

# Tax Alert: Proposed changes to Act 154

On October 25, 2010, the Government of Puerto Rico enacted Act 154-2010 to establish a 4% Excise Tax on certain *personal property* and *services* transactions between related entities for taxable years commenced after December 31, 2010. The tax generally applies to foreign companies that have an office, or are treated as having a permanent place of business in Puerto Rico, and reaches certain threshold levels of production.

## **Act 154-2010**

At the time, the Puerto Rico government stated that the tax would be transparent for those entities affected by it and, therefore, would be allowed by the U.S. Internal Revenue Services (“IRS”) to claim it as a credit for federal income tax purposes.

On April 18, 2011, the IRS released Notice No. 2011-29, whereby the agency committed to evaluate the fiscal impact of Act 154-2010 but during said evaluation, it would not challenge taxpayer’s claiming the 4% Excise Tax as a foreign tax credit.

Since its enactment, the tax has provided the government’s coffers with almost \$2 billion annually, creating what some analyst might consider an indirect government bail-out - a benefit that none of the States of the Union have ever had. Approximately 90% of the aforementioned \$2 billion in revenues is contributed by roughly 10 companies, with an additional 20 providing the remaining 10%.

Presently, revenues derived from Act 154-2010 account for about 20% of the Puerto Rico General Fund

Originally slated to be eliminated by December 31, 2016, the Excise Tax was extended until December 31, 2027 by the administration of Gov. Ricardo Rosselló through Act No. 3 of 2017.

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Understanding that there is not a “one-size-fits-all” solution for the treatment of excise tax payments, the government is evaluating various alternatives under Act 154-2010.

The extension, though necessary in light of Puerto Rico worsening economic situation, creates some uncertainty as to the creditability of the excise tax payment in Puerto Rico for US tax purposes, since the IRS has not made further declarations on the matter, aside from Notice 2011-29 and the elements under which said Notice were issued have changed, in particular, the revised end-date for the excise tax [i.e. December 31, 2027].

Moreover, one must also consider the new political background. The Trump administration has vastly different economic and administrative views from the predecessor under which Notice 2011-29 was issued. It is quite possible that the IRS may very well re-visit their position if it's not congruent with the current administration's fiscal reform.

To complicate matters further, the Fiscal Oversight Board established by the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”) has stressed to the Rosselló administration that both the government's budget as well as any economic plan must not take into consideration the revenues generated under Act 154-2010.

That may prove a tall order since its inception every administration has readily depended on Act 154-2010 collections for budgetary purposes. Considering that a small decrease in intercompany transactions, or worse the cessation of operations of one of the 10 that account for 90% of the revenues would result in a considerable reduction to the available funds, taking it out altogether from all planning projection will test the creativity, mettle and resolve of the administration to deal with the imposed economic realities.

Mindful of the present political landscape, and with the insecurity as to the perpetuation of the favorable treatment for excise tax payments against federal income tax and the Island's current situation, the administration of Gov. Rosselló is discussing various alternatives to Act 154-2010, understanding that there is not a “one-size-fits-all” solution and that they must find a more permanent solution to the Act 154-2010 challenge. Among the various alternatives to Act 154-2010, the following or a combination thereof, have been considered:

1. a modified version of the income source rules;
2. an increased income tax on exempted income;
3. an income tax withholding on royalties or cost allocation payments;
4. a withholding income tax on profit distributions.

No matter which alternative is undertaken, the goal is to provide greater certainty and simplicity by moving the excise tax into a new vehicle that will afford companies doing business in Puerto Rico full creditability for U.S. tax purposes by fiscal year 2019. Nonetheless, said creditability must not come at the expense of economic growth for Puerto Rico.

It is clear that Puerto Rico has its work cut out for it. With a looming Tax Reform at the federal level, there is uncertainty as to how will Puerto Rico be considered for federal tax purposes. Will it be treated as a domestic jurisdiction for tax reasons or will it remain a foreign one? Given the undefined state of affairs, the Puerto Rico government is weighing both outcomes and drafting legislation to both ends in order to have a measured response and blueprint to each alternative.

**Note:** As highlighted in our July 1, 2016 Tax Alert, PROMESA seeks to provide Puerto Rico with fiscal and economic discipline through the creation of a control board, among other things. Virtually every fiscal decision by the Government of Puerto Rico will be made or approved by the Oversight Board created by PROMESA. On this regard, the board has authority to prevent the execution or enforcement of a contract, rule, executive order or regulation to the extent that it is inconsistent with the approved fiscal plan.

Please contact our Tax Department should additional information is required regarding this or any other tax issue. We will be glad to assist you.



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