

The Tax Advisor

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

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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

- I. 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% ($12\% \times 37.5\%$ 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

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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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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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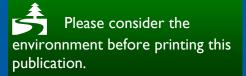
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