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CIRCULAR LETTER NO. 12-10

ATTENTION: CORPORATIONS, PARTNERSHIPS, AND INDIVIDUALS THAT MAY BE SUBJECT TO THE EFFECTIVELY CONNECTED INCOME SOURCE RULE UNDER SECTION 1035.05 OF THE PUERTO RICO INTERNAL REVENUE CODE OF 2011 OR SUBJECT TO THE EXCISE TAX UNDER SECTION 3070.01 OF THAT CODE.

SUBJECT: QUESTIONS AND ANSWERS WITH RESPECT TO THE APPLICATION OF THE EFFECTIVELY CONNECTED INCOME SOURCE RULE AND THE EXCISE TAX.

Act 154-2010, as amended, introduced changes to the effectively connected income source rules (the "ECISR") under Section 1123(f)(4)(A)(ii) and (f)(4)(B) of the Puerto Rico Internal Revenue Code of 1994, as amended (the "1994 Code"). These changes established certain rules for purposes of determining the income, gain or loss of a nonresident individual or a foreign corporation or partnership that is treated as having income effectively connected with a trade or business in Puerto Rico.¹

On March 31, 2011, the Department of the Treasury ("Hacienda") issued Internal Revenue Informative Bulletin No. 11-08 ("Bulletin 11-08") answering certain questions related to the application of the ECISR introduced by Act 154-2010. On August 8, 2012, Hacienda issued Administrative Determination 12-12 describing, among other things, conditions under which composite returns could be filed to report income under the ECISR.

¹ Section 1035.05 of the Internal Revenue Code for a New Puerto Rico (the "2011 Code"), which generally replaced the 1994 Code, provides that the provisions of Section 1123(f) of the 1994 Code shall remain in effect after the approval of the 2011 Code. Section 3070.01 of the 2011 Code provides that the provisions of Sections 2101 through 2106 of the 1994 Code shall remain in effect after the approval of the 2011 Code.

This Circular Letter provides additional answers to questions asked by taxpayers regarding the application of the ECISR.

QUESTIONS AND ANSWERS

1. How can a taxpayer elect to use the “50-50 Method” of apportioning income to Puerto Rico under the ECISR?

Where applicable, the 50-50 Method provides generally that, in the case of a nonresident alien individual or foreign corporation or partnership subject to the ECISR, fifty (50) percent of the income resulting from the sale or exchange without Puerto Rico of personal property manufactured or produced in whole or in part within Puerto Rico shall be treated as effectively connected with a trade or business within Puerto Rico.

All taxpayers subject to the ECISR are eligible to adopt the 50-50 Method. Taxpayers are *not* required to obtain pre-authorization from Hacienda in order to adopt the 50-50 Method. A taxpayer electing to use the 50-50 Method must state on its income tax return that it has adopted the 50-50 Method.

Taxpayers subject to the ECISR are permitted to use the standard method of allocation prescribed in Section 1123(f)(4)(B)(v). In addition, taxpayers are permitted to request an administrative determination from Hacienda permitting the use of a different allocation method.

Once a method of apportioning income has been used by a taxpayer for a taxable year, the taxpayer may not change that method of apportionment for that taxable year by amendment of its return or otherwise. A taxpayer may use a different method for a subsequent taxable year, however, provided that the taxpayer meets any requirements for using that method (e.g., in the case of a method other than the standard method prescribed in Section 1123(f)(4)(B)(v) or the 50-50 Method, the taxpayer requests an administrative determination from Hacienda in a timely manner).

2. Are there circumstances where a taxpayer may credit against the tax due under the ECISR amounts deposited as Excise Tax under Section 2101, and may a taxpayer credit estimated income tax payments under the ECISR against Excise Tax imposed under Section 2101?

A taxpayer that is subject to the Excise Tax imposed by Section 2101 on certain acquisitions of tangible personal property manufactured or produced in whole or in part in Puerto Rico and on certain acquisitions of manufacturing services performed in Puerto Rico (the “Excise Tax”) is not subject to the ECISR. Hacienda recognizes that, as of the time that a payment of estimated tax under the ECISR is due, or as of the time a deposit of Excise Tax under Section 2101 is due, a particular taxpayer may be

uncertain as to whether it is subject to the ECISR or the Excise Tax.² A taxpayer is permitted to treat a deposit of Excise Tax under Section 2102 as a payment of estimated ECISR taxes,³ similarly, a payment of estimated ECISR taxes may be treated as a deposit of Excise Tax under Section 2102. Where deposits of Excise Tax are treated as a payment of estimated tax, the earliest made deposit of Excise Tax is applied first to the earliest ECISR estimated tax payment due (a first-in, first-out method or "FIFO"). Similarly, where ECISR estimated tax payments are treated as deposits of Excise Tax imposed by Section 2101, such estimated tax payments will be applied to such Excise Tax on a FIFO basis.

Note that, regardless of whether a taxpayer ultimately owes tax under either Section 1123(f) or Section 2101, any controlled group that is subject to the Excise Tax is required to file an Excise Tax return for each calendar quarter no later than the last day of the month following the end of the calendar quarter even if no Excise Tax is due because of application of Excise Tax credits.

3. When may penalties under the estimated tax rules applicable to the ECISR be imposed? When may penalties be imposed for failure to deposit Excise Taxes?

In general, where a taxpayer has acted reasonably and in good faith in making deposits of Excise Tax and the taxpayer's quarterly Excise Tax returns have been filed in accordance with the requirements set forth in Section 2103(a)-1(a) of the Regulations, no penalties will be imposed for failure to make estimated payments of ECISR taxes. Similarly, where a taxpayer has acted reasonably and in good faith in making estimated payments of ECISR taxes, no penalties will be imposed for failure to make timely deposits of Excise Tax. The reasonableness of any projections must be evaluated on an ongoing basis.

Where a taxpayer that uses a fiscal year for income tax purposes is uncertain at the end of that fiscal year as to whether the taxpayer will be an Excise Tax payer or an ECISR taxpayer for all or a portion of that taxable year, the taxpayer must request an extension of time to file its income tax return. Where a taxpayer that uses a fiscal year for income

² Article 1123(f)-4(i) of the Regulations provides that, where the \$75,000,000 gross receipts threshold is met, the Excise Tax imposed by Section 2101 shall be imposed in lieu of ECISR. However, if the Excise Tax imposed by Section 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, then ECISR applies. See *also* Reg. Sections 2101(b)-1(d), Example 2; 2102(a)-2(j), Example 3.

³ All corporations subject to the ECISR must comply with the estimated tax payments requirements of Section 1061.23 of the 2011 Code. The estimated tax payments under the ECISR are to be made together with Form 480.37, or using "Colecturia Virtual" at www.hacienda.gobierno.pr.

tax purposes determines that it is an ECISR taxpayer for only a portion of its fiscal year, such taxpayer must contact Hacienda about the appropriate method to use in determining its liability under the ECISR for such portion of the fiscal year.

The Examples below illustrate these rules.

Unless otherwise provided, in all of the Examples below each person acquiring tangible property manufactured or produced in whole or in part in Puerto Rico or manufacturing services performed in Puerto Rico (an "acquiring member") and each person engaged in manufacturing or production or the provision of manufacturing services in Puerto Rico (a "disposing member") are corporations and members of the same controlled group. Each disposing member has had gross receipts of \$75,000,000 or more in each of the three preceding common taxable years (which common taxable years are calendar years), and each acquiring member satisfies one or more of the ten percent tests in Section 2101(c). In addition, each controlled group qualifies for only the general credit of Section 2102(a)-2(b) of the Regulations. Company A is the sole acquiring member of the group, and Company D is the sole disposing member of the group. Company D has advised Company A that, based on Company D's reasonable projections, the employee baseline requirement of Section 2102(a)-2(i)(1) of the Regulations should be satisfied for the year. Company A and Company D have taxable years beginning on January 1, 2011 and ending on December 31, 2011.

Example 1

Company A projects on January 1, 2011 that it will make total taxable acquisitions of \$102,000,000 during 2011 and that its taxable acquisitions for each month will be \$8,500,000. Thus, Company A projects that its Excise Tax for calendar year 2011 would be \$80,000 (4% of \$102,000,000 or \$4,080,000, less the general credit of \$4,000,000). Because Company A projects that it will pay Excise Tax, Company A projects that it will not be subject to the ECISR.

Company A's projections of taxable acquisitions from Company D are accurate for each month from January 2011 through November 2011—taxable acquisitions are in fact \$8,500,000 per month. Company D timely deposits Excise Tax of \$6,667 (tentative Excise Tax of \$340,000 [\$8,500,000 times 4%] less credit of \$333,333 [\$4,000,000 divided by 12]) on behalf of Company A for each such month. Excise Tax returns are timely filed for Company A for the calendar quarters ended March 31, June 30 and September 30, 2011 reflecting Company A's taxable acquisitions and tax deposits.

As of December 1, 2011, Company A projects that its taxable acquisitions for December will be \$4,500,000. The projection is accurate and thus Company A's taxable acquisitions for 2011 amount to \$98,000,000. The Excise Tax on that amount would be \$3,920,000, an amount that would be eliminated by the general credit. As a consequence, Company A determines as of December 1, 2011 that it is a ECISR

taxpayer for the taxable year ending December 31, 2011. Company A would be able to credit the amounts deposited on its behalf for the months of January through November, \$6,667 per month or \$73,337 in total, against its ECISR tax for the taxable year ending December 31, 2011. Further, Company A would not be subject to penalties for failure to deposit estimated payments of tax as required by Section 1061.23 of the 2011 Code for installments required to be deposited before December 1, 2011. To avoid penalties, Company A must make the estimated payment of ECISR tax due December 15, 2011 in accordance with Section 1061.23 of the 2011 Code, if necessary. To compute its estimated payment due December 15, 2011, Company A must take into account its estimated ECISR liability for the entire taxable year ending December 31, 2011 and reduce the amount of the payment by the amount of Excise Tax deposits already made.

Example 2

Company A projects at the start of its taxable year on January 1, 2011 that its taxable acquisitions for the year will be \$8,000,000 per month or \$96,000,000 for the year. Because the Excise Tax on \$96,000,000 of taxable acquisitions (\$3,840,000) would be less than the amount of the general credit (\$4,000,000), Company A projects that it will be subject to tax under the ECISR. Company A intends to adopt the 50-50 Method of apportioning income to Puerto Rico under Article 1123(f)-4(g) of the Regulations and reasonably estimates that it will acquire goods for \$96,000,000, incur certain costs in distributing the goods, and sell the acquired goods for the sum of \$116,000,000 and the distribution costs that it incurs. Consequently, Company A projects that it will have income subject to tax under the ECISR of \$10,000,000 (50% of the income from the purchase and disposition of tangible personal property manufactured and produced in whole or in part in Puerto Rico [\$20,000,000]). In accordance with the estimated tax requirements of Section 1061.23 of the 2011 Code, Company A makes estimated tax payments on or before the fifteenth day of each of the months of April, June, September and December 2011 based on a projected tax liability of \$3,000,000 (30% of \$10,000,000). Excise Tax returns are timely filed for Company A for the calendar quarters ended March 31, June 30 and September 30, 2011 reflecting Company A's taxable acquisitions of \$8,000,000 per month, Excise Tax before credit of \$320,000, and its available Excise Tax credits (up to \$333,333 per month).

In December 2011, Company A makes taxable acquisitions of \$14,000,000, rather than the projected taxable acquisitions of \$8,000,000. (It was not reasonable to project acquisitions in such amount before December 16, 2011.) Thus, for the year, Company A makes taxable acquisitions of \$102,000,000. Company A owes Excise Tax of \$80,000 for the year (4% of \$102,000,000, or \$4,080,000 less the general credit of \$4,000,000). On its return for the calendar quarter ending December 31, 2011, Company A may credit the amounts deposited as estimated income tax against the

Excise Tax.⁵ Company A will not be treated as having failed to deposit Excise Tax so as to be unable to benefit from Excise Tax credits under Article 2102(a)-2(j)(3) of the Regulations. (While in this Example 2, Company A should have paid \$3,000,000 in estimated payments of ECISR liability, the result that Excise Tax credits otherwise available would not be lost on account of a failure to deposit Excise Tax would also be true if Company A had timely made estimated tax payments of tax under the ECISR of any other amount so long as the projections of liability under the ECISR (and not the Excise Tax) and the amount of the estimated ECISR tax liability were reasonable at the time that each estimated tax payment (or deposit of Excise Tax) was required to be made.)

Example 3

Company A has a taxable year ending June 30, and Company A and Company D have elected a common taxable year ending June 30. Independent of Company A's taxable year, Excise Tax under Section 2101 is computed on a calendar-year basis. Section 2101(a), Section 2101(b)(4), and Section 2103. (The common taxable year election is relevant only for purposes of (i) computing gross receipts of the disposing member and (ii) determining whether any of the 10 (ten) percent tests of Section 2101(c)(1) and Section 1123(f)(4)(A)(ii)(II) are met.)

Calendar year 2011. On January 1, 2011, Company A projects that it will make total taxable acquisitions from Company D of \$110,400,000 during calendar year 2011 and that its taxable acquisitions for each month will be \$9,200,000. Thus, Company A projects that its total Excise Tax for the calendar year 2011 will be \$416,000 (4% of \$110,400,000 less the general credit of \$4,000,000).

For each month from January 2011 through December 2011, Company A's taxable acquisitions from Company D are consistent with its projections—for each such month Company A's acquisitions are in fact \$9,200,000—and Company A pays a total of \$416,000 in Excise Tax for taxable acquisitions made during calendar year 2011. An Excise Tax return is timely filed for Company A for each calendar quarter of 2011. Company A is not subject to the ECISR for any portion of its taxable year ended June 30, 2011. (The Excise Tax was not effective for the period from July 1, 2010 through December 31, 2010. Company A was subject to the Excise Tax for all of calendar year 2011.) Company A is not subject to the ECISR for the period from July 1, 2011 through December 31, 2011 because it was subject to the Excise Tax for such period.

Calendar year 2012. Company A projects that it will make total taxable acquisitions of \$110,400,000 during calendar year 2012 and that its taxable acquisitions for each

⁵ Company A may carry forward the excess of the amount deposited over the Excise Tax obligation for the year for use against Excise Tax in subsequent periods (or the ECISR, as applicable).

month will be \$9,200,000. Thus, it projects that its total Excise Tax for 2012 will be \$390,000 (3.75% of \$110,400,000 or \$4,140,000 less the general credit of \$3,750,000). Because Company A projects that it will pay Excise Tax during 2012, Company A projects that it will not be subject to the ECISR for its fiscal year ending June 30, 2012.

For each month from January 2012 through April 2012, Company A's taxable acquisitions from Company D continue to be \$9,200,000 per month. Company D deposits monthly Excise Tax of \$32,500 on behalf of Company A with respect to taxable acquisitions made in each of January through April (3.75% of \$9,200,000 or \$345,000 less one-twelfth of the general credit of \$3,750,000 for 2012 or \$312,500). An Excise Tax Return is timely filed for Company A for the calendar quarter ending March 31, 2012. As of May 16, Company A's reasonable projections for taxable acquisitions in May, June and July are reduced to \$5,000,000 per month. Company A's projections for the months of August through December are that taxable acquisitions will again be \$9,200,000 per month. Thus, Company A projects that taxable acquisitions for the calendar year will be \$97,800,000 (nine months of taxable acquisitions of \$9,200,000 each and three months of taxable acquisitions of \$5,000,000 each). Company A's taxable acquisitions for the months of August through December 2012 are in fact \$9,200,000 per month so that its total taxable acquisitions for 2012 are \$97,800,000.

As of May 16, 2012, Company A may no longer reasonably project that it will pay Excise Tax for 2012. As a consequence, Company A begins to make deposits of estimated ECISR tax instead. Company A must, consistent with its projections, continue to make estimated payments of ECISR tax liability for the period from July 1, 2012 through December 31, 2012 (a portion of its taxable year ending June 30, 2013). Excise Tax returns are filed for Company A for the calendar quarters ended June 30, September 30 and December 31 reflecting that no Excise Tax is due. Company A may credit the deposits of Excise Tax made for taxable acquisitions from January through April 2012 against its estimated ECISR tax liability. Company A will not be subject to penalties for underpayment of estimated tax so long as all estimated taxes due after May 16, 2012 for Company A's taxable period from January 1, 2012 through June 30, 2012 (the end of its fiscal year) are made based upon then-reasonable estimates of its ECISR tax liability.

In analyzing Company A's tax liabilities for its taxable year ended June 30, 2012, one must determine whether it is treated as an Excise Tax payer for all portions of its taxable year. Company A was an Excise Tax payer for calendar year 2011 which covers the portion of its fiscal year from July 1, 2011 through December 31, 2011. However, Company A owes no Excise Tax for calendar year 2012. As a consequence, Company A is a ECISR taxpayer for that portion of its taxable year from January 1, 2012 through June 30, 2012. Company A must contact Hacienda regarding the appropriate method to use in determining its liability under the ECISR for such portion of the fiscal year.

The period from July 1, 2012 through December 31, 2012 is part of Company A's taxable year ending June 30, 2013. Because Company A is not an Excise Tax payer for any part of calendar year 2012, Company A is a ECISR taxpayer for that period. Whether Company A is a ECISR taxpayer for the portion of its taxable year from January 1, 2013 through June 30, 2013 is dependent upon whether Company A is in fact an Excise Tax payer for calendar year 2013.

Example 4

Company A has a taxable year ending June 30, and Company A and Company D have elected a common taxable year ending June 30. Company A projects on January 1, 2011 that its taxable acquisitions will be \$96,000,000 for the calendar year, or \$8,000,000 per month.

For 2011, Company A projects that the Excise Tax on such taxable acquisitions would be \$3,840,000 and would be eliminated by the general credit of \$4,000,000. Thus, Company A projects that it will not pay Excise Tax for 2011. Company A must make estimated payments of ECISR tax for the January 1, 2011 through June 30, 2011 portion of its taxable year ending June 30, 2011.

For the months of January 2011 through August 2011, Company A's projections are accurate, and taxable acquisitions are \$8,000,000 per month, for a total of \$64,000,000. Excise Tax returns are filed for Company A for the calendar quarters ended March 31 and June 30, 2011 reflecting that no Excise Tax is due. On September 1, 2011, Company A projects that taxable acquisitions will be \$10,000,000 for each month from September through December 2011. Company A's revised projections are correct, and Company A's taxable acquisitions for calendar year 2011 are \$104,000,000. Company A's Excise Tax for the year is \$160,000 (4% of \$104,000,000 or \$4,160,000 less the general Excise Tax credit of \$4,000,000). Company A may credit estimated payments of ECISR tax already made for the period January 1, 2011 through June 30, 2011 against its Excise Tax for the calendar year 2011. An Excise Tax return consistent with the later projections must be filed for the calendar quarter ending September 30, 2011 no later than October 31, 2011. An Excise Tax return for the quarter ending December 31, 2011 must be filed by January 31, 2012. If Company A has made reasonable estimates of its ECISR liability and timely made payments of such tax, Company A will not be subject to penalties under the Excise Tax for failure to deposit Excise Tax.

Example 5

Company A projects in January 2011 that it will make total taxable acquisitions of \$102,000,000 during 2011 and that its taxable acquisitions for each month will be \$8,500,000. Company D has advised Company A, that based on Company D's reasonable projections, the employee baseline requirement of Section 2102(a)-2(i)(1) of

the Regulations should be satisfied for the year. Thus, Company A projects that its Excise Tax for 2011 would be \$80,000 (4% of \$102,000,000 or \$4,080,000, less the general credit of \$4,000,000). Because Company A projects that it will pay Excise Tax, Company A projects that it will not be subject to the ECISR.

Company A makes taxable acquisitions of \$8,500,000 in January 2011 and on February 15, 2011 Company D deposits Excise Tax of \$6,667 (Excise Tax of \$340,000 [4% of \$8,500,000] less one-twelfth of the annual general Excise Tax credit or \$333,333 [\$4,000,000 divided by 12]) on behalf of Company A. At the end of January 2011, however, Company A determines that it will not be able to sell profitably its previously planned acquisitions and it reduces its orders from Company D to \$8,000,000 monthly beginning with March 2011. (On the basis of its orders to Company D, Company A could expect at that point to make taxable acquisitions of \$97,000,000 for 2011. The general credit of \$4,000,000 could be expected to eliminate the Excise Tax on such taxable acquisitions.) On March 15, Company D deposits Excise Tax of \$6,667 on behalf of Company A with respect to Company A's \$8,500,000 of taxable acquisitions in February. On April 15, 2011 Company D deposited no Excise Tax with respect to Company A's \$8,000,000 of taxable acquisitions for March determining that no Excise Tax was due for March's taxable acquisitions (Excise Tax of \$320,000 [4% of \$8,000,000] less one-twelfth of the annual general Excise Tax credit or \$333,333). An Excise Tax return is timely filed for Company A for the calendar quarter ending March 31, 2011. For subsequent months, Company A's taxable acquisitions are \$8,000,000 per month and Company D deposits no Excise Tax on behalf of Company A because the Excise Tax for such months is less than the available amount of general Excise Tax credit. Company A does not make any estimated payments of ECISR tax. For 2011 Company A makes total taxable acquisitions of \$97,000,000; the \$3,880,000 of Excise Tax (\$97,000,000 times 4%) is eliminated by the general Excise Tax Credit. Excise Tax returns are timely filed for Company A for the calendar quarters ending June 30, September 30 and December 31, 2011.

While the Excise Tax deposited by Company D on behalf of Company A may be applied against Company A's ECISR tax liability, because Company A's projections that it would be an Excise Tax payer for 2011 are not reasonable beginning as of the end of January 2011, Company A may be subject to penalties for failure to deposit estimated payments of tax under the ECISR for installments that should have been made in April, June, September and December 2011.

4. Are there any circumstances under which a ECISR taxpayer is *not* required to file financial statements with its Puerto Rico income tax return?

Yes. If, as part of a ECISR tax filing, a taxpayer that (i) is organized in a jurisdiction that imposes an income tax; (ii) has, for the same taxable year, filed an income tax return in the jurisdiction where it is organized; and (iii) submits such income tax return with its

Puerto Rico income tax return (along with a certified translation of the income tax return if the income tax return is not already in English), then the taxpayer is *not* required to file separate financial statements with its Puerto Rico income tax return.

Otherwise, any ECISR taxpayer should submit financial statements with its Puerto Rico income tax return in lieu of the income tax return described above. Such financial statements should be accompanied by an Auditor's Report issued by a Certified Public Accountant licensed to practice in Puerto Rico.

5. Which taxable years are relevant in determining whether a potential payer of income tax under the ECISR or Excise Tax has satisfied one of the ten (10) percent tests provided for in Section 1123(f)(4)(A)(ii)(II) and Section 2101(c)(1)?

ECISR.

In general, the ECISR applies if at least one of the ten (10) percent tests is satisfied for the current taxable year or any of the three preceding taxable years. The ECISR does not apply to a taxpayer for a taxable year if the taxpayer is subject to the Excise Tax for all of such taxable year and in fact pays Excise Tax for all of such taxable year. A ECISR taxpayer should file an income tax return for any year in which it meets the requirements of a ten (10) percent test provided for in Section 1123(f)(4)(A)(ii)(II), even if none of the ECISR's ten (10) percent tests have been satisfied in a preceding taxable year. Section 1123(f)(4)(A)(ii)(II). All ECISR taxpayers are required to comply with the estimated income tax payment rules.

Excise Tax.

In general, the Excise Tax applies for a calendar year if at least one of the ten (10) percent tests is met for at least one of the three preceding taxable years and there are acquisitions from a person that (i) 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 in Puerto Rico, and (ii) has had gross receipts in excess of \$75,000,000 for any of the three preceding common taxable years or, if such person has not been in existence for each of the three preceding common taxable years, such person has had gross receipts in excess of \$75,000,000 for any taxable year during its period of existence, including the current taxable year. Sections 2101(b)(1); 2101(c)(1) and Reg. Sections 2101(b)-1(c)(4); 2101(d)-1(a); and 2101(d)-1(b). Where a person that has not been in existence for more than three taxable years (i) acquires personal property manufactured or produced in whole or in part in Puerto Rico or acquires manufacturing services from a person meeting the gross receipts threshold described above and (ii) meets the requirements of one of the Excise Tax's ten (10) percent tests for such year, then such person will be subject to the Excise Tax

for such year. Reg. Section 2101(d)-1(b). See also Reg. Section 2101(b)-1(c)(4). In addition, a controlled group will be obligated to begin making Excise Tax filings as soon as it may be reasonably determined that such person is likely to meet one of Section 2101's ten (10) percent tests.

These rules may be illustrated by the following examples.

Example 1

For purposes of this Example, Company A (an "acquiring member") is a corporation that came into existence in 2011. Corporation D (a "disposing member") engages in manufacturing or production or the provision of manufacturing services in Puerto Rico and is a member of the same controlled group as Company A. Company A and Company D are calendar-year taxpayers. Company A acquires tangible property manufactured or produced in whole or in part in Puerto Rico or manufacturing services performed in Puerto Rico from Company D.

Company D had gross receipts of more than \$75,000,000 in 2010. In 2011, Company A acquired personal property and services directly or indirectly from Company D amounting to more than ten (10) percent of the total gross receipts of Company A from the sale of personal property manufactured or produced, and services performed, in Puerto Rico.

Under Section 2101(d)-1(b) of the Regulations, Company A has satisfied the requirements of one of Section 2101's ten (10) percent tests—in particular, the test described at Section 2101(c)(1)(A)—and is, thus, subject to Excise Tax for 2011. The controlled group that includes Company A and Company D must make Excise Tax filings as soon as it reasonably determines that Company A would be an Excise Tax payer for that year.

Example 2

The facts are the same as in Example 1, except that Company A was in existence in 2008 and the transactions between Company A and Company D did not satisfy any of the ECISR's or Excise Tax's ten (10) percent test requirements until 2011. Company A would not be an Excise Tax payer for 2011 because it did not meet any of the Excise Tax's ten (10) percent tests in 2008, 2009, or 2010. Company A would, however, be a ECISR taxpayer for 2011 because it did meet a ten (10) percent test, provided for in Section 1123(f)(4)(A)(ii)(II), for 2011 and it was not an Excise Tax payer for such year.

Example 3

The facts are the same as in Example 1, except that Company D came into existence in 2011 and, as a result, has not been in existence for more than three taxable years. Nevertheless, Company D reasonably expects to have gross receipts in excess of \$75,000,000 for 2011. In 2011, Company A acquires personal property and services directly or indirectly from Company D amounting to more than ten (10) percent of the total gross receipts of Company A from the sale of personal property manufactured or produced, and services performed, in Puerto Rico. If Company D in fact has gross receipts in excess of \$75,000,000 for 2011 and Company A satisfies one of the Excise Tax's ten (10) percent tests for 2011, then Company A is subject to Excise Tax for 2011. See Reg. Sections 2101(b)-1(c)(4) and 2101(d)-1(b).

The controlled group that includes Company A and Company D must make Excise Tax filings as soon as it may be reasonably determined that Company A may be subject to the Excise Tax.

6. **Under what circumstances is an acquiring member of a controlled group obligated to pay either ECISR tax or Excise Tax where the acquiring member acquires tangible property manufactured or produced in whole or in part in Puerto Rico or subject to manufacturing services in Puerto Rico (i) from a member of its controlled group that has gross receipts in excess of \$75,000,000 for any of the three preceding taxable years and (ii) from a member that does not have gross receipts in excess of \$75,000,000 for any of the three preceding taxable years?**

ECISR.

In general, the ECISR will apply if at least one of the ten (10) percent tests provided for in Section 1123(f)(4)(A)(ii)(II) is satisfied for the current taxable year *or* any of the three preceding taxable years. In addition, assuming that the acquiring member acquires tangible property from a disposing member in its controlled group that engages in manufacturing or production or the provision of manufacturing services in Puerto Rico that has not had gross receipts in excess of \$75,000,000 for any of the three preceding common taxable years (and the acquiring member does not acquire tangible property from any disposing member in its controlled group that has in excess of \$75,000,000 of gross receipts for any of the three preceding common taxable years), then the acquiring member will be subject to ECISR tax.

Excise Tax.

In general, the Excise Tax will apply if the following requirements are met. First, the acquiring member satisfies at least one of the Excise Tax's ten (10) percent tests

provided for in Section 2101(c)(1). Second, there are acquisitions from a person meeting the requirements of Section 2101(b)(1) (**\$75,000,000 gross receipts requirement**).

If both requirements are met, regardless of whether the acquiring member acquires tangible property from a disposing member that has not had gross receipts in excess of \$75,000,000 for any of the three preceding common taxable years, so long as the acquiring member pays Excise Tax for the calendar year (its Excise Tax exceeds any available Excise Tax credits), then the acquiring member is subject only to the Excise Tax for such year. The acquiring member will not be subject to the ECISR for such calendar year even though it has made acquisitions from a disposing member that did not meet the \$75,000,000 gross receipts threshold for any of the three preceding taxable years. See also Reg. Section 2101(b)-1(d), Example 2 and Reg. Section 2102(a)-2.

If available Excise Tax credits eliminate the Excise Tax owing by the acquiring member on its acquisitions from the disposing member that has gross receipts in excess of \$75,000,000 for any of the three preceding common taxable years, then the acquiring member will be subject to the ECISR, and must take into account its acquisitions from both disposing members.

These rules may be illustrated by the following examples.

Example 1

Company S, Company T, Company U, and Company V are members of the same controlled group. There are no other members of the controlled group. Both Company S and Company T substantially transform tangible property through the activities of its respective employees or contractors in Puerto Rico. Neither Company U nor Company V engage in any manufacturing activities. Company S, Company T, Company U, and Company V are all calendar-year taxpayers. For the common taxable years of the controlled group ended in 2008, 2009, and 2010, Company S had gross receipts of \$40,000,000, \$45,000,000, and \$50,000,000, respectively. For the same years, Company T had gross receipts of \$80,000,000, \$85,000,000, and \$90,000,000, respectively.

In 2011, Company U acquired from Company S tangible property that Company S had manufactured or produced in Puerto Rico. Company U did not acquire property from Company T. In 2011, regardless of whether Company U satisfied at least one of the ECISR's ten (10) percent tests either in 2011 or any of the three preceding taxable years, because Company S did not have gross receipts in 2008, 2009, or 2010 of more than \$75,000,000, acquisitions by Company U from Company S are not subject to the Excise Tax imposed by Section 2101. Assuming that Company U satisfied at least one

of the ECISR's ten (10) percent tests either in 2011 or any of the three preceding taxable years, Company U is subject to the ECISR under Section 1123(f)(4).

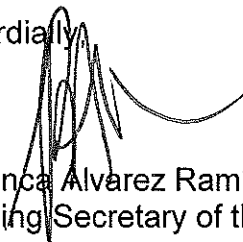
Example 2

The facts are the same as in Example 1 and in 2011, Company V acquired from Company T tangible property that Company T manufactured or produced in Puerto Rico; Company V also acquired from Company S tangible property that Company S manufactured or produced in Puerto Rico. Company V satisfies one or more of the Excise Tax's ten (10) percent tests for at least one of the three preceding taxable years. Available Excise Tax credits are less than the amount of Excise Tax owing by Company V on its acquisitions from Company T. See Reg. Section 2102(a)-2. Company V's acquisitions from Company T in 2011 will be subject to Excise Tax under Section 2101, and Company V is not subject to tax under the ECISR even though its acquisitions from Company S are not subject to Excise Tax because Company S has not had more than \$75,000,000 of gross receipts for any of the three preceding taxable years.

Example 3

The facts are the same as in Example 2 except that available Excise Tax credits eliminate the Excise Tax owing by Company V on its acquisitions from Company T. See Reg. Section 2102(a)-2. In such a case, Company V is subject to the ECISR and must take into account acquisitions from both Company S and Company T.

Cordially,



Blanca Alvarez Ramírez
Acting Secretary of the Treasury