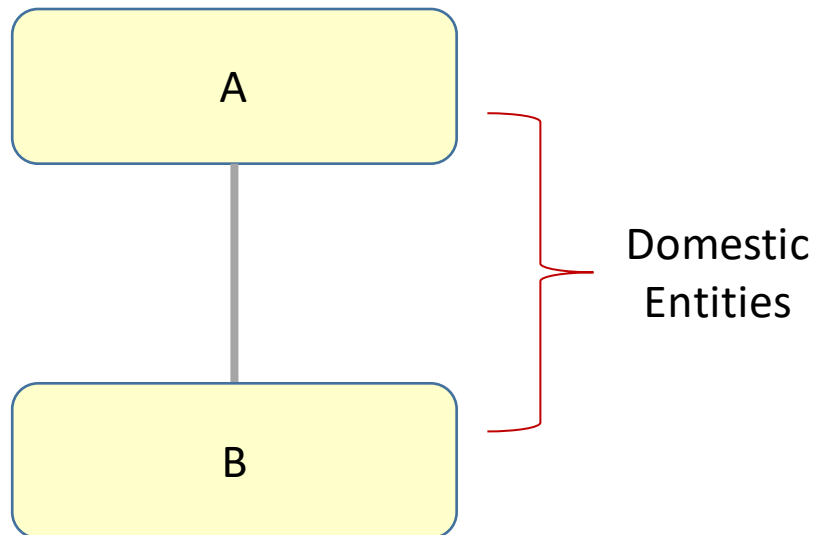


# Example 1 – Regular Scenario



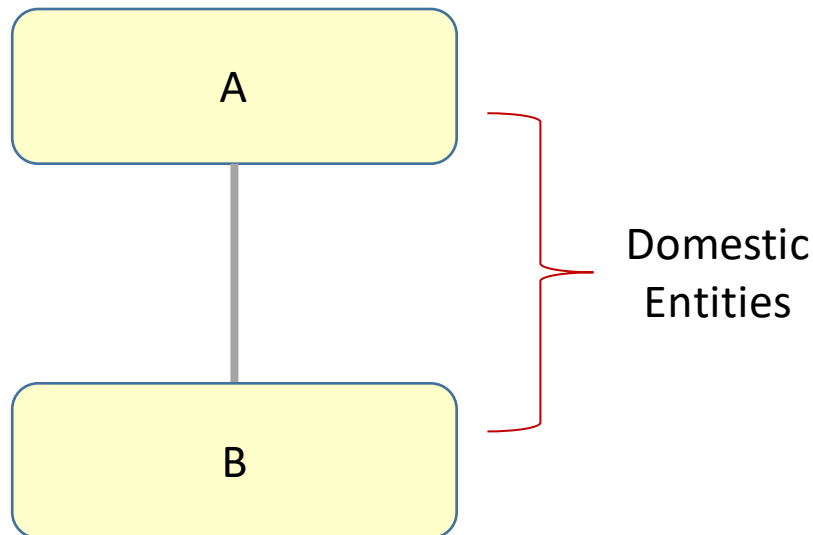
	<b>Taxes Paid</b>	
	<b>US</b>	<b>PR</b>
Tax Rates	35%	39%
Net taxable Income	\$ 1,000	\$ 1,000
Tax Credit	\$ 350 (390)	\$ 390 -
	\$ (40)	\$ 390

# Example 2 – PR Exemption Only



	<b>Taxes Paid</b>	
	<b>US</b>	<b>PR</b>
Tax Rates	35%	39%
Net taxable Income	\$ 1,000	\$ 1,000
Tax Credit	\$ 350	\$ -
	\$ 350	\$ -

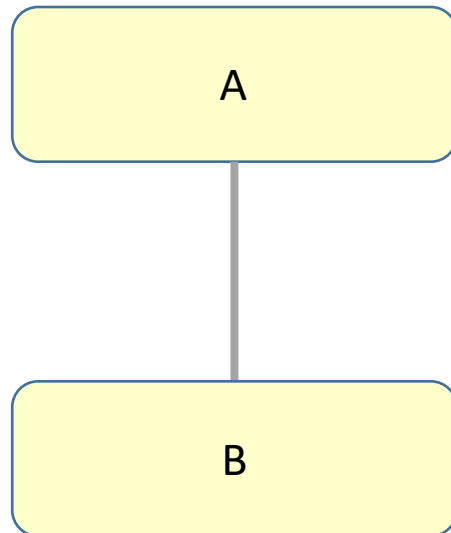
# Example 3 – US Exemption Only



	Taxes Paid	
	US	PR
Tax Rates	35%	39%
Net taxable Income	\$ 1,000	\$ 1,000
Tax Credit	\$ -	\$ 390
	\$ -	\$ 390

# Example 4 – Both Exemptions (936)

## Section 936



Domestic  
Entities

### Taxes Paid

	US	PR
Tax Rates	35%	39%
Net taxable Income	\$ 1,000	\$ 1,000
Tax Credit	\$ 350 (350)	\$ 390 (390)
	\$ -	\$ -

# Challenges

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- Incentive to allocate income to Puerto Rico
- Cost to Federal Government
  - Cost of the Incentive
  - Cost Per Employee



# Allocation to Puerto Rico

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- Forced to create transfer pricing methodologies
- Specific methods were set for Puerto Rico (1982)
  - Cost Sharing
  - Profit Split

# Consideration to Repeal

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- Congressional Budget Office
  - Potential Economic Impact of Changes to PR Status (1990)
  - “Several arguments suggest that Section 936 corporation in Puerto Rico may not reduce their investment significantly if the island were to become a state, but CBO has not incorporated all of them into this analysis.”
  - Factors
    - High Profit Margins
    - Lack of Response to TEFRA (1982)
    - Other Cost Advantages of Puerto Rico

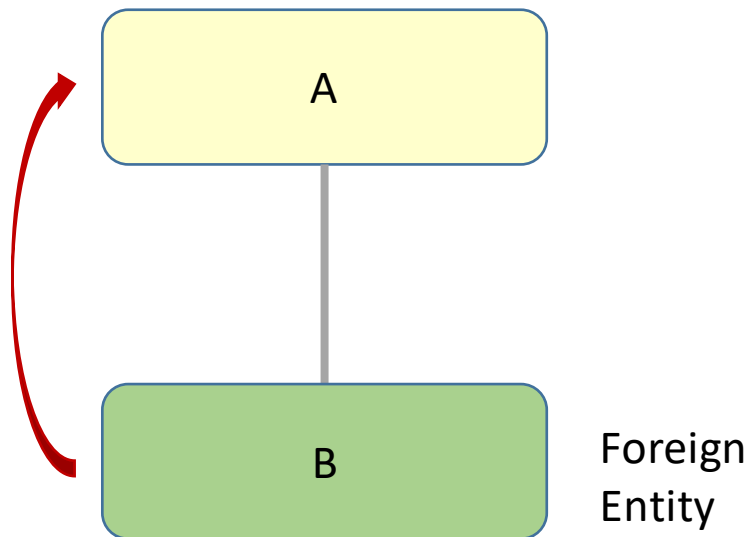
# Repeal of Section 936

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- Repealed in Small Business Job Protection Act of 1996
- 10 year transition (1996-2005)
- Methodologies
  - Percentage Limitation
    - From 100% to 60%-40%
  - Economic Activity Limitation
    - Salaries
    - Depreciation
    - Investment



# Controlled Foreign Corporation

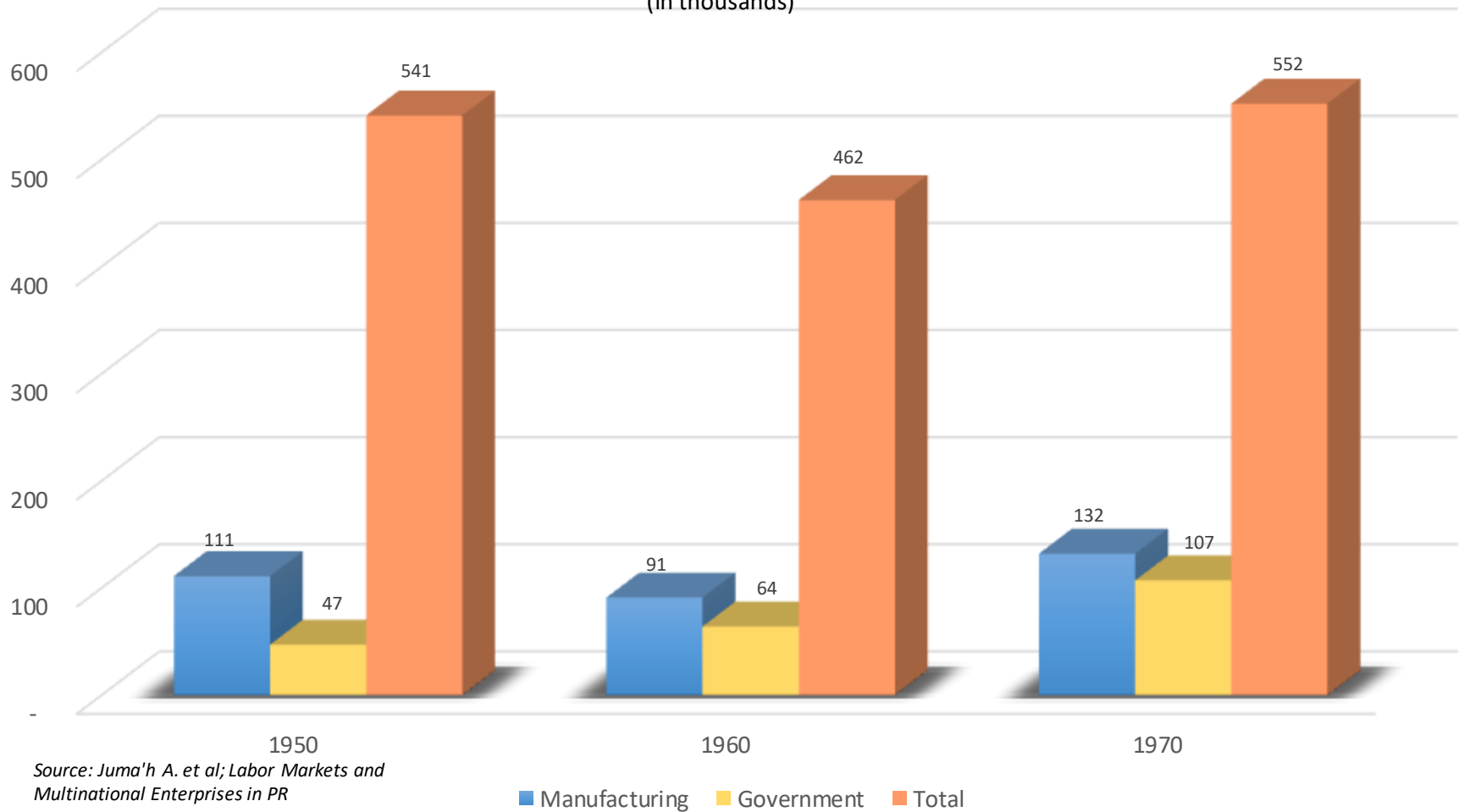


	Taxes Paid	
	US	PR
Tax Rates	35%	4%
Net taxable Income	\$ 1,000	\$ 1,000
Tax	\$ 350	\$ 40
Credit	(40)	-
	\$ 310	\$ 40

US Tax imposed upon dividend payment.  
Same tax regime as any other foreign jurisdiction

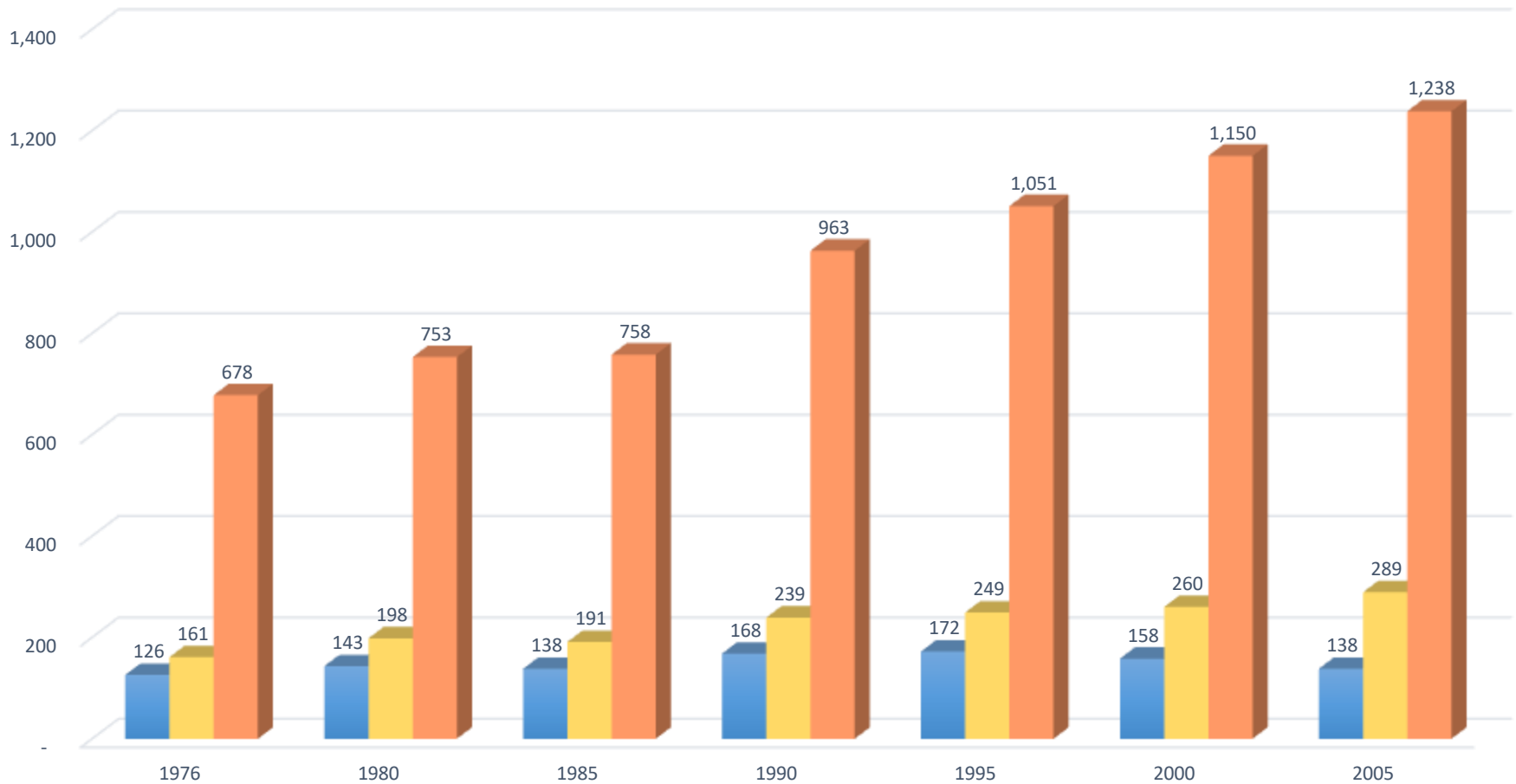
## Number of Persons Employed by Major Industrial Sector Fiscal Years 1950-1970

(in thousands)



## Number of Persons Employed by Major Industrial Sector Fiscal Years 1976-2005

(in thousands)

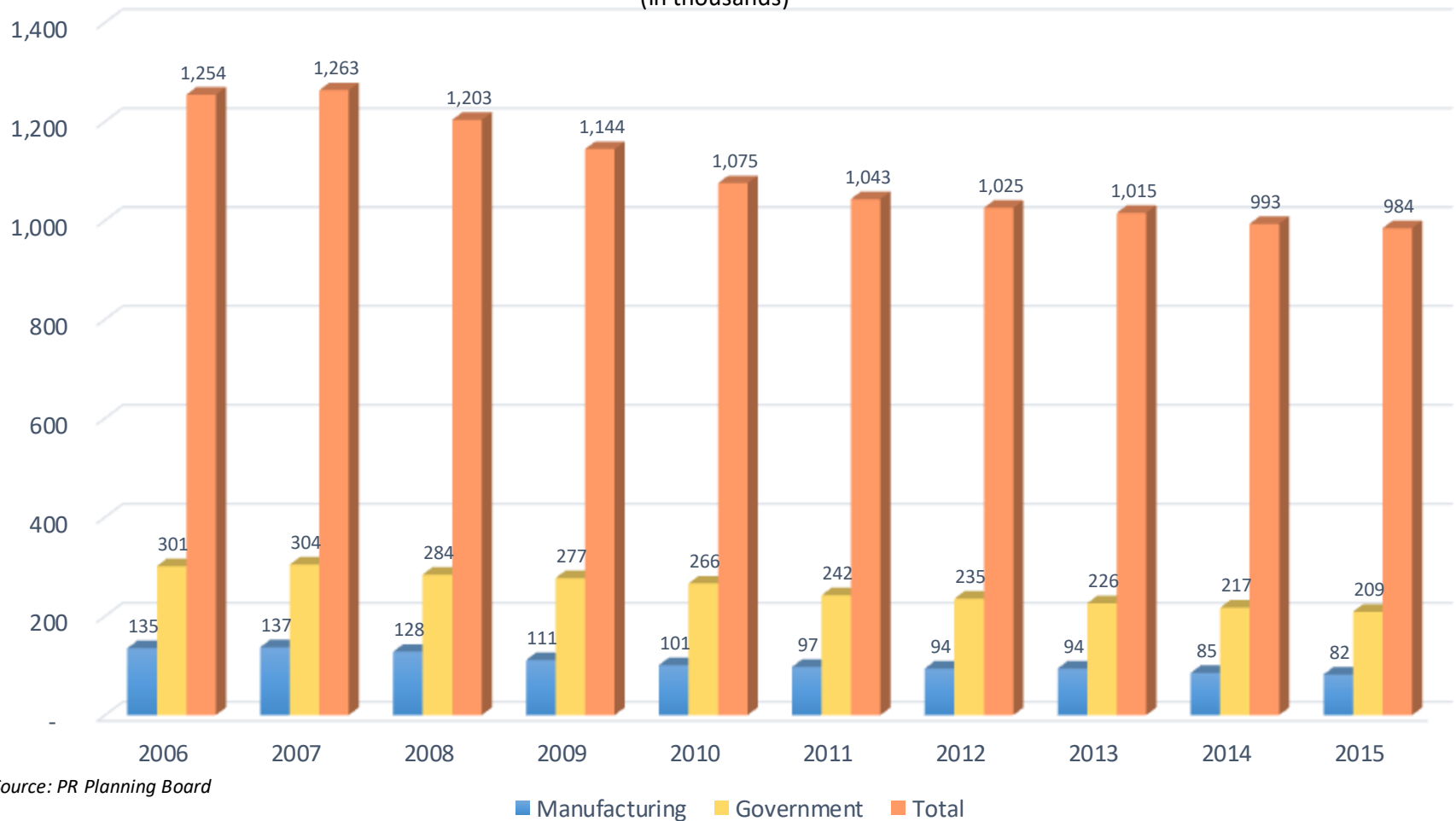


Source: PR Planning Board

■ Manufacturing ■ Government ■ Total

## Number of Persons Employed by Major Industrial Sector Fiscal Years 2006-2015

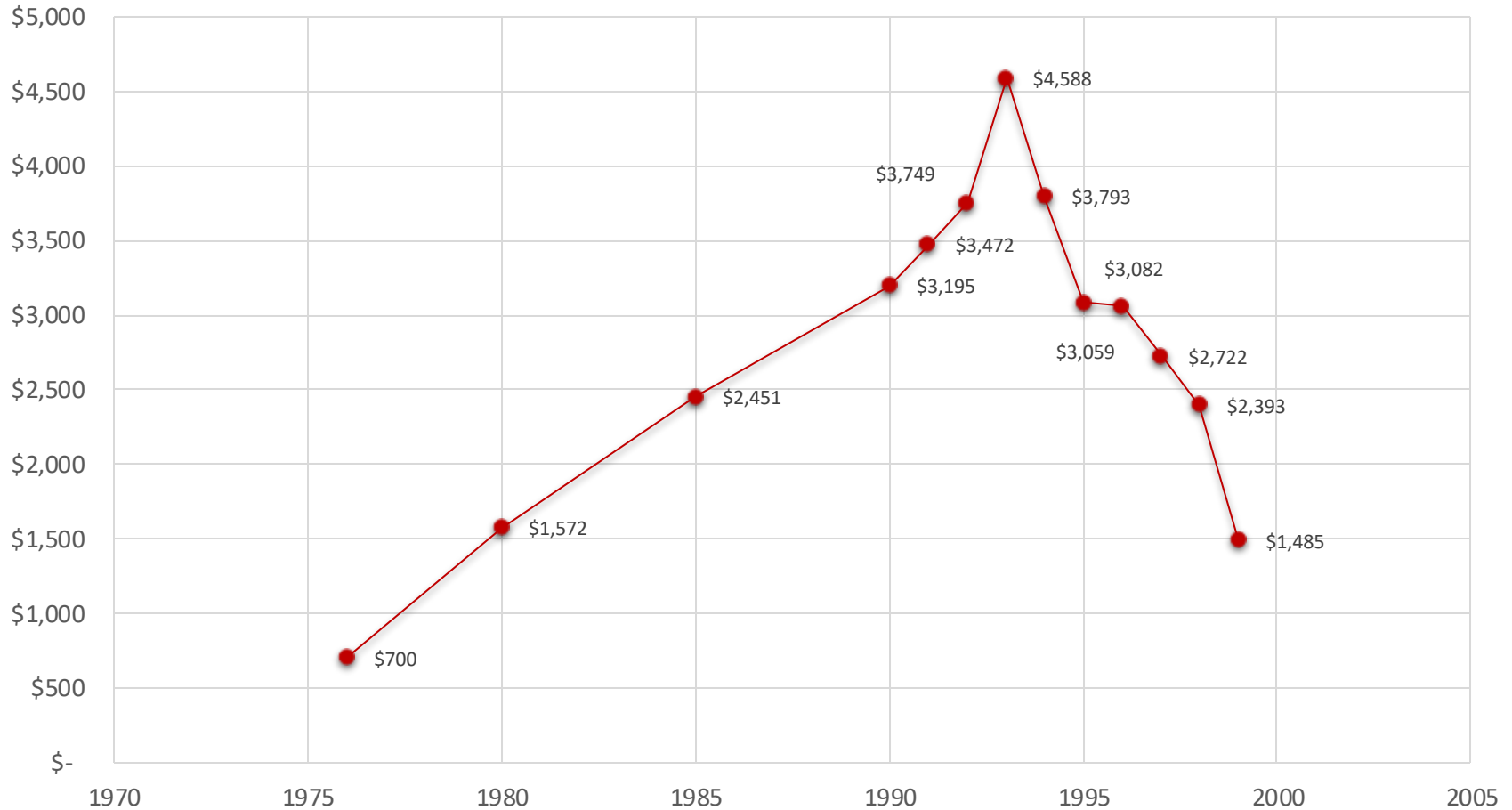
(in thousands)



Source: PR Planning Board

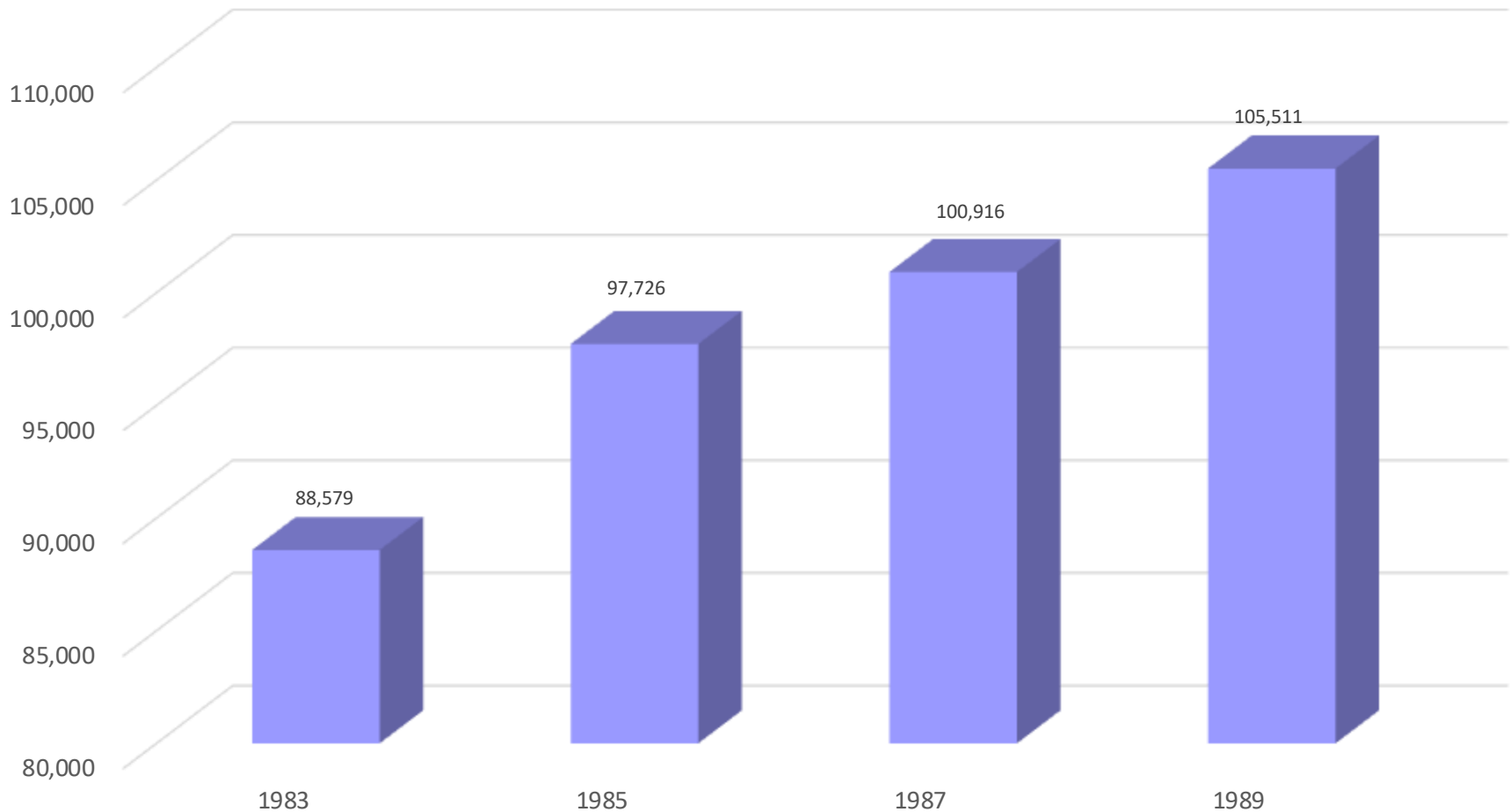
## Possessions Tax Credit

(in millions of \$)



Source: James L. Dietz; Puerto Rico  
 Negotiating Development and Change

## Estimated Number of Employees of Section 936 Manufacturing Corporations

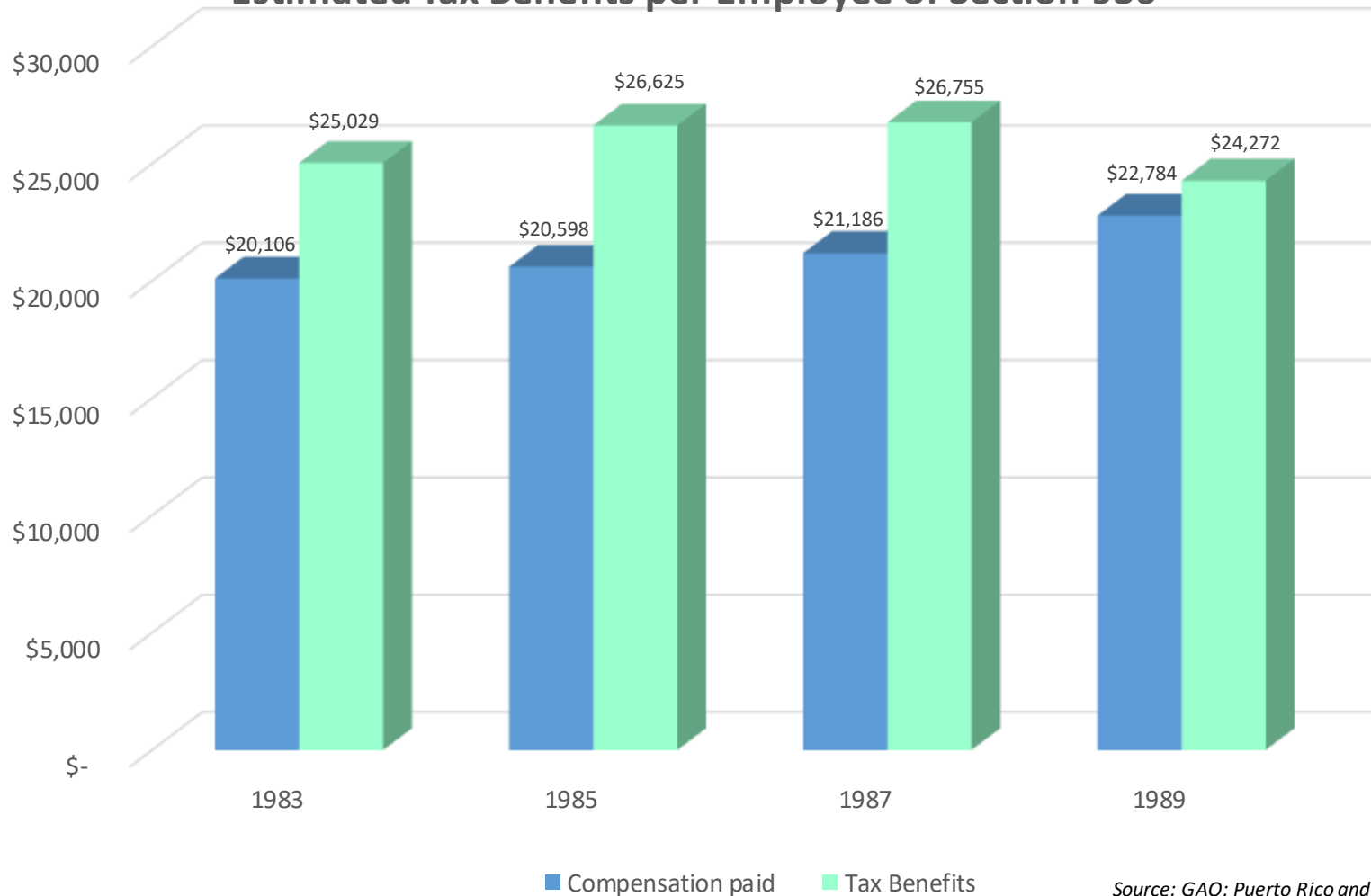


Source: GAO; Puerto Rico and the Section 936  
Tax Credit (June 1993)

## Estimated Compensation Paid per Employee of Section 936

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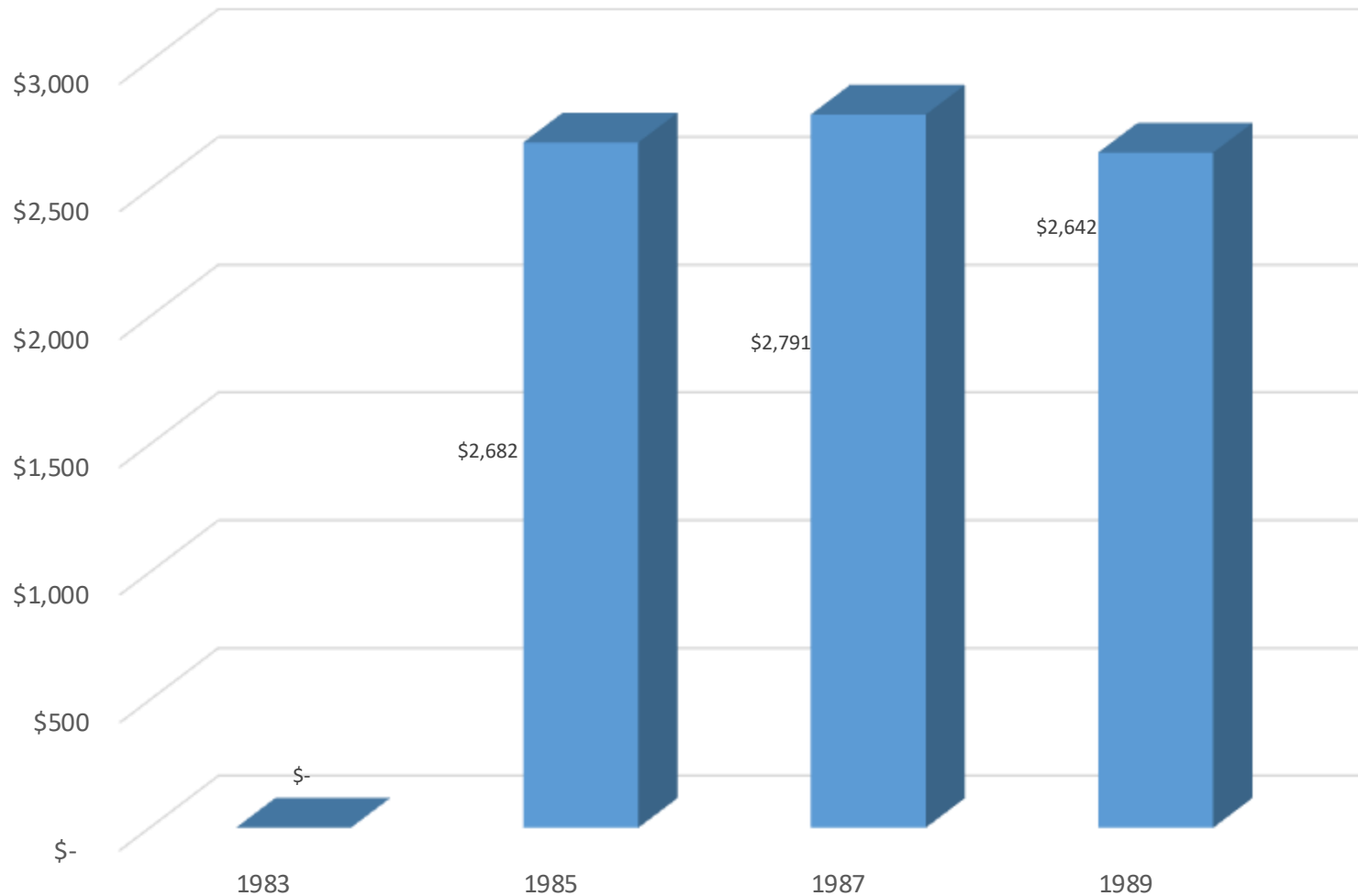
## Estimated Tax Benefits per Employee of Section 936



Source: GAO; Puerto Rico and the  
 Section 936 Tax Credit (June 1993)

**TRUSTworthy**

## Estimated Tax Benefits of Sections 936 Corporations



Source: GAO; Puerto Rico and the  
 Section 936 Tax Credit (June 1993)





# U.S. Tax System

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# Types of tax systems

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- Worldwide Regime
  - Required to pay income taxes on worldwide income
    - Mitigation: Foreign Tax Credits
- Territorial Regime
  - Required to pay income taxes only on income generated within the country

# World Tendencies - Rates

- Average top corporate income tax rate (188 countries)
  - In 2016 was 22.5%
  - In 2003 was 30%
- Region
  - Europe (lowest) 18.88%
- United States
  - 38.92%
  - 3<sup>rd</sup> Highest in the World
  - Highest in OECD
- Puerto Rico
  - 39%
  - 2<sup>nd</sup> Highest in the World
    - Highest United Arab Emirates – 55%
- Source Tax Foundation Fiscal Fact 525 Corporate Income Tax Rates 2016 (August 18, 2016)



# Transfers of gains

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- Concept
  - Transfer pricing
  - Base Erosion Profit Shifting

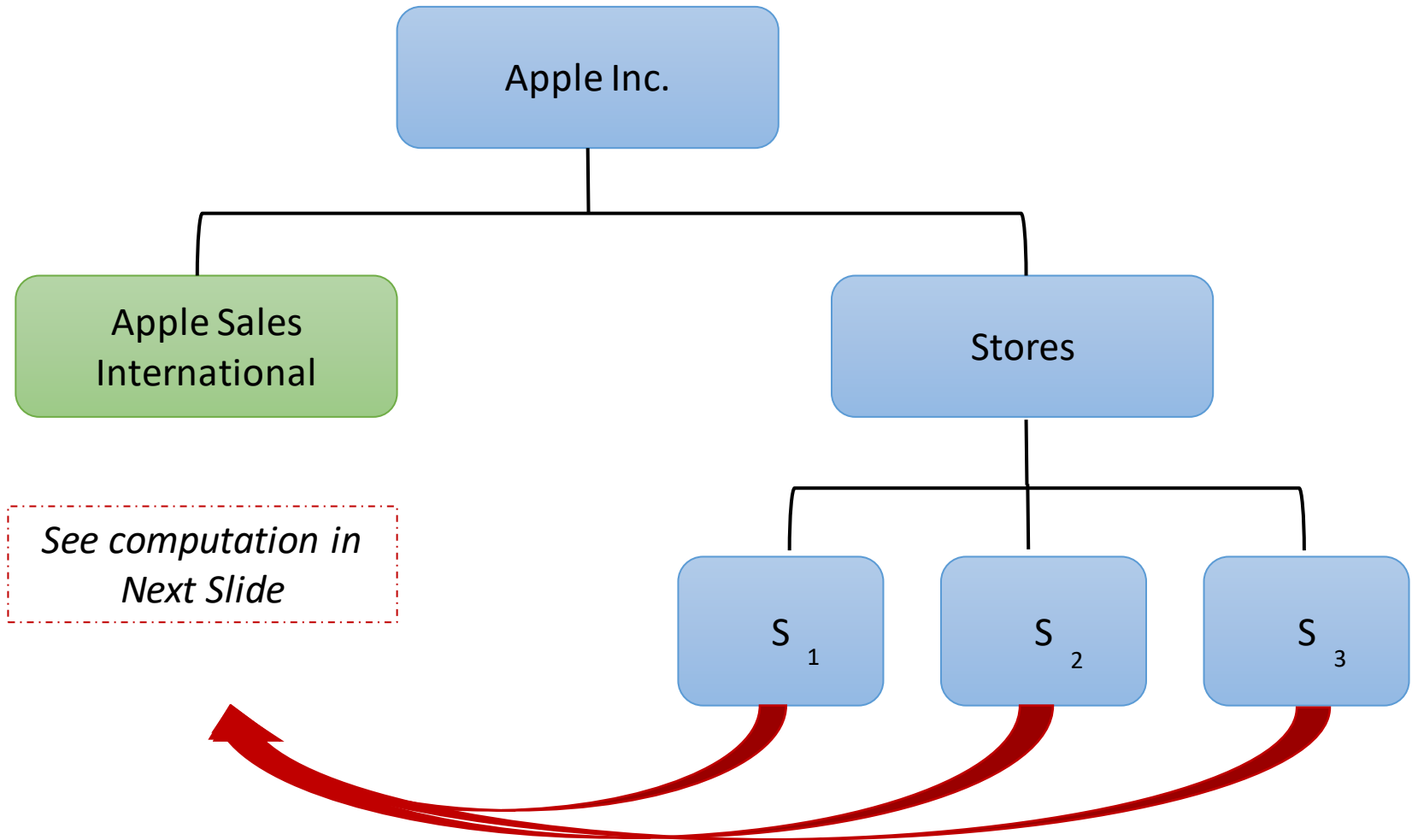


# Shamrocks and Apples

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- Ireland
  - Basic Corporate Tax Rate 12.5% (1998)
    - Prior Regular Rate 50%
    - FDI
      - 1956-1980 – no tax
      - FDI 1980-2010 – 10%
        - Established Prior to 1998
  - Follows a territorial Regime
    - Non Tax Resident
    - Agreements





# Apple Sales International

## With Agreement

Sales	\$1,000
G&A Expenses	200
Cost of Goods	<u>500</u>
Net Taxable Income	\$ 300
APA Allocation	<u>12.5%</u>
Ireland Income	\$ 37.50
Tax Rate	<u>12.5%</u>
Taxes to be paid	<u><u>\$ 4.69</u></u>

## Without Agreement

Sales	\$1,000
G&A Expenses	200
Cost of Goods	<u>500</u>
Net Taxable Income	\$ 300
Tax Rate	<u>12.5%</u>
Taxes to be paid	<u><u>\$ 37.50</u></u>

# European Commission

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- Authorized to review compliance with EU rules
- EU does not authorize
  - State Aid
    - Reduced Rates
    - Other Benefits
- Commission Rules
  - APA between Ireland and Apple was a state aid
  - Required Apple to pay \$14.5B
    - 10 years
    - Apple's nest \$230B



# Reactions

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- Ireland
  - Plans to appeal



- Apple
  - “You can have taxes or you can have jobs, but Apple is in no mood to deliver both.”

# Other Reactions

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- United States
  - The commission “sought to impose penalties retroactively based on a new and expansive interpretation of state aid rules.”
    - BEPS Initiative
  - “appears to be targeting US companies”
  - “targets income that member states have no right to tax”
  - “could undermine US tax treaties with EU members”.

# Specific Situations

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- Starbucks
- Apple
- Fiat
- Amazon



# Current Economic Status

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# Economic Aspects

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- Actual Ranking
  - WEF
  - Taxation
- Economic Growth & Employment
- Taxation
- Financial Oversight and Management Board

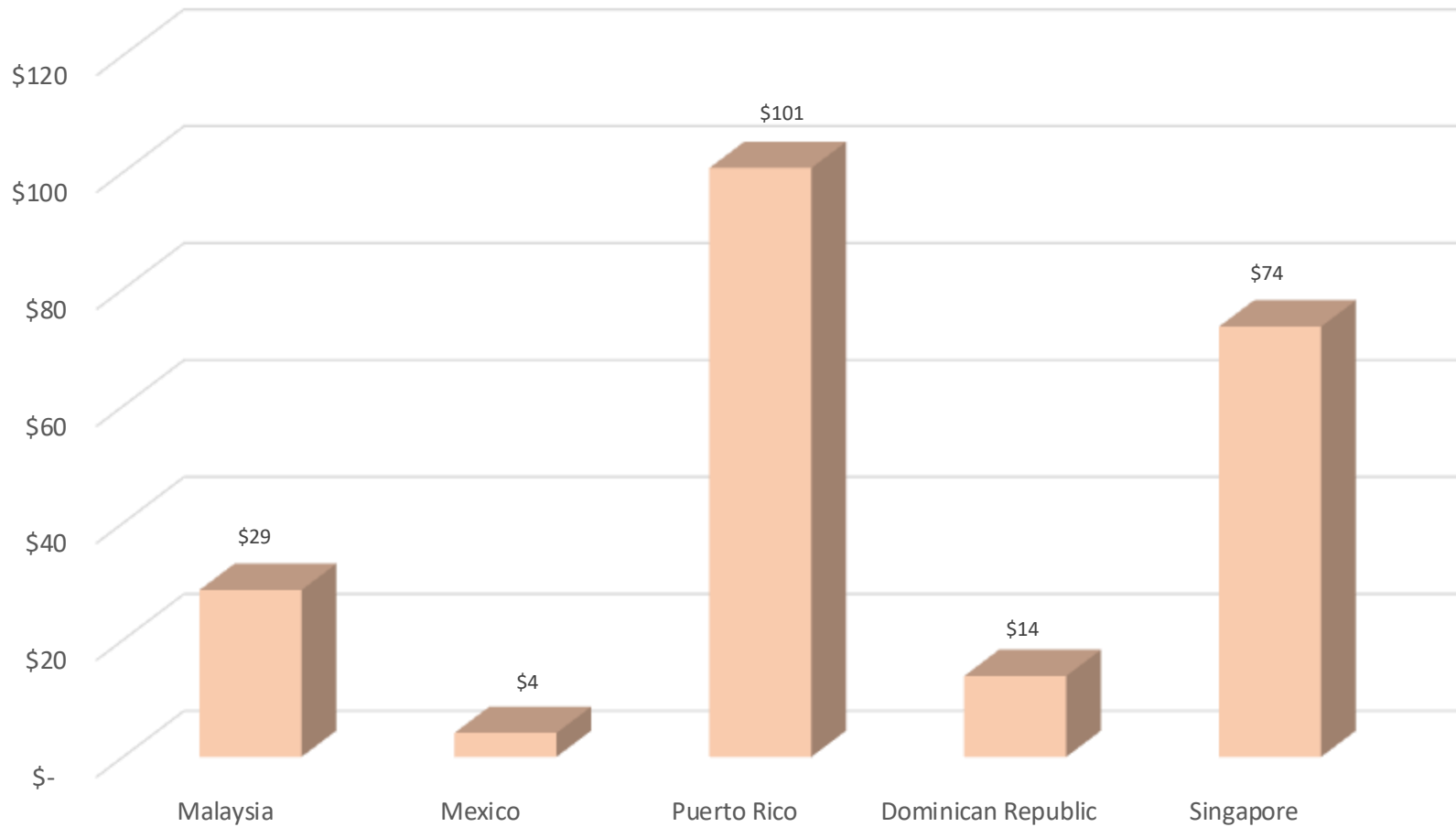


# Act 154-2010

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- Imposes a 4% tax on manufacturing operations that sell to certain affiliates outside of PR
- Is labeled as an excise on the purchaser
- IRS allowed to get a credit
- Revenues \$1.9B (20% of General Fund)
  - Expires on 2017
  - Approximately 75% applies to US companies
    - Cost to US \$1.5B

## Average basic wage for labor in manufacturing/day(\$)



Source: Juma'h A. et al; Labor Markets and Multinational Enterprises in PR

# Section 245A

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# Origin

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- Designed by the public sector
- Originally drafted as 933A
  - More aggressive and inclusive
- Included under the economic development initiatives under PROMESA

# Specific Benefits - PRMA

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- Set strong base erosion rules
- Could establish mandatory repatriation
- New investment and American jobs to US Soil
- Particular treatment to PR
- Address critical situation of territory
- Keeping proprietary knowledge in US soil

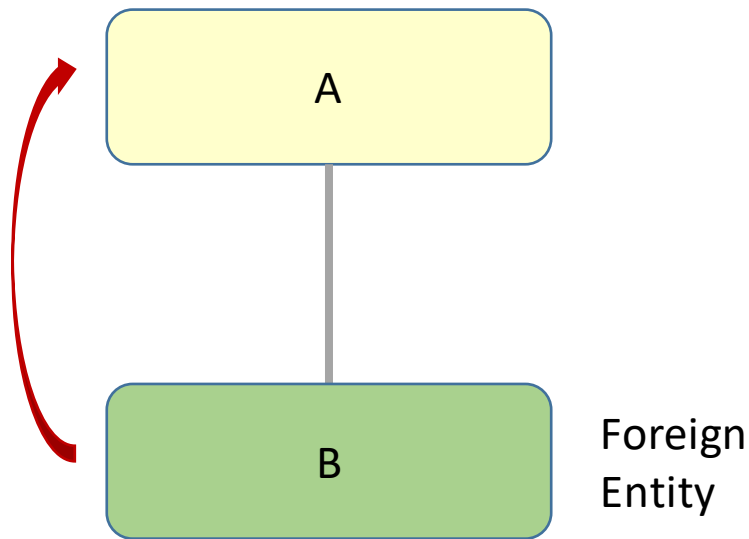
# Proposal

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- Description of Benefits
  - Allows an 85% dividend received deduction to income derived in PR, and
  - Allows a 50% income tax exemption on such income

# Example

## Section 245A



### Taxes Paid

	<b>Taxes Paid</b>	
	<b>US</b>	<b>PR</b>
Tax Rates	35%	4%
Net taxable Income	\$ 1,000	\$ 1,000
DRD (85%)	(850)	
	\$ 150	
Exemption (50%)	(75)	
Net taxable Income	\$ 75	\$ 1,000
Tax	\$ 26	\$ 40
Credit	-	-
	\$ 26	\$ 40

# Challenges

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- 936 References
- Cost to US
  - Not based on salaries or investment
- Passive Income & Foreign Tax Credit
- Upfront Payment 1<sup>st</sup> year
- Timing (end of election year)

# Other Alternatives

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- Cabotage Law
- Hub Zones
- Payroll Holiday
  - \$495M - \$550M (2%)
- Credits
  - Earned Income Credit - \$998M
  - Child Tax Credit - \$222M
  - American Opportunity - \$79M per year
    - How Statehood Would Affect Federal Programs, GAO 2014

# Questions and/or Comments

