February 9, 2021

VIA FEDERAL eRULEMAKING PORTAL
ID: IRS-2020-0040-0001

The Honorable Janet Yellen
Secretary
U.S. Department of the Treasury

The Honorable Mark J. Mazur
Deputy Assistant Secretary
Office of Tax Policy

U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, D.C. 20220

Dear Secretary Yellen and Deputy Assistant Secretary Mazur:

On behalf of the Government of Puerto Rico, I am pleased to provide the following comments to the United States Government in connection with the proposed regulations relating to the Foreign Tax Credit [REG-101657-20]. We appreciate the opportunity Treasury has provided us to discuss over the past several years the issues set forth below.

As further explained below, it is the position of the Government of Puerto Rico that the proposed rules should not apply to the taxes imposed under Act No. 154 of 2010, as amended, both for policy and for technical reasons and we hope that Treasury will agree on both counts.

I. THE PROPOSED REGULATIONS SHOULD NOT APPLY AS A POLICY MATTER TO US TERRITORIES.

It is our understanding that the primary purpose of the proposed regulations is to address the digital goods taxes that began to proliferate in the OECD and that are now becoming a part of the tax systems of a growing number of nations in which American companies do business. While the Government of Puerto Rico takes no position with respect to these taxes generally, we believe that the vast differences between the relationship between Puerto Rico and the United States and the relationship between foreign sovereign nations and the United States by itself supports the position that the proposed rules should not apply to any US territory.

Puerto Rico has been a territory of the United States since 1898 and individuals born in Puerto Rico are citizens of the United States. Today, there are approximately 3.5 million US citizens living in Puerto Rico, including mainland born US citizens. As discussed below, Puerto Rico is treated under the same rules that apply to a "foreign" jurisdiction" for some aspects of the US

Internal Revenue Code only for technical reasons and that are directly associated to the policy reasons of Puerto Rico being part of the United States.

The governing arrangement between the United States and Puerto Rico was established under the authority of the "territorial clause" in Article four of the U.S. Constitution, which provides:

> The Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States; and nothing in this Constitution shall be so construed as to Prejudice any Claims of the United States, or of any particular State.

Under that authority, Congress has enacted federal legislation applicable to Puerto Rico, but not others. In the area of taxation, residents of Puerto Rico are subject to Federal income tax on their worldwide incomes (same as all Americans) with the exception of income earned from Puerto Rico sources. Residents of Puerto Rico are also subject to US employment taxes, such as Social Security, Medicaid, Medicare, and FUTA, which employers in Puerto Rico are required to collect. The application of the proposed regulations to Puerto Rico is only an issue because Congress chose to treat Puerto Rican corporations and US corporations operating a separate Puerto Rican or foreign corporation operating in Puerto Rico as "foreign".

Nonetheless, even if the US Internal Revenue Code treats a subsidiary of a US corporation in Puerto Rico as "foreign", that entity is located on American soil, its employees are US citizens subject to US income of their non-Puerto Rico source income and US employment taxes, and the business is subject to most US labor, environmental, health and safety, and commercial laws.

The foreign countries that are imposing digital goods taxes on US companies are **truly** foreign and the taxes they collect go to foreign Treasury departments for use in supporting foreign government programs. The United States does not benefit from the imposition of these taxes and they do nothing to improve the US Government or the lives of Americans. We understand fully why the United States Government would not want to subsidize these taxes or encourage foreign governments to impose them.

By contrast, the Act 154 taxes are imposed by an American territorial government for the purpose of supporting government operations that benefit American citizens. In practical terms, these taxes have the same economic impact as taxes imposed by any US state or local government. The impact of the proposed regulations- if Treasury concludes that they do apply technically to Puerto Rico- would be to deprive an American territory of close to one fourth of its budget, potentially cause US companies to leave Puerto Rico with a sharp increase in unemployment, and other forms of economic harm in a territory of the United States that has suffered from a long-term economic recession and a massive hurricane that delayed its economic recovery.

It is also relevant and important to note that the preamble to the proposed regulations state that *"[I]n addition, the proposed regulations, when finalized, would not affect the application of existing income tax treaties to which the United States is a party with respect to covered taxes (including any specifically identified taxes) that are creditable under the treaty".* As previously explained, Puerto Rico is a territory of the United States and, within the context of this relationship; Puerto Rico and the United States have formalized the Tax Coordination Agreement between the United States of America and the Commonwealth of Puerto Rico that became effective on May 26, 1989 (the "USPRTCA"). USPRTCA was the result of the unique and close relationship between the United States and Puerto Rico and is intended to address the interaction between Puerto Rico and United States tax matters in a manner that is analogous to a treaty with a real foreign country.[1] The USPRTCA has been actively used by the IRS and Puerto Rico throughout the years and has been a solid instrument in the enforcement of the tax laws of both jurisdictions. Issues related to treaty country taxes are regularly resolved through bilateral negotiations between the two countries as provided under the treaties. Similarly, any issues with respect to Puerto Rico income taxes should be dealt with through such negotiations as provided under the USPRTCA.

In the next section we present amendments to the proposed regulations to make clear that they do not apply in Puerto Rico. We suggest that these modifications should be made not only for technical tax reasons, but also because the primary motivating force for the proposed regulations, the imposition of taxes by foreign governments on US companies, does not exist with respect to Puerto Rico, and territorial and public policy considerations suggest that in no event should the proposed regulations apply to the income tax imposed by Puerto Rico under the MSR (as defined herein) and the Act 154 excise tax.

II. THE PROPOSED REGULATIONS SHOULD NOT APPLY AS A TECHNICAL MATTER.

A. <u>Background of Puerto Rico's international income tax system and similarities with the USIRC</u>

1. <u>The 1954 PRITA</u>

The origins of Puerto Rico's current income tax system can be traced to the Puerto Rico Income Tax Act of 1954, as amended (the "1954 PRITA"). The 1954 PRITA was modeled after the U.S. Internal Revenue Code of 1939, as amended in the early 1950's. In terms of the rules affecting foreign corporations and nonresidents (hereafter referred to as the "international tax rules"), the 1954 PRITA contained source of income rules that substantially mirrored the source of income rules found in Sections 861 through 863 of the US Internal Revenue Code (as in effect

[1] As explained by the IRS, the USPRTCA authorizes the exchange of information between Puerto Rico and the United States and provides for the establishment of cooperative agreements to resolve disputes arising from inconsistent positions taken by the IRS and Puerto Rico. Revenue Procedure 2006-23, 2006-1 CB 900. Similar procedures to resolve disputes arising from inconsistent positions exist within the context of treaties with foreign countries. Revenue Procedure 2015-40, 2015 -35 IRB 236.

at that time) (hereafter referred to as the "USIRC") and imposed income taxes on foreign corporations under rules that were similar to the rules found in Sections 881 and 882 of the same (as in effect at that time).

Puerto Rico's Tax Reform legislation of 1987[2] continued the approach of following the US income tax rules by adding to the 1954 PRITA a number of "international tax" provisions that were added to the US Internal Revenue Code as part of the Foreign Investors Tax Act of 1966. More specifically, Puerto Rico's 1987 Tax Reform legislation added section 119(f) to the 1954 PRITA to include "effectively connected income rules" that were based on the "effectively connected rules" of Section 864(c) of the USIRC.

Under the "effectively connected income" rules of the 1954 PRITA (the "PR ECI Rules"), foreign corporations were subject to income tax in Puerto Rico on business profits only to the extent that such corporations had income that was "effectively connected" with a trade or business in Puerto Rico. Thus, to be subject to income tax in Puerto Rico under the these rules, a foreign corporation was required to (i) have a trade or business in Puerto Rico and (ii) have income that was effectively connected with that trade or business. If such a corporation had a trade or business in Puerto Rico, the determination of whether income was treated as effectively connected with that trade or business depended on whether the income was Puerto Rico source income. Puerto Rico source income was generally treated as effectively connected with a trade or business in Puerto Rico under the so called "force of attraction rule".[3] In contrast, income that was not Puerto Rico source income was treated as effectively connected with a Puerto Rican trade or business under a rule (that is similar to Section 864(c)(4) of the USIRC only if such income was "attributable" to an "office or fixed place of business in Puerto" Rico under rules that followed the principles of Section 864(c)(5) of the USIRC. In certain cases and under rules similar to those found under Section 864(c)(5)(A) of the USIRC, an office or fixed place of business of a person other than the taxpayer (including related persons) would constitute the taxpayer's office or fixed place of business for purposes of determining whether income was effectively connected related only if that other person regularly exercised the authority to negotiate and conclude contracts, or had a stock of merchandise from which he regularly could fill orders, on behalf of the foreign corporation.

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The similarity of the PR ECI rules with the rules of section 864(c) of the USIRC is quite evident and, as further explained herein, is entirely relevant to the comments here presented in connection with the scope of the proposed regulations and their application to Puerto Rico.

[2] Act. No. 2 of October 6, 1987.
[3] Puerto Rico's "force of attraction rule" is similar to but not identical to the limited "force of attraction rule" of Section 864(c)(3) of the U.S. Internal Revenue Code.

2. The 1994 PRIRC

a. General

The 1954 PRITA was substituted in 1994 by the Puerto Rico Internal Revenue Code of 1994, as amended (the "1994 PRIRC").[4] In terms of the international taxation rules, the 1994 Code continued with the same rules that had been previously established in the 1954 PRITA. In other words, the 1994 PRIRC continued to include in its Section 1123(f) the "effectively connected income rules" generally described above and that, as previously indicated, were originally based on the "effectively connected rules" of Section 864(c) of the USIRC and the branch tax rules of Section 884 of the USIRC that were added to the USIRC by the 1986 Tax Reform Act.[5]

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b. 2010 Amendments to Section 1123(f) of the 1994 Code-Act No. 154 of October 25, 2010

i. The Modified Source Rule

As previously indicated, the PR ECI Rules provide that the activities of a related person in Puerto Rico are treated as an office or fixed place of business of a nonresident foreign corporation only when that related person regularly exercises the authority to negotiate and conclude contracts, or has a stock of merchandise from which he regularly fills orders, on behalf of the nonresident foreign corporation. However, Act No. 154 of October 25, 2010, as amended ("Act 154"),[6] amended the PR ECI Rules to add the so called "modified source rule" (the "MSR"). Attached is the official English version of Act No. 154.

On the one hand, the MSR expanded the scope of an "office or fixed place of business" to provide that a nonresident foreign corporation would be treated as having an office or fixed place of business in Puerto Rico and treated as being engaged in a trade or business in Puerto Rico if a related person had an office or fixed place of business in Puerto Rico and the foreign corporation engaged in transactions with the related person in Puerto Rico that met certain thresholds.[7]

[4] Act No. 120 of October 31, 1994.
[5] Section 1123(f) of the 1994 Code was the successor to Section 119(f) of the 1954 PRITA.
[6] Act No. 157 of October 28, 2010 made technical amendments to Act No. 154.
[7] The thresholds were: (a) where a foreign corporation (a "Purchaser") purchased goods from a related company that manufactures personal property or performs services in Puerto Rico (a "Seller") that account for (i) at least 10 percent of the total gross receipts of the Seller from the sale of personal property manufactured or produced and services performed in Puerto Rico by the Seller, (ii) at least 10 percent of the total costs of personal property and services acquired by the Purchaser for the taxable year or any of the three preceding taxable years, (b) the Purchaser engaged in transactions involving personal property manufactured or produced in whole or in part in Puerto Rico or services performed in Puerto Rico by the Seller with respect to which the Purchaser earns commissions or other fees that account for at least 10 percent of the total amount of commissions or other fees earned by such Purchaser for the taxable year or any of the three preceding taxable years, or (c) the Seller engaged in sales of personal property

On the other hand, the MSR expanded the scope of Puerto Rico source income by providing that a portion of the gains, profits, and income that the foreign corporation derived from the sale or exchange outside Puerto Rico of personal property manufactured or produced in whole or in part within Puerto Rico by the related person was treated as Puerto Rico source income that was effectively connected with the conduct of a Puerto Rican trade or business. The portion of the foreign corporation's income that is treated as Puerto Rican source is determined under one of two provisions. Under the first provision (the "Formulary Provision"), the portion of the income treated as Puerto Rican source income is determined by multiplying the total income of the foreign purchasing corporation by a percentage based on a formula. The Formulary Provision is based on four equal factors: purchases, sales, property, and payroll. The percentage is computed by taking an average of four fractions: (1) purchases in Puerto Rico divided by total purchases; (2) sales in Puerto Rico divided by total sales; (3) property in Puerto Rico divided by total property; and (4) Puerto Rican payroll divided by total payroll. The sum of these fractions divided by four is multiplied by the foreign corporation's total income to determine the amount of its Puerto Rican source income. Under the second provision, the MSR provides that if any taxpayer believed that the apportionment to Puerto Rico determined under the Formulary Provision results in a greater portion of its total income than is reasonably attributable to business or sources within Puerto Rico, the taxpayer is entitled to file a statement of its objection and propose an alternative method of apportionment as it believes to be proper under the circumstances.[8]

ii. The Act 154 Excise Tax

In order to ease the burdens in administrating the MSR, Act No. 154 imposes an excise tax on purchases made by the purchasing foreign corporation from the related sellers in Puerto Rico whose gross receipts exceeded $75,000,000 for any of the preceding three taxable years (known as the "Act 154 Excise Tax"). The Act 154 Excise Tax was designed so that, for purposes of the foreign tax credit rules of Section 901 of the USIRC, it qualified to be treated tax as a tax paid or accrued "in lieu of an income tax" under Section 903 of the USIRC. To achieve this result, Act No. 154 first provided the MSR, as discussed above, and then providing that the MSR did not apply if the sales of the related entity operating in Puerto Rico exceeded $75

manufactured or produced in whole or in part in Puerto Rico or performed services in Puerto Rico that were facilitated by the Purchaser that, together with the transactions described in the three other 10-percent tests, accounted for at least 10 percent of the total gross receipts of the Seller or at least 10 percent of the total gross receipts of the Purchaser for the taxable year or any of the three preceding taxable years. The MSR also contained an anti-abuse rule that would disregard any transaction. or series of transactions, where one of the principal purposes of such transaction or series of transactions is the avoidance of any of the 10-percent tests described above.

[8] In addition, where a foreign corporation is unwilling or unable to provide adequate documentation regarding the information necessary to apply the four factors in the Formulary Provision properly and is unable to demonstrate a sufficient alternative formula or method as allowed by that provision, then a simpler computation is provided. This alternative applies to treat 50 percent of the income from the sale or exchange of property manufactured or produced in whole or in part within Puerto Rico as sourced where the property is manufactured or produced (i.e., Puerto Rico).

million and, if that were the case, then in lieu of being subject to Puerto Rico income tax under this rule, the foreign affiliate was subject to the Act 154 Excise Tax and not the MSR.

The treatment of the Act 154 Excise Tax as qualifying as a tax paid or accrued in lieu of an income tax under Section 903 of the IRC was immediately addressed to by the IRS in Notice 2011-29[9], which also describes the MSR as the "Expanded ECI Rules". The IRS has not revoked, modified or otherwise altered Notice 2011-29. Accordingly, since then US corporations that pay the Act 154 Excise Tax have relied on Notice 2011-29 in treating the Act 154 tax as a creditable tax under Section 903.

The Act 154 Excise Tax is not a permanent tax as it expires in 2026. However, the MSR will continue to apply and, therefore, foreign corporations that were not subject to the MSR on account of being subject to the Act 154 Excise Tax would then be subject to Puerto Rico income tax under the MSR.

3. <u>The 2011 PRIRC</u>

The 1994 PRIRC was substituted by the Puerto Rico Internal Revenue Code of 2011, as amended (the "2011").[10] In terms of the international taxation rules, the 2011 Code continued with the same rules that had been previously established in the 1954 PRITA and the 1994 PRIRC. In other words, the 2011 PRIRC continues to include the "effectively connected income rules" generally described above and that, as previously indicated, were originally based on the "effectively connected rules" of Section 864(c) of the USIRC.[11]

It isalso relevant to note that the 2011 PRIRC adopted source of income rules from the sale of personal property that were modeled after Section 865 of the USIRC, thus further confirming the similarities between the 2011 PRIRC and the USIRC.

In terms of the Act 154 Excise Tax it is important to note that the annual amount that Puerto Rico collects in connection with the Act 154 Excise Tax ranges between $1.8-2 billion, and it represents over 25% of Puerto Rico's General Fund net revenues. In addition, it is imposed on a group of companies that enable over 78,000 direct/indirect jobs on the island. This source of revenues is of extreme importance to Puerto Rico and its plan to recover from its fiscal crisis, stabilize its economy and continue relying on the manufacturing sector as a key player in the pending recovery.

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[9] Notice 2011-29 was issued on March 30, 2011.

[10] Act No. 1 of January 31, 2011.

[11] The provisions of Section 1123(f) of the 1994 Code are incorporated into the 2011 PRIRC by Section 1035.05 of the 2011 PRIRC. Similarly, the Act 154 Excise Tax imposed under the 1994 PRIRC is incorporated into the 2011 PRIRC by Section 3070.01 of the 2011 PRIRC.

III. AMENDMENTS TO THE PROPOSED REGULATIONS

We respectfully submit the following amendments to the proposed regulations to make clear that they are not aimed at the taxes that Puerto Rico imposes under the rules further described above.

The proposed regulations address a number of issues related to the provisions of Sections 901 and 903 of the USIRC. Among other things, the proposed regulations impose a jurisdictional requirement for purposes of determining whether a foreign tax is creditable under Section 901. The explanations to the proposed regulations state:

> "The Treasury Department and the IRS have determined that in order to qualify as a creditable income tax, the foreign tax law must require a sufficient nexus between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income being taxed. For example, a tax imposed by a foreign country on a taxpayer's income that lacks a sufficient nexus to such country (such as the lack of operations, employees, factors of production, or management in that foreign country) is not an income tax in the U.S. sense and should not be eligible for a foreign tax credit if paid or accrued by U.S. taxpayers. Such a nexus is required in order for persons and income to be subject to U.S. income tax, and so a similar nexus reflecting the foreign country's exercise of taxing jurisdiction consistent with Federal income tax principles should be required in order for foreign taxes to be eligible for a dollar-for-dollar credit against U.S. income tax. The proposed regulations therefore require that for a foreign tax to qualify as an income tax, the tax must conform *with established international norms, reflected in the Internal Revenue Code and related guidance*, for allocating profit between associated enterprises, for allocating business profits of nonresidents to a taxable presence in the foreign country, and for taxing cross-border income based on source or the situs of property (together, the "jurisdictional nexus requirement"). Proposed §1.901-2(c)(1)(i) generally provides that in the case of a foreign country imposing tax on nonresidents, the foreign tax law must determine the amount of income subject to tax based on the nonresident's activities located in the foreign country (including its functions, assets, and risks located in the foreign country). *Thus, for example, rules that are consistent with the rules under section 864(c) for taxing income effectively connected with a U.S. trade or business*, or with Articles 5 and 7 of the U.S. Model Income Tax Convention for taxing profits attributable to a permanent establishment, will meet this requirement. However, foreign countries that, for example, impose tax by using as a significant factor the location of customers, users, or any other similar destination-based criterion to allocate profit (for example, by deeming a taxable presence based on the existence of customers) will not satisfy the jurisdictional nexus requirement."

In terms of the "in lieu of income tax" rules of Section 903, it states that:

> "In addition, the proposed regulations provide that an in lieu of tax under section 903, by virtue of the substitution requirement, *must also satisfy the jurisdictional nexus requirement described in proposed §1.901-2(c)*."

A reasonable reading of the proposed regulations is that the Puerto Rico income tax imposed under the MSR should continue to qualify as a creditable tax under Sections 901 because the MSR can be viewed as satisfying the jurisdictional nexus requirement described in proposed §1.901-2(c). The same reading occurs under Section 903 with respect to the Act 154 Excise Tax since it could be viewed as qualifying to be creditable under Section 903 because the MSR would meet the jurisdictional nexus requirement. As explained above, Puerto Rico's international tax rules "*are consistent with the rules under section 864(c) for taxing income effectively connected with a U.S. trade or business.* In this sense, the MSR should be viewed as an expansion of the Puerto Rico's ECI rules, as recognized by the IRS in Notice 2011-29, and is designed to allocate income reasonably attributable to business or sources within Puerto Rico.

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However, considering that the Act 154 Excise Tax is such a crucial and important source of revenues to Puerto Rico and that Puerto Rico needs to rely on this source of revenues as it works through its fiscal stabilization, the proposed regulations should be clear in recognizing that the Puerto Rico income tax imposed under the MSR qualifies under Section 901 and that the Act 154 Excise Tax continues to qualify under Section 903 under Notice 2011-29. In acknowledging that the Act 154 Excise Tax was not designed as a permanent tax, Puerto Rico also recognizes that reliance on Notice 2011-29 should only continue for a period of time that will permit Puerto Rico to orderly phase out of the Act Excise Tax as it works through its fiscal stabilization and is able to identify alternate sources of tax revenues, including continued reliance on the MSR, that would also meet the requirements of Section 901 of the USIRC.

Providing certainty on the treatment of the MSR and the Act 154 Excise Tax is also crucial to companies that are subject to these rules. Any level of uncertainty concerning the impact of the proposed regulations on the MSR and the Act 154 Excise Tax has the potential of adversely impacting the level of operations that these companies will continue to have in Puerto Rico.

Accordingly, we submit the following underlined amendments to proposed regulation §1.901-2(c)(1) and §1.903-1(e) to confirm the treatment of the income tax imposed by Puerto Rico under the MSR for purposes of Section 901 and the continued reliance of Notice 2011-29 during a transition period for purposes of Section 903:

Amendments to cover the MSR under §1.901-2(c)(1)(i)

"(1)…..

(i) Income attribution based on activities nexus. The income that is taxable in the foreign country is limited to income that is attributable, under reasonable principles, to the nonresident's activities within the foreign country (including the nonresident's functions, assets, and risks located in the foreign country), without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion. For purposes of the preceding sentence, attribution of income under reasonable principles includes rules similar to those for determining effectively connected income under section 864(c). The attribution of income of a nonresident under the laws of a possession (territory) of the United States will be treated as meeting the requirements of this paragraph (c)(1)(i)."

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Amendments to cover the MSR under §1.901-2(c)(1)

In the alternative and considering that any issues with respect to Puerto Rico income taxes could be dealt with through the USPRTCA, Reg. §1.901-2(c)(1) could be amended to add at the end the following sentence:

"(1) Tax on nonresidents. Each of the items of income of nonresidents of a foreign country that is subject to the foreign tax must satisfy the requirements of paragraph (c)(1)(i), (ii), or (iii) of this section. The provisions of this paragraph will not apply to income of a nonresident of Puerto Rico to the extent it is covered by the Tax Coordination Agreement Between the United States of America and the Commonwealth of Puerto Rico that became effective on May 26, 1989 or any similar Agreement."

Amendments to cover Notice 2011-29 under §1.903-1(e)

§1.903-1 Taxes in lieu of income taxes.

"(a)….

(b)….

(c)….

(d)….

(e) Applicability date. This section applies to foreign taxes paid or accrued in taxable years beginning on or after [the date final regulations are filed with the **Federal Register**]. However, foreign taxes imposed by a possession (territory) of the United States that have

> <u>been covered by a Notice or announcement issued by the IRS under Section 903 prior to October 1, 2020, shall continue to be covered by said Notice or announcement until the end of the third taxable year beginning on or after [the date final regulations are filed with the Federal Register]</u>."

We appreciate the attention and interest that the Administration has provided Puerto Rico and hope that this letter will contribute positively to continue a dialogue that will help the U.S. Treasury achieve its goals while allowing Puerto Rico to stabilize and strengthen its economy. We look forward to working with you and your team to find a solution for the benefit of all.

Should you have any questions or need any further information regarding the above, do not hesitate to contact me at your convenience.

Cordially,

Francisco Parés III

Francisco Parés Alicea
Secretary