Puerto Rico Manufacturers Association
CEO SUMMIT

FEDERAL AND LOCAL INCENTIVES

WHERE WE ARE, WHERE WE WANT TO BE

IF WE JUST HAD A CRYSTAL BALL . . .

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Federal and local incentives, particularly tax incentives directed towards the manufacturing industry, have played a crucial role in the economic development of Puerto Rico. The manufacturing industry, in turn, has contributed to the economic growth of the island. Today, it is estimated that 3.3 direct and indirect jobs are created for each manufacturing job and that for each $1,000,000 of income derived by this industry, approximately $2,630,000 are generated in the local economy. Salaries in the manufacturing industry have consistently been higher than those in other industries. Approximately 42.1% of the gross national product, and 45.4% of the net national product comes from the manufacturing industry, which is also responsible for about 99.1% of exports from Puerto Rico.[2] This beautiful island has become one of the most important consumers of U.S. exports, as well as the center for the production of 16 of the 20 most sold pharmaceutical products and a world-class center for biotechnology industries. The United States, Puerto Rico and the manufacturing industry have been partners in progress, and this partnership has been successful.

Federal tax incentives promoting the establishment of manufacturing operations in Puerto Rico have existed since 1921, with Section 262 of the Revenue Act of 1921, which provided that a U.S. corporation operating in a U.S. possession (including Puerto Rico)[3] could exclude from gross income all income from sources outside the U.S., provided it derived at least 80% of its gross income from U.S. possession sources and at least 50% from the active conduct of a trade or business in the U.S. possession. Therefore, these companies deferred federal income taxation on earnings from Puerto Rico operations until their repatriation into the U.S.[4]

1. The author is the president of the Puerto Rico Manufacturers Association's tax committee.
2. Data provided by the Puerto Rico Manufacturers Association.
3. For purposes of this article, the term U.S. possession includes the Commonwealth of Puerto Rico.
4. Section 262 was later renumbered as section 931.

Section 936 of the Internal Revenue Code of 1986, as amended, was enacted by the Tax Reform Act of 1976, and provided that any U.S. corporation complying with certain requirements could elect to utilize a tax credit equal to the portion of U.S. taxes attributable to the amount of taxable income from sources outside the U.S. derived from the active conduct of a trade or business within a U.S. possession, as well as from qualified possession source investment income (QPSSI). For a quarter of a century, section 936 was the most important promotional vehicle for the Puerto Rico manufacturing industry. This tax sparing credit suffered significant changes in 1982 and 1993, and the Small Business Protection Act of 1996 finally decreed its ten-year phased-in repeal. Corporations formerly using the economic activity or wage method to determine creditable amounts under section 936 would now do so under the new section 30A, providing benefits for employment, capital investment, and research, formerly available under Section 936. These benefits would also be subject to the ten-year phased-in repeal.

The phased-in repeal of the benefits under Sections 936 and 30A prompted many companies to look for alternatives, and many transferred their Puerto Rico operations to foreign entities, thus becoming controlled foreign corporations ("CFCs").[5] As foreign entities not doing business in the U.S., the results of their operations would not be subject to federal income taxes until the actual or imputed repatriation of earnings to the U.S. parent. Imputed repatriation exists under the Subpart F provisions of the Internal Revenue Code, which taints certain types of income derived by the foreign subsidiary. Subpart F income includes certain investments in U.S. property by the foreign subsidiary pursuant to section 956.[6]

The elimination of the 936/30A benefits, coupled with the realities of increased global competition, have triggered much discussion as to the possible alternatives for federal incentives in favor of U.S. possessions operations. This discussion has been influenced by federal budgetary concerns, therefore prompting an interest in promoting repatriation of foreign earnings, and an increasing movement in favor of strengthening the job market available to U.S. citizens. Many have been careful not to forget that nearly 4,000,000 of those U.S. citizens live in Puerto Rico. Certain provisions of the American Jobs Creation Act of 2004 (the "JOBS Act") are in part a product of such discussions. It provides for a special phased-in 9% deduction for qualifying production activities income, which will reduce the effective rate from 35% to 32%. Unfortunately, this deduction does not apply to manufacturing operations conducted in Puerto Rico. In addition, the JOBS Act promotes repatriation by allowing an 85% dividend received deduction to corporate shareholders receiving extraordinary dividends from their foreign subsidiaries and reinvesting such dividends in the United States. The qualifying reinvestment requirement does not apply to investments in Puerto Rico.

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5. A foreign corporation is a CFC if more than 50% of its stock (by vote or value) is owned by U.S. Shareholders, that is, U.S. persons owning at least 10% of the voting stock of the foreign entity.

6. Initially, CFCs operating in Puerto Rico that complied with certain requirements were not subject to the imputation of income provisions of Subpart F, exclusion that was eliminated in 1986.

Many proposals for federal incentives have been mentioned, all with one common objective, to promote the establishment of operations in U.S. possessions instead of in foreign countries. These alternatives have included, among others, the following:

1. Temporarily extending the life of Section 30A;

2. Amending section 956 (which treats as Subpart F income certain investments in U.S. property) to allow a deduction of 90% of the income included under said provision as Subpart F income;

3. Excluding CFCs operating in a U.S. possession from the Subpart F provisions;

4. Including Puerto Rico as an Enterprise/Empowerment Zone; and

5. Including Puerto Rico operations among the qualified production activities in the context of the JOBS Act deduction.[7]

Another alternative, which is being promoted by the Puerto Rico Manufacturer's Association since last year, contemplates an amendment to Section 243 to treat certain corporations organized and operating in a U.S. possession as a domestic (U.S.) corporation only for purposes of allowing the dividend received deduction to their stateside corporate stockholders (hereinafter, the "243 Proposal"). In its current form, the dividend received deduction under section 243 is not available in the case of distributions made by U.S. possessions companies to their U.S. corporate parents. A corporation is entitled to a special deduction of 70% of dividends received from a domestic corporation that is subject to federal income taxes. If the stockholder corporation owns 20% or more of the stock in the distributing corporation, then the deduction allowed is 80% of the dividend. The effect of this deduction is to reduce the effective rate on the dividend received to 10.5% or 7% depending on whether the 70% or the 80% deduction is allowed. A 100% dividend received deduction is allowed in connection with certain qualifying dividends. Qualifying dividends are those received by a corporation that is a member of the same affiliated group as the distributing entity.[8] Section 246 imposes certain limitations on the maximum amount of deduction that may be claimed.

To qualify for the dividends received deduction under the 243 Proposal, the U.S. possession corporation must derive at least 80% of its income from the active conduct of a trade or business within the U.S. possession in which it was organized. Depending on

7. Some have recommended that the Puerto Rico government fully tax Puerto Rico operations by stateside companies doing business here, under the assumption that such tax which would be creditable for federal tax purposes. Under this proposal, the Puerto Rico government would provide grants and subsidies to such entities commensurate to the taxes paid in Puerto Rico. This recommendation, however, overlooks the principles behind the foreign tax credit provisions, which would preclude crediting any amount of taxes paid that is related to subsidies or grants by the Puerto Rico government.

8. In this context, an affiliated group includes one or more chains of includible corporations connected through stock ownership with a common parent corporation, which is also an includible corporation. Ownership of at least 80% of the stock by vote and value is required. The term includible corporation under section 1504(b) excludes foreign corporations. Conforming amendments would have to be made under the 243 Proposal to allow the 100% dividend received deduction with respect to the qualifying U.S. possessions companies.

the level of ownership of the U.S. parent, a 70%, 80% or even a 100% deduction would be allowed for actual (not Subpart F imputed distributions) distributions of earnings and profits generated in the active conduct of a trade or business in such possession.

The 243 Proposal would impact corporate stockholders that are subject to federal income taxes and that directly own a U.S. possessions corporations. This alternative is viewed as an effective way to attract to Puerto Rico mid-size U.S. companies that are not currently inclined to establish operations in Puerto Rico because of the double level of taxation involved in a parent-subsidiary scenario. Entities with more complex corporate structures may not receive direct tax savings, although other benefits are expected due to the potential increased availability of suppliers within the possession. In addition, the repatriation of foreign earnings would be promoted.

In view of the fast-approaching phase out of the benefits under sections 936 and 30A, it is crucial that a comprehensive plan and strategy for federal incentives be designed and promoted. Such plan should take into consideration the needs of Puerto Rico and of the United States as a whole, and the threats and challenges that both are facing in a world of globalization and competition. The much awaited results of studies being conducted by the General Accountability Office (GAO) and the Joint Committee on Taxation, both expected to be issued by Fall, will certainly influence the determination of which alternative is best for all the parties.

Some have advised against waiting that long to commence efforts in favor of a proposal for federal incentives. Not surprisingly, others hold the contrary view. In the meantime, the Puerto Rico Report from Washington (February 2005) is already reporting on several initiatives being analyzed by the Joint Committee on Taxation, which could impact Puerto Rico. These are: (1) adopting a dividend exemption system for foreign business income; (2) adopting new rules for corporate residency; and (3) establishing a uniform excise tax for all alcoholic products sold in the U.S. The dividend exemption system would classify income earned abroad by foreign subsidiaries of U.S. parents into two categories, passive and highly mobile income, which would be taxed to the U.S. parent, and all other income, which would be exempt from U.S. tax even in the event of repatriation to the U.S. Non-dividend payments from the subsidiary to the U.S. parent (such as interest, royalties, service fees, income from inter-company sales) would be fully subject to tax, and not offset by cross-crediting. The new residency rules would require that publicly traded companies incorporated abroad be treated as U.S. residents if managed and controlled in the U.S.

The Puerto Rico government is aware that with each day competition from foreign countries increases, and thus, that relying on federal incentives alone is not an option. Puerto Rico has moved to establish strategies to meet this challenge. Currently, qualifying entities can obtain flat rates that range from 7% to 2% on industrial development income and can reach zero in the case of pioneer high technology industries. Other incentives include partial exemptions from municipal license, property and excise taxes, special rates for certain operations such as the establishment of headquarters in Puerto Rico, and credits or deductions for certain expenses such as

research and development and purchases of Puerto Rico manufactured products for exportation.[9]

Although local tax incentives are already aggressive, there is always room from improvement. Some proposals that have been presented to the government include providing appropriate government officials more flexibility (within limits) to negotiate applicable rates on royalty payments and reduce income tax rates on operations income accordingly, and creating ways to help financing the start up of operations. Puerto Rico should also continue its efforts to maintain and improve its competitive position as an attractive forum for investment, particularly in biotechnology and high technology operations. Infrastructure, availability of prepared human capital and suppliers, and a government role directed towards facilitating local operations will be determinative in this effort.[10]

Both the federal government and the Commonwealth face difficult decisions. It is up to us to help them achieve an alternative that is effective and fair. Different points of view are bound to arise. Each of us may feel that we have the monopoly of reason and truth in defending one alternative over the others, and probably neither of us will in fact be completely right. If only we had a crystal ball to show us what the future holds for Puerto Rico and what the best course of action is.... But the fact is we have only our vision and best intentions. One thing is clear, we must strive to speak with one voice when the time comes, and all our efforts must be directed towards making that one voice be heard loud and clear. After all, regardless of how different our points of view may be, we all pursue the same objective, to provide for a better future to our children.

9. Some visionary municipalities have enacted ordinances providing for a reduction of applicable municipal license and property tax rates on the taxable portion of volume of business and assessed property values, respectively.

10. In this respect, the Secretary of the Treasury has expressed interest in developing, with the cooperation of the industry, creative ways to increase its contribution to the fisc in order to generate funds that would be earmarked for infrastructure projects.