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A Different Approach to the Old Problem of Transfer Pricing

The following article is the first in the series of special bulletins in which Zaragoza & Alvarado discusses the provisions of Act 1 of January 31, 2011, the Internal Revenue New Code for a New Puerto Rico (the "New New Code").

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During the last twenty years we have seen how tax jurisdictions around the world have given increased relevance to the transfer pricing area specially when dealing with nonresident persons. In Puerto Rico, due to the significance of the manufacturing base for most of the second part of the twentieth (20th) century, and to the fact that these entities were mostly foreign and covered by a preferential tax treatment, the Puerto Rico Treasury Department ('Treasury") did not pay too much attention to the issue because the motivation was pushing income to the local jurisdiction instead of the other way around. The aforesaid explained the few resources and the low level of importance traditionally assigned by Treasury to this area.

However, as the Puerto Rico's economy has been moving away from a manufacturing base to one based on the sale of goods and services (areas which are controlled by foreign entities that rarely enjoy tax preferential treatment) the transfer pricing area (as well as all types of intercompany charges) have been gaining increased importance among the areas monitored by Treasury. As a result of the above, the Internal Revenue Code for a New Puerto Rico (the "Code"), Act. Num. 1 of January 31, 2011 incorporates a new floor to the alternative minimum tax computation based on intercompany purchases effective for taxable years beginning after December 31, 2010.

AMENDMENTS TO THE ALTERNATIVE MINIMUM TAX PROVISIONS

As part of the Code, Treasury walked away from the traditional approach of complicated provisions dealing with transfer pricing coupled with increased human resources such as economists and other professionals. Instead, it applies an indirect approach to monitor the reasonability of transfer prices by amending the alternative minimum tax ("AMT") provisions to incorporate a new minimum tax of one percent (1%) of purchases of tangible personal property from related parties.

Until this amendment, the AMT provisions were directed, in general terms to eliminate the timing benefits of other code

Continues on Page 2

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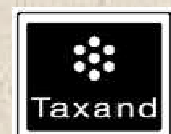

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A Different Approach... Continued from Page 1

provisions which granted preferential tax treatment by allowing for either the acceleration of deductions or the deferral of income. Under the old rules, the AMT was the greater of the regular income tax or twenty percent (20%) of the regular taxable income adjusted for certain preference items, amount known as the alternative minimum taxable income. The computation resulted in a non refundable tax credit applicable against the regular income tax responsibility in future years, position in which the entity would fall once the timing benefits begin their reversal pattern.

The amendments add a new use to the timing benefit add back mechanism of the AMT by using it as a control valve under which the only way for a taxpayer to avoid the excessive accumulation of AMT credits, with a small prospect of use in the future, will be by adjusting the transfer price to increase the income to be generated in Puerto Rico. This is done by establishing that the amount against which the regular income tax will be compared against to determine the AMT will be greater of twenty percent (20%) of the alternative minimum taxable or one percent (1%) of intercompany purchases. Taxpayers subject to AMT will receive a non reimbursable credit against future years' regular income taxes equal to the excess of the AMT determined, over the regular income tax liability. This credit has no expiration date.

The one percent (1%) floor will be determined based on the purchases of tangible personal property from a related party, other than raw materials and intermediate products to be used in a manufacturing process. For these purposes, the determination of what is a related party is made using a direct or indirect ownership test using a fifty percent (50%) threshold.

This floor will not apply in the following circumstances:

- When the purchaser of the goods has gross receipts from its Puerto Rico trade or business of less than fifty million dollars ($50,000,000);
- To purchases related to activities enjoying tax exemption under Act 73 of May 28, 2008 ("Act 73") or any similar successor or predecessor act;
- To goods subject to the liquor tax;
- When the purchaser or any member of its controlled group is subject to the provisions of the four percent (4%) excise tax applicable to nonresident related parties on their purchases of goods or services from their resident manufacturing or service provider affiliate (i.e. Act 154 of October 25, 2010); or
- When the Secretary of the Treasury determines that the value of the tangible personal property purchased from the related party is equal or substantially similar to the value used to sell such property to an unrelated party.

This last exception opens the door for the use of transfer pricing studies, in a manner similar to an advance pricing agreement, to substantiate to the Secretary the reasonability of the transfer price and avoid being subject to the AMT floor based on intercompany purchases.

Finally it is worth mentioning that the incorporation of this new floor under the AMT rules based on intercompany purchases is just a continuation of Treasury's efforts in the related party transactions' area which began in 2008, with the addition of an AMT add back adjustment for the intercompany charges for services rendered outside Puerto Rico which are not subject to taxation locally.

OPTION TO CONTINUE TO BE TAXED UNDER THE PROVISIONS OF THE 1994 INTERNAL REVENUE CODE, AS AMENDED (THE "1994 CODE")

The Code provides corporate taxpayers the option to determine their tax and file their return under the provisions of the 1994 Code for the taxable year beginning after December 31, 2010 and the next four taxable years. This option will require corporate taxpayers to evaluate, in the medium term, the tax costs and benefits under the Code to determine whether to make this election or not. One of the main benefits under the Code is a significant reduction in the corporate income tax rates. The maximum marginal rate will decrease from thirty nine percent to thirty percent (39% to 30%) during the first three taxable years after December 31, 2010 and to twenty five percent (25%) thereafter subject to compliance, by the P.R. Government, with certain budgetary thresholds.

In the case of taxpayers subject to the new AMT floor they will have to analyze the economic and financial reasons behind their

Continues on Page 3

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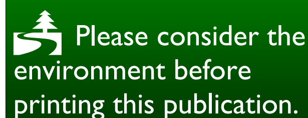
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A Different Approach... Continued from Page 2

AMT position in order to determine if its nature is more a permanent one than temporary. If it is permanent in nature, then they will probably be better off staying under the 1994 Code, under which the maximum marginal rate is thirty nine percent (39%), versus a real cash basis tax rate of possibly up to sixty percent to seventy percent (60% to 70%) under the new AMT rules (to the extent the credits can never be used).

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