



Pharma and life sciences tax news: Vol. 10, No. 2

Puerto Rico's new excise tax and income source rules: Final regulations issued

Background and overview

Puerto Rico issued final regulations December 29, 2010, under Act 154, which modifies Puerto Rican (PR) tax law by adopting new source-of-income rules and imposing a temporary excise tax on certain purchases by offshore companies whose gross receipts exceed \$75 million. The new regulations follow the signing of Act 154 by Governor Luis G. Fortuño October 25, 2010, during a rare weekend legislative session. The law, enacted as part of a tax reform initiative, could raise an estimated \$5.8 billion over the next six years.

The final regulations define relevant concepts, such as property subject to the excise tax; provide guidance regarding the application of 10% tests and anti-abuse rules; and introduce a number of tax credits that could partly offset the burden of the new excise tax. The regulations on transactions took effect January 1, 2011. An opportunity for public comment on the regulations extends until January 31, 2011.

Income source rule

The new source-of-income rule may apply to nonresident, e.g. US parent company, purchasing of goods and/or services from PR affiliates manufacturing personal property or performing services in Puerto Rico. The new rule treats income from the resale of purchases from PR affiliates by a nonresident business as PR source income effectively connected with the conduct of a PR trade or business. The income is calculated using an equally weighted, four-factor formulary apportionment method that involves sales, purchases, property, and payroll. Under this method, the foreign taxpayer's entire net income is multiplied by a fraction (the numerator is the sum of the four factors, and the denominator is 4).

The PR source income is taxed at the local corporate income tax rate, which comprises a normal tax of 20% and a graduated surtax up to a maximum combined effective tax rate of 39%. However, under proposed tax code revisions, the maximum rate could decline to slightly lower than 30%. Furthermore, a potential 10% dividend tax on deemed distributions could apply.

The foreign taxpayer's net income is determined based on the jurisdiction under which it is organized, provided that such jurisdiction has tax laws that impose tax on net income. Otherwise, net income is determined based on PR income tax law. For example, in the case of a taxpayer organized in the United States, the net income should be determined by applying the US Internal Revenue Code.

The entire net income to be reported under the source rules will not include royalties already subject to withholding tax under Section 1221 or 1231 of the PR Tax Code or

under the industrial tax incentive laws. In addition, the foreign taxpayer cannot deduct any amount paid or incurred that is attributable to such royalties.

Taxpayers subject to the new sourcing rules must register with the PR Treasury Department and file a PR tax return annually. Presumably, they must pay estimated tax each quarter.

The source-of-income rules apply to income realized after December 31, 2010, regardless of the taxpayer's taxable year, making the first year of applicability 2011. Taxpayers should select the accounting year for which they will report the taxable income under these source rules.

Anti-abuse rule

An anti-abuse rule disregards any transaction for which one of the principal purposes is to avoid taxes due under the source rules, including:

- the organization or use of corporations, partnerships, or other entities
- use of tolling, commission, or commissionaire arrangements (including facilitation arrangements)
- use of any other plan or arrangement to avoid satisfying the controlled group test or gross receipts, cost, commission, or fee requirements.

Excise tax

Companies with manufacturing operations in Puerto Rico may be subject to a new excise tax, which is calculated on a taxable base of gross intercompany purchases. The excise tax rate amounts to 4% in 2011 and then gradually scales down over its six-year lifespan to 1%. The tax applies to nonresident businesses that purchase goods or services from PR affiliates that have gross receipts in excess of \$75 million for any of the three preceding taxable years. The PR affiliates bear the responsibility of collecting and remitting the excise tax to the Secretary of the Treasury.

This new excise tax is imposed in lieu of the PR income tax that otherwise would arise from the application of the new source-of-income rules. If a taxpayer is not required to pay the excise tax for whatever reason, including the applicability of tax credits stated in the excise tax regulations, the taxpayer should compute the tax under the source-of-income rules.

What is taxable under the final regulations

The excise tax applies to the acquisition of personal property and services by one member of a controlled group of corporations (as defined by Section 1028 of the PR Code) from another member with manufacturing operations in Puerto Rico or providing services related to a manufacturing operation in Puerto Rico. For purposes of the modified source rules, the nonresident party and the domestic entity are part of the same controlled group if another entity owns more than 50% of the total combined voting power and total value of the stock of both entities.

The final regulations define *personal property* and *services* as follows:

- **Personal property:** tangible property manufactured or produced in whole or in part in Puerto Rico.

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- **Services:** services performed in Puerto Rico in connection with the manufacture or production of tangible property.

A person is treated as having manufactured or produced tangible property in Puerto Rico if one or more of the following provisions apply:

- Employees or contractors substantially transform the property in Puerto Rico.
- The assembly or conversion costs account for 20% or more of the total sale price.
- The product is produced or manufactured under industrial incentives legislation, including the Puerto Rico Economic Development Incentives Act of 2008 (Act 73), the Tax Incentives Act of 1998 (Act 135), the Tax Incentives Act of 1987 (Act 8), or the Industrial Incentives Act of 1978 (Act 26).

The regulations specify that the tax does not apply to the following:

- “Mere packaging, repackaging, labelling, or minor assembly operations in Puerto Rico.”
- Beverage ingredients or any property subject to the provisions of Subtitle D of the PR Internal Revenue Code of 1994, as amended.

‘Acquisition’ defined

Section 2101 defines *acquisition* as “any action, transaction, or series of actions or transactions by which any person or enterprise”:

- obtains or procures legal title, beneficial ownership, or physical possession of tangible property
- obtains, receives, or procures the benefit of services.

Acquisition includes the electronic transmission or communication of a computer program from a location in Puerto Rico. An acquisition occurs on the day on which the tangible property is acquired, transmitted, communicated, or first loaded onto a vehicle or placed in the custody of a common carrier for transportation from the manufacturer or producer in Puerto Rico.

Value of personal property and services defined

The excise tax is based on the value of the acquired personal property and services. Factors used in determining that value include:

- **bill for property or services:** the price shown on a bill, assuming other bills do not reflect different prices for the same goods or services
- **fair market value:** the value established for tax reporting (where no bill exists)
- **exclusion of separately priced publicly traded components:** the value recorded in financial records
- **acquisition of services:** the value of the personal property to which the services relate, not the services themselves
- **transfer pricing adjustments:** allowable through the filing of an amended return within 20½ months following the month of the acquisitions, but the adjustments must reflect fair market value

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- **returned property:** adjustments are allowed in the month during which the rejection and return occurs, provided it occurs within 12 months following the month of the taxable acquisition.

10% test

Section 2101 applies only when the product or service accounts for one of the following:

- At least 10% of the total gross receipts of the PR member from the sale of property manufactured or produced or services performed in Puerto Rico during any of the three preceding tax years
- At least 10% of the total amount of personal property or services acquired by the foreign member during any of the three preceding tax years
- At least 10% of the total amount of commissions or other fees earned by the foreign member during any of the three preceding tax years
- In the case of transactions facilitated by the nonresident taxpayer, such transactions, together with the activities mentioned above, account for at least 10% of total gross receipts of the PR member or at least 10% of the nonresident taxpayer's total gross receipts from facilitation services for any of the three preceding tax years.

Credits

The final regulations allow for credits to be used among all eligible members of a controlled group. These credits could provide partial relief from the excise tax or even wipe out the tax in some cases. If the tax credit is in excess of the excise tax for any particular month, then such excess is carried over to the following month, to the extent that the month falls within the same calendar year. Credits that may offset the excise tax include the following:

1. **General credit against tax:** \$4 million or the aggregate tax liability in 2011. After 2011, the credit will equal the excise tax rate for each year divided by 4% times \$4 million. Generally, the tax credits should be divided by 12. If a tax credit exceeds the excise tax for any particular month, such excess should be carried over to the following month. No unused credit for the calendar year may be carried forward or back or refunded.

Example:

In December 2010, the controlled group of which Company B is a member projects taxable acquisitions for 2011 of \$125 million. In January 2011, there are taxable acquisitions of \$8 million, and the controlled group claims a credit pursuant to the provisions of the general credit of \$320,000 (4 percent [the tax rate for 2011] times 8 million, which is less than the maximum monthly credit for January of 333,000). In February 2011, there are taxable acquisitions of \$12 million. The controlled group may claim a credit for February 2011 of \$346,666 (\$4 million [the maximum pursuant to the provisions of the general credit]) divided by 12 [\$333,333] times 2 [\$666,666] less \$320,000 [the credit claimed for January 2011]).

2. **Alternative credit based on gross receipts:** In lieu of the general credit, a controlled group that meets certain conditions may elect this credit. The maximum credit is \$7 million in 2011 and reduces thereafter in the same proportion as the reduction of the excise tax rate.

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3. **Alternative credit where taxable acquisitions exceed certain thresholds:** In lieu of credits 1 and 2 above, some controlled groups with taxable acquisitions of \$4 billion, a monthly average employment in excess of 400 employees, and a payroll of \$20 million (including fringe benefits) may elect an alternative credit. For 2011, the amount of the alternative credit varies from \$20 million to \$80 million, based on the dollar amount of taxable acquisitions. After 2011, the credit will equal the excise tax rate for each year divided by 4% times the amount of the credit.
 4. **Addition to alternative credit for incremental increase in employees:** A controlled group that meets the requirements outlined in credit 3 above is eligible for additional credits for each calendar month in which the number of employees exceeds by 25 the baseline defined in the regulations. That credit will be \$187,500 plus another \$187,500 for each additional 25 employees, up to a maximum of 500 employees. The credit cannot exceed \$3.75 million. After 2011, the credit will equal the excise tax rate for each year divided by 4% times the amount of the credit.
 5. **Controlled groups with manufacturing and production facilities in multiple municipalities in Puerto Rico:** In lieu of the credits provided in 3 and 4, but in addition to the credit provided in 1 or 2, a controlled group with members engaged in manufacturing and production or manufacturing services in facilities located in three or more PR municipalities and employing a monthly average of more than 30 in such municipalities is eligible for a credit of up to \$5 million per municipality. The credit cannot exceed \$20 million. After 2011, the credit will equal the excise tax rate for each year divided by 4% times the amount of the credit.
 6. **Economically disadvantaged or critical industry suppliers:** A controlled group that purchases property or services from a certified economically disadvantaged or critical industry supplier will be entitled to a credit as follows:
 - If the cost of purchases is less than or equal to 75% of total purchases and exceeds the average annual direct purchases from such suppliers for the preceding two calendar years, a credit of 100% of such excess is allowed.
 - If the cost of purchases exceeds 75% of total purchases, the credit equals 150% of the excess.The credit, which is in addition to the credits provided in 1 through 5 above, may not exceed 1% of the excise tax owed after the application of any other credits.
 7. **Knowledge corridor and research and development (R&D) investment credit:** A controlled group is eligible for a credit based on its contributions to the Puerto Rico Science, Technology and Research Trust or Special Economic Development Fund or for R&D investment, as follows:
 - 100% of its contributions, up to 1% of the excise tax owed after the application of any other credit.
 - 100% of the excess of R&D investment over the average investment for the preceding two calendar years, up to 2% of the excise tax owed after the application of any other credit.

If the excise tax does not apply for any reason, including the availability of tax credits equal to or exceeding the excise tax, the source-of-income rules will determine the PR tax.

The PR government, through its outside legal counsel, has requested the written position of the US IRS regarding the US creditability on the excise or source-of-income tax as a foreign tax credit. However, the IRS has not yet issued guidance.

Maximum tax

With limited exceptions, the maximum amount of the annual excise tax will be \$375 million, less the economically disadvantaged or critical industry suppliers credit and the knowledge corridor credit.

For more information

[Pharma and Life Sciences Tax News, Vol. 9, No. 13](#)

[Pharma and Life Sciences Tax News, Vol. 9, No. 18](#)

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