

New Legislation Affects Foreign Corporations

On October 25, 2010, the Governor of Puerto Rico approved Act No. 154 (the "Act"), which amends the 1994 Puerto Rico Internal Revenue Code, as amended (the "Code"), effective January 1, 2011. The following summarizes the most important aspects of such legislation.

Objectives of the Act

This revenue raising measure imposes taxes on certain nonresident individuals and foreign corporations and partnerships ("Foreign Taxpayers") that were not taxed under Puerto Rico's previously existing tax regime. Under the new rules, these Foreign Taxpayers will be taxed in Puerto Rico if certain relationship tests are met with respect to a manufacturing or service providing affiliate resident of Puerto Rico (the "Resident Entity").

Overview of Changes in Tax Regime Applicable to Nonresident Foreign Corporations

In general terms, Puerto Rico taxes nonresident foreign persons only on their gross (not net) income from sources within Puerto Rico (with certain exceptions). The existence of a Puerto Rico trade or business by a Foreign Taxpayer has two

effects, first it expands the types of income which are taxable in Puerto Rico to include (aside from Puerto Rico source income) the foreign source income which is effectively connected with a Puerto Rico trade or business and, second, changes the taxation regime to one in which income is taxed on a net basis rather than on a gross basis.

Under the Act, a Foreign Taxpayer not otherwise considered engaged in a trade or business in Puerto Rico, at least under the traditional minimum contact standards applicable to income taxes or even sales and use taxes (which are traditionally lower), will be considered as such (the "Deemed Resident Taxpayer") to the extent it has a manufacturing or service providing affiliate operating in Puerto Rico and the level of certain commercial transactions between both entities exceeds pre-established thresholds (the "Commercial Transactions Tests").

The Act imposes a tax on Deemed Resident Taxpayers based on two different mechanisms depending on the sales level of the Resident Entity. If the sales level exceeds \$75 million, purchases by the Deemed Resident Taxpayer from the Resident Entity, will be subject to an export excise tax of 4%.

For cases not meeting the sales threshold, a four factor test is used to characterize as Puerto Rico source income a portion of the Deemed Resident Taxpayers' income generated outside Puerto Rico.

How the Changes are Accomplished

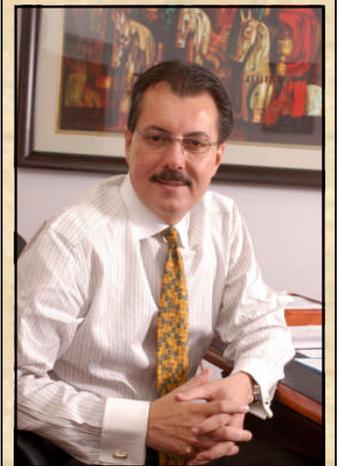
The Act amends the effectively connected income rules under the Code (which up to this point had no pertinence in determining whether a Foreign Taxpayer was engaged in a trade or business in Puerto Rico), as follows:

- I. It expands the scope of what is considered an office or fixed place of business of a Foreign Taxpayer. This will happen under the following circumstances:
 - a. the Resident Entity has the authority to negotiate and conclude contracts on behalf of the Foreign Taxpayer or has stock of merchandise from which to

Continues on Page 2

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New Legislation Affects...
Continued from Page 1

fill orders on its behalf and regularly does so; except general commission, agent, broker or independent agent agreements; or

- b. the Resident Entity is a member of a controlled group (as said term is defined in the Act) of the Foreign Taxpayer and one of the following Commercial Transactions' Tests are met:

Sales Test: for the current taxable year or any of the three preceding taxable years, at least 10% of the gross receipts of the Resident Entity is derived from the sale of personal property manufactured in whole or part in Puerto Rico or services rendered in Puerto Rico by the Resident Entity for or on behalf of the Foreign Taxpayer;

Purchases Test: for the current taxable year or any of the three preceding taxable years, the sales of personal property manufactured in whole or part in Puerto Rico or services rendered in Puerto Rico by the Resident Entity to the Foreign Taxpayer account for at least 10%

(measured by cost) of the purchases of the Foreign Taxpayer;

Commissions Test: for the current taxable year or any of the three preceding taxable years, the commissions earned by the Foreign Taxpayer with respect to transactions related to personal property manufactured in whole or part in Puerto Rico or services rendered in Puerto Rico by the Resident Entity, represent at least 10% of its total commissions; or

Facilitator Test: for the current taxable year or any of the three preceding taxable years, at least 10% of the total gross receipts of the Resident Entity are derived from the sum of the sales of personal property manufactured in whole or part in Puerto Rico or services rendered in Puerto Rico facilitated by the Foreign Taxpayer and the gross receipts resulting from the transactions described in the Sales, Purchases and Commissions Tests referred to above.

The Act also expands the scope of what is considered Puerto Rico source income, to characterize as such a portion of the income, gains and profits of the Deemed Resident Taxpayer, earned

outside Puerto Rico based on formula which averages four factors: property, payroll, sales and purchases. In the absence of this rule, no part of the foreign source income of the Deemed Resident Taxpayer would be subject to tax in Puerto Rico.

As a result of these two changes (which are permanent in nature), certain Foreign Taxpayers that previously were not considered engaged in trade or business in Puerto Rico, are now considered as such, and certain income derived by such Foreign Taxpayers which was previously considered income from sources without Puerto Rico (and, thus, not subject to Puerto Rico income tax) is now treated Puerto Rico source income (or effectively connected income) and, therefore, subject to Puerto Rico income tax.

New Excise Tax Withholding

The Act amended the excise tax provisions of the Code to impose an excise tax withholding where the Resident Entity's gross receipts from the sale of personal property manufactured in whole or in part in Puerto Rico or services rendered in Puerto Rico exceed \$75 million. In those cases, the Deemed Resident Taxpayers will not be subject to the above rules, and the following rules will apply:

- A. An excise tax is imposed on the acquisition by the Deemed Resident Taxpayer, of tangible personal property manufactured or produced in whole or in part in Puerto Rico and services

Continues on Page 3

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New Legislation Affects...
Continued from Page 1

performed in Puerto Rico in connection with the manufacture or production of tangible property, provided that such property or services are acquired from an affiliate engaged in the manufacturing or rendering of such good and services and that has derived gross receipts in excess of \$75 million.

- B. The excise tax must be withheld on the sum of the total charges for such property or services reflected in the commercial invoice or on their fair market

value in the absence of an invoice.

- C. The applicable tax rates are the following:

1. 4% for years commencing after 12-31-10;
2. 3.75% for years commencing after 12-31-11;
3. 2.75% for years commencing after 12-31-12;
4. 2.50 % for years commencing after 12-31-13;
5. 2.25% for years commencing after 12-31-14;

6. 1.0% for years commencing after 12-31-15 and ending on or before 12-31-16.

New Filing Requirements

In the case of the excise tax, the seller of the products or services will have the responsibility to collect the tax and remit it to the Puerto Rico Treasury on a quarterly basis (April 30, July 31, October 31 and January 31).

If the Foreign Taxpayer is not subject to the excise tax withholding, it will have to file an annual corporate income tax return on or before the 15th day of the fourth month after the closing of its taxable year.

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