

# Tax Alert: Related parties' transactions tax is unconstitutional

## The First Circuit of the United States Court of Appeals upheld the Puerto Rico Federal District court decision in favor of Wal-Mart Puerto Rico against the Puerto Rico Secretary of Treasury.

On March 2016, the Puerto Rico Federal District Court decided in the case presented by Wal-Mart Puerto Rico, Inc. (Wal-Mart) against the Puerto Rico Secretary of Treasury (Secretary) that the Alternative Minimum Tax (AMT) provisions of Act 72-2015 were unconstitutional. The Secretary challenged this decision by recurring to the First Circuit Court of Appeals. The appeals court finally issued its ruling affirming the lower court's decision last night.

### Background – Act 40-2013

On June 2013, the Puerto Rico government approved Act 40-2013 which among others brought two important limitations to Puerto Rico taxpayers that had transactions with related parties not engaged in a trade or business and not subject to tax in Puerto Rico.

The first limitation impacted the ordinary tax computation. In this case, if a Puerto Rico taxpayer had charges or expenses billed from a related party not engaged in a trade or business in Puerto Rico, it was not allowed to deduct those expenses. Notwithstanding, the Secretary was provided with the authority to approve a waiver from this disposition of the law.

Also, the AMT computation was also amended to impose a 2% tax on personal

property purchases (i.e. inventory) from a related party outside of Puerto Rico. In addition, another component was introduced to the AMT by charging a tax of 20% on the expenses charged or incurred with a related party not engaged in trade or business in Puerto Rico. As with the case of the deduction limitations for the ordinary tax purposes, the Secretary was authorized to issue a waiver from the application of these dispositions to those taxpayers that requested such waiver in accordance to certain guidelines that the Secretary should have issued on that regards.

Subsequently, the Secretary issued various communications with the guidance to request the waivers from the dispositions of Act 40-2013 with respect to the related party transactions.

### Act 72-2015 changes

Act 72-2015 brought significant changes to the rules for related party transactions that initiated with Act 40-2013. First, it limited the amount of the expenses that the Secretary could waive to 60%. It also eliminated the waiver process for the purchases of personal property and provided an increase on the tax over those purchases from 2% to a gradual rate from 2.5% to 6.5%, depending on the taxpayer's gross revenues.

### Wal-Mart Action

On December 4, 2015, Wal-Mart initiated legal action against the Secretary to challenge the changes brought by Act 72-2015. The focus of Wal-Mart's claim was particularly with



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the AMT imposition on the purchases of personal property as it is the area in which it received the most impact. Wal-Mart requested an injunction against the continued enforcement of the AMT provisions sustaining that they were unlawful under the Dormant Commerce Clause, the Equal Protection Clause, the Bill of Attainder Clauses, and the Federal Relations Act.

The initial action from the Secretary was to challenge the jurisdiction of the court to accept the case. The court deferred the ruling on such matter and decided to evaluate the case.

On March 28, 2016, the district court issued an order stating its findings of fact and conclusions of law. It held that (1) it had jurisdiction under the Butler Act because of the lack of a “plain, speedy and efficient remedy” in Puerto Rico courts; (2) the AMT violates the dormant Commerce Clause; (3) the AMT violates the Federal Relations Act; (4) the AMT violates the Equal Protection Clause; and (5) the AMT does not violate the Bill of Attainder Clauses.

The Secretary followed appealing the District Court decision.

#### The Court of Appeals determination

The Court of Appeals affirmed the District Court’s decision, therefore the injunction against the enforcement of the AMT against Wal-Mart continues. It indicates that the District Court had jurisdiction because Wal-Mart, at the time of the suit, lacked a plain, speedy, and efficient remedy in the Puerto Rico courts. As to the merits of the Commerce Clause’s challenge, the Appeals Court mentioned that “the AMT is a **facially discriminatory statute** that does not meet the heightened level of scrutiny required to survive the Dormant Commerce Clause”.

Having affirmed the unconstitutionality of the AMT dispositions in light of the Dormant

Commerce Clause, the Appeals Court indicated that it was not necessary to decide on the Federal Relations Act or the Equal Protection Clause issues.

Even though Wal-Mart’s claim was focused on the AMT implications on purchases of personal property, the Court of Appeals decision establishes in its analysis of the implications of the dormant Commerce Clause some findings that merit to be highlighted as they certainly apply to related party transactions beyond purchases of personal property.

The Appeals Court recognized that prior to Act 72-2015, the Secretary had the authority to tax related party transactions at a lower tax if he found that the transfer price paid by the taxpayer to the related entity was equal or substantially similar to the price for which such related party sells such property to an unrelated party.

Moreover, it explains that the Dormant Commerce Clause precludes States from discriminating between transactions on the basis of interstate element. It expands by adding that a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State.

The decision censures the AMT dispositions by stating that it is indisputable that Act 72-2015 is discriminatory as it taxes only cross-border transactions between a PR corporate taxpayer and a related entity outside of Puerto Rico. Furthermore, the Appeal’s Panel concluded also that if Act 72-2015 would have been valid, it would prevent multistate corporations from enjoying the functional integration, centralization of management, and economies of scale associated with their interstate business model.

Lastly, the decision mentions that Act 72-2015 is based on the incorrect presumption that all

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intercorporate transfers to a Puerto Rico branch from a related party are fraudulently priced to evade taxes. It says that the Secretary admits that there are alternatives to validate if there is an undue profit shifting, as it is the case with **“the already existing set of regulations that authorize the Puerto Rico Treasury to conduct a traditional transfer-pricing audit of interstate transactions between related parties and to adjust specific transfer prices...to recapture improperly shifted profits.”**

Certainly, the Appeals Court decision reaffirms, not only the unconstitutionality of these recent arbitrary impositions on related party transactions, but emphasizes the fact that Puerto Rico has regulations to review transactions among related parties, similar to those in the Federal Tax System.

Today, the Secretary has expressed that the government of Puerto Rico will not appeal the case and that instead, a set of transfer pricing regulations is expected to be issued by October this year.

We certainly expect an increase effort on documenting transactions between related parties in different jurisdictions with the methodologies of a formal Transfer Pricing Study in order to support the pricing structures being applied in Puerto Rico.



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