



December 10, 2010

Proposed Source Rule Regulations

Reg. § 1123(f)-4.

* * *

(d) Definitions.—

(1) In General.—Where a term that is used in Chapter 7 of Subtitle B is used in Code sec. 1123(f) and is not otherwise defined in Code sec. 1123(f) or these regulations, such term has the meaning ascribed to it in Chapter 7 of Subtitle B and the regulations thereunder.

(2) Personal property.—

(i) Personal property means tangible property manufactured or produced in whole or in part in Puerto Rico.

(ii) Tangible property manufactured or produced in whole or in part in Puerto Rico means property that a person has manufactured or produced in Puerto Rico by satisfying the provisions of subdivision (I), (II), or (III) below.

(I) Substantial transformation of tangible property.—The tangible property is substantially transformed by such person through the activities in Puerto Rico of its employees or contractors.

(II) Other manufacture of tangible property.— Such person's employees or contractors perform activities with respect to such property in Puerto Rico that that are substantial in nature. Without limiting this substantive test, the activities of such person's employees or contractors in Puerto Rico will be considered to be substantial in nature if any assembly or conversion costs (direct



labor and factory burden) attributable to such person's employees or contractors in Puerto Rico account for 20 percent or more of the total cost of the tangible property that is sold. If such costs account for less than 20 percent of the total cost of the tangible property that is sold, whether the activities of such person's employees or contractors will be considered to be substantial in nature will depend on the facts and circumstances of each case.

(III) Products covered by Tax and Industrial Incentives

Acts.—The tangible property consists of a product or an item of property that is treated as produced or manufactured by such person's employees or contractors in whole or in part in Puerto Rico under a decree issued under Act No. 73 of May 28, 2008, as amended, known as the Puerto Rico Economic Development Incentives Act of 2008; Act No. 135 of December 2, 1998, as amended, known as the Tax Incentives Act of 1998; Act No. 8 of January 24, 1987, as amended, known as the Tax Incentives Act of 1987; Act No. 26 of June 2, 1978, as amended, known as the Industrial Incentives Act of 1978; or any previous or subsequent industrial incentives legislation.

(iii) In no event will activities that do not occur in Puerto Rico constitute the manufacture or production of property in Puerto Rico for purposes of Code sec. 1123(f)(4).

(iv) In no event will mere packaging, repackaging, labeling, or minor assembly operations in Puerto Rico, without more, constitute the manufacture or production of property in Puerto Rico for purposes of Code sec. 1123(f)(4).

(v) Tangible property manufactured or produced in whole or in part in Puerto Rico does not include any property that is subject to the provisions of Subtitle D of the Puerto Rico Internal Revenue Code of 1994, as amended.

(3) Services.—Services means services performed in Puerto Rico in connection with the manufacture or production of property.

(e) Rules applicable to nonresident alien individuals or foreign corporations or partnerships that satisfy Code sec. 1123(f)(4)(A)(ii)(I) and (II). General rule.—Each nonresident alien individual or foreign corporation or partnership that satisfies Code sec. 1123(f)(4)(A)(ii)(I) and (II) shall, except as otherwise provided in this paragraph (e),



determine, based on documentation satisfactory to the Secretary, the portion of the entire net income of such nonresident alien individual or foreign corporation or partnership that is treated as gains, profits and income from sources within Puerto Rico by multiplying its income by a fraction, the numerator of which is the sum of the property factor, the payroll factor, the sales factor and the purchases factor and the denominator of which is four.

(1) For purposes of this article, the property factor is a fraction, the numerator of which is the average value of the real and tangible personal property owned and used or rented and used by the nonresident alien individual or foreign corporation or partnership in Puerto Rico during the taxable year, and the denominator of which is the average value of all the real and tangible personal property owned and used or rented and used by the nonresident alien individual or foreign corporation or partnership during the taxable year and located everywhere, to the extent that such property is used to produce income.

(i) Property owned by a nonresident alien individual or foreign corporation or partnership shall be valued at its original cost plus the cost of additions and improvements. Property rented by the nonresident alien individual or foreign corporation or partnership shall be valued at eight times the annual rental rate paid by the nonresident alien individual or foreign corporation or partnership. The value of movable tangible personal property used both within and without Puerto Rico shall be included in the numerator to the extent of its utilization in Puerto Rico. The extent of such utilization shall be determined by multiplying the total value of such property by a fraction, the numerator of which is the number of days of physical location of the property in Puerto Rico during the taxable period and the denominator of which is the number of days of physical location of the property everywhere during the taxable period. The number of days of physical location of the property may be determined on a statistical basis or by such other reasonable method acceptable to the Secretary.

(ii) The average value of property shall be determined by averaging the value at the beginning and ending of the taxable year, but the Secretary may require the averaging of monthly values during the taxable year if reasonably required to reflect properly the average value of the property of the nonresident alien individual or foreign corporation or partnership.

(2) For purposes of this article, the payroll factor is a fraction, the numerator of which is the total amount paid or accrued in Puerto Rico during the tax period by the nonresident alien individual or foreign corporation or partnership for compensation, and the denominator of which is the total compensation paid or



accrued everywhere during the taxable year, to the extent that such payroll is used to produce income.

(i) Compensation is paid or accrued in Puerto Rico where the employee's service is entirely or predominantly performed within Puerto Rico;

(ii) Compensation is paid or accrued in Puerto Rico where some of the service is performed in Puerto Rico and the base of operations, or, if there is no base of operations, the place from which the service is directed or controlled, is in Puerto Rico; or the base of operations or the place from which the service is directed or controlled is not in any state of the United States or foreign country in which some part of the service is performed, but the employee's residence is in Puerto Rico.

(iii) For this purpose, compensation includes all amounts paid for services rendered, including bonuses, vacation allowances, and fringe benefits.

(3) For purposes of this article, the sales factor is a fraction, the numerator of which is the total sales of the nonresident alien individual or foreign corporation or partnership in Puerto Rico during the taxable year, and the denominator of which is the total sales of the nonresident alien individual or foreign corporation or partnership everywhere during the taxable year, to the extent that such sales are used to produce income.

(i) Sales of tangible personal property are in Puerto Rico if such property is received in Puerto Rico by the purchaser. In the case of delivery by common carrier or other means of transportation, the place at which such property is delivered to such common carrier shall be considered as the place at which such property is received by the purchaser. Direct delivery in Puerto Rico, other than for purposes of transportation, to a person or firm designated by a purchaser, constitutes delivery to the purchaser in Puerto Rico, and direct delivery outside Puerto Rico to a person or firm designated by the purchaser does not constitute delivery to the purchaser in Puerto Rico, regardless of where title passes, or other conditions of sale.

(ii) Sales, other than sales of tangible personal property, are in Puerto Rico if the income-producing activity is performed in Puerto Rico, or the income-producing activity is performed both in and outside Puerto Rico and a greater proportion of the income-producing activity is performed in Puerto Rico than in any other state of the United States or foreign country, based on costs of performance.



(4) For purposes of this article, the purchases factor is a fraction, the numerator of which is the total purchases of the nonresident alien individual or foreign corporation or partnership in Puerto Rico during the taxable year, and the denominator of which is the total purchases of the nonresident alien individual or foreign corporation or partnership everywhere during the taxable year, to the extent that such purchases are used to produce income.

(i) Purchases of tangible personal property are in Puerto Rico if such property is manufactured or produced in Puerto Rico by a member of the controlled group that includes the purchaser, whether such purchases are made directly or indirectly from the manufacturer or producer;

(ii) Whether purchases of tangible personal property that is not manufactured or produced by a member of the controlled group that includes the purchaser are in Puerto Rico is determined under the rules of subparagraph (3) for sales.

(iii) Purchases, other than purchases of tangible personal property, are in Puerto Rico if the income-producing activity of the seller is performed in Puerto Rico, or the income-producing activity of the seller is performed both in and outside Puerto Rico and a greater proportion of the income-producing activity is performed in Puerto Rico than in any state of the United States or foreign country, based on costs of performance.

(5) If any nonresident alien individual or foreign corporation or partnership believes that the method of allocation prescribed in Code sec. 1123(f)(4)(B)(v) and this paragraph (e) as administered by the Secretary has operated or will operate so as to subject it to taxation on a greater portion of its income than is reasonably attributable to business or sources within Puerto Rico, the nonresident alien individual or foreign corporation or partnership shall be entitled to file with the Secretary a statement of objections and of such alternative method of allocation or apportionment as such nonresident alien individual or foreign corporation or partnership believes to be proper under the circumstances with such detail and proof and within such time as prescribed in paragraph (f) below. If the Secretary concludes that the method of allocation or apportionment prescribed in Code sec. 1123(f)(4)(B)(v) is in fact inapplicable or inequitable, the Secretary shall redetermine the taxable income by such other method of allocation or apportionment as seems best calculated to assign to Puerto Rico the portion of the income reasonably attributable to business and sources within Puerto Rico, not exceeding, however, the amount which would be arrived at by application of the rules of Code sec. 1123(f)(4)(B)(v). Any change or modification to the method or formula for allocating income previously authorized shall be requested in writing



and authorized by the Secretary, prior to the change or modification, through an administrative opinion or determination.

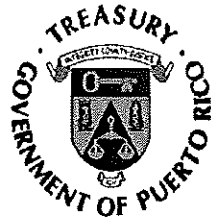
(6) The total income of such nonresident alien individual or foreign corporation or partnership that is treated as gains, profits and income from sources within Puerto Rico under Code sec. 1123(f)(4)(B)(i) does not include any royalties subject to tax under Code sec. 1221(a)(1)(A) or 1231(a)(1)(A) or section 3(b) of the Economic Incentives Act for the Development of Puerto Rico of 2008, or any equivalent provision of any prior or subsequent industrial incentives act. Provided furthermore that in determining the taxable income of such nonresident alien individual or foreign corporation or partnership, no deduction shall be allowed for any amount paid or incurred by such taxpayer that is directly or indirectly attributable or allocable to any such royalties.

(7) The rules of this paragraph (e) do not apply for any taxable year for which the nonresident alien individual or foreign corporation or partnership pays tax under Code sec. 2101 that is not refunded or credited against the excise tax for other periods.

(f) Alternative method of allocation.—A nonresident alien individual or foreign corporation or partnership that wishes to object to the method of allocation prescribed in Code sec. 1123(f)(4)(B)(v) and to submit an alternative method of allocation, shall request an administrative determination that complies with the requirements set forth in the Puerto Rico Treasury Department Circular Letter 99-01, or any subsequent pronouncement that modifies or replaces it. For an administrative opinion or determination to be effective for a taxable year other than 2011, a request must be filed within the first one hundred twenty (120) days of such year. For taxable years ending in 2011, a request must be filed by June 30, 2011. The administrative letter request shall include, in addition to the information and documents prescribed in Circular Letter 99-01, or any substitute guidelines, the following:

(1) A comparison between the income deemed to be from Puerto Rico sources under the criteria set forth in Code sec. 1123(f)(4)(B)(v) and the income deemed to be from Puerto Rico sources under the proposed alternative method, including the calculation of the income deemed to be from Puerto Rico sources under the criteria set forth in Code sec. 1123(f)(4)(B)(v) and under the proposed alternative method;

(2) An explanation of the alternative method of allocation proposed pursuant to Code sec. 1123(f)(4)(B)(vi) and the justification for the use of the alternative method;



(3) A description of the entities within the controlled group operating in Puerto Rico that includes those physically operating there, treating income as attributable to, or realized by, a trade or business in Puerto Rico or Puerto Rican entity, profits there, organized there, or with other direct connections to Puerto Rico;

(4) An organization chart reflecting the ultimate and intermediate ownership of each entity described in subparagraph (f)(3), or making payments to, or receiving payments from, such an entity;

(5) A report containing the following information for each member of the controlled group described in subparagraph (f)(3):

(i) Gross receipts

(ii) Volume of total sales

(iii) Volume of sales to affiliated companies

(iv) Volume of sales within Puerto Rico and volume of sales to the rest of the world

(v) Cost of goods sold

(vi) Full-time employees

(vii) Temporary employees

(viii) Contract employees

(ix) Outsourced employees

(x) Average monthly full-time employees for the twelve (12) months ended October 1, 2010

(xi) Total salaries paid for the twelve (12) months ended December 31, 2010

(xii) Total payroll expense for the twelve (12) months ended Dec 31, 2010

(xiii) Number of plants engaged in manufacturing or production in Puerto Rico (and the municipalities in which such plants are located)



(xiv) Total amount of total services purchased

(xv) Total amount of total services purchased from companies in Puerto Rico

(xvi) A description of any intellectual property owned, licensed, or otherwise exploited in Puerto Rico

(xvii) Amounts paid to, or received from, affiliates for advertising, marketing, or managerial services

(xviii) Total amounts paid as royalties

(xix) Total amounts received as royalties

(xx) Total amount of royalties subject to tax under Code sec. 1221(a)(1)(A) or 1231(a)(1)(A) or section 3(b) of the Economic Incentives Act for the Development of Puerto Rico of 2008, or any equivalent provision of any prior or subsequent industrial incentives act

(xxi) Other costs related to the sales of products manufactured or produced in Puerto Rico or manufacturing services performed in Puerto Rico

(6) Any other information or documentation that the Secretary may consider necessary or appropriate to determine that the proposed alternative method clearly reflects the taxpayer's Puerto Rico source income, including, but not limited to, sales invoices, purchases orders, payroll account detail, raw materials, work-in-progress, and finished goods inventories.

(7) The Secretary reserves the right to examine the supporting documentation related to the reports, information and/or documentation requested from the taxpayer under this paragraph (f). Such an examination may be made, in the Secretary's discretion, following the procedures established under Code sec. 6121 and Code sec. 6140, as applicable.

(g) Failure To Provide Adequate Documentation. If a nonresident alien individual or foreign corporation or partnership that satisfies paragraphs Code Sec. 1123(f)(4)(A)(ii)(I) and (II) does not provide adequate documentation to support the computation of the property factor, the payroll factor, the sales factor and the purchases factor used in computing the income allocable to Puerto Rico and does not file, in accordance with paragraph (f), a timely statement of objections and of such alternative method of allocation or apportionment as the taxpayer believes to be appropriate, then the portion of



the income of the nonresident alien individual or foreign corporation or partnership of the gains, profits and income from the sale or exchange without Puerto Rico of personal property manufactured or produced in whole or in part within Puerto Rico that will be treated as effectively connected with a trade or business within Puerto Rico shall be fifty (50) percent.

(h) Anti-abuse rule.—There shall be disregarded any transaction, or series of transactions, one of the principal purposes of which is the avoidance of Code sec. 1123(f)(4)(A)(ii) or Code sec. 1123(f)(4)(B), including, without limitation, 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, to avoid satisfying the controlled group test of Code sec. 1123(f)(4)(A)(ii)(I) or the gross receipts, cost, commission or fee requirements of Code sec. 1123(f)(4)(A)(ii)(II).

(i) Application of Code sec. 2101 in lieu of application of Code sec. 1123(f)(4)(B)(i) and (ii).—Where the requirements of Code sec. 1123(f)(4)(B)(iii)(I) are met, the excise tax imposed by Code sec. 2101 of Subtitle B shall be imposed in lieu of the application of Code sec. 1123(f)(4)(B)(i) and (ii). Provided, however, that, if the excise tax imposed by Code sec. 2101 does not apply for any reason, including, but not limited to, the availability of credits equal to, or in excess of, the amount of excise tax otherwise computed under Code. sec. 2101, then Code sec. 1123(f)(4)(B)(i) and (ii) shall apply.

(j) Effective date of certain provisions.—The rules of paragraphs (d), (e), (f), and (g) are effective for income realized after December 31, 2010, in accordance with the taxpayer's tax accounting methods, and regardless of the taxpayer's taxable year.