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## Are We There Yet? U.S. Foreign Tax Credit Treatment of Puerto Rico's Excise Tax Unwind

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### INTRODUCTION

On September 16, 2022, the U.S. Internal Revenue Service (IRS) released Notice 2022-42, providing taxpayers much-needed guidance on certain foreign tax credit (FTC) issues presented by measures currently being undertaken by the government of Puerto Rico to restructure tax incentives in a way that addresses the commonwealth's fiscal needs, while providing taxpayers the certainty necessary to support continued investment in and operations on the island. This article summarizes the long and winding road that led us to this point, and notes some planning considerations for affected taxpayers.

### BACKGROUND

#### Puerto Rico's Legal Status and Tax Incentives

One critical aspect of Puerto Rico's hybrid status as a U.S. commonwealth is that Puerto Rico — while be-

ing a part of the United States for many legal, economic, and practical purposes — is treated as a foreign country for purposes of the Internal Revenue Code (“the Code”).<sup>2</sup> For many years, the U.S. Congress provided special tax incentives aimed at promoting economic development in Puerto Rico (and other U.S. possessions).<sup>3</sup> One rationale for these incentives was that Puerto Rico faces competitive constraints from its hybrid status (e.g., U.S. wage and shipping regulations), and thus the United States should ensure that these constraints do not inhibit Puerto Rico from competing in global markets with similarly situated countries that do not face these constraints.<sup>4</sup> From 1976 until 2006, the possessions tax credit under §936 served as the core U.S. tax incentive in this regard, enabling U.S. domestic corporations to elect a credit that effectively exempted them from U.S. tax on certain possessions income, provided various requirements were met. However, policy makers eventually became concerned that the revenue forgone as a result of §936 might have been disproportionate to the economic development benefits of the provision, and thus Congress repealed it in 1996, with transition rules extending until 2006.<sup>5</sup>

Since then, multinationals generally have operated in Puerto Rico through controlled foreign corporation

<sup>2</sup> See §7701(a)(9) (defining the “United States” for federal income tax purposes as including “only the States and the District of Columbia”). Except as otherwise specified, all “§” references herein are to the Code, or to the Treasury regulations issued thereunder.

<sup>3</sup> See Jt. Comm. on Tax'n, *An Overview of the Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options*, JCX-24-06 (June 23, 2006) (summarizing much of this history); Gov't Accountability Office, *Puerto Rico and the Section 936 Tax Credit*, GAO/GGD-93-109 (June 1993) (same).

<sup>4</sup> See *id.*

<sup>5</sup> See Small Business Job Protection Act, Pub. L. No. 104-188 (Aug. 20, 1996), sec. 1601 (terminating §936 and providing a reduced transitional credit under a new §30A until 2006).

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This article may be cited as David G. Noren, *Are We There Yet? U.S. Foreign Tax Credit Treatment of Puerto Rico's Excise Tax Unwind*, 51 Tax Mgmt. Int'l J. No. 11 (Nov. 4, 2022).

(CFC) structures, relying on a combination of the commonwealth's U.S. federal income tax status as foreign country and its practice of granting reduced tax rates under long-term agreements with taxpayers maintaining a sufficiently robust presence on the island (generally referred to as tax decrees).

## The Act 154 Saga

By 2010, however, the Puerto Rican government concluded that it needed a new revenue source, and existing tax decrees prevented it from simply increasing corporate income taxes on CFCs with business operations on the island. Puerto Rico circumvented the decrees by enacting an entirely new tax.<sup>6</sup> This new tax was structured as an excise tax ("the Excise Tax") imposed on large related-party purchasers of goods produced or services performed on the island. Because it was a new tax, imposed on a legal entity other than the local entity that was entitled to the benefits of a tax decree, the government concluded that such decrees presented no impediment to using the Excise Tax to generate more revenue from large multinational groups with operations in Puerto Rico. The Excise Tax operated in lieu of modified effectively connected income (ECI) rules that were expanded in 2010 to create a taxable presence for non-resident entities in Puerto Rico for local income tax purposes, even in situations in which these entities lacked any trade or business on the island under longstanding principles.

Puerto Rico's enactment of the Excise Tax raised the issue of whether the tax was a creditable "in lieu of" tax under §903. Under §903, an income tax for FTC purposes includes a tax paid or accrued in lieu of an income tax that is otherwise generally imposed. The tax must be imposed in substitution for and not in addition to a generally imposed income tax, and the liability for the tax cannot depend (by its terms or otherwise) on the availability of a credit for the tax (i.e., the tax cannot be a "soak up" tax).<sup>7</sup>

In Notice 2011-29, the IRS stated that it was studying the FTC issues presented by the Excise Tax, but that, in the meantime, the IRS would not challenge a taxpayer's position that the Excise Tax qualified as an "in lieu of" tax under §903. Notice 2011-29 also indicated that any change in the IRS's position on this issue in future guidance would be only prospective in application. This provisional creditability status continued for quite some time, with occasional grumbling from U.S. Treasury officials that it could eventually be revisited.

<sup>6</sup> Puerto Rico Act No. 154-2010 (Act 154) (Oct. 25, 2010).

<sup>7</sup> §903; Reg. §1.903-1(b)(1), §1.903-1(b)(2) (prior to amendment by T.D. 9959, 87 Fed. Reg. 45,021 (Dec. 28, 2021)).

## The Attribution Requirement Under the New FTC Regulations

Meanwhile (for reasons having relatively little to do with Puerto Rico), Treasury and the IRS issued new regulations at the end of 2021 significantly restricting the availability of FTCs in a range of situations, including in particular claims with respect to foreign taxes, such as digital services taxes, that may be imposed on a taxpayer despite the lack of any standard jurisdictional nexus in the country imposing the tax. This new restriction took the form of a new "attribution" requirement that must be satisfied in order for a foreign tax to qualify as an income tax for FTC purposes.<sup>8</sup>

Puerto Rico's modified ECI tax and the Excise Tax under Act 154 do not satisfy the new attribution requirement, as they are both imposed on taxpayers that lack the necessary traditional nexus with the tax-imposing jurisdiction. As applied to Puerto Rican taxes, the new requirement takes effect for taxes paid or accrued in taxable years beginning on or after January 1, 2023.<sup>9</sup>

## Puerto Rico's Enactment of Act No. 52-2022

In response to these developments, Puerto Rico enacted Act No. 52-2022, which allows taxpayers to agree to amend their existing tax decrees and thereby achieve exclusion from the modified ECI tax and Excise Tax under Act 154.<sup>10</sup> The amended decrees will be extended an additional 15 years beyond their prior existing terms, and are expected to result in Puerto Rican income tax liabilities higher than those under the decrees' prior existing terms, but lower than those under the generally applicable Puerto Rican income tax laws in the absence of a decree.

## NOTICE 2022-42

Under this decree amendment process, multinational groups effectively will replace the Excise Tax

<sup>8</sup> See Reg. §1.901-2(b)(5) and §1.903-1(c)(1)(iv) (added by T.D. 9959, 87 Fed. Reg. 45,021 (Dec. 28, 2021)). It is far from clear that the new attribution requirement represents a valid exercise of regulatory authority, insofar as it has nothing to do with the character of a foreign tax as an income tax, and the Code requires that FTCs be made available for foreign income taxes. See §901(a), §901(b). Extraterritorial income taxes may be objectionable, but they would seem to be a kind of income tax.

<sup>9</sup> See Reg. §1.901-2(h), Reg. §1.903-1(e). Comments had requested that Puerto Rican taxes be exempted from the attribution requirement entirely. Treasury and the IRS rejected these requests, but did provide a deferred effective date in recognition of the special circumstances described above. See T.D. 9959, 87 Fed. Reg. 45,021 (Dec. 28, 2021).

<sup>10</sup> Puerto Rico Act No. 52-2022 (June 30, 2022).

liabilities of various off-island related entities with increased income tax liabilities imposed on their CFCs with operations on the island. There should be no doubt that the generally applicable Puerto Rican income tax is a creditable foreign income tax as a general matter under the attribution and other applicable FTC requirements, but the act of amending a decree in such a way as to increase the amount of income tax owed relative to the pre-amendment baseline presents a new FTC issue. Specifically, under longstanding regulations, an amount remitted to a foreign government is not a compulsory payment, and thus cannot be considered an amount of income tax paid, to the extent that it exceeds the amount due under the relevant foreign tax law.<sup>11</sup> Where foreign tax law provides computational options or elections whereby a taxpayer's liability may be permanently decreased in the aggregate over time, a taxpayer's failure to use such options or elections is treated as giving rise to a non-compulsory payment.<sup>12</sup>

In Notice 2022-42, the IRS announced that, under forthcoming regulations, amending a tax decree with Puerto Rico pursuant to Act 52-2022 on or before December 31, 2022 will not cause any amount of income tax paid or accrued to Puerto Rico to be treated for FTC purposes as a noncompulsory payment by reason of any difference between the original and the amended decree terms. It remains necessary that the income tax liability under the amended decree be less than the liability that would result under Puerto Rico's generally applicable income tax laws, but this requirement presumably will be met. Until regulations are issued, taxpayers can rely on Notice 2022-42.<sup>13</sup>

The IRS emphasized that it issued Notice 2022-42 in order “[t]o facilitate Puerto Rico’s transition to Act 52-2022, and given Puerto Rico’s status” vis-à-vis the United States. Accordingly, the IRS cautioned, “[n]o inference as to the application of the noncompulsory payment regulations in any other context should be drawn from this Notice.”<sup>14</sup>

Notice 2022-42 also revokes Notice 2011-29, effective for Excise Tax paid or accrued in taxable years beginning on or after January 9, 2023. Thus, any taxpayers that may continue to pay the Excise Tax rather than agreeing to amended decree terms eventually will lose the protection of Notice 2011-29 and thus could be challenged by the IRS under the attribution and potentially other requirements of the FTC regulations.

<sup>11</sup> See Reg. §1.901-2(e)(5)(i).

<sup>12</sup> See Reg. §1.901-2(e)(5)(iii)(A).

<sup>13</sup> Notice 2022-42, §4.

<sup>14</sup> Notice 2022-42, §3.

## OBSERVATIONS AND PRACTICAL CONSIDERATIONS

Notice 2022-42 is welcome relief to taxpayers that want to continue operating in Puerto Rico, and found themselves caught between the commonwealth's fiscal needs and troublesome U.S. issues presented by fundamental changes to the FTC regulations. Hopefully this one-time measure will help normalize what has been a strange and fraught state of affairs, by allowing Puerto Rico to raise the revenues it needs under its income tax laws rather than under the Act 154 contraption, while allowing taxpayers to claim FTCs for Puerto Rican income taxes generally as they would with respect to their operations in other countries.

Although Notice 2022-42 addresses only the compulsoriness requirement, taxpayers presumably can take some measure of comfort that the IRS did not identify other issues that could stand in the way of the general creditability of Puerto Rican income taxes under the amended decrees. Obviously, the specific terms of any amended decree will need to be considered in confirming the amounts creditable in any given case, but clearly the intent of Notice 2022-42 is that these taxes generally be creditable. In particular, there should be no concern that the taxes might be considered soak-up taxes under the regulations. Although the history makes it obvious that the relevant Puerto Rican measures were designed with some attention to the creditability issue, the Puerto Rican income tax should not be treated as dependent, by its terms or otherwise, on the availability of a credit.<sup>15</sup>

Affected taxpayers need to move quickly to avail themselves of the treatment afforded under Notice 2022-42, because it applies only to decrees that are amended on or before December 31, 2022, regardless of a particular taxpayer's taxable year end. The Puerto Rican government has established an expedited inter-agency evaluation process to accommodate taxpayers' need for immediate action to amend their decrees.<sup>16</sup> This short timetable may present challenges for taxpayers that may need to consider other FTC implications of effectively replacing one entity's Excise Tax liability with a different entity's Puerto Rican income tax liability (e.g., in some cases this will entail moving from a direct §901 credit to an indirect §960 credit, which may have FTC limitation and other consequences). Although the revocation of Notice 2011-29, paired with the new attribution requirement in the

<sup>15</sup> See Reg. §1.901-2(e)(6).

<sup>16</sup> See Carlos E. Serrano, Alba I. Joubert Pereira, and Ernesto J. Zayas Garcia, *Act 52-2022 Provides New Alternative Income Tax Framework on Controlled Foreign Corporations Subject to the Act 154-2010 Regime* (July 8, 2022), <https://reichardescalera.com/wp-content/uploads/2022/07/Tax-Update-Act-52-July-8-2022.pdf>.

FTC regulations, means that future FTC claims with respect to the Excise Tax itself would have to entail a regulation validity challenge, some taxpayers may wish to proceed down that path, depending on the re-

sults of modeling the FTC effects described above.<sup>17</sup>

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<sup>17</sup> As noted above, the attribution requirement may well be invalid, and affected taxpayers (not necessarily involving the Puerto Rican situation addressed in this article) may bring validity challenges at some point.