

Part III - Administrative, Procedural, and Miscellaneous

Application of Noncompulsory Payment Regulations to Amendments of Certain Puerto Rico Tax Decrees; Revocation of Notice 2011-29

Notice 2022-42

SECTION 1. PURPOSE

This Notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to amend the regulations under section 901 with respect to the application of the noncompulsory payment regulations to certain amended Puerto Rico tax decrees.

SECTION 2. BACKGROUND

The Treasury Department and the IRS are aware that certain U.S. taxpayers with operations in Puerto Rico (including operations conducted indirectly through subsidiaries or other affiliates) have negotiated long-term tax agreements with Puerto Rico, known as tax decrees, that provide more favorable tax treatment than under the generally applicable Puerto Rico tax laws. Among other benefits, these tax decrees provide for reduced rates of tax levied on U.S. taxpayers and their affiliates performing certain activities in Puerto Rico. However, the tax decrees do not modify the application of the modified effectively connected income rules (Modified ECI Rules) of section 1123(f)(3)(B) of the Puerto Rico Internal Revenue Code of 1994, as amended (1994 PR IRC) and incorporated by reference into the Puerto Rico Internal Revenue Code of 2011, as amended (2011 PR IRC), by section 1035.05 of the 2011 PR IRC. The

Modified ECI Rules impose a tax on income deemed to be earned in connection with a Puerto Rico trade or business (Modified ECI Tax). Similarly, the tax decrees do not modify the application of the excise tax (Excise Tax) on the acquisition of certain personal property manufactured or produced in Puerto Rico and amounts paid for certain services performed in Puerto Rico that is imposed by sections 2101 through 2106 of the 1994 PR IRC and incorporated by reference into the 2011 PR IRC by section 1035.05 of the 2011 PR IRC.

Notice 2011-29 states that the Excise Tax raises novel issues that require further study and that, pending the resolution of those issues, the IRS will not challenge a taxpayer's position that the Excise Tax is a tax paid in lieu of an income tax under section 903. Notice 2011-29 further provides that any change in the foreign tax credit treatment of the Excise Tax will apply to Excise Tax paid or accrued after the date that further guidance is issued.

On December 28, 2021, final regulations were filed with the Federal Register, including regulations under Treas. Reg. §§1.901-2(b)(5) and 1.903-1(c)(1)(iv). These final regulations provide that a foreign tax imposed on a nonresident is a foreign income tax within the meaning of Treas. Reg. §1.901-2(a)(2) for which a credit is allowable only if the tax is based on (1) the nonresident's activities in the taxing jurisdiction, (2) income properly sourced to the taxing jurisdiction, or (3) the sale or exchange of certain property located in the taxing jurisdiction. T.D. 9959 (87 FR 276, 339-340, 357-358). Under the final regulations, the Modified ECI Tax and the Excise Tax do not constitute foreign income taxes. Therefore, a credit would not be allowed for those taxes under

section 901. The final regulations under Treas. Regs. §§1.901-2 and 1.903-1 apply to any Modified ECI Tax and Excise Tax paid or accrued (depending on the taxpayer's method of accounting for foreign income taxes) in taxable years beginning on or after January 1, 2023. Treas. Reg. §§1.901-2(h) and 1.903-1(e).

On June 30, 2022, Act 52-2022 was enacted into law in Puerto Rico. Act 52-2022 allows taxpayers to amend their existing tax decrees to replace the existing income tax and royalty withholding tax framework with a new income tax and royalty withholding tax framework. If a taxpayer elects to amend an existing tax decree, the remaining term of the amended tax decree is extended by 15 years. Taxpayers that opt to amend their existing tax decrees pursuant to Act 52-2022 are no longer subject to the Modified ECI Tax and the Excise Tax. In certain cases, the decision to amend an existing tax decree pursuant to Act 52-2022 may result in a U.S. taxpayer and/or one or more of its affiliates owing a greater total amount of tax to Puerto Rico than would be owed absent the amendment. However, the terms of the amended tax decrees are expected to result in taxes imposed at rates lower than those under the generally applicable Puerto Rico income tax laws absent any decree.

Treas. Reg. §1.901-2(e)(5)(i) provides that an amount remitted to a foreign country is not a compulsory payment, and thus is not an amount of foreign income tax paid, to the extent that the amount remitted exceeds the amount of the taxpayer's liability for foreign income tax under the foreign tax law (the "noncompulsory payment regulations").

Treas. Reg. §1.901-2(e)(5)(iii)(A) provides that where foreign tax law provides a

taxpayer with options or elections in computing its liability for foreign income tax whereby a taxpayer's foreign income tax liability may be permanently decreased in the aggregate over time, the taxpayer's failure to use such options or elections results in a foreign payment in excess of the taxpayer's liability for foreign income tax.

SECTION 3. APPLICATION OF NONCOMPULSORY PAYMENT REGULATIONS TO AMENDED PUERTO RICO TAX DECREES

The Treasury Department and the IRS are aware that questions have arisen as to whether a decision to amend an existing tax decree pursuant to Act 52-2022 will cause any amount remitted to Puerto Rico in excess of the amount of tax that would have been owed but for amending the existing tax decree to be considered a noncompulsory payment under §1.901-2(e)(5), and therefore not an amount of foreign income tax paid or accrued for which a credit is allowed under section 901.

To facilitate Puerto Rico's transition to Act 52-2022, and given Puerto Rico's status as a territory of the United States, the Treasury Department and the IRS have determined it is necessary and appropriate to provide guidance on the application of Treas. Reg. §1.901-2(e)(5) to amounts remitted to Puerto Rico under the terms of a tax decree amended pursuant to Act 52-2022 on or before December 31, 2022. Therefore, the Treasury Department and the IRS intend to issue regulations under section 901 (the "forthcoming proposed regulations") to provide that amending an existing tax decree with Puerto Rico pursuant to Act 52-2022, on or before December 31, 2022, does not cause any amount of foreign income tax paid or accrued to Puerto Rico pursuant to the amended tax decree to be treated as a noncompulsory amount under Treas. Reg.

§1.901-2(e)(5).

Under the forthcoming proposed regulations, amending an existing tax decree pursuant to Act 52-2022 (as enacted on June 30, 2022) will not, solely by reason of any difference in the amount of income tax liability to Puerto Rico under the existing tax decree as compared with the amended tax decree, be considered to increase the taxpayer's liability for Puerto Rico income tax over time for purposes of Treas. Reg. §1.901-2(e)(5) if the existing tax decree is amended pursuant to Act 52-2022 on or before December 31, 2022, and the taxpayer's Puerto Rico income tax liability under the amended tax decree in each taxable year is less than the amount of income tax the taxpayer would have owed to Puerto Rico under Puerto Rico's generally applicable income tax laws in the absence of any tax decree in the taxable year. No inference as to the application of the noncompulsory payment regulations in any other context should be drawn from this Notice.

SECTION 4. TAXPAYER RELIANCE

The forthcoming proposed regulations will provide that the rules set forth in section 3 of this Notice apply to taxable years ending on or after October 11, 2022. Until the date of issuance of the forthcoming proposed regulations, taxpayers may rely on the rules set forth in section 3 of this Notice.

SECTION 5. REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS invite comments on the forthcoming proposed regulations. Commenters are strongly encouraged to submit public

comments electronically. Comments should include a reference to Notice 2022-42. Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (type IRS-2022-0015 in the search field on the regulations.gov homepage to find this Notice and submit comments). Send paper submissions to the Office of Associate Chief Counsel (International), Attention: Andrew Naughton, Internal Revenue Service, IR-4549B, 1111 Constitution Avenue, NW, Washington, DC 20224. Once submitted, comments cannot be edited or withdrawn. For further information regarding this Notice, contact Dr. Naughton of the Office of Associate Chief Counsel (International) at (202) 317-5356 (not a toll-free call). Written or electronic comments must be received by January 9, 2023.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Notice 2011-29 is revoked, effective for Excise Tax paid or accrued in taxable years beginning on or after January 1, 2023.