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Marvin I. Kelner

Lloyd J. Fingerhut

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Puerto Rico—Tax Haven or Tax Trap?

Marvin I. Kelner & Lloyd J. Fingerhut**

WITH THE PASSAGE of the Puerto Rican Industrial Incentive Act,[1] many United States businesses have found it advantageous to settle their production facilities in Puerto Rico where they can enjoy profits free from both Federal Income Taxes and Puerto Rican Income Taxes. Domestic corporations which meet the requirements of Sec. 931 [2] of the Internal Revenue Code of 1954 (principally that 80% of their gross income be from sources within a U. S. Possession) are free from Federal Taxation on such sales. Both of the above situations seem simple enough means to escape Federal Taxation on the surface, yet when coupled with the fact that the products of such corporations are consumed entirely or almost entirely in the United States, they bring into focus the following question:

How do such corporations manage to get their products into the United States and avoid Federal Income taxes on such sales?

This article does not encompass the entire subject of foreign taxation but is limited to two specific questions involved therein:

1. Where does a sale take place for purposes of Federal Taxation?
2. If it is determined that the sale takes place partly within and partly without the U. S., how much of the income from such sales is taxable to the U. S.?

Regulations Sec. 1.861-7(c) [3] deals with the determination of with-

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* Both, graduates of Ohio State Univ.; formerly agents of the U. S. Internal Revenue Service; and seniors at Cleveland-Marshall Law School.

[1] Act No. 6, of December 15, 1953, as amended.

[2] Sec. 931 may be summarized as follows:

(a) In the case of domestic corporations, gross income means only gross income from sources within the United States if the following paragraphs are satisfied:

(1) If 80% of the gross income of the domestic corporation for the three year period preceding the close of the taxable year was from sources within a U. S. Possession.

(2) In the case of a domestic corporation, if 50% or more of its gross income was derived from the active conduct of a trade or business within a U. S. Possession.

[3] Reg. Sec. 1.861-7(c) (T. D. 6258, filed 10/23/57) may be summarized as follows:

Country in which sold. For the purposes of sections 861 to 864, inclusive,

(Continued on next page)

in what country a product is sold. It does not, however, deal with specific guidelines which can be relied upon in these situations, and as a result, we must look to the courts for a judicial definition of the place of sale.

Perusing the limited number of court cases which have discussed this question, several broad theories formulated by the courts may be spotlighted. The first and foremost in our opinion is that the place of sale is a question of fact in every case. As evidence of this, the court has rejected every attempt by the Commissioner of Internal Revenue to project one act of the taxpayer in a particular case as a determining factor in all other cases. For example, the Commissioner attempted in G. C. M. 8594 [4] to lay down the rule that the place of execution of a contract of sale is the decisive factor in determining the place of sale and, hence in determining whether the source of income resulting from such a contract is within or without the United States. Several court decisions following[5] this G. C. M. refuted this rule and the Commissioner was forced to back down in G. C. M. 25131 (1947) [6] and revoke the rule.

The second broad theory formulated by the courts in determining this question is that the sale is consummated where the seller surrenders all his right, title and interest to the buyer. This is the question of fact which the courts have attempted to decide in all the pertinent cases. Practically speaking, the issue narrows down to this question—at what point are the right, title and interest of the seller transferred to the buyer?

Academically, this is a legal question which in its most basic form can only be answered through legal analysis by a court after the transaction is completed. From the practical tax viewpoint, the answer to this question is unique because the tax consequences of the transaction are a primary motive in shaping the point at which the property passes to the buyer.

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and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. . . . *However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, . . . the sale will be treated as having been consummated at the place where the substance of the sale occurred.* (Italics supplied.)

4 CB IX-2, 354 (1930).

5 Primarily, East Coast Oil Co., S. A. v. Comm., 31 BTA 558, affd. 85 F. 2d 332 (5 Cir. 1936) cert. den. 12/14/36, 299 U. S. 608.

6 CB 1947-2, p. 85.

Illustration

As a simplified illustration, let us examine the case of the XYZ Corporation of America. XYZ Corp. is a domestic corporation incorporated in 1950 under the laws of the state of Delaware. It manufactures small household appliances. Its main offices and only factory are located in Puerto Rico. It employs several hundred employees and its sales range to $10,000,000.00 annually. XYZ appliances are very popular in the USA and almost all of its appliances are sold there. Question: How does XYZ Corporation qualify under Sec. 931 (IRC 1954)? When XYZ Corp. was formed in 1950, it interested a group of persons in the U. S. to become the sole distributor of XYZ appliances in the U. S. Consequently, XYZ Imports, Inc. was organized under the laws of the state of New York, having as its purpose the purchase and sale of XYZ appliances in the U. S. A contract was formally entered into between XYZ Corp. of America and XYZ Imports, Inc. giving XYZ Imports, Inc. exclusive rights to the distribution of XYZ products in the U. S. There are no common shareholders of both corporations. The details of the relationship are as follows:

(a) XYZ Imports sends a purchase order to XYZ Corp. specifying the quantity of products desired, where it is to be shipped, usually the name of the boat and the date of shipment.

(b) XYZ Imports pays the freight from the moment the goods are loaded on the boat in Puerto Rico. It also pays the insurance.

(c) XYZ Imports employs salesmen to sell the product in the U. S. and it also maintains at least one warehouse to store the product in the U. S.

(d) XYZ Corp. maintains no offices in the U. S. and has no salesmen for that area.

Judicial Interpretations

In analyzing the above situation, it is necessary for us to examine several leading court cases for guideposts. First, let us look at the cases of *Ronrico Corp. v. Commissioner*[7] and the *Exolon Corp. v. Commissioner*.[8] In the *Ronrico* case, we have almost an identical situation with the exceptions that (1) Ronrico Corp.

[7] 44 BTA 1130, acquiescence, CB, 1944, 24.

[8] 45 BTA 844, acquiescence, CB 1947-2, p. 2.

was incorporated under the laws of Puerto Rico and (2) Ronrico Corp. maintained several sales promotion offices in the U. S. which assisted its distributor in the promotion of Ronrico Rum. In that case, the court held for the taxpayer, stating that the fact that the buyer takes financial responsibility for the goods at the Puerto Rican docks implies that the sale is consummated at that point. Further, since the control of the goods was in the buyer from the time the goods reached the Puerto Rican docks (inasmuch as the buyer picked the ship, paid the freight and insurance, etc.), it could not be said that the seller retained any interest in the goods. The *Exolon* case varied somewhat in the facts but in principle was the same so that the court in this case merely amplified the *Ronrico* decision to apply to domestic corporations (Exolon Corp. was incorporated in the U. S.).

In *East Coast Oil Co.,*[9] which involved the sale of Mexican oil to U. S. customers, the court pointed out that since delivery of the oil took place in Mexico and became the responsibility of the buyer at that point, then the sale was consummated in Mexico. The case of *Compania General de Tabacos de Filipinas v. Collector,*[10] which was discussed at length in *East Coast Oil Co., supra,* held that an executory contract negotiated in the U. S. was not completed until confirmation of the sale was given by the company's home office in the Phillippines. The court in *East Coast Oil Co., supra,* commenting on the holding in the *Filipinas* case, stated that the holding did not conflict with the general rule that the sale took place where the title, right and interest passed to the buyer but confirmed the decision by saying: "The stipulation (that the sale was made in the U. S. subject to being confirmed in the Philippines) was consistent only with the proposition that property in the goods passed *eo instanti* upon the confirmation made in the Philippines—that the place of sale is where the final act of the seller, causing title to pass, was done."

Relating the above court decisions to our XYZ Corp., we would have to cite the *Ronrico* and *Exolon* decisions as controlling. That is, that the sale of XYZ Corp. appliances took place in Puerto Rico because at the instant the goods were unloaded at the docks of Puerto Rico (from the trucks of XYZ Corp.), they became the property of XYZ Imports, Inc. The placing of the shipment into the hands of the carrier was the final act of the seller causing the property to pass to the buyer.

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[9] See note 5, supra.

[10] 279 U. S. 306, 49 S. Ct. 304.

It should be apparent from the preceding discussion, that it is very possible to shape the business transaction to concur with the prior decisions most favorable to the individual situation *before* any tax problems arise. On the other hand, some of the restrictions imposed thereby can blossom into real business disadvantages; for example, with no sales offices in the U. S., lack of control over the promotion of the product might result in serious difficulties for the Puerto Rican manufacturer; also, were it necessary to obtain approval of the home office before a sale is closed, the sale might thereby be lost. Following are some situations which tend to cloud the application of the rules mentioned above:

(1) XYZ Corp. (the manufacturer) maintained one or more warehouses in the U. S.

(2) If XYZ Corp. employed salesmen in various cities in the U. S. who actually sold the products to other distributors (even though the freight and insurance were paid by such distributors).

(3) If XYZ Corp. of America and XYZ Imports, Inc. had the same shareholders in control of each *or if XYZ Imports was a subsidiary* of XYZ Corp. of America.

(4) If the freight and insurance costs were paid by XYZ Corp. of America (or F.O.B.—U.S.A.).

(5) If XYZ Corp. and XYZ Imports had an agency relationship.

Summary as to Point of Transfer

1. The determining question of fact in each case is at what point in the transaction are the right, title and interest of the seller transferred to the buyer?[11]
2. If the product is shipped F.O.B., F.A.S. (free along shore), C.I.F. (costs including insurance and freight), Puerto Rico, there is a strong possibility that the sale will be considered to have taken place in Puerto Rico.[12]
3. The place where the final act of the seller causing title to pass to the buyer occurs is the place of sale.[13]

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[11] Reg. Sec. 1.861-7(c) and CCM 25131, supra.

[12] Ronrico Corp. and The Exolon Corp., supra.

[13] East Coast Oil Co., S. A. v. Comm., note 5, supra. See also U. S. v. Blanovski et al., 236 F. 2d 298 (2 Cir. 1956), revg. on this point 131 F. Supp. 898.

PART II

Now that the determination of the place of sale has been analyzed, we will restrict the following discussions to those corporations whose sales have been determined to take place in the U. S. Once the place of sale has been determined, it is still necessary to determine the source of income with regard to:

(a) status of corporation
 1) domestic
 2) foreign
(b) type of income
 1) This discussion concerns only sales of personal property
(c) Computation of amount of taxable income
 1) This discussion concerns only personal property produced in Puerto Rico and sold in the U. S.

The subject is dealt with under regulations of the I R C of 1954 (dated May 6, 1956) covering secs. 861-864.

The broad underlying assumption throughout the discussion is that we are talking about sales of personal property in the U. S. of goods which are produced (manufactured) in Puerto Rico. The question of source of income with regard to other types of income (such as interest, rents, dividends, etc.) and with regard to the sale of personal property *purchased* in Puerto Rico and sold in the U. S. is too broad to consider. From available information, it appears that most tax problems will concern property *manufactured* in Puerto Rico and sold in the U. S. and so the discussion is confined to this latter situation.

Domestic Corporations

Domestic corporations are, of course, taxable under Sec. 11[14] of the I R C of 1954. Sec. 91 of the code, however, provides for the exemption of certain corporation, 80% of whose income is derived from sources within a U. S. possession and 50% of whose income is from the active conduct of a trade or business. However, if a determination is made with regard to such a corporation that the source of income is not within a U. S. possession because its sales are made in the U. S., then its income would be *fully taxable* to

[14] Sec. 11, Internal Revenue Code of 1954 may be summarized as follows:
(a) *Corporations in General.*—A tax is hereby imposed for every taxable year on the taxable income of every corporation.

the U. S. with but one exception: If its product is manufactured in Puerto Rico and sold in the U. S., then we would have to allocate its taxable income according to Sec. 863,[15] even though we have determined that as much as 100% of its sales are made in the U. S. Therefore, this corporation though not qualifying for Sec. 931 would qualify under Sec. 863 to having its taxable income allocated partly to the U. S. (taxable) and partly to the possession (non-taxable). The method of allocation is described in later paragraphs.

Foreign Corporations

Foreign corporations which are incorporated under the laws of Puerto Rico are not subject to the U. S. tax unless they are engaged in a trade or business in the U. S. (Sec. 862 (a)).[16] It is the opinion of the writers that if it is determined that the sale of P. R. corporation are made in the U. S., then such corporation will be deemed to be engaged in a trade or business in the U. S. If so determined, the corporation is termed a "resident foreign corporation" and taxed the same as a domestic corporation (Sec. 882 (a)). Therefore, in order to determine how much of the corporation income is subject to tax, we would have to make an allocation under sec. 863 (Reg. sec. 1.882-1 (a) (2)).[17]

15 Sec. 863 . . . (b) *Income Partly From Within and Partly From Without the United States.*—In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary or his delegate . . ."

16 Sec. 882. TAX ON RESIDENT FOREIGN CORPORATIONS:
(a) *Imposition of Tax.*—A foreign corporation engaged in trade or business within the United States shall be taxable as provided in section 11. [Note that a corporation incorporated under the laws of Puerto Rico would be classed as a foreign corporation. As to incorporations in every state and territory of the U. S., see 1 Oleck, Modern Corporation Law (1958).]

17 Reg. (T. D. 6258, filed 10/23/57) Sec. 1.882-1(a) General
(1) *Imposition of tax.* Except as otherwise provided by subparagraph (7) of this paragraph, a resident foreign corp. is, in accordance with section 882(a), subject to tax as prescribed by paragraphs (b) and (c) of the section. . .
(2) *Taxable Income.* For purposes of this section, the taxable income of a resident foreign corporation includes only the taxable income from sources within the United States, determined in accordance with the provisions of sections 63(a), 861 to 864, inclusive, 882, and 883, and the regulations thereunder.

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Type of Income

There are many variations of doing business, many types of income and various methods of determining the amount of taxable income. Secs. 861-894 deal with almost all of the possible variations, but we are limiting this discussion solely to the production of personal property by a domestic or foreign corporation within the possession of Puerto Rico and the sales of those goods in the U. S., assuming that we have already determined that the sales take place in the U. S. Following are some of the items which would change the entire complexion of this discussion and which should not be included as having the same particular sections of the law apply to them:

(a) If the goods are *purchased* in P. R. as opposed to being *manufactured* in P. R.

(b) If the goods were purchased or manufactured anywhere other than Puerto Rico, i.e., in U. S. or foreign country, etc. (but not another possession)

(c) If the personal property is stocks, securities, commodities, etc. (they would of course be purchased articles, not manufactured articles)

Computation of Amount of Taxable Income.

Secs. 861 and 862 are not applicable to this discussion because Sec. 863 is the only section which deals with the type of income specified above, namely, personal property produced in a *possession* of the U. S. and sold in the U. S.[18] The Internal Revenue Code arbitrarily (and inferentially) says that the net income of a corporation in this class is due from two factors: (1) manufacture and (2) marketing. It says that the net income resulting from the manufacturing operations within the possession is not to be taxed but the income resulting from selling in the U. S. should

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Sec. 1.882-1(b) *Normal Tax.* A resident foreign corporation is liable to the normal tax imposed by section 11(b).

Sec. 1-882-1(c) *Surtax.* A resident foreign corporation is also liable to the surtax imposed by section 11(c).

[18] Sec. 863(b)(2) . . . from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or *produced (in whole or in part)* by the *taxpayer without and sold within the United States. . .*" (Italics supplied.)

be taxed. This allocation is called "income derived partly from sources within and partly from sources without the United States." Therefore, it is necessary to determine what is the source partly *without* the U. S. and what is the source of income partly *within* the U. S.

Regs. sec. 1.863-3 (c)[19] deals with income partly from sources within the U. S. and partly from sources within a possession.

Regs. sec. 1.863-3 (c) (3)[20] deals with the formulae necessary to make the allocation and is extremely complicated. There are 3 examples given in this subsection with minor subsections and subparagraphs dealing with definitions pertinent to the examples. They will be dealt with one at a time. *Example* (1) is the same as example (1) under Regs. sec. 1-863-3 (b) (2) which is as follows and is very much condensed, paraphrased, and interpreted.

A. *Assumptions*

(1) that taxpayer sells to wholly independent distributors

(2) that taxpayer established fairly an independent factory price

(3) that the selling branch or department of taxpayer is located in a different country than the factory

(4) that the taxpayer sells his product to his selling branch located in a different country at the same independent factory price he sells to the wholly independent distributors.

B. *Rule*

(1) Then the independent factory price will be the gross income of the taxpayer within the possession of the U. S. and the income of the selling branch less the independent factory price (purchase price to the selling branch) less its expenses shall be the taxable income within the U. S.

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[19] Reg. sec. 1.863-3 (c) *Income partly from sources within a possession of the United States*—(1) General. This paragraph relates to gains, profits, and income which, pursuant to sec. 863(b), are treated as derived partly from sources within the United States and partly from sources within a U. S. Possession.

[20] Reg. sec. 1.863-3(c)(3). This subparagraph relates to gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States.

Illustration

Suppose company X sells to company A, company B and company C all located in the U. S. and in addition sells to its own branch located in the U. S. at a price of 1.50 per unit, then the income from sources without the U. S. (within the U. S. possession) will be all sales at 1.50 per unit. The income within the U. S. will be the selling price of the unit by the branch agency in the U. S. less its purchase price of 1.50 less its expenses.

Example (2)

Example 2 comprises several steps:

(1) Determine amount of net income attributable to income partly from sources within U. S. possession and partly from sources within the U. S.

Illustration

Let us assume Company A has gross sales in Puerto Rico of 50,000.00 and gross sales in U. S. of 450,000.00. Its only plant and sales office is located in Puerto Rico. Assume the following profit and loss:

Gross Sales		500,000
Cost of goods sold (320,000 applicable to U. S. Sales)	350,000	
Expenses (90,000 applicable to the U. S. sales)	100,000	450,000
Net Profit		50,000

	(U. S. Sales) Gross income partly within U. S. and partly within U. S. possessions.		(Puerto Rican Sales) Gross income within U. S. possessions.	
Gross income		450,000.00		50,000.00
Cost of goods sold	320,000		30,000.00	
Expenses	90,000	410,000.00	10,000.00	40,000.00
Net Income		40,000.00		10,000.00

The answer to step 1, then, is 40,000.00 of net income from sources partly within the U. S. and partly within U. S. possession.

(2)a. Split the income (40,000.00 in half; answer: 20,000.00)

(2)b. Multiply the one half net income by a fraction, the numerator of which is the taxpayers' property in the U. S. and the denominator of which is the taxpayers' property in U. S.

Taxpayers' property in U. S.		(assumed)
Taxpayers' property in possession	100,000	(assumed)
Total property	100,000	

$$\frac{\text{Property in U. S. —0—}}{\text{Total property 100,000}} \times 20{,}000.00 = \text{—0—}$$

Therefore, of this ½ of the net profits, no part is from sources within the U. S. (non-taxable)

(2)c. Multiply the other half of the net profits by a fraction, the numerator of which is the taxpayers' "business" in the U. S. and the denominator of which is taxpayers' business in the U. S. and in the possession.

Taxpayers' business in the U. S.	
Sales	450,000.00
Purchases (none made in U. S.)	—0—
Expenses (none incurred in U. S.)	—0—
Total Business in U. S.	450,000.00
Taxpayers' business in Possession	
Sales	50,000.00
Purchases (all incurred in P. R.)	350,000.00
Expenses (all incurred in P. R.)	100,000.00
Total business in possession	500,000.00
Total business in U. S.	450,000.00
Total business in U. S. and Possession	950,000.00

Therefore:

$$\frac{\text{Total business in U. S.} \quad 450{,}000.00}{\text{Total business (U. S. and poss.)} \quad 950{,}000.00} \times 20{,}000 = 9{,}473.40$$

Therefore of this ½ net profit, 9,473.40 is from sources within the U. S. and is taxable.

The business of the taxpayer as differentiated from gross sales of the taxpayer is gross sales (from sources partly within the U. S. and partly within a U. S. possession) plus applicable (to income from sources partly within the U. S. and partly within U. S. possession) cost of goods sold plus applicable expenses.

In the opinion of the writers, the above is the formula which will be most applicable to Puerto Rico. To summarize the above arithmetic: we have determined that 40,000 of net income of company A is due to income partly from sources within the U. S. and partly from sources within a U. S. possession.

This, of course, would be the U. S. sales of the product which is manufactured in Puerto Rico. Then we take this 40,000 net income and split it in half. Then we take one of the halves

(20,000.00) and multiply it by the taxpayers' property in the U. S. over the taxpayers' property in the U. S. and in Puerto Rico. (This property would be real property, plant and equipment, office furniture and fixtures, etc.) Then we take the other half of the net profit (20,000.00) and multiply it by the total business of the taxpayer in the U. S. over the total business of the taxpayer in the U. S. and in the possession. Then we take the result of these two multiplications, add them together and that equals the amount of net income from sources within the U. S. and, therefore, taxable to the U. S. (in the usual manner).

Example 3

The third example given in the regulations merely gives the right to the taxpayer to use a different method of determining the net income taxable, based upon the taxpayers' books and records and subject to the approval of the commissioner.

Summary as to Taxability

The sum and substance of this section (863 (b)) and the regulations sec. 1.863-3 (c) is that income earned of the type discussed is subject to apportionment between that income earned as a result of manufacture in Puerto Rico and that income earned as a result of sales (due to said manufacture) which are made in the U. S. As a logical conclusion of this latter interpretation, then in any case where the value of the product in Puerto Rico is equal to or greater than the value it is sold at in the U. S., there would be no profits taxable because all of the increment of value is earned in the possession. To illustrate in example 1, if the independent factory price *in Puerto Rico* is equal to the price sold in the U. S. by the manufacturer, then none of the net income of that sale is from sources within the U. S. This is best illustrated in G.C.M. 7545, [21] and will probably be the most common defense of taxpayers once taxability is conceded.

But in any case where these equal values cannot be proved and example 1 will not be applicable (for various reasons, i.e., no sales office in the U. S.; doesn't sell to independent distributors, etc.), then example 2 will be applied and, since most of the companies in Puerto Rico do not have property in the U. S., the formula illustrated will be fairly closely applied.

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[21] C. B. XI-I, p. 215.

Most important to this discussion is the fact that foreign corporations will *not* be allowed the foreign tax credit provided under sec. 901 of the IRC of 1954. (Sec 882 (c) (4) IRC 1954).[22]

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[22] Sec. 882(c)(4) Foreign Tax Credit.—Foreign corporations shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by Sec. 901.