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DIVIDENDS FREE OF TAXES!

SYDNEY KRAUSE*

The alluring subject of this article concerns itself with dividends declared by Puerto Rican tax exempt corporations.¹

Are dividends declared by a tax exempt corporation and paid to continentals who have established residence in Puerto Rico tax exempt?

Section 6 of the Exemption Act² is entitled *Income Tax Exemption on Profit or Dividend Payments* and provides, in subdivision a, as follows:

Dividend . . . distributions by a corporation . . . exempted hereunder from the payment of taxes, made from the income derived from the operations thereof covered by the exemption and paid to the following stockholders shall be tax exempt:

- (1) persons residing in Puerto Rico
- (2) persons not residing in Puerto Rico, who are not obligated to pay in any jurisdiction outside of Puerto Rico any tax on income derived by them from any source in Puerto Rico.

Until the enactment of the Federal Revenue Act of 1950, the exemption accorded the first category, i.e., “. . . persons residing in Puerto Rico . . .”, presented a series of interesting problems which have now been resolved insofar as they relate to income received on and after January 1, 1951. The federal tax status of dividends declared and received from the time of the enactment of the tax exemption statute in 1947 to December 31, 1950, a period of about three and one-half years, involves considerations consider-

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1. Many continental persons and firms have taken advantage of what Governor Munoz Marin has called “Operation Bootstrap,” the program of tax exemption to new industries, which was inaugurated in Puerto Rico in 1947. The extensive literature on the subject of the program itself in magazines and periodicals makes unnecessary a re-statement of the program at this time.

The necessity for such a program and the extent to which it has been achieved are the subjects of: *Profit Hunters in Puerto Rico*, FORTUNE, May 1950; *Puerto Rico Reaches for Industry*, BUSINESS WEEK, May 13, 1950; *Facts for Business Men Interested in Establishing an Industry in Puerto Rico, USA*, prepared by the Legal and Economic Research and Information Departments, Puerto Rico Industrial Development Co., San Juan, Puerto Rico, December, 1949.

An analysis of the Act which preceded the present Act (Act #346, approved May 12, 1947, as amended by Act #22, of December 5, 1947) appears in Baker and Curry, *Taxpayers Paradise in the Caribbean*, 1 VAND. L. REV. 194 (1948).

It will suffice to say here that corporations which qualify under the Puerto Rican tax exemption statute for a period running beyond 1960 are relieved from a variety of Puerto Rican taxes, including income taxes, as well as real and personal property taxes.

2. The Industrial Tax Exemption Act of Puerto Rico, (Act #184 approved May 13, 1948, as amended by Act #352, Act #355 and Act #365 of May 14, 1949, and by Act #232 of May 6, 1950, and Act #243 of May 8, 1950).

ably more complex than a determination of the simple fact of residence and these problems still remain to be decided.

It can now be stated with assurance that dividends of Puerto Rican tax exempt corporations received after January 1, 1951 by a continental United States citizen who resides in Puerto Rico during the entire calendar year are free of Puerto Rican income taxes until the tax exemption expires and are permanently free of all federal income taxes.³

THE LAW PRIOR TO THE FEDERAL REVENUE ACT OF 1950

A proper understanding of what the new Federal Revenue Act has accomplished requires an examination of the situation as it existed prior to its enactment.

Clearly, under the terms of Section 6a(1), the dividends received by a person resident in Puerto Rico would be exempt from Puerto Rican taxes. Formerly, residence in Puerto Rico, by itself, did not necessarily relieve the resident from federal income taxes.

Persons residing in Puerto Rico were of four general categories:

1) Persons who were born in Puerto Rico and properly could be classified as citizens of a territory or possession (*i.e.*, Puerto Rico) and of the United States⁴ but who were never otherwise citizens of the United States.

2) Persons who emigrated from a foreign country to Puerto Rico and became citizens of Puerto Rico and of the United States by naturalization in Puerto Rico⁵ but who were never otherwise citizens of the United States.

3) Persons who emigrated from a foreign country to Puerto Rico but never became citizens thereof or of the United States.

4) Persons, citizens of the United States by birth or naturalization in the United States, who came from continental United States to Puerto Rico and became bona fide residents and citizens⁶ thereof but who, nevertheless, did not necessarily divest themselves of their United States citizenship.⁷

3. See *infra*, The Effect of the Federal Revenue Act of 1950.

4. The Temporary Organic Act of Puerto Rico, 31 STAT. 79 (1900), 48 U.S.C. § 733 (1946); 54 STAT. 1138 (1940), as amended, 60 STAT. 721 (1946), 8 U.S.C. § 601 (1946); 54 STAT. 1139 (1940), 8 U.S.C. § 602 (1946); 54 STAT. 1137 (1940), 8 U.S.C. § 501 (1946).

5. 31 STAT. 85 (1900), as amended, 37 STAT. 648 (1913), 39 STAT. 965 (1917), 41 STAT. 1412 (1921), 44 STAT. 919 (1926), 52 STAT. 118 (1938), 60 STAT. 716 (1946), 62 STAT. 989 (1948), 48 U.S.C. § 863 (Supp. 1950) and n. 4; 54 STAT. 1142 (1940), 8 U.S.C. § 707(a) (1946).

6. 47 STAT. 1418 (1927), as amended, 47 STAT. 158 (1932), 48 U.S.C. § 733(a) (1946) provides "All citizens of the United States who have resided or who shall after March 4, 1927, reside in the island for one year shall be citizens of Puerto Rico."

7. 54 STAT. 1168 (1940), as amended, 58 STAT. 4 (1944), 58 STAT. 677 (1944), 58 STAT. 746 (1944), 8 U.S.C. § 801 (1946), sets forth the general means of losing

It is clear that with respect to the first two classes named, dividends received by them from a Puerto Rican tax exempt corporation were not subject to federal taxation.⁸

This article will not undertake to consider the status of the third class.⁹ It remains necessary, therefore, to examine the status of the fourth class. A person who went from continental United States to Puerto Rico and took up permanent residence there was still a citizen of the United States and obliged to pay income taxes and to file income tax returns in the United States.¹⁰

Prior to January 1, 1943, Section 116(a) of the Internal Revenue Code provided that six months physical absence from the United States would permit the taxpayer to exclude from his gross income and be exempt from

United States nationality. Briefly they consist of: (a) obtaining naturalization in a foreign state, with certain provisions; or (b) taking an oath of allegiance to a foreign state; or (c) serving in the armed forces of a foreign state; or (d) accepting any post under a foreign state for which only nationals of such state are eligible; or (e) voting in a political election in a foreign state; or (f) making a formal renunciation of nationality before a diplomatic officer of the United States in a foreign state; or (g) deserting the armed forces of the United States in time of war, with certain provisos; or (h) committing an act of treason against the United States with certain provisos; or (i) making in the United States a formal written renunciation of nationality before an officer designated by the Attorney General, whenever the United States shall be in a state of war and the Attorney General shall approve such renunciation; or (j) departing from or remaining outside of the jurisdiction of the United States in time of war for the purpose of evading service in the armed forces of the United States.

54 STAT. 1169 (1940), as amended, 58 STAT. 677 (1944), 8 U.S.C. § 803 (1946), provides that no national can expatriate himself, or be expatriated, while within the United States or any of its outlying possessions, but expatriation shall result from performance within United States or outlying possessions of the acts or the fulfillment of any of the conditions specified if and when the national thereafter takes up residence abroad.

54 STAT. 1137 (1940), 8 U.S.C. § 501 (1946), provides ". . . (d) The term 'United States' when used in a geographical sense means the continental United States, Alaska, Hawaii, Puerto Rico, and the Virgin Islands of the United States. (e) The terms 'outlying possessions' means all territory, other than as specified in subsection (d), over which the United States exercises the rights of sovereignty, except the Canal Zone."

54 STAT. 1171 (1940), 8 U.S.C. § 808 (1946), entitled "Exclusiveness of means of losing nationality" provides "The loss of nationality under this chapter shall result solely from the performance by a national of the acts or fulfillment of the conditions specified in this chapter."

Puerto Rico is a possession of the United States, and not a foreign country. U.S. Treas. Reg. 111 § 29.131. See also U.S. Treas. Reg. 111, § 29.11-3, U.S. Treas. Reg. 111, § 29.251-4.

8. The Organic Act of Puerto Rico, 39 STAT. 954 (1917), as amended, 60 STAT. 158 (1946), 48 U.S.C. § 734 (1946) and INT. REV. CODE § 252(a) which provided "Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this chapter only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources." And see also U.S. TREAS. REG. 111, § 29.252-1.

9. No investigation has been made to determine the extent to which such dividends may be taxable to citizens of other nations by the country of their nationality.

10. See note 7 *supra*, INT. REV. CODE § 11, and U.S. Treas. Reg. 111, § 29.11-2 which provides—"In general, citizens of the United States, wherever resident, are liable to the tax, and it makes no difference that they may own no assets within the United States and may receive no income from sources within the United States."

taxation on amounts received from sources without the United States, if such amounts would constitute earned income, as defined by the Code.

As of January 1, 1943, Section 116(a) was amended¹¹ to read that an American citizen, who was a bona fide resident of a *foreign country* during the *entire* taxable year could exclude from his gross income and be exempt from taxation on amounts received from sources without the United States, if such amounts would constitute earned income, as defined by the Code.

However, under the Regulations,¹² Puerto Rico was not a foreign country, so that residence in Puerto Rico, even for the entire calendar year, would not have brought the taxpayer within the provisions of §116(a) as so amended.

In order to determine the taxpayer's status it was necessary to have a recourse to Section 251 of the Internal Revenue Code, which dealt with *Income from sources within possessions of the United States* and which, by the Regulations^{12a} was specifically made applicable to Puerto Rico.

As applied to individuals, the relevant portion of Section 251 read as follows:

(a) General Rule.—In the case of citizens of the United States . . . satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) if 80% or more of the gross income of such citizen . . . (computed without benefit of this section), for the three-year period immediately preceding the close of the taxable year (or for such part of said period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States, and . . .

(3) if . . . 50% or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or an agent of another.

A United States citizen, who migrated from continental United States to Puerto Rico, had to bring himself within the provisions of both subdivisions of the foregoing section or else was constrained to report all of his Puerto Rican income in his federal income tax return.¹³ The mere circumstance of permanent residence in Puerto Rico did not suffice. The additional consideration of an unimpeachable good faith intention to remain a permanent resident of Puerto Rico did not suffice. The two criteria established by Section 251 had to be met:

i) 80% of the income of the taxpayer from the time he arrived in

11. Revenue Act of 1942, § 148, 56 STAT. 841 (1942).

12. U.S. Treas. Reg. 111, § 29.131-2, U.S. Treas. Reg. 111 § 29.251-4.

12a. U.S. Treas. Reg. 111, § 29.251-4.

13. But see INT. REV. CODE § 31 and § 131 of which subdivision (a) Allowance of Credits, read—"If the taxpayer chooses to have the benefits of this section, the tax imposed by this chapter, except the tax imposed under § 102, shall be credited with:

(1) Citizens . . . In the case of a citizen of the United States . . . the amount of any income, war profits and excess-profits taxes paid or accrued during the taxable year to . . . , any possession of the United States; . . .

Puerto Rico to the end of the taxable year had to be derived from sources within Puerto Rico; and

ii) 50% or more of the taxpayer's gross income during such period must have been derived from the active conduct of a Puerto Rican business, either for the account of the taxpayer or of someone by whom he was employed in Puerto Rico.

In order to clarify these criteria, some examples may be helpful:

Example #1: Jones, a citizen of the United States and a resident of New York State, arrived in Puerto Rico on July 1, 1948. By December 31, 1948 he had received \$15,000.00 as salary from a tax exempt Puerto Rican corporation. He had made a profit of \$5,000.00 through the sale of a parcel of real estate in Puerto Rico and he had derived an income of \$10,000.00 from rental of property located in the United States.

Even though Jones had earned 50% of his gross income from the active conduct of a trade or business in Puerto Rico, he had to report all of his income in his federal income tax return because only 66 $\frac{2}{3}$ % was derived from sources in Puerto Rico during the three-year period immediately preceding the close of the taxable year or for such part of such period immediately preceding the close of such taxable year which might be applicable, which, in this example was only a six month period.

Example #2: The same Jones, from July 1, 1948 to December 31, 1948, had earned \$5,000.00 as salary in Puerto Rico and had made a profit of \$10,000.00 on the sale of a parcel of Puerto Rican real estate. He had had no United States income. Nevertheless, Jones had to include all of his Puerto Rican income as gross income in his federal income tax return because even though more than 80% of his income had been earned in Puerto Rico, 50% thereof had not been derived from the active conduct of a trade or business in Puerto Rico.

The regulations^{13a} confounded the situation further by providing that "Dividends received by a citizen from a corporation whose income was derived from the active conduct of a business within a possession of the United States, although such citizen was actively engaged in the management of such corporation, does not represent income derived from the active conduct of a trade or business within a possession of the United States, either on the taxpayer's own account or as an employee or agent of another."

The implications of this regulation can be made clearer by an example:

Example #3: Jones had come to Puerto Rico and had organized a tax exempt corporation, of which he owned all of the outstanding stock. Having in mind the provisions of Section 6 of the Industrial Tax Exemption Act of Puerto Rico, exempting from Puerto Rican taxes dividends received from a Puerto Rican tax exempt corporation by persons residing in Puerto Rico, Jones decided to pay himself a nominal salary of \$10,000.00 per year.

13a. U.S. Treas. Reg. 111, § 29.251-1.

At the end of the taxable year Jones' corporation had prospered and he declared a dividend to himself of \$100,000.00.

He had no income from continental United States so that his total income had been derived from sources within Puerto Rico.

Nevertheless, by virtue of the regulation just mentioned, Jones had to include all of his Puerto Rican income in his federal income tax return because 50% or more of his gross income was not derived from the active conduct of a trade or business in Puerto Rico. Even though Jones was the sole stockholder of the Puerto Rican corporation and was actively and dominantly associated with its management, the dividend declared by such corporation and received by him was not income derived from the active conduct of a trade or business.

Using the hypothetical case just given, if Jones had drawn \$10,000.00 as salary, he could have declared a dividend of up to \$10,000.00 and not included the \$20,000.00 of income thus received in his federal tax return. Under these circumstances, his total income would have been \$20,000.00, all derived from sources within Puerto Rico, and 50% of that, or \$10,000.00, was derived from the active conduct of a trade or business within Puerto Rico. To the extent of the \$10,000.00 earned as salary, Jones would have paid a Puerto Rican income tax and to the extent of the \$10,000.00 dividend, he would have been exempt under the provisions of Section 6.

This, then, was the state of the law prior to the enactment of the Revenue Law of 1950.

THE EFFECT OF THE FEDERAL REVENUE ACT OF 1950

The net effect of the new revenue law is that if a person is a resident of Puerto Rico for the entire taxable year, his prior status as a continental United States citizen is no longer important.¹⁴

The House Ways & Means Committee, in its report on the new Revenue Act when it was proposed as a bill, stated:

A disparity exists between the treatment accorded two different classes of United States citizens who are residents of Puerto Rico, those who are citizens only by reason of the Organic Acts establishing the Government of Puerto Rico (the first two classes mentioned in the prior discussion of this article) and those who are citizens because they were born or naturalized in the United States (the fourth class mentioned in the prior discussion in this article).¹⁵ In the opinion of your Committee, the existing federal income tax treatment of United States citizens in Puerto Rico is confusing and the discrimination . . . is unfair.

Under Section 217 (enacted as Section 221) of your Committee's bill, all United States citizens, who are bona fide residents of Puerto Rico during the entire taxable year, receive the same tax treatment. They are not taxed under the federal individual income tax with respect to

14. Section 221 of the Revenue Act of 1950, entitled Residents of Puerto Rico.

15. H.R. REP. No. 8920, 81st Cong., 2nd Sess. 60 (1950).

any income derived from sources within Puerto Rico. The tax is limited to income derived from sources outside Puerto Rico, including income from the United States itself.¹⁶

The above changes in taxation were accomplished, the Committee stated,¹⁷ by the following amendments:

Section 251 of the Internal Revenue Code was made inapplicable to Puerto Rico in the case of citizens of the United States.¹⁸

Section 252(a) of the code was made inapplicable to citizens of Puerto Rico.¹⁹

A new Section 116(1), providing for the exclusion from gross income of income from sources within Puerto Rico in the case of individuals who are bona fide residents of Puerto Rico during the entire taxable year, was added to the Code.²⁰

In addition, Section 131a(2), relating to credits against taxes, was also amended to provide that in the case of a resident of Puerto Rico during an entire taxable year, a credit be given for the amount of any taxes, except taxes imposed under Section 102, paid or accrued during the taxable year to any possession of the United States.²¹

In general amendments above referred to, made by Section 221, shall be applicable with respect to taxable years beginning after December 31, 1950 except that amendments made by subsection (i) of said section (relating to the collection of taxes in Puerto Rico) is effective when enacted (Sept. 23, 1950).²²

16. *Id.* at 61.

17. *Id.* at 103.

18. INT. REV. CODE § 251(d) was amended by said § 221 to read:

(d) Definition.—As used in this section the term 'possession of the United States' does not include the Virgin Island of the United States, and such term, when used with respect to citizens of the United States, does not include Puerto Rico.

19. INT. REV. CODE § 252(a) was amended by said § 221 by adding at the end thereof the following new sentence:

This subsection shall have no application in the case of a citizen of Puerto Rico.

20. INT. REV. CODE § 116 which specified certain items which shall not be included in gross income and shall be exempt from taxation, was amended by said § 221 by adding at the end thereof the following new subsection:

(1) Income From Sources Within Puerto Rico—

(1) Resident of Puerto Rico for Entire Taxable Year.—In the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico (except amounts received for services performed as an employee of the United States or any agency thereof); but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this paragraph. . . .

21. Paragraph 2 of INT. REV. CODE § 131(a) (relating to allowance of credit) was amended by said § 221 to read as follows:

(2) Resident of the United States or Puerto Rico—

In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States. . . .

22. INT. REV. CODE § 221(k).

It can now be stated without equivocation that a continental United States citizen, who establishes permanent residence in Puerto Rico, which extends through the entire taxable year, will receive dividends from Puerto Rican tax exempt corporations free of both Puerto Rican and federal income taxes.

THE CORPORATE STOCKHOLDER

The prior discussion has been confined to the situation as it affected an individual stockholder of a Puerto Rican tax exempt corporation. There still remains the problem of certain disadvantages that affect a continental corporate stockholder in a Puerto Rican tax exempt corporation and here it would seem that the remedy lies with the Puerto Rican Legislature.

If the Puerto Rican corporation is a wholly-owned subsidiary of a continental United States corporation, dividend distributions would not be exempt by reason of either subdivision (a) or (b) of Section 6 and the entire dividend would be subject to a 28% Puerto Rican income tax, which would be deducted at the source.²³

Had a similar distribution been made by a continental subsidiary to a continental parent, only 15% of the distribution would have been taxable²⁴ at 38% under the Revenue Act of 1948, but at 45% under the Revenue Act of 1950.

Although the continental parent company may ordinarily deduct from its federal income tax the tax paid in Puerto Rico,²⁵ the deduction shall not exceed the proportion of the United States income tax against which the credit is taken, which the corporation's normal-tax net income from sources within the foreign country bears to its entire normal-tax net income for the same taxable year; and the aggregate credit shall not exceed the proportion of the United States income tax which the normal-tax net income from all sources within the United States bears to the entire normal-tax net income for the same taxable year.²⁶

In consequence, there may be instances where the 28% dividend deducted at the source will be considerably greater than the amount of tax credit to which the continental parent company would be entitled, resulting in substantial prejudice by reason of the wording of the Puerto Rican statute.

In fairness to the continental parent company and to accomplish the obvious purposes for which the statute was designed, *i.e.*, to attract United States capital, subdivision a(2) of Section 6 should be amended to provide that the tax to be paid to Puerto Rico should not exceed the tax that would be payable to the jurisdiction outside of Puerto Rico.

This would work substantial equity since in the event of such an

23. INCOME TAX ACT OF PUERTO RICO § 22 (1924), as amended.

24. INT. REV. CODE §§ 13, 15.

25. *Id.* at § 131(a).

26. *Id.* at § 131(b).

amendment, the entire tax on the dividends payable in Puerto Rico would constitute a credit against the federal tax payable by the continental parent.

CONCLUSION

The elimination of the uncertainty regarding federal taxes on dividends of Puerto Rican tax exempt corporations should give added impetus to "Operation Bootstrap." The early elimination of the inequity that presently affects dividends received by continental corporate stockholders will furnish even additional incentive to this interesting experiment.