

Puerto Rico Enacts New Excise Tax That Impacts U.S. Companies

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A temporary excise tax recently enacted in Puerto Rico will have a significant impact on U.S.-based multinational groups conducting, or considering conducting, manufacturing activities in Puerto Rico. Companies should consider the creditability of the excise tax for U.S. purposes and, even if the excise tax is creditable, whether their current organizational structure allows them to fully utilize the foreign tax credit.

Overview

On October 25, 2010, Puerto Rico enacted a temporary excise tax on related party purchases of products manufactured in Puerto Rico or services performed in Puerto Rico. The tax is imposed on the value of the products or services purchased. The rate of the tax will decrease during the years of its existence from 4 percent in 2011, to 3 percent in 2012, to 2.75 percent in 2013, to 2.5 percent in 2014, to 2.25 percent in 2015 and down to 1 percent in 2016, when it will expire on December 31. The tax will have a significant impact on U.S.-based multinational groups that engage in manufacturing activities in Puerto Rico.

Currently, many U.S. companies manufacture products in Puerto Rico that are subsequently sold throughout the world by affiliates. By way of example, assume a U.S. corporation (USP) owns the stock of a Dutch company (BV) that constitutes a controlled foreign corporation. Through a branch in Puerto Rico (PR Branch), BV engages in the manufacture of Product A. PR Branch sells Product A to an affiliate of USP (Purchaser), that in turn sells Product A to customers throughout the world.

Under current Puerto Rican law, the profit derived by PR Branch on the sale of Product A to USP's worldwide affiliates is subject to tax in Puerto Rico. However, under Puerto Rican tax incentives legislation, the Puerto Rican government often grants industrial tax exemptions to encourage manufacturing activity in Puerto Rico. These exemption grants entitle the manufacturer to pay little Puerto Rican tax on its income. Purchaser's income is often not subject to Puerto Rican tax because it is not Puerto Rican source. The exemption grants generally also provide relief from other Puerto Rican taxes, including an earlier excise tax.

Along with the enactment of the excise tax, Puerto Rico amended its rules for determining when income is considered as from Puerto Rican sources (the source rule). Specifically, new Section 1123(f) of the Puerto Rico Internal Revenue Code (PR-IRC) expands the source rule to treat a nonresident individual or a foreign corporation or partnership as having an office or fixed place of business in Puerto Rico as a result of certain regular transactions

between such person and a related party performing activities in Puerto Rico. When this threshold is satisfied, the amendments to the source rule treat a portion of the income of the nonresident individual, foreign corporation or partnership as from Puerto Rican sources, based on a four-factor apportionment formula that includes purchases as a factor. Thus, under the example above, a portion of Purchaser's income could be characterized as Puerto Rican source.

Puerto Rico enacted the excise tax as a substitute for the newly expanded source rule. The tax is imposed on Purchaser, but PR Branch is required to collect and deposit the tax with Puerto Rican tax authorities. Using a combination of the source rule and the excise tax, Puerto Rico intends to tax the value of the products or services purchased, rather than Purchaser's net income, using a tax that may qualify as an "in lieu of" tax for purposes of the U.S. foreign tax credit regime.

The Excise Tax

PR-IRC Section 2101 will impose the excise tax on "the acquisition after December 31, 2010 of personal property and services by a nonresident alien individual or foreign corporation or partnership that has, or is treated as having, office or other fixed place of business in Puerto Rico ... equal to the value applicable percentage of the value of such personal property and services."

For purposes of determining whether the nonresident alien individual or foreign corporation or partnership has an "office or other fixed place of business in Puerto Rico," PR-IRC Section 2101 refers to the expansion of that concept as reflected in new PR-IRC Section 1123(f), the source rule.

Under this rule, a person may have a deemed office or fixed place of business if it acquires personal property or services directly (or, it appears, indirectly) from another member of the same controlled group, or where a person provides distribution or facilitation services for or on behalf of another member of the same controlled group, including services on a commission or commissionaire basis, that account for:

(A) At least 10 percent of the total gross receipts of such other member from the sale or personal property manufactured or produced, and services performed, in Puerto Rico by such other member for the taxable year or for any of the three preceding taxable years

(B) At least 10 percent, by cost, of the total amount of personal property and services acquired by such person for the taxable year or for any of the three preceding taxable years

(C) At least 10 percent of the total amount of commissions or other fees earned by such person for the taxable year or for any of the three preceding taxable years

(D) In the case of transactions facilitated by the nonresident alien or foreign corporation or partnership, such transactions, together with the activities in (A), (B) and (C) above, account for at least 10 percent of the total gross receipts of such other member or at least 10 percent of the total gross receipts of the nonresident alien or foreign corporation or partnership from facilitation services for the taxable year or for any of the three preceding taxable years

The terms “personal property” and “services” mean tangible property manufactured or produced in whole or in part in Puerto Rico and services performed in Puerto Rico in connection with the manufacture or production of tangible property, acquired from any person that engages in the manufacture or production of tangible property in Puerto Rico, or performs services in Puerto Rico in connection with the manufacture or production of tangible property, having gross receipts of \$75,000,000 for any of the three preceding taxable years.

New PR-IRC Section 2101 also contains a broad anti-abuse rule disregarding any transaction, or series of transactions, one of the principal purposes of which is the avoidance of PR-IRC Section 2101, including, but not limited to, the organization or use of corporations, partnerships or other entities, the use of commission or commissionaire arrangements (including facilitation arrangements) or the use of any other plan or arrangement. Further, the use of non-arm’s length charges for personal property or services is disregarded.

While the excise tax is levied on the purchaser, it is collected by the seller under new PR-IRC Section 2102. The failure to accurately and timely collect and deposit the tax with the Puerto Rican tax authorities will result in a penalty under the new law.

The excise tax is technically imposed on each related purchaser of the personal property or services. Thus, it may impose multiple levels of tax on a series of sales between related parties. The law provides for a credit intended to prevent multiple layers of taxation. However, as currently drafted, the law may not accomplish this goal in many cases.

Considerations

The imposition of the new excise tax by Puerto Rico will affect many U.S. companies currently conducting or considering conducting manufacturing activities in Puerto Rico. Companies should consider the creditability of the excise tax for U.S. purposes. The Puerto Rican government has obtained an opinion from counsel that the excise tax should be creditable for U.S. tax purposes. Guidance from the U.S. Treasury and IRS on this point would be welcome. Even if the excise tax is creditable, U.S. companies may still need to consider whether their current

organizational structure allows them to fully utilize the foreign tax credit. Finally, companies should monitor potential reactions to the new excise tax on the part of the U.S. Congress.

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