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The End of the Act 154 of 2010 "4% Excise Tax"

By: César De Jesús-Umpierre

The release of final regulations by the U. S. Internal Revenue Service ("IRS"), related to the Foreign Tax Credit for taxes paid to other jurisdictions (including Puerto Rico) limited the allowed tax credit in the U.S. income tax return for taxes paid in Puerto Rico under Act 154 of 2010, as amended ("Act 154"). As a result, it has triggered a change in the active Puerto Rico tax incentives laws to replace the Act 154 excise tax, which became one of the primary sources of income for the Government of Puerto Rico.

Act 154 Excise Tax

Act 154, effective for taxable years commencing after December 31, 2010, imposed a 4% excise tax (the "4% Tax") on a controlled group's member acquisition from a group member of certain personal property manufactured or produced in Puerto Rico and certain services performed in Puerto Rico. Originally, the 4% excise had a phase out period after six (6) years. However, it was later amended to be effective until December

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31, 2027. In cases where the sale of the personal property or services, between the members of the group, was less than $75,000,000, the 4% Tax was not Applicable. Nevertheless, such entities were subject to different rules on the sourcing of the income which resulted in more taxable income attributed and recognized in the Puerto Rico jurisdiction (the "Modified Sourcing Rules").

The U.S. Tax Credit

Since Act 154 was enacted, the IRS has permitted the member of the controlled group, subject to the 4% Tax, to claim a credit against its U.S. income tax for such tax paid to Puerto Rico. Accordingly, if there is sufficient income tax in the U.S. to absorb the 4% Tax credit, this tax does not represent an incremental tax to the controlled group. However, pursuant to regulations issued by the IRS in December 2021, the 4% Tax will not be allowed as a credit in the U.S. for taxable years beginning on or after January 1, 2023, which means that it will be an incremental tax to the group.

The Option Out

To mitigate the incremental tax, on June 30, 2022, the Governor of Puerto Rico signed Act 52-2022 ("Act 52") to, among other things, amend Act 135-1997, Act 73-2008 and Act 60-2019 (collectively the "Tax Incentives Acts") to provide an option to eliminate the 4% Tax (the "Option Out"). This Option Out provides for the following income tax rates on the company's industrial development income ("IDI") and withholding tax on its royalty payments:

Alternate Income Tax and Royalty Withholding Tax

1. General Rule
   a. Income Tax = 10.5%
   b. Royalty Tax = 12%
      i. When an exempt business has at least 100 average employees during the year, 37.5% of the royalty payments made will be exempt from this tax.
2. Special Exemptions
   a. 1,000 Employees or more and $300,000,000 or more of IDI during the year
      i. Income Tax = 8.4% (**20%** exemption (10.5% x 80%))
      ii. Royalty Tax = 12%
   b. 1,000 Employees or more and $2,500,000,000 or more of IDI during the year
      i. Income Tax = 3.47% (67% exemption (10.5% x 33%))
      ii. Royalty Tax = 7.5% (12% x 37.5% exemption)
   c. 1,000 Employees or more and $7,500,000,000 or more of IDI during the year
      i. Income Tax = 2.63% (75% exemption (10.5% x 25%))
      ii. Royalty Tax = 7.5% (12% x 37.5% exemption)
   d. 4,000 Employees, and total royalty payments made were at least 90% of IDI for the year
      i. Income Tax = 1.05% (90% exemption (10.5% x 10%))
      ii. Royalty Tax = 13%
      May be reduced to 12% when the royalty payments made for the year increase by at least 10% when compared to the average of the three (3) prior years.

Manner of the Option Out and Effect

To be taxed under the above Alternate Income Tax, and accordingly not be subject to the 4% Tax, the member of the controlled group that performs the manufacturing business in Puerto Rico ("Exempt Business") must request an amendment to its Tax Grant electing these Alternate Tax Rates.

By making this amendment, the Exempt Business, or any member of the controlled group of the Exempt Business, will not be subject to the 4% Tax nor to the Modified Sourcing Rules.

Any Exempt business with an active Tax Grant issued under Act 135-1997 or Act 73-2008 that elects to be taxed under the above Alternate Tax qualifies for a 15-year extension of its tax grant under its corresponding tax incentives act.

Effect of a US Global Minimum Tax

If the U.S. amends the Internal Revenue Code of 1986, as amended, to impose an income tax of at least 15% on all or any part of the income of a controlled foreign corporation, the 10.5% Alternate Tax mentioned above will increase to 15%.

ATBA Comments

It is expected that most Exempt Businesses, currently subject to the 4% Tax and the Modified Sourcing Rules provided in Act 154 will benefit from the Option Out included in Act 52. Nevertheless, careful analysis should be made, taking into consideration the income and royalty withholding tax rates pursuant to their current tax grants, to determine the effect on the income tax position

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ABOUT THE AUTHOR
César De Jesús-Umpierre

César is a Member at Alvarado Tax & Business Advisors. Prior to that, he was Partner at Zaragoza & Alvarado LLP. His Curriculum Vitae also includes previous experience in the corporate and individual tax advisory area working as Tax Manager for Wal-Mart Puerto Rico, Inc., and Assistant Vice-President Responsible for all business tax consulting and tax compliance work for over 30 entities in Puerto Rico and US at Interstate General Properties L.P., S.E., a member of American Community Properties Trust (a publicly traded partnership) with real estate operations in Puerto Rico and Maryland.

César provides corporate tax services for clients in the manufacturing, advertising, retail, insurance and banking industries. He is frequently invited as speaker at many tax seminars sponsored by the Puerto Rico Society of Certified Public Accountants. He is a member of the Puerto Rico Certified Public Accountants Society and the American Institute of Certified Public Accountants, with a Bachelor degree in Business Administration, major in Accounting from the University of Puerto Rico.

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of the controlled group. Should you need assistance or if you have any questions, our tax professionals are available to assist you with these or any other tax related matters.

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Alvarado Tax & Business Advisors LLC

104 Acuarela Marginal Street
Martinez Nadal Expressway
Guaynabo PR 00969

PO Box 195598
San Juan PR 00919-5598

T. 787.999.4400
F. 787.999.4646
E. taxadvisors@alvatax.com
www.alvatax.com
www.taxand.com

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Key Contacts at Alvarado Tax & Business Advisors LLC

Juan A. Alvarado-Zayas, Esq., CPA
Managing Member
787-620-7730
jalvarado@alvatax.com

Felipe Mariani-Franco, CPA
Member
787-620-7736
fmariani@alvatax.com

Sandra Marie Torres-Martínez, CPA
Member
787-620-7728
storres@alvatax.com

Carlos R. González-Martínez, CPA
Member
787-620-7739
cgonzalez@alvatax.com

César De Jesús-Umpierre, CPA
Member
787-620-7734
cdejesus@alvatax.com

Rosirma García-Rivera, CPA
Member
787-620-7733
rgarcia@alvatax.com

Corali Del Llano-Torres, Esq., CPA
Member
787-999-3011
cllano@alvatax.com

Elisa Vélez-Pérez, Esq., CPA
Member
787-999-3001
evelez@alvatax.com

Luis Torres-Llompart, CPA
Director
787-649-4153
ltllompart@alvatax.com

Edgardo Sanabria-Valentín, CPA
Special Advisor
787-999-3015
esanabria@alvatax.com
