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TAX ALERT

New Puerto Rico Taxes on Certain Foreign Corporations

On October 25, 2010, Governor Luis G. Fortuño signed into law Act 154, which amends the Puerto Rico Internal Revenue Code of 1994, as amended (%Code+), to modify the source of income rules and to impose a new excise tax. The purpose of Act 154 is to finance upcoming tax reform legislation.

The new tax provisions will apply to certain alien individuals and foreign legal entities not engaged in trade or business in Puerto Rico, that are part of a controlled group or unitary business engaged in manufacturing or service activities in Puerto Rico, when they engage in substantial transactions outlined in the legislation.

A. Act 154

Act 154 changes the way Puerto Rico taxes foreign corporations and introduces a unitary business concept by adopting: 1) a modified source of income rule and 2) a related temporary excise tax (%Excise Tax+) that will apply in certain cases in lieu of the income tax that would otherwise result from the application of the source of income rule.

1. Source of Income Rule

The new source of income rule will apply to income realized after December 31, 2010, and expands the scope of the %office or fixed place of business+concept, to provide that the office or fixed place of business of a person in Puerto Rico will be treated as the office of the nonresident individual or foreign corporation when they are members of the same controlled group and engage in certain transactions above specified thresholds (i.e., the unitary business). The transactions relate to the purchase and sale of personal property manufactured or produced in whole or in part in Puerto Rico, or to the rendering of services in Puerto Rico, among these controlled corporations. The thresholds require that these purchases or services meet: (i) a 10% gross receipts test; (ii) a 10% cost test; (iii) a 10% commissions and fees test; or (iv) a facilitation services test. The effect of this provision is to treat the nonresident alien individual or foreign corporation as if it were engaged in trade or business in Puerto Rico.

The new source of income rule also expands the scope of Puerto Rico source income to provide that a portion of the income earned by the purchasing affiliate from the resale of goods purchased from a related seller will be treated as Puerto Rico source income and subject to Puerto Rico tax as income effectively connected with the conduct of a trade or business in Puerto Rico. The portion of the income considered Puerto Rico source income will generally be determined by applying a four factor formula based on the ratio of Puerto Rico versus total payroll, sales, property and purchases. Special rules apply where an alien individual or purchasing affiliate believes that the application of such four factor formula will result in a greater allocation of income to Puerto Rico than is reasonable to attribute, or where adequate documentation is not provided or timely objection to the four factor formula is not filed.

Initially, income taxation based on these rules will apply to purchasers acquiring personal property and services from related sellers whose gross receipts are \$75,000,000 or less for any of the three preceding taxable years. The term ~~%personal property+~~means tangible personal property manufactured or produced in whole or in part in Puerto Rico, and the term ~~%services+~~means services performed in Puerto Rico in connection with the manufacture or production of tangible property, and that are acquired from any person engaged in the manufacture of said property or that performed said services in Puerto Rico. As a result of the new rules, a corporation located outside of Puerto Rico will be treated as if it had an office or fixed place of business in Puerto Rico that will generate Puerto Rico source income on a portion of its sales if it purchases from certain affiliated entities located in Puerto Rico. The source of income rule does not contain a sunset provision.

2. Transitory Excise Tax

An excise tax is imposed on persons acquiring personal property and services meeting the 10% tests noted above from related sellers whose gross receipts exceed \$75,000,000 for any of the three preceding taxable years. Taxpayers subject to the Excise Tax are exempted from the application of the income tax that would otherwise result from the application of the source of income rule. In the event the Excise Tax were not to apply, taxation would be based on the new source of income rule.

The Excise Tax is equal to the ~~%applicable percentage+~~of the value of such personal property and services. The Excise Tax will apply for 6 years. The ~~%applicable percentage+~~will be 4% for taxable years that begin after December 31, 2010 and end on or before December 31, 2011, declining every subsequent year to 3.75%, 2.75%, 2.5%, 2.25% and 1%, so that by the seventh year the Excise Tax will no longer apply. Although this Excise Tax is imposed on the purchasing affiliate, it is to be collected and remitted by the seller on or before the fifteenth day of the month following the month in which the acquisition occurs. The statute provides a mechanism to claim a credit for taxes paid in Puerto Rico on a series of purchases, or certain taxes paid to any of the States of the U.S. on these purchases.

B. Roll-out of changes

The Government of Puerto Rico kept the contents of this legislation strictly confidential until October 22, 2010, when the Legislature of Puerto Rico unveiled a substitutive bill to House Bill 2526. On October 23, 2010, the Government of Puerto Rico, represented by the Secretary of Economic Development and Commerce, the President and Executive Vice President of the Government Development Bank (GDB), the Governor's Chief Legal Counsel, and the Government's external counsel on this matter (the Washington DC law firm of Steptoe & Johnson LLP, one of whose partners was described as the author of the new tax proposal), held a meeting with a small group of Puerto Rico tax practitioners, among which were members of our firm, to explain the new statute. During the meeting, the Government's representatives also explained the Government's efforts in working with the United States Government (the United States Treasury Department and the Internal Revenue Service (IRS)) to find ways to avoid potential double taxation due to the new tax on the affected corporations.

While explaining that discussions are still ongoing, the Government officers expressed optimism that the Government will be able to persuade the IRS to implement a satisfactory solution to those affected by the new taxes regarding the U.S. tax treatment thereof.

Moreover, Government officers indicated that its external counsel will issue a legal opinion concluding that the new income tax, as well as the Excise Tax, should withstand constitutional and jurisdictional challenges, and should be entitled to a foreign tax credit for federal income tax purposes. The GDB President indicated that this opinion will be made available to all entities that may be subject to these taxes, as well as to their representatives.

If you have any questions or would like our assistance, you may call any of the following members of our Tax and Tax Exemption groups:

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