ECONOMIC ANALYSIS

New Puerto Rico Investor Breaks Echo Section 936

by Martin A. Sullivan

It took only three months of lopsided military victories for the United States to defeat Spain in 1898. The Treaty of Paris, signed in December of that year, left the United States in control of Puerto Rico, along with the Philippines, Cuba, and Guam. For a brief period, the island was governed by the military forces that defeated the Spanish. In 1900 Congress passed the Foraker Act, which gave Puerto Rico a civil government headed by a presidentially appointed governor. It would not have an elected governor until 1948 or its own constitution until 1952.

In a series of opinions known as the Insular Cases, the Supreme Court held that the U.S. Constitution fully applied to incorporated territories like Hawaii and Alaska but that it had only limited application in unincorporated territories like Puerto Rico and the Philippines. One consequence of its unincorporated status is that the Constitution's tax uniformity clause does not apply to it.

Four years after the birth of the income tax and one month before it declared war on Germany, Congress passed the Jones Act of 1917. The law included a bill of rights and allowed the popular election of members of both houses of the Puerto Rico Legislative Assembly. But it was a long way from self-rule. All laws passed by the Puerto Rico legislature could still be blocked by the presidentially appointed governor, the president, or Congress. Although there was little desire in Congress to set Puerto Rico on the path to statehood, with war imminent lawmakers did not want the strategically important island to assert its independence. This gave rise to the most far-reaching aspect of the Jones Act — the extension of U.S. citizenship to Puerto Ricans (Cesar Ayalya and Rafael Bernabe, *Puerto Rico in the American Century*, UNC Press, 2007, pp. 57-59).

Not constrained by the uniformity clause, the Jones Act proclaimed that all U.S. laws would be in force in Puerto Rico with one exception: the internal revenue laws. The exclusion from income tax for Puerto Rico would later be included in section 252 of the Internal Revenue Code of 1939. Later it was embodied in the codes of 1954 and 1986 as section 933. In general, when the code uses the term ''United States,'' it refers only to the 50 states and the District of Columbia. For purposes of the income tax, Puerto Rico, like other U.S. possessions, is treated as a foreign country. Corporations incorporated in Puerto Rico are treated as foreign corporations.

Historian David F. Ross argues that the Foraker Act's exemption did not have anything to do with the principle of no taxation without representation. After all, citizens of incorporated territories at the time, like Alaska and Hawaii, were subject to federal income taxes (*The Long Uphill Path: A Historical Study of Puerto Rico's Program of Economic Development,* Edil Press, 1969). And aside from income taxation, the federal government was not shy about imposing burdens on Puerto Rico. For example, it levied excise taxes on Puerto Rican goods. And after the United States entered the First World War, it drafted 18,000 Puerto Rican men into military service (James L. Dietz, *Economic History of Puerto Rico*, Princeton, 1986).

The exemption from federal income taxation gave the Puerto Rico Treasury Department breathing room to collect its own income tax, which it had been levying since 1913. Modeled after the federal income tax, it would become an important component of government finances. ''It is not unreasonable to anticipate that in the near future the income tax will constitute the main source of revenue for the insular Treasury,'' stated the ''1920 Annual Report of the Governor of Porto Rico.'' As long as the government of Puerto Rico continued to collect significant amounts of corporate and individual income tax, the exemption from federal income tax meant little to businesses and individuals in Puerto Rico, and it did little to promote economic development. For Puerto Rico to become a tax haven, the local government would have to match federal tax relief.

On the corporate side, this would occur in the late 1940s, when the Puerto Rican government adopted an economic development plan to transition from an agrarian to an industrial economy. Its primary tool for achieving this goal was targeted tax relief. In 1947 the Puerto Rican legislature passed the Industrial Incentives Act, which provided manufacturers, in addition to exemption from property and excise taxes, complete exemption from Puerto Rico income taxes until 1959. This new law, coupled with relief from U.S. tax under section 931 (the predecessor of section 936), resulted in massive new investment in Puerto Rico by U.S. corporations.

Act 22

In 2011 Puerto Rico moved to do for U.S. individuals what it did for U.S. businesses in 1947. To fully realize the potential of Puerto Rico's special federal tax status as a tool for economic development, it provided generous tax relief to affluent newcomers to the island. José Ramón Pérez-Riera, secretary of the Economic Development and Commerce Department in the administration of then-Gov. Luis Fortuño, spearheaded the effort. His idea was to exempt from Puerto Rico income tax all investment income already exempt from federal tax under section 933.

On October 11, 2011, Pérez-Riera's plan was introduced in the Puerto Rico House of Representatives.

On November 3 that body approved the legislation on a 33-16 vote. On November 7 the Senate passed it on a 19-9 vote. The Individual Investors Act (Act 22) came into immediate effect when it was signed into law by Fortuño on January 17, 2012.

In November 2012 Fortuño, a member of the pro-statehood New Progressive Party, narrowly lost his bid for reelection to Alejandro García Padilla of the rival pro-commonwealth Popular Democratic Party. But there would be no decline in official support for the new law. Padilla and his economic development team actively promoted the incentives of Act 22. Seminars in San Juan, visits to New York financial advisers, and direct appeals to the public were all used to spread the word. Based on figures cited in various reports in *Caribbean Business*, as of the end of 2014, approximately 300 individuals have applied tax exemptions available under Act 22.

Important Details

New individuals eligible for Act 22 benefits are called resident individual investors. To qualify, an individual must not have been a resident of Puerto Rico at any time during the 6 years before passage of Act 22. The individual must complete a seven-page application and gain the approval of the Office of Industrial Tax Exemption. The individual must also pass three residency tests. The physical presence test can be met in a variety of ways, including maintaining physical presence in Puerto Rico for a period of 183 days during the tax year. The tax home test requires that the individual's principal place of business (or, if none, the principal place of residence) be located in Puerto Rico. The closer connection test takes into consideration nine different factors to determine whether the individual has a closer connection to Puerto Rico than to any other jurisdiction.

What income of these new residents is eligible for privileged treatment? In general, it's passive income that is exempt from U.S. tax under section 933. The complicated details are summarized in Table 1. It is certainly not the case, as some headlines and sound bites suggest, that all investment income of investors migrating to Puerto Rico is free of tax.

Act 22 exempts all interest and dividend income of resident individual investors from Puerto Rico income tax. That sounds good, but only Puerto Rican-source interest and dividends are exempt from U.S. income tax and, with anti-conduit rules in place to prevent abuse, those generally will be no more than a miniscule fraction of a diversified investor's portfolio income. Interest and dividends generally are sourced according to the payer's residence. Interest and dividends paid by U.S. and foreign (excluding Puerto Rico) corporations are not Puerto Rican-source income.

Both the U.S. and Puerto Rican treatment of capital gains of resident individual investors depends on when gains accrue and when gains are realized. Gains that accrue after Puerto Rico residency is established are the easy part. They are exempt from both Puerto Rican and federal income tax.

Built-in gains that accrued before the investor became a Puerto Rico resident are subject to tax. For built-in gains realized within the 10-year period after residency has been established, no benefit is obtained from emigration to Puerto Rico. These built-in gains are subject to full U.S. tax (23.8 percent for top-bracket taxpayers). They are also subject to a 10 percent Puerto Rican tax. But the Puerto Rican tax is creditable against U.S. tax, so there is no net burden to the investor from the Puerto Rican tax. It is, in effect, paid by the U.S. treasury.

In contrast, built-in gains realized after 10 years of Puerto Rico residency receive highly favorable treatment. For these gains, there is no U.S. income tax (under section 937), and only a 5 percent Puerto Rican tax applies under Act 22.

These tax benefits are available without the loss of U.S. citizenship. And unlike in the situation of a U.S. citizen who moves to a tax haven and renounces U.S. citizenship, section 877A does not apply. Added to the code in 2008, section 887A treats all property of an expatriating individual as if it were sold on the day before expatriation.

Repeating Past Mistakes

Puerto Rico has a long history of receiving federal support through the tax code (see Table 2). The most notable of these tax benefits were provided through section 936. Combined with preferential tax treatment under Puerto Rican tax law, section 936 gave U.S. multinational corporations billions of dollars in tax savings. Beneficiaries set up manufacturing facilities in Puerto Rico and designated huge amounts of profits attributable to intangible assets as Puerto Rican-source income free of tax under section 936. Section 936 credits peaked in 1993 at $4.7 billion. With the passage of the Small Business Job Protection Act of 1996, Congress began the 10-year phaseout of section 936. Most Puerto Rican subsidiaries that had been section 936 corporations now operate as controlled foreign corporations.

Congress repealed section 936 because it was an expensive and inefficient method of promoting economic growth in Puerto Rico. The inefficiency (often measured as the ratio of jobs created to estimated revenue loss) was high because tax relief was not directly tied to the factors that are important to economic development — namely, employment, research, and capital spending. Once a manufacturing facility was in place on the island, tax benefits would flow not only to the profits generated from the manufacturing but also to income from valuable intangible assets developed in the United States and transferred to Puerto Rico. In fact, for many pharmaceutical and tech companies,

Table 1. Summary of U.S. and Puerto Rican Tax on Passive Income of Resident Individual Investors

	Puerto Rican Tax (Act 22)	U.S. Federal Income Tax (Sections 933, 937)
Interest and Dividends		
Puerto Rican Source	exempt	exempt
Other	exempt*	taxable
Capital Gains		
Post-Migration Gain	exempt	exempt
Built-In Gain		
Realized Within 10 Years	10%**	taxable
Realized After 10 Years	5%*	exempt

* Regular Puerto Rican rates would apply after 2035 if Act 22 is not modified.
** Puerto Rican income tax is creditable against U.S. income tax.

most of the tax-favored income was from intangibles. Section 936 was more of an incentive for profit shifting than for job creation.

During the phaseout period, Congress improved the efficiency of tax benefits, tying them more closely to measurable economic activity on the island (mostly wages) and thereby limiting the tax benefits available to income shifted from the United States.

Passage of Act 22 has created a situation with many similarities to the section 936 experience. First, both were enacted with the purpose of promoting employment and growth in an economy with average income far below the U.S. average. However, while section 936 promoted the relocation of U.S. businesses to Puerto Rico, Act 22 is promoting the relocation of wealthy U.S. citizens to Puerto Rico.

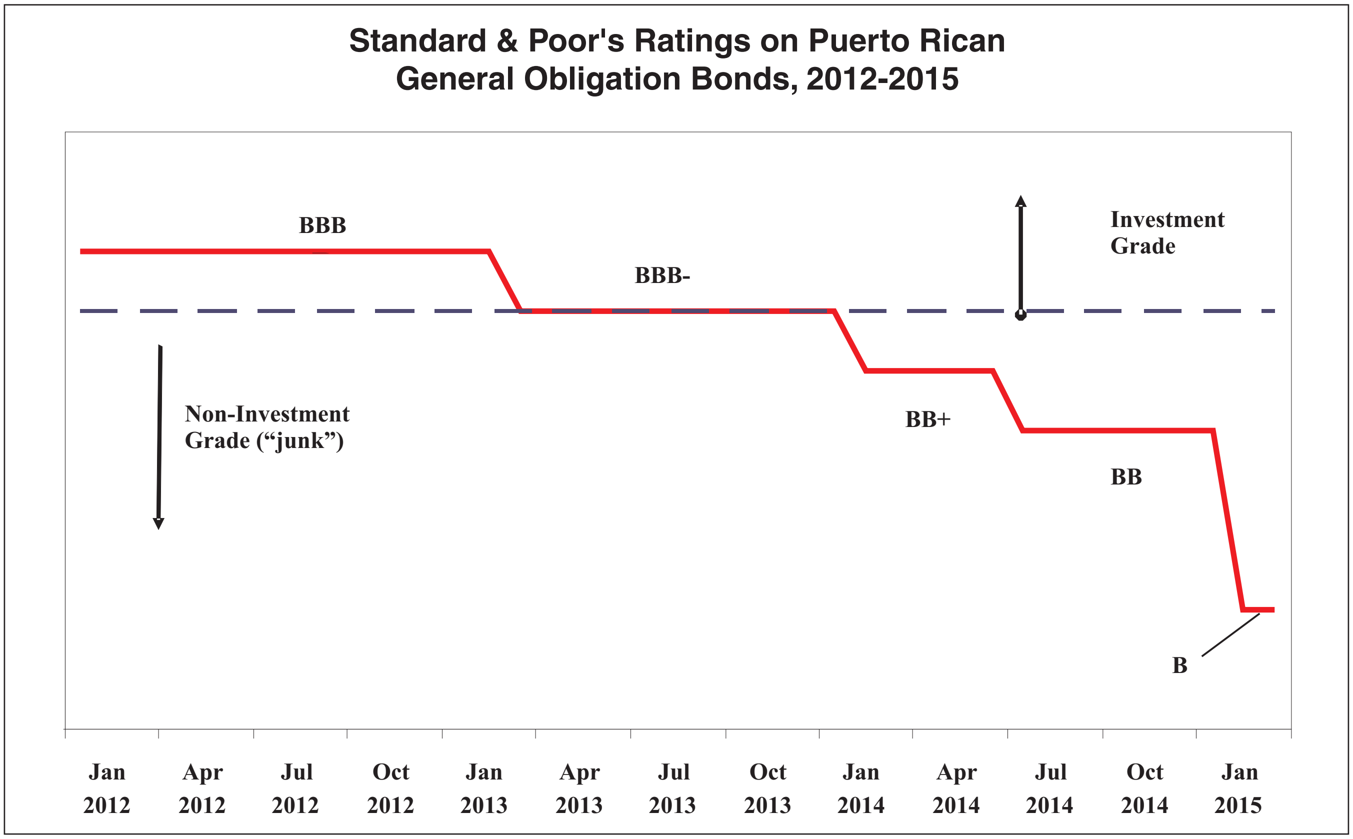
Second, because few of these relocations would have occurred without the tax benefits, the cost to Puerto Rico of providing relief from Puerto Rican tax was minimal. As a result, in both cases, the cost of the tax subsidies is borne almost entirely by the U.S. treasury.

Third, Act 22 shares with section 936 the unattractive feature of being an inefficient tool for economic development. As with section 936, there is no denying that the tax incentives provided by Act 22 benefit the Puerto Rican economy. Individuals with investment income have an incentive to relocate. After they begin residing in Puerto Rico, the new arrivals will consume more goods and services from the local economy, and they may even invest in Puerto Rican businesses. As Pérez-Reira has written, ''This relocation should result in new local investments in real estate, services, and other consumption products and in capital injections to the Puerto Rico Banking sector, all of which will accelerate the economy of Puerto Rico'' (*Corporate Business Taxation Monthly*, May 2012, p. 23).

But as with section 936, there is no direct linkage between the tax benefits provided and the factors critical to Puerto Rico's economic development. This manifests itself in a variety of ways:

- Although eligible capital gains in a legal sense are Puerto Rican-source income, the bulk of the gains from the investment portfolios of individuals who have relocated do not arise from capital located in Puerto Rico that could create jobs there.
- To qualify for tax benefits, an individual must reside in Puerto Rico for a specific amount of time. This will entail spending that will benefit the local economy. But the amount of that local spending could be modest relative to tax benefits. Those benefits depend on the characteristics and size of an investor's portfolio, not on the investor's expenditures in Puerto Rico. Once the move has been made, there is no incentive at the margin to spend more.
- Under Act 22, tax benefits can be expected on average to be proportional to wealth. But spending that benefits the local economy on average will not rise proportionately to wealth. (Warren Buffett may be 50 times wealthier than your average fledgling billionaire, but we would not expect him to spend 50 times more during a six-month stay in Puerto Rico.) Thus, per dollar of lost revenue, the economic benefit provided by the act is less for the superrich than it is for the modestly wealthy. An efficient incentive would as much as possible strive to give all investors the same bang for the buck for the benefits provided.

Although newcomers taking advantage of Act 22 will hopefully invest and start businesses in Puerto Rico, there is no requirement that they do so. They will have an incentive on the margin to invest in



Puerto Rican businesses and real estate because investment income from those sources, as long as they are not held by a U.S. corporation, will be exempt under Act 22. This incentive, however, gives rise to another source of inefficiency and unfairness because new resident investors will have a considerable competitive advantage in the local economy over long-standing Puerto Rican residents.

Export Services Act (Act 20)

At the same time that the Puerto Rico legislature enacted Act 22, it passed Act 20, known as the Export Services Act. This new law leverages federal tax advantages by replacing the corporate graduated rate structure (with a top rate of 39 percent for incomes over $275,000) with a flat 4 percent rate on income from specific export services performed in Puerto Rico. Dividends from affected corporations paid to residents of Puerto Rico are tax free under U.S. and Puerto Rican law.

Under Act 20, export services are services performed for nonresident individuals and for U.S. and foreign entities that have no nexus with Puerto Rico. Although all the press attention about this law is on the possibility of hedge fund and private equity managers moving their businesses to Puerto Rico, there is a long list of other types of businesses that qualify. The list includes legal, tax, accounting, and consulting services; computer programming; data processing centers; call centers; and financial services (including securities trading).

As an economic development tool, Act 20 is superior to Act 22. It does not require residency (although benefits are enhanced under Act 20 if business owners move to Puerto Rico). And it does not reward passive investment in non-Puerto Rican businesses (as does the preferential treatment of capital gains in Act 22). Although Act 20 does not have any quantitative investment or employment requirements, the performance of services by the taxpayer's business in Puerto Rico will entail some employment (if only self-employment) and the purchase of supplies, equipment, and office space in Puerto Rico.

Act 20 compares favorably with Act 22 because it does not just apply to businesses transplanted from elsewhere. It applies to start-ups (regardless of the residence of the owners), and to a limited degree, it applies to existing Puerto Rican businesses. For existing businesses, the 4 percent rate applies only to increases in qualified income from the average income of the three prior years.

Although the businesses involved will likely be much smaller in their size and scope than those that benefited from section 936, the tax provisions of Act 20 will likely set the stage for new transfer pricing disputes. For corporations with multiple business lines operating in multiple locations, income and expense

Table 2. Simplified Overview of Major Tax Rules Providing Benefits to Puerto Rico

Tax Provision	Puerto Rican Tax	U.S. Federal Tax	Who Bears Cost?	Direct Beneficiaries
Section 936 (repealed).	0%	0%	U.S. Govt.	U.S. Multinationals
Deferral for controlled foreign corporations operating in Puerto Rico (combined with Puerto Rican development grants).	0%	0%	U.S. Govt.	U.S. Multinationals
Act 22 (combined with exemption under section 933).	0%	0%	U.S. Govt.	New Residents
Exemption of interest on Puerto Rican bonds.	0%	0%	U.S. Govt.	P.R. Govt.
Law 154 excise tax (creditable against U.S. income tax).	Tax	Credit	U.S. Govt.	P.R. Govt.
U.S. rum excise tax (revenue collected by U.S. treasury directed to Puerto Rico; Puerto Rico now shares some revenue with rum producers).	None	Tax	U.S. Govt.	P.R. Govt./ Rum Producers
Act 20 (exemption for services performed in Puerto Rico for non-Puerto Rican clients; not limited to new arrivals; requires business activity).	4%	0%	U.S. Govt./ P.R. Govt.	Service-Providing Businesses

must be allocated between qualified and nonqualified types of services. Then the income and expense must be allocated between services provided to Puerto Rican clients and others. Finally, the income and expense must be allocated between services provided in Puerto Rico and elsewhere.

Future Shock?

Investment adviser Mark Nestmann warns individuals who may be considering moving to Puerto Rico to take advantage of the Individual Investors Act that not only may the benefits be less generous than advertised, but they may be repealed (''Puerto Rico: Yes, It Really Is Too Good to Be True,'' Nov. 18, 2014, available at www.nestmann.com).

Nestmann describes three possibilities — first, he believes that there's at least a 90 percent chance that Congress will restrict the benefits of section 933 for Puerto Rican residents who qualify for Act 22. For example, an exit tax on built-in capital gains, like that imposed by section 877A, could be imposed on emigrants to Puerto Rico even though they retain their U.S. citizenship. Although unlikely, another option is that Congress could simply pass a law that directly overturns Act 22.

Second, Puerto Rico itself could negate the benefits of the law. Given Puerto Rico's perilous financial condition, it is likely that taxes will rise and public services will shrink. Under these conditions, the existence of a group of wealthy non-native Puerto Rican citizens with special tax rules may be politically unsustainable. Although beneficiaries of Act 22 have contracts with the Puerto Rican government that provide income tax exemption until 2035, the government could devise an alternative levy that does not violate the signed agreements. This would not be unprecedented. U.S. multinationals also have agreements with the Puerto Rican government for a wide range of tax benefits. But in 2010 Puerto Rico adopted Act 154, which imposed an excise tax on exports to foreign related parties that was collected by their Puerto Rican affiliates. (Prior analysis: *Tax Notes*, Jan. 27, 2014, p. 367.)

Third, Act 22 may be declared unconstitutional. Section 3 of the Puerto Rico Constitution plainly states that taxes must be uniform.

Potential Improvements

Puerto Rico's economy is floundering, and the finances of its government and government-run enterprises are in shambles. Historically, average income in Puerto Rico has been consistently less than half that of Mississippi, the poorest of the 50 states. To make matters worse, the economic contraction that began in Puerto Rico in 2006 has not been reversed. The Puerto Rico Government Development Bank's economic activity index (which closely tracks inflation-adjusted gross national product) declined by 20 percent between 2006 and 2015. Puerto Rico's unemployment rate in January was 12.4 percent. Puerto Rico's population, now approximately 3.55 million, is down 4.7 percent since 2010.

In February 2014 Puerto Rico's general obligation bonds were downgraded to junk status. Additional downgrades followed in July 2014 and February of this year (see Figure 1). Explaining its latest rating, Standard & Poor's stated: ''The outlook on all [Puerto Rico] bonds remains negative, reflecting liquidity, budget, and economic uncertainty over the next year that could further erode credit quality.''

In February, to promote economic growth and help restore government finances, Padilla proposed a sweeping overhaul of Puerto Rico's tax system that on a net basis could raise significantly more revenue than current law. The centerpiece of the new plan is a new VAT with a 16 percent rate. But with strong opposition from the Popular Democratic Party and generally negative public reaction to the plan, the fate of the Padilla proposal is uncertain (''House Speaker Says 12% IVA Seen as 'Most Viable Option,''' *The San Juan Daily Star*, Mar. 19, 2015).

As it desperately tries to fend off financial collapse, it is understandable that Puerto Rico would seek to use tax rules to promote economic development, especially if most of the cost ultimately is borne by the U.S. treasury. But for the same reasons it repealed section 936, Congress should wipe out the tax benefits associated with Act 22. It is a poorly targeted incentive that provides a large portion of its tax benefits to shifted income.

Congress should consider replacing the Act 22 benefits with tax rules that provide direct incentives to increase employment. This could be done by increasing the labor supply through an expansion of the earned income tax credit. Under current law, most Puerto Ricans are ineligible for EITCs because the child and the taxpayer must have their principal place of abode in the United States. As noted above, the IRC definition of the United States excludes Puerto Rico. In a 2006 pamphlet, the Joint Committee on Taxation provided an overview of the arguments for and against expanding the earned income credit to Puerto Rico (JCX-24-06).

Alternatively, Congress could enact tax incentives to increase labor demand in Puerto Rico through an investment credit or a wage credit. Congress already allows research conducted in Puerto Rico to qualify for section 41 tax credits. When Congress enacted the Restoring GI Bill Fairness Act of 2011, it extended the work opportunity tax credit to wages paid to veterans employed in Puerto Rico. To provide tax benefits to Puerto Rico employers that do not pay federal income tax, that act set up a mechanism for the U.S. treasury to compensate the Puerto Rican government for providing a parallel credit under its tax code. A similar structure could be used to provide a more general wage credit to Puerto Rican employers.

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France Renews Focus on Digital Economy

by Margaret Burow and Teri Sprackland

France keeps looking for ways to bring down its €4 billion deficit, but choices range from difficult to impossible. That may be why France is pushing again to tax the digital economy, roping in big multinational companies such as Google, Amazon, and Facebook.

France Stratégie, a government body commissioned by Prime Minister Manuel Valls, has released a report, ''Taxation and the digital economy: A survey of theoretical models,'' that recommends the introduction of a tax on advertising and sales revenue generated in a particular tax jurisdiction by companies such as Google, Amazon, and Facebook.

A tax on France's €2.8 billion digital economy would increase revenue, but not directly from French taxpayers, who are hard-pressed by personal tax rates higher than 50 percent. However, the digital tax approach is already facing fierce criticism. It would be a major deviation from prior OECD commitments not to ''fence off'' the digital economy and to treat it for tax purposes on an equal footing with traditional economic contributors, critics say. (Prior coverage: *Tax Notes Int'l*, Sept. 22, 2014, p. 979.)

But France is cornered. The European Commission has given the country two more years to bring its deficit down from 4.1 percent to 3 percent of GDP, the maximum permissible under EU treaty law. This third extension was widely expected because France's contribution to the EU economy makes it impractical for the commission to impose significant fines or austerity measures.

Other options, such as raising taxes, cutting expenditures, or selling off assets, would be political suicide for unpopular President François Hollande and his government, which still hopes that economic growth will increase GDP and bring down the percentage of the economic deficit without unpopular government intervention. Increased criminal proceedings for tax evasion are part of Hollande's plan to recoup an estimated €2 billion this year through fines and increased voluntary ''regularization'' by those who now fear legal repercussions.

As the co-founder of the euro currency and the second largest economy in Europe, France is supposedly bound by the EU's excessive deficit procedure, which may fine a member nation 0.2 percent of its GDP.

''What the government is really doing is praying,'' Marie-Pasale Antoni, taxation director for Mouvement des Enterprises de France, the French business confederation, told Tax Analysts. ''What are they going to do? Sell off Air France? Their hope is that lower oil prices, and maybe more exports because of the lower value of the euro against other currencies, will thus