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Offshore firms subject to permanent taxation under new ‘Source Rule’

A multinational fight expected over Puerto Rico’s precedent-setting new tax

By John Marino
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Luis Fortuño
Governor of Puerto Rico

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Agriculture program saves dollars and jobs in island chicken industry
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Front-Page STORY

Puerto Rico reaches offshore to finance its tax reform

New tax strategy called a threat to multinational business model

Gov. Luis Fortuño, left center, confers with members of his Tax Reform Commission, which worked for months on the proposal unveiled by the governor last week.

BY JOHN MARINO
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Under changes to the island's Internal Revenue Code that accompanied a new tax enacted by Gov. Luis Fortuño last week, the Puerto Rico government would be able to permanently levy income taxes on offshore firms benefiting from island production of goods and services, according to tax experts and a legal opinion of the recent changes.

While administration officials have highlighted the temporary nature of a proposed 4% excise tax for firms with gross sales above $75 million annually to offshore affiliates, firms with lower sales will be exposed to the normal 39% corporate income tax on the portion of their income found to be sourced to Puerto Rico under the new regulation, the experts added.

Moreover, while the excise tax expires after six years, and reduces down over that time to 1% in its last year, the amended "Source Rule," and the tax responsibility it spells out, is permanent, experts say.

"The Source Rule applies to income accruing after Dec. 31, 2010. The Source Rule does not contain any expiration or 'sunset' provision. It is anticipated that the Source Rule will be a permanent change to Puerto Rico's law," states a legal opinion for the government of Puerto Rico by the Steptoe & Johnson law firm, one of the top firms in Washington, D.C., that was obtained by CARIBBEAN BUSINESS.

Also, "if the excise tax does not apply for any reason, then the Source Rule applies," the legal opinion states. "If purchasers were to succeed in a challenge to the excise tax, this would simply subject the purchasers to the Source Rule instead."

Because the law states that either the Source Rule or the excise tax will apply to the offshore affiliated company, once the excise tax expires in six years, the Source Rule should apply to the firms, said Carlos Bonilla, chairman of the Puerto Rico Manufacturers Association (PRMA) Tax Committee.

The main thrust of the legal opinion is aimed at arguing why the excise tax should be fully credible for federal taxes, and the crux of the argument consists of establishing that the Source Rule is an income tax on the offshore firm that does business with an island affiliate and the excise tax is "in lieu" of that income tax.

"The Source Rule should be considered part of Puerto Rico's generally applicable Corporate Income Tax," the analysis states.

On Oct. 25, the Saturday during which the Legislature passed the legislation, top government officials, including Government Development Bank President Carlos García, met with island tax attorneys to brief them on the development. There was confusion among the officials over whether the Source Rule was permanent, according to one participant, but Philip R. West, the tax attorney who developed the new tax

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initiative, clarified that the Source Rule was permanent and would apply to all companies after the six-year excise tax phases out (see sidebar).

The private sector is reportedly mulling a push for clarification and an amendment stipulating a sunset clause for the Source Rule as well, according to one account. Administration officials have declined to discuss the technical aspects of the new tax.

Around 30 firms are expected to be taxed under the excise tax and another 30 firms under the Source Rule, for a total of 60 firms, Bonilla said.

As a general rule, nonresident corporations are not subject to Puerto Rico taxes if they are not engaged in trade or business here. Under current law, tax authorities will subject a corporation to local taxation if it receives income deemed to be attributable to an office or fixed place of business in Puerto Rico. The amendments broaden the scope of the Source Rule to include transactions between a local business and its offshore affiliates. If these transactions surpass a certain threshold, a portion of the offshore affiliate's income is considered Puerto Rico-source income and is subject to Puerto Rico taxation under the new rule.

The amended regulation and the new 4% excise tax only apply to the offshore firms that purchase goods and services from affiliated local manufacturers. Such transactions must account for at least 10% of the offshore affiliate's total and meet other conditions in order for the income-tax rule to apply.

Under the Source Rule, the apportionment of the offshore firm's earnings that is sourced to Puerto Rico will be determined by an analysis involving the quantity and type of transactions taking place between the island and offshore affiliates, and a comparison of their property, payroll and other holdings. An alternate formula would levy an income tax on the earnings from 50% of Puerto Rico property sales, which would mean an effective tax rate of 19.5%, if applying half the current corporate tax rate.

A MULTINATIONAL TAX FIGHT

Written by the best tax law minds in the United States, the tax initiative deftly avoids violating existing tax-exemption decrees with local manufacturers, while levying an income tax on their related firms that benefit from their production.

Gov. Luis Fortuño

Government Development Bank President Carlos García

Because the tax is placed on the offshore, U.S. or foreign corporation, the island government is not violating its tax-exemption decrees with the local manufacturer, and a tax should be able to be used as a dollar-for-dollar tax credit against federal taxes owed, according to the administration's top flight, Washington, D.C. legal counsel.

Moreover, both taxes also are easy to enforce as the local manufacturer must collect the tax at the moment of sale from the affiliate and remit it to the Puerto Rico Treasury Department.

"This is all set," Senate President Thomas Rivera Schatz said of the new excise tax on the multinationals, saying it was carefully planned for months by La Fortaleza and its tax experts in Washington, and was written up in consultation with U.S. Treasury Department officials. "It had the input from the top law firms in Washington, D.C. and the federal government."

The process leading up to the enactment of this law was a well-planned and thought-out process, with input from all interested parties, over a period of months. This has been well documented," he said.

Puerto Rico will likely need wise counsel, however, as its bold move to tax offshore companies has sparked not only sharp criticism, but also is expected to ignite fierce legal, political and public relations battles against the new tax. That is because there is much more at stake than just the $6 billion the tax aims to raise over the next several years, industry observers say.

What has really roiled the industry is that Puerto Rico is the birthplace of tax exemption to spur offshore investment. It was the lynchpin of the successful Operation Bootstrap model in the 1940s and 1950s which successfully transformed the island into a modern industrial economy from a poor agricultural-based economy, officials said. Now, the island is leading the charge with a precedent-setting tax that could upset the multinational-development model that has grown as more and more nations across the world have begun adapting the Puerto Rico model of offering tax exemptions to investors.

"If they allow Puerto Rico to get away with this, then it may become a threat to the multinational model. Then the Irish, Singapore and Spain may try to emulate Puerto Rico," said Bonilla, the PRMA Tax Committee chief. "Puerto Rico is saying it has the right to impose a tax on a foreign company that has never been in Puerto Rico. This is something totally new."

No other country has a similar tax, West told the island's tax attorneys, but he expressed confidence that Puerto Rico has the ability to levy the tax and that it would qualify for a federal tax credit. West told the tax attorneys that discussions with the Internal Revenue Service (IRS) "have been favorable but are at a critical point in the discussion," one participant recalled. The firm is believed to have asked for an IRS ruling on the matter.

As soon as the affected corporations found out about the new tax, they immediately began to quantify its costs, to re-examine their investment plans and to begin an analysis of their corporate structure, several sources said.

"They are analyzing all the alternatives. And that includes going to the Congress," one industry executive told CARIBBEAN BUSINESS.

Island manufacturers could also be exposed to similar taxes levied by competitors, since most import products from other destinations and use them in completing production of specific products.

Industry leaders said they will wait for a ruling by the IRS on the matter before gauging the full effect of the new tax's impact. Many can't see the U.S. Treasury Department blessing the new tax, given that it will cost $6 billion over the next six years. And while the island government is confident in its ability to levy the tax, industry leaders and opposition Popular Democratic Party (PPD) lawmakers believe the new tax will not only be open to legal challenges, but also that such challenges are currently being drawn up.

Many of the potential challenges are discussed in the legal opinion produced on behalf of the government, including a constitutional challenge of the Source Rule for potential violations of the Commerce and Export-Import clauses, and why the government's attorneys believe the new law will survive these challenges.

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Besides potential legal challenges, critics also say the new tax may not raise what it intends, as corporations will work to adjust their corporate structure or their interaffiliate activity to try to narrow or eliminate its application. That analysis also is already underway, industry officials said.

"They said the U.S. Treasury would get $10 billion from Section 936's repeal," recalled PPD Sen. Eduardo Bhatia, referring to the federal tax break that was phased out over a decade beginning in 1996. "They got nothing. The companies simply reorganized as controlled foreign corporations [CFCs] to avoid federal taxation."

THE CASE FOR THE NEW TAX

Fortuño administration officials acknowledge the fierce backlash from the business community, both on the island and stateside, over the swift passage of legislation that aims to raise $5.8 billion over the next six years to fund huge local tax cuts under tax reform, but insist that the impact of the new taxes will be blunted in most cases by the ability to claim a dollar-for-dollar federal tax credit for the additional tax paid to Puerto Rico. Officials also assert that the island's deep fiscal crisis warranted the extraordinary move.

Moreover, they argue, by using the money raised to finance a sweeping tax reform, which will not only cut taxes but also restructure the system so that it rewards investment, savings and hard work, the administration also is laying the groundwork for a stronger island economy, which will help the companies operating in Puerto Rico in the end. The tax reform will cut corporate taxes by an average 30% and individual taxes by an average 50%.

Gov. Luis Fortuño has been personally reaching out to the heads of the largest firms, which are largely pharmaceuticals, to both justify the move and try to do everything possible to blunt the negative impact the laws might have on company operations.

Part of these discussions involves focusing on how the new tax will impact a particular firm, and what additional help the local government might be able to provide. The governor also is stressing the fact that the tax will finance a tax reform that will help the island economy, and that it actually replaced a bill to slap a permanent, minimum 10% tax on offshore corporations, which had large support among both the majority New Progressive and minority Popular Democratic parties.

Puerto Rico Manufacturers Association President Pedro Watlington

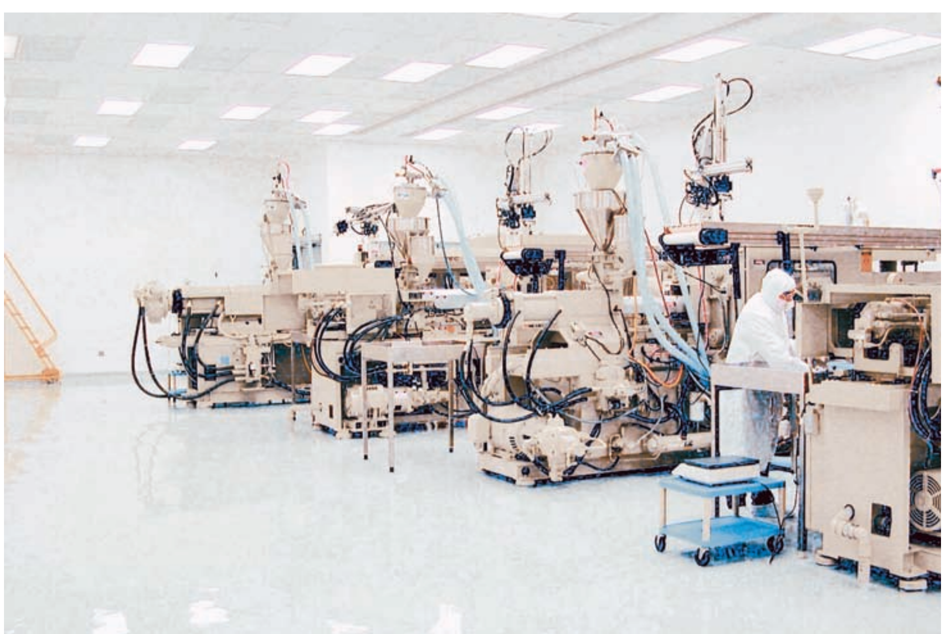
Puerto Rico Manufacturers Association Tax Committee Chairman Carlos Bonilla

The governor also is personally making the case to the CEOs and CFOs of the affected companies that Puerto Rico is encountering an extraordinary economic situation and that the tax has been levied only after huge sacrifices were made by other sectors of the island.

Those sacrifices include the firing of 13,000 government employees and other measures that governors stateside "would not dare take" to deal with the huge $3.2 billion deficit he encountered upon assuming office in January 2009, the official added.

"The truth of the matter is that Puerto Rico has been at the tipping point. We haven't really grown in the last decade. Our fiscal situation, despite extremely aggressive measures, is still not healthy enough," the administration source said.

"Every sector in Puerto Rico in the last 22 months has contributed, and hopefully these offshore affiliates also will contribute. It is in their interest to have a viable Puerto Rico, and tax reform will help bring that.



"The governor never met a tax that he liked. But he also believes it is unconscionable that local firms are paying an effective tax rate of 41%. That's why the corporate tax rate is coming down to 30% right away, and we hope to lower it even more over the next few years," the source added.

Securing more corporate income revenue was a central objective of the Tax Reform Commission appointed by Gov. Luis Fortuño last February to reform the island tax system, according to the Steptoe & Johnson legal opinion. Administration officials said the decision to impose taxes on offshore affiliates stemmed from calls for a more just tax burden for island businesses.

"Since last year, different sectors locally have been clamoring for a more balanced distribution of the tax burden and a larger contribution from the industrial sector," Economic Development & Commerce Secretary José Ramón Pérez-Riera said. "This year, four bills authored by legislators from both the majority and the minority delegations seeking to impose a much larger contribution on the corporate sector than the governor pushed for have been filed and discussed at public hearings."

When asked to respond to criticism that the administration is changing the ground rules for offshore investors on the island, Pérez-Riera reiterated that the law "does not apply to manufacturing companies operating in Puerto Rico, but to the distribution companies operating outside Puerto Rico that purchase the products that manufacturing companies produce in Puerto Rico.

"The law expands the base of worldwide income that ought to be recognized as income generated in Puerto Rico because the sales of the distribution company benefit from Puerto Rico's labor and infrastructure," he said.

Pérez-Riera and other administration officials acknowledge the impact of the 4% excise tax, but believe its fallout will be limited

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and that reforming the tax system, coupled with the other initiatives the administration has undertaken, will bring much more positive economic benefits.

The excise tax on "some transactions of some companies…will not outweigh the positive, pro-growth effect of our tax reform and the other pro-competitive reforms that we have implemented," Pérez-Riera added.

"Our vision is that a lower tax burden on both individuals and companies is indispensable to foster an economically stronger and more competitive Puerto Rico. But given the challenges Puerto Rico has right now, there is an imperative need to achieve a better balance of the tax burden among all the members of our society," he said.

The revenue raised from the tax will be used to pay for the tax reform Gov. Fortuño proposed last month, which will deliver an average 50% cut for individual taxpayers and 30% cut for businesses when it is fully implemented over the next several years.

BIG BUSINESS STRIKES BACK

Just as swiftly as the Legislature and administration enacted the measure, business groups responded with force, with the powerful U.S. Chamber of Commerce in Washington, D.C. leading the charge.

U.S. Chamber of Commerce President Thomas J. Donohue denounced the tax as "punitive and discriminatory" in a letter to Gov. Fortuño, and warned him it would hinder Puerto Rico's ability to attract outside investment.

"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," Donohue added.

Joining the chorus was the National Association of Manufacturers President & CEO John Engler, who said the new excise tax on multinational manufacturers "could jeopardize the jobs of over 100,000 people and could damage business relationships that have taken years to develop

Popular Democratic Party President Héctor Ferrer

Popular Democratic Party Sen. Eduardo Bhatia

between the affected companies and the government of Puerto Rico."

Engler argued the six-year excise tax will hit U.S.-based manufacturers that have invested in Puerto Rico, which represents about 80% of all manufacturing on the island and accounts for nearly 26% of the island's gross domestic product (GDP).

"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," Engler said. "These manufacturers provide stable and high-paying jobs for Puerto Ricans. The Puerto Rican government's decision to impose this discriminatory tax could profoundly impact companies as they consider both existing and future operations."

Pharmaceutical Research and Manufacturers of America (PhRMA) President John Castellani said biopharmaceutical companies last year invested more than $65.3 billion in research and development throughout the world and helped to create jobs in Puerto Rico

"This [tax] 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," he said.

Biotechnology Industry Organization (BIO) President & CEO Jim Greenwood echoed similar criticism.

"The bioscience industry has remained a bright spot through one of the worst economic recessions on record. This is particularly true in Puerto Rico, where the bioscience industry accounts for providing stable, high-paying jobs," said Greenwood, referring to the 20,000 people employed in the pharmaceutical industry. "Without a doubt, the bioscience industry is crucial to the economic health of Puerto Rico."

He said the new tax "places an unprecedented and excessive burden on many of the biopharmaceutical and medical-device companies located in Puerto Rico. This particularly ill-timed tax increase is a drastic change to longstanding tax law and is potentially detrimental to new and existing foreign investment in Puerto Rico.

"Puerto Rico has historically proven itself to be a center of excellence in attracting foreign investment and venture capital from innovative bioscience companies and investors," Greenwood said. 'That is why it is particularly vexing that this legislation moved through both houses in a weekend, offering no time for public hearings, discussions or review of comments on the bill.

"This new tax increase will profoundly affect the decision-making of foreign corporations as they consider whether to continue to do business and deploy their capital in Puerto Rico or not," he said.

A VITAL INDUSTRY FACES UNCERTAINTY

While the new tax may legally circumvent tax decrees with the local operations by placing the tax on related offshore companies, they break the spirit of them, critics say.

"This is irreparably damaging Puerto Rico's credibility," said longtime PRMA Executive Director

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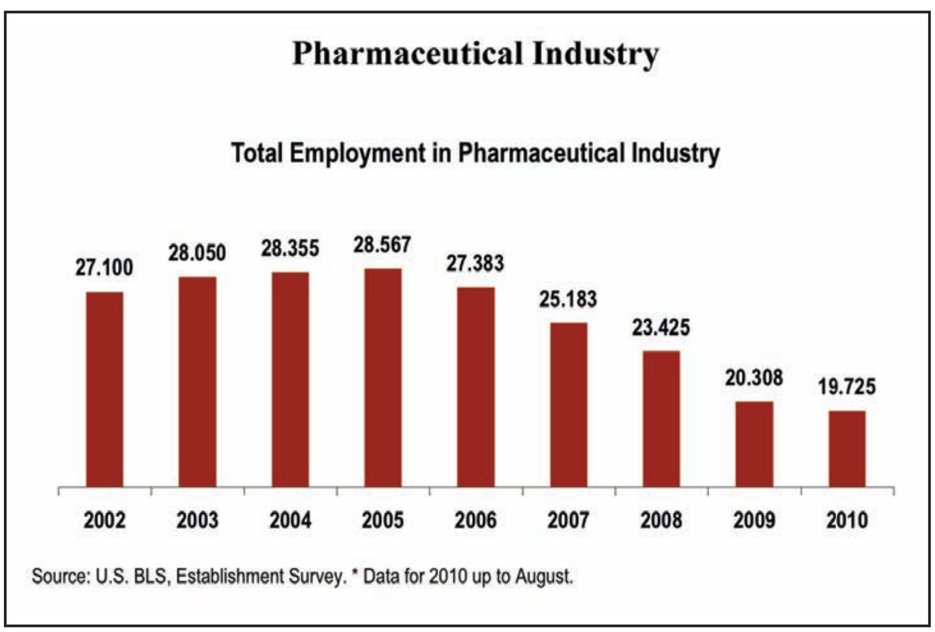

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William Riefkohl. "Anything that might have been in the pipeline is now under review."

The island was already in a difficult competitive position because of its high energy costs and inflexible labor laws, maintaining a competitive standing mainly due to its tax incentives, PRMA officials said.

"With this measure, Puerto Rico loses its competitiveness," PRMA President Pedro Watlington added. "Puerto Rico is closed for business."

The impact of the new tax will be different in different manufacturing sectors, with those operating on the thinnest margins probably getting hurt the most, manufacturing industry officials said. The new tax will essentially double the tax burden that exempt companies now face, Riefkohl said. In 2009, the PRMA accounted for $1.4 billion, or 57.9%, of all corporate income tax collections. That is about the amount the administration expects to raise during the new tax's first year in effect.

Four of the largest firms in Puerto Rico also have written letters to Fortuño expressing their displeasure over how the tax was implemented and for what they say will be its nefarious effects, the PRMA said.

PDP officials allege that as many as five projects in the pipeline are now under review as a result of the development.

"The approval of a new tax on the manufacturing sector will have serious repercussions on the stability and security of jobs for thousands of mothers and fathers," PDP President Héctor Ferrer said.

While the manufacturing sector has been shrinking over the last decade, it is still a source of well-paid jobs, employing about 90,000, and still accounts for 45% of the island economy and pays 58% of the corporate taxes the Treasury Department receives.

The number of jobs in the pharmaceutical sector has steadily declined in the past five years to 19,725 in August, down from 28,567 in 2005, according to data from the U.S. Bureau of Labor Statistics Establishment Survey. After pharmaceutical employment expanded by as much as 3.5% in 2003, it has

Puerto Rico Manufacturers Association Executive Director William Riefkohl

shrunk 35.3% since 2006, including a 13.3% contraction in 2009, the steepest single-year drop in the period, and a decrease of 2.9% this year until August, according to the same data.

The pharmaceutical sector's share of the island's GDP—the total value of all goods and services produced by a country in a year, including income earned domestically by foreigners but not income earned by domestic residents overseas—grew slightly from 24.8% in 2007 to 25.7% in 2009, according to commonwealth Planning Board figures.

The nearly 20,000 jobs in the pharmaceutical industry made up 22.4% of the island's 89,400 manufacturing jobs and 2.2% of the total 921,500 nonagricultural salaried jobs, according to commonwealth Labor Department figures.

The administration is trumpeting the ability of companies to take a federal tax credit for the new island tax to which the manufacturers' affiliates will be exposed, and in many cases this could effectively blunt the damage inflicted by the new tax.

Many companies, however, may not need a federal tax credit, and they are nontransferable, Riefkohl said. That is especially the case with

Tax Reform Commission President Xenia Vélez

non-U.S. firms or firms selling the majority of their products outside the United States.

Puerto Rico Pharmaceutical Industry Association President Daneris Fernández said for many the federal tax credit would do little to soften the blow because the top eight pharmaceutical firms on the island, represented by the association, sell most of their products to jurisdictions outside the United States.

"This varies from companies selling 40% of their products outside the United States, which would not feel much of an impact, to companies selling between 75% and 90% of their production outside the United States, which would receive the biggest blow," she said

She also said the 4% tax on off-island corporations could jeopardize plans by the largest pharmaceutical multinationals to expand operations on the island, and may even drive corporations to lower-tax jurisdictions.

Both Bhatia and Ferrer attributed the administration decision to political considerations aimed at winning re-election for the governor. They said that because of the island's open economy, tax cuts alone won't spark economic development, especially given the protracted recession.

"The responsible public policy would have been to enact the tax for a two-year period and gauge the behavior of the industry," Bhatia said.

While the plan to tax multinationals had been in the works for months, it was kept under wraps until the Legislature had passed the legislation enacting the new tax.

"It was Pearl Harbor," one Hato Rey business consultant said of the move. "The administration won. Now, they have to run with the ball and hope it works out all right."

"It was regrettable that the tax was passed over the weekend, without opportunity for those impacted to weigh in. Everyone impacted by the tax reform should have the opportunity to provide input on all aspects of the tax reform proposals," said Stephen J. Ubl of the Advanced Medical Technology Association.

Ferrer said the process destroyed "the transparency that should be at the core of a democratic society," and said New Progressive Party (NPP) lawmakers did not even know what it was they were approving.

"Ninety percent of them have no idea what they have done," he said. "Just ask them if they know what an excise tax is. They won't."

A SHIFTING ECONOMIC PARADIGM

NPP officials note, however, that previous legislation, authored by Senate President Rivera Schatz, would have imposed a minimum 10% tax on exempt manufacturing firms on the island. Private industry had ample opportunity to comment during public hearings held on that legislation. In fact, the bill that established the new excise tax was a substitute bill for Rivera Schatz's original legislation, they added.

Other observers said the course chosen by the government, which was to keep the plan a well-guarded secret until the final moment and only begin disclosure after the legislation had been approved, might have been the best, given the fierce reaction it has provoked from the firms, and their ability to influence outcomes because of their vast resources.

"The pharmaceuticals would not have given an inch," one consultant

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noted. "The government had no choice but to proceed this way."

Life-sciences and biotechnology firms, which the government hopes will play an important role in the island's economic future, also have railed against the new tax.

However, Manuel Gómez, director of the University of Puerto Rico (UPR) Resource Center for Science and Engineering, praised the tax, calling it "a brilliant decision by the governor because he taxed the industry at the point of least harm.

"He is taxing the net profit these companies transfer to other sites anyway. With taxation as low as 0% on these companies, Puerto Rico is not getting anything back," Gómez said, noting that the massive transfer of wealth overseas due to drug exports has opened an ever-widening gap between the island's annual GDP of $90 billion, which includes the multinational transactions, and its gross national product (GNP) of $60 billion, which do not.

"This will help lift a burden on local taxpayers. If the governor manages to solve the island's recession, the UPR will get more money to cover its deficit and have more funds left over for research and development," said Gómez, who is codirector of the four-year-old Institute for Functional Nanomaterials, which aims to find commercial applications for the emerging technology that could turn the island into a new Silicon Valley.

He said the tax will not undermine efforts to make the island a global center for biotechnology and nanotechnology, given that "inventions do not yield profits directly, they only do when these are commercialized." He said start-ups for such emerging technologies already have tax incentives.

"I'm convinced the 4% tax will not drive away any industries, but, instead, will strengthen Puerto Rico's economic development," Gómez said.

Despite the furor raised by big business, Pérez-Riera is also upbeat. He said the Puerto Rico Industrial Development Co. (Pridco) is in discussions with many companies on the island to expand their operations. While the new law will impact their analysis, he said the government is working with them to move these expansions forward.

"Puerto Rico—with all the pro-competitiveness and pro-growth reforms we are implementing in the areas of public-private partnerships, permits, energy and government services, as well as the 50% and 30% reductions in individual and corporate tax rates, respectively—will continue to be a competitive jurisdiction for these companies, and a significant portion of these expansions being negotiated will take place," Pérez-Riera said. ■

CARIBBEAN BUSINESS Economics Senior Editor Carlos Márquez, Legislative Affairs Editor Mario Santana and Staff Reporter José Alvarado Vega contributed to this report.

Philip R. West: The architect of the excise tax and change in the 'Source Rule'

BY CARLOS MÁRQUEZ
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Philip R. West, a partner in the Washington, D.C. office of Steptoe & Johnson LLP (Steptoe), is considered by insiders to have been the architect of the excise tax structure on exports of major manufacturing companies and the permanent change in the "Source Rule" in Puerto Rico.

West is considered by CARIBBEAN BUSINESS' Washington, D.C. sources to be one of "super lawyers" in the U.S. capital and one of the world's leading business lawyers regarding international taxation.

Having served as international tax counsel for the U.S. Treasury Department, "West is a good choice for foreign tax credits, transfer pricing and tax treaty issues," a source said. He is an international tax practitioner and former high-ranking government official "who just gives phenomenal deal advice."

With over 25 years of experience, West focuses on complex and sensitive international tax matters involving advocacy before the Internal Revenue Service (IRS), Treasury and Congress, as well as corporate, partnership and financing transactions and tax minimization planning.

West has particular expertise in deferral, foreign tax credit, treaty and transfer pricing matters. He served for nearly four years as the U.S. Treasury Department's International Tax Counsel—the senior international tax lawyer in the U.S. government—playing a central role in virtually all international tax developments during his tenure. West has taught at Harvard, New York University, Michigan and other leading law schools, and is a frequent speaker and writer for professional audiences.

Reportedly, the government has a $600,000 contact for legal services with Steptoe and West is their lead man. Not a bad deal for the government if you are considering potential revenue of approximately $6 billion in six years.

In more than 65 years of practice, Steptoe, with more than 500 lawyers, has gained a national and international reputation for vigorous representation of clients before government agencies, successful advocacy in litigation and arbitration, and creative and practical advice in guiding business transactions.

Steptoe has offices in Beijing, Brussels, Chicago, London, Los Angeles, New York City, Phoenix and Washington, D.C.

According to the Steptoe & Johnson website, West has deep and substantive knowledge of income deferral, foreign tax credit, transfer pricing and tax treaty matters, as well as the tax aspects of mergers, acquisitions, joint ventures and financings, investment funds and tax-minimization structures and transactions.

He also devotes significant attention to helping clients resolve controversies with, and obtain rulings from, the IRS, and he has been particularly active with "competent authority matters," according to the website.

Earlier in his career, West litigated tax cases with the Justice Department, advised Judge Carolyn Miller Parr as a tax court clerk, counseled financial institutions and other clients with a Wall Street law firm, and practiced in the national office of an international accounting firm. ■

Senate president fiercely defends new excise taxes on offshore corporations

BY MARIO SANTANA
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Senate President Thomas Rivera Schatz defended the excise tax on offshore corporations that purchase goods or services produced on the island, saying the impact of the levy on businesses would be minimal.

In an exclusive interview with CARIBBEAN BUSINESS, Rivera Schatz emphasized that the new excise tax will finance the initial phases of the announced tax reform.

"The tax reform terms offered to individuals and business taxpayers will be guaranteed from 2010 to 2013 with this legislation," he said. "These first four years will be guaranteed without problems."

"We want to lower taxes on everybody, but in this critical moment we need to make those who contribute absolutely nothing to contribute a reasonable amount to reach a balance in the fiscal health of the government of Puerto Rico," he added.

He said that the excise tax was consulted "with law firms in the U.S. and with the federal government."

Rivera Schatz explained that the excise tax on offshore corporations that purchase goods or services in Puerto Rico "has the virtue of allowing the collection of the new tax at the moment of the transaction," as opposed to a more complex unitary system of combined reporting with formulary apportionment.

He further explained the new excise tax would affect "35 companies, maybe a bit more or a bit less," adding that "the government has begun to hold a series of meetings with these corporations."

He said the offshore corporations that purchase goods or services in Puerto Rico "will not be affected as has been presumably represented" because what they pay with the new excise tax will be creditable against U.S. federal income tax.

Rivera Schatz rejected the argument that some of the offshore corporations to be taxed under the new legislation will not be able to claim a credit under the U.S. Internal Revenue Code because the destination of the purchases they made in Puerto Rico is not in the mainland U.S.

"History has told us that these corporations are wise enough to find a subterfuge to claim the credit," he said.

He pointed to Chile, which levies a 17% excise tax on offshore companies, the Dominican Republic, which has a 25% excise tax and some U.S. states that levy a 7% to 8% excise tax.

"What they will pay in Puerto Rico is much less, and it is reasonable given the profits they make on the transactions here," he said.

"What we are saying," the Senate president said, "is that the collection of the excise tax is reasonable and is not burdensome in terms of making them move elsewhere to do business. In that sense, we do not see danger, but rather that it is fair that they contribute more."

Asked whether the new excise tax could be changed if Congress amends the U.S. Internal Revenue Code provisions that deal with foreign-controlled corporations, Rivera Schatz answered that "any movement in federal legislation that would affect Puerto Rico's economic stability will be examined."

He also said the excise tax will not affect any corporation operating in Puerto Rico that enjoys a tax-exemption decree under Law 73 of 2008—the Economic Incentives Law for the Development of Puerto Rico—or the previous industrial incentive taxes.

"These are corporations that are based outside of Puerto Rico, that simply do trade transactions in Puerto Rico, but are not benefiting from tax decrees," he said. "What happens is that some are affiliates of corporations based in Puerto Rico that enjoy a tax-exemption decree."

"History has told us that these corporations are wise enough to find a subterfuge to claim the credit."

—Thomas Rivera Schatz

He added that because the corporations subject to the excise tax do not have a physical presence in Puerto Rico, the tax would not increase costs to Puerto Rican consumers.

Rivera Schatz also said the new excise tax would be temporary.

"As you know, this will begin at a 4% [rate] and then will be reduced each year until a 1% [rate is applied] during the sixth year," he said.

But he did not say the excise tax would be repealed after the six-year period. What he did say is that repealing the new tax is one of several possibilities.

"From 2014 on, by examining the numbers and seeing the economic behavior and how events have unfolded, it will be decided if it will continue, be revised or repealed," he said.

Rivera Schatz rebuts lack of public hearings

When asked why the excise tax on offshore corporations cleared the Legislature on Saturday, Oct. 23 without the benefit of public hearings, Rivera Schatz answered that the Senate previously heard the positions of the companies to be affected when his Senate Bill 1355 was discussed in public hearings.

"The legislative process was typical because public hearings were held on Senate Bill 1355," he said. "We summoned to the public hearings all sectors that could be affected, and there were statements in favor and against, along with suggestions and a voluminous report on what we are discussing here."

But Senate Bill 1355 dealt with a tax proposal that differed from the excise tax on offshore corporations. That bill aimed to set a minimum 10% tax on all corporations with at least $10 million in annual revenue. The measure was meant to apply specifically to those corporations that enjoy tax-exemption decrees under Law 73 or the previous industrial incentive laws.

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Business groups like the Puerto Rico Manufacturers Association and the Chamber of Commerce at that time attacked Rivera Schatz's bill, arguing that it would damage the island's investment climate, especially for the manufacturing sector, which accounts for 41.5% of Puerto Rico's gross product.

Rivera Schatz's bill hit an insurmountable hurdle during the first of the two public hearings the Senate Treasury Committee held on the measure when committee Chairwoman Migdalia Padilla acknowledged that the bill violates Article 3, Section 17 of the Puerto Rico' Constitution, which mandates that all bills to levy taxes be originated in the House of Representatives.

> "The legislative process was typical because public hearings were held on Senate Bill 1355."
>
> —Thomas Rivera Schatz

Senate President Thomas Rivera Schatz, left, said the excise tax on offshore corporations will be creditable against federal income taxes. From right, CARIBBEAN BUSINESS Executive Editor José L. Nieto, Editor of Government Affairs John Marino, Executive Editor of Economics Carlos Márquez and Editor of Legislative Affairs Mario Santana

A few days later, on March 5, a group of 11 House New Progressive Party (NPP) representatives headed by José Luis Rivera Guerra filed House Bill 2526 in the lower chamber. Rivera Schatz recalled that the House bill was "identical to mine," adding that the lower chamber approved the bill.

What really happened was that House Bill 2526 was suddenly changed to Substitutive House Bill 2526 on Oct. 22 and a day later it cleared the House and the Senate. This is precisely the bill that amended the Puerto Rico Internal Revenue Code to levy a six-year excise tax on offshore corporations that purchase goods or services produced on the island.

Rivera Schatz also acknowledged that his 10% minimum tax rate on all corporations making at least $10 million annually has not been withdrawn or repealed and that he still believes it is good legislation.

"What I believe is that the corporations that are under this law can contribute more than they are contributing," he said. "It might not necessarily be 10%, but they can contribute more because they make large profits in Puerto Rico."

He said that the legislation less subject to legal attacks is that which establishes a prospective application of a minimum tax rate, shielding from the tax those corporations that enjoy tax-exemption decrees. ■