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Topic: Income Tax and Sales and Use Tax

Act: 1-2011

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Text

I. STATEMENT OF FACTS

Reference is made to your letter dated June 9, 2016, wherein you requested our rulings (the "Request") in connection with the Puerto Rico sales and use tax ("SUT") and income tax treatment of a transaction involving Companies ABC and Companies DEF, which are part of a controlled group of corporations (the "Group"), pursuant to the provisions of the Puerto Rico Internal Revenue Code of 2011, as amended ("2011 Code").

For the valid business reasons explained in the Request, the Group is currently in the process simplifying its current operational structure by grouping different business segments. The Group has determined that the objectives can be achieved by creating Companies DEF to handle different business segments currently handled by Companies ABC (the "Global Restructuring").

Companies ABC currently own inventory in Puerto Rico, consisting entirely of raw materials and work in progress (the "Inventory"). The Inventory is converted into finished product in Puerto Rico by Company G, a related entity, or third parties under tolling service arrangements. G has historically entered into such type of tolling service arrangements with multiple foreign (i.e., non-Puerto Rico) companies not engaged in trade or business in Puerto Rico ("Tolling Arrangements").

To achieve the Global Restructuring, Companies ABC will be winding down their activities with respect to products currently manufactured under the Tolling Arrangements and these functions will be assumed by Companies DEF. As a consequence, you represented that Companies ABC plan to transfer all of their Inventory to Companies DEF (the "Transfers"). It is expected that Companies ABC, except one of the companies, will make each one main transfer of the Inventory to the Companies DEF and an additional transfer once the closing inventory reconciliation is undertaken. It is currently estimated that there will be a total of 10 Transfers that will take place as detailed in the Request.

Company G will have no participation in the Transfers. As a result of the Restructuring, the Inventory physically remaining in Puerto Rico will continue to be processed under new Tolling

Arrangements that will be entered into by Companies DEF. Companies DEF will follow the same process as Companies ABC.

According to the representations, Companies ABC and Companies DEF are all foreign entities not engaged in trade or business in Puerto Rico ("ETB-PR"). Companies ABC have never sold property located in Puerto Rico nor have they ever transferred title of inventory located in Puerto Rico and it is not expected for such entities to, except for the Transfers, undertake such type of transaction. Companies ABC and Companies DEF Puerto Rico merely own the Inventory being converted into finished product under the Tolling Arrangements.

II. RULINGS REQUESTED

1. The Transfers are not subject to SUT.
2. Companies ABC or Companies DEF shall not be deemed to be ETB-PR solely by reason of the Tolling Arrangements and the Transfers.
3. Any gain derived in connection with the Transfers shall not be subject to Puerto Rico income taxation.

III. LAW AND ANALYSIS

a. Sales and Use Tax

Pursuant to Article 4010.01(ss)-1(b)(7) of the SUT regulations issued under the Puerto Rico Internal Revenue Code of 2011, as amended ("2011 Code Regs."), occasional or sporadic sales do not constitute a sale for SUT purposes. As a result, they are not subject to SUT.

Pursuant to Article 4010.01(y)-1(b) of the 2011 Code Regs., an occasional or sporadic sale occurs when the seller is not engaged in a trade or business in Puerto Rico, but performs one or several taxable item sales transactions that are insufficient in number, scope, magnitude, or character for the seller to have the obligation to register in the Puerto Rico Department of the Treasury's Merchants' Registry. An occasional or sporadic sale is also deemed to occur when the seller, even if he or she is a merchant engaged in a trade or business in Puerto Rico, is not engaged in the business of selling said taxable items in the ordinary course of his or her business.

Article 4010.01(y)-1(b)(1) of the 2011 Code Regs. further provides that to determine that a sale is occasional or sporadic, the following factors, none of which shall be determinative in and of itself, shall be considered:

- (i) the number of transactions made by the person during a 12-month period;
- (ii) the scope or magnitude of the transactions made by the person. This shall be evaluated, among others, by the frequency or time proximity with which the transactions are made and their monetary value; and

- (iii) the nature of the transactions made by the person. This shall be evaluated considering the relationship between the potentially occasional or sporadic sale and the person's regular activities.

Regarding the number of transactions made during a 12-month period, the Transfers are expected to take place through one main transfer by each company and additional transfers once the closing inventory reconciliation is undertaken.

As to the scope or magnitude of the transactions, the Transfers represent overall isolated transactions the sole purpose of which is to facilitate the Global Restructuring. The Transfers do not represent frequent sales transactions as they are expected to be the only transactions to be undertaken by Companies ABC of property located in Puerto Rico, and will facilitate the transition of the Companies ABC's Tolling Arrangements to Companies DEF as part of the Global Restructuring.

Finally, in terms of the nature of the transactions, Companies ABC's regular business activities do not include the sale of property such as the Inventory. Rather, as discussed above, Companies ABC sell the finished goods outside Puerto Rico. The Transfer is necessary to allow Companies ABC to wind down their activities with respect to the products currently manufactured under the Tolling Arrangements. Furthermore, the Companies ABC have never sold property located in Puerto Rico and it is not expected for such entities to, except for the Transfers, undertake such type of transaction.

b. Income Taxes

i. Engaged in a Trade or Business in Puerto Rico

The determination as to whether a foreign corporation is ETB-PR depends on all the facts and circumstances that are present during the particular taxable year. The 2011 Code does not provide a complete definition of the level of activity necessary to render a corporation ETB-PR. The concept of what constitutes being ETB-PR under the 2011 Code remained the same as it was under the Internal Revenue Code of 1994 of Puerto Rico, which was modeled after a predecessor version of the United States Internal Revenue Code of 1986, as amended, U.S. regulations, cases and rulings on the subject are considered persuasive authority at the local level, as long as the related statute reads identical. See Peña Clos v. Cartagena, 114 DPR 576, 588 (1983) and Belaval v. Secretario de Hacienda, 83 DPR 251 (1961).

In general, a trade or business in a jurisdiction had been held to exist if the foreign corporation's activities undertaken in the jurisdiction are "considerable, continuous, and regular." Pinchot v. Comr., 113 F.2d 718, 719 (2nd Cir. 1940); de Amodio v. Comr., 34 T.C. 894, 906 (1960), *aff'd* 299 F.2d 623 (1962); Spermacet Whaling and Shipping Co. v. Comr., 30 T.C. 618, 634 (1959), *aff'd*, 281 F.2d 646 (6th Cir. 1960). As a result, whether a foreign corporation is engaged in a trade or business in a given jurisdiction will depend both on the type and the amount of its activities in such jurisdiction. Being engaged in a trade or business implies more than a single isolated act or

transaction; it means “conducting and continuing business by carrying on progressively all the acts normally conducted in the business.” Llewellyn v. Pittsburgh, 222 F. 177 (1915).

As previously indicated, Companies ABC have never sold property located in Puerto Rico and it is not expected for such entities to, except for the Transfers, undertake such type of transaction. In addition, Companies ABC have no office or fixed place of business in Puerto Rico and no employees located in Puerto Rico.

Because the Transfers represent the only transactions Companies ABC expect to undertake with property located in Puerto Rico, they should not constitute “considerable, continuous, and regular” activities that rise to the level of a trade or business for income tax purposes.

However, we are not in a position to confirm or deny that the Companies ABC and Companies DEF are not ETB-PR by reason of the Tolling Arrangements.

ii. Taxation

Pursuant to Section 1092.01(a) of the 2011 Code, foreign corporations not engaged in trade or business in Puerto Rico are subject to tax in Puerto Rico on certain income from sources within Puerto Rico at a specified tax rates. Interest received from a related person (as said term is defined in Section 1010.05 of the Code), rents, royalties, salaries, annuities, compensation, remunerations, emoluments, certain distributions from exempt organizations, income attributable to the distributive share of a partner in certain entities, net capital gains, or other fixed or determinable annual or periodical income (other than insurance premiums or interest), are subject to a tax of twenty-nine (29) per cent. While dividends are subject to a tax of ten (10) per cent. Income derived from the sale of inventory in Puerto Rico by a foreign corporation not ETB-PR is not fixed or determinable annual or periodic income. Therefore, the Transfers are not subject to income tax in Puerto Rico based on the representation that the sellers are not ETB-PR.

IV. CONCLUSION

Based solely on the facts, documents, and representations submitted for our consideration, the provisions of the Code, and the applicable regulations, this Department rules that:

1. The Transfers are not subject to SUT.
2. Companies ABC or Company DEF shall not be deemed to be ETB-PR solely by reason of the Transfers.
4. Any gain derived in connection with the Transfers shall not be subject to Puerto Rico income taxation provided, as represented, that Companies ABC and Companies DEF are not ETB-PR.

No opinion is expressed as to the tax treatment of the above transaction under any provisions of the 2011 Code, or the regulations thereunder, that may also be applicable thereto, or to the tax

treatment of any condition existing at the time or any effect resulting therefrom, that is not specifically covered by this ruling. This ruling is based on the factual representations as described above. Any misrepresentation or hiding of a material fact shall render this ruling null and void. The opinion expressed herein shall be valid only upon the continued existence of the facts as submitted for our consideration. This letter ruling is directed only to the taxpayer requesting it and may not be used or cited as precedent.

Cordially,

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