

TAX REFORM

The Government of Puerto Rico enacted a fiscal reform that is the most comprehensive and fairest to all taxpayers in the history of Puerto Rico. As a result, Act No. 1 of January 31, 2011, known as the “Code of Internal Revenue for a New Puerto Rico”, was approved. Named ***More Money in Your Pocket***, this tax reform provides a dramatic reduction in tax, with relief for all taxpayers, and aims to assure that everyone can assume their tax load. The More Money in Your Pocket reform is focused in the following objectives:

1

Tax relief for individuals and corporations

2

To encourage economic growth and job creation

3

Simplify Puerto Rico’s tax return system

4

Reduce tax evasion

First Phase

More Money in Your Pocket will be implemented in two phases. The first one, which applies to fiscal year 2010, will bring relief to all taxpayers. Taxpayers that earn \$ 40,000 or less, will get a reduction of 15% for 2010 in their taxable income; those who make between \$ 40,000 and \$ 100,000 (\$ 150,000 for married couples that declare jointly), will get a reduction of 10% and those who make over \$ 100,000 (\$ 150,000 for married couples that declare jointly), will get a reduction of 7%.

2010 REFORM	
Income	Tax Credit
\$ 0 - \$ 40,000	15%
\$40,000 - \$ 100,000 (\$ 150,000 – married)	10%
Over \$ 100,000	7%

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Additionally, businesses, particularly small and medium sized businesses, which are the ones that generate more jobs, were granted tax relief for fiscal year 2010. For these businesses, a tax credit of 7% was implemented for all non-exempt corporations, with the condition that they pay the total amount for the Christmas Bonus to all their employees.

Also, the carry over period for losses incurred during fiscal years between 2005 and 2012 was incremented from 7 to 10 years in order to help those companies most affected by the economic recession.

Second Phase

The second phase of More Money in Your Pocket will represent an annual tax relief of over \$ 1,200 million during each of the next six (6) years (more than \$ 1,500 annually, for each taxpayer), which constitutes, without any doubt, the highest relief given by a tax reform in the history of Puerto Rico. In turn, it represents a positive impact three (3) times higher than the 1994 reform.

In comparison, for example, the tax reform of 1994 represented a relief of \$ 400 million annually, while the 2006 reform, instead of reducing taxes, resulted in an additional tax load for taxpayers of \$ 180 million annually.

In general, individuals' taxes are reduced by an average of 50% and businesses' by an average of 30% through a just and simple tax system that counts with aggressive measures to fight evasion, provide job incentives and relief for our senior citizens. Additionally, it promotes economic development and the aggressive creation of more jobs.

INDIVIDUALS

The second phase of the reform, which starts in fiscal year 2011, includes a countless number of changes that dramatically reduce individual taxes while they simplify the rules.

In this phase, taxpayers with a gross income of less than \$ 20,000 won't pay taxes; this encompasses 46% of Puerto Rico taxpayers. Besides that group, there will be substantial reductions in tax rates for all taxpayers. This reduction is achieved by broadening the ranges so taxpayers currently in a higher tax bracket can contribute at a lower tax rate. That is to say, the same income will pay progressively less when taxed at a lower rate.

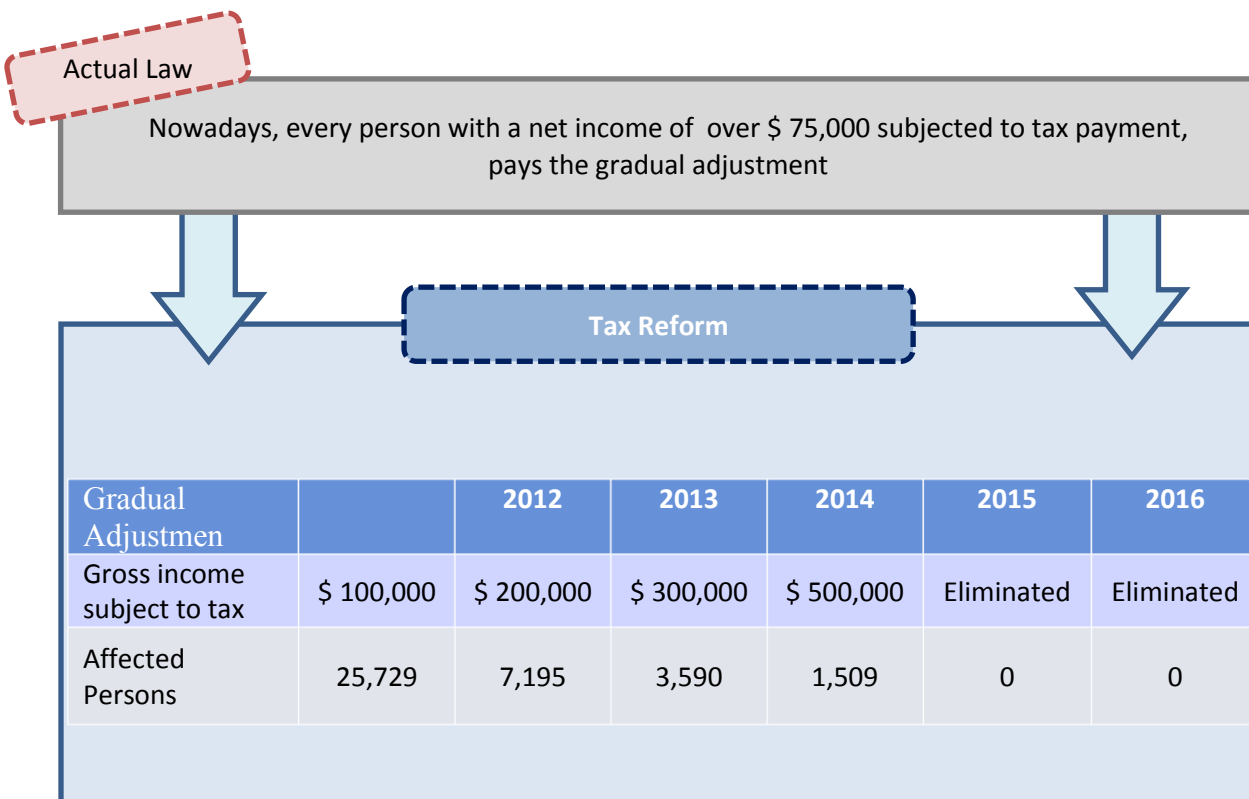
Let's see the following examples:

- An employee earning the federal minimum wage, making **\$ 15,080** per year... paid \$ 619 in taxes during fiscal year 2009. This year, 2010, the same employee will pay \$ 93 less. And from next year on, he/she will not pay taxes any more. ***Next year he/she will receive a reimbursement of \$ 248... that will keep on increasing every year until it reaches \$ 498, which he/she will keep on receiving every year.***

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- A nurse, single, with no dependents, with an income of \$ 22,050... during 2009 paid \$ 1,421 in taxes. With More Money in Your Pocket, this year, the same nurse, will pay \$ 213 less. ***Next year, instead of having to pay \$ 1,421 in taxes, she will only pay \$ 256... a relief of \$ 1,164. And in 5 years, instead of paying taxes, she will receive a reimbursement.***
- A family with a \$ 61,490 income, where both work and have three dependents... paid \$ 4,318 in taxes last year. With More Money in Your Pocket, this year they will receive a tax relief of \$ 648. ***Next year, their taxes will be reduced to half, from \$ 4,318 to \$ 2,232. And in six years, this family will be paying only \$ 647 in taxes... a reduction of 85% on their tax load. During that period, the family will have saved \$ 16,816.***
- And a family with an income of \$ 100,000, where both work and have one dependent... paid \$ 14,675 in taxes last year. With More Money in Your Pocket, ***this year they will receive a relief of \$ 1,386. Next year, their taxes will decrease 32%, from \$ 14,675 to \$ 10,045, a savings of \$ 4,630. For 2016, their taxes will have been reduced to more than half, paying only \$ 6,650. In six years, that family would have saved \$ 38,846!***

In agreement with these tax reductions, the Gradual Adjustment will be eliminated progressively. This change will be done gradually, increasing the minimum income, for gradual adjustment purposes, from \$ 75,000 to \$ 100,000 for fiscal year 2011 and so on and so forth, increasing it until it reaches \$ 200,000 in 2012, \$ 300,000 in 2013, \$ 500,000 in 2014, and completely eliminating it in fiscal year 2015.



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Likewise, with the purpose of reducing the tax load, particularly of the working middle class, the last residues of the “marriage penalty” are eliminated. The law provides that in the case of married couples that file separately, and married couples who both work and choose the optional method for tax calculation, the 50% limits applicable to the top of the net income subject to the gradual adjustment, and the top of the income subject to the basic alternate tax, are eliminated. The ceiling applied to these cases will be the same one applied to an individual taxpayer.

Aside from the tax reduction and the broadening of the ranges above mentioned, many of the dispositions of the Code are simplified in order to facilitate the compliance with tax laws. For example, for tax form purposes, the categories applicable to individuals to determine their personal status are reduced from five to three: married filing jointly, married filing separately and individual taxpayer— this category consolidates single, head of the family, and married who doesn’t live with his/her spouse.

Also, in order to simplify the tax system, only certain deductions will be allowed. To this end, the major part of the detailed deductions and the additional deductions are eliminated, and the segregation between detailed deductions and additional deductions are also eliminated. Instead of choosing between the fixed or detailed deduction plus the additional deductions, every individual could claim any of the following deductions in his/her tax form:

1. Deduction for interest paid or accumulated over residential property – This deduction will be limited to 30% of the taxpayer’s adjusted gross income, but modified by some entries.
2. Donations for charities and other contributions – each dollar contributed to charitable organizations will be deductible up to a maximum of 50% of the taxpayer adjusted gross income. In the case of a non-cash donation, whose market value is more than 25% of the donators’ adjusted base, a deduction for the market value of the donated good will be granted, up to a maximum of 30% of the adjusted gross income.
3. Medical expenses deduction – Deduction for medical expenses in excess of 6% of the adjusted gross income.
4. Interests paid over student loans at college level – This deduction remains the same as in the actual code, that is, a 100% of the interests paid over student loans is accepted as a deduction.
5. Contributions to certain pension or retirement system in the case of government employees – Under the actual law, this is an additional deduction. Under the new Code, it will be one of the admissible deductions.
6. Retirement savings: Contributions to individual’s retirement accounts – The maximum amount of \$ 5,000 per spouse or taxpayer is maintained, and this same contribution amount could be taken as

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a deduction. Additionally, the limitation on the deduction for contributions to IRA accounts in the case of salaried employees who participate in a qualified retirement system (401(k) plans) is eliminated.

7. Contributions to Education IRA – This deduction remains with a maximum of \$ 500 per minor.
8. Contributions to Health Savings Accounts – The dispositions pertaining the health savings accounts are amended in order to allow more flexibility and encourage that individuals with health insurance plans with high deductibles can contribute to a health savings account. This account has as an objective to pay for medical deductibles and to make those contributions deductible in the tax form. A maximum annual deduction of \$ 3,100 is granted in the case of an individual taxpayer and of \$ 6,200 in the case of married couples.
9. Deduction for losses due to fortuitous causes – The deduction remains.

Aside from these deductions, the Code establishes a deduction for taxpayers whose only source of income consists of income for the concept of: compensation for services as an employee, professional services, own business, profit from a property sale, pensions, or pensions due to divorce or separation (alimony). This deduction applies if the total of the income received does not exceed \$ 20,000. This deduction will be made as shown in the table below.

If the total income perceived does not excede \$20,000 the deduction will be:

<u>Year</u>	<u>Amount</u>
2011	\$9,350
2012	\$8,600
2013	\$6,850
2014	\$4,600

The deduction will be reduced at a rate of fifty cents (\$0.50) per each dollar of income in excess of \$20.000.

To neutralize the elimination of other deductions existing nowadays, the personal exemption is being increased. Under the current law, personal exemption is \$ 1,300 for single or married people who do not live with their spouses, \$ 1,500 for married people who file separately and \$ 3,000 for married people who file jointly, or head of household. This will be increased to \$ 3,500 per taxpayer on fiscal year 2011 (including individual and married taxpayers that file separately). In the case of married people who file jointly, the exemption will be of \$ 7,000 (\$ 3,500 per taxpayer).

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The deduction for veterans remains, in addition to the personal exemption, as an additional one. This exemption is \$ 1,500 per veteran taxpayer. In the case of married couples who file jointly, if both were veterans, the additional personal exemption will be three thousand (3,000) dollars.

The deduction for dependents remains at \$ 2,500 per dependent. However, a special rule is established in the case of separated or divorced parents with the right to shared custody. In these cases, the deduction per dependent will be divided to half amongst both parents.

The earned income tax credit is preserved and increased in order to encourage job creation and stimulate the economy. The credit will increase 0.5% each year (with an increase in the credit maximum amount of \$ 50 per each year), until it reaches 6% of the earned income during fiscal year 2016 and a maximum credit of \$ 600. The credit applies to all taxpayers who have generated an income as a result of their work, up to \$ 10,000. In the case of a taxpayer with an earned income exceeding \$ 10,000, the credit will be reduced by an amount equal to 2% of the earned income in excess of \$ 10,000, up to an income ceiling. The maximum annual income will be as follows:

Year	Maximum Annual Income
2011	22,500
2012	25,000
2013	27,500
2014	30,000
2015	32,500
2016	35,000

Also, the \$ 300 credit remains for those pensioners whose only source of income comes from a pension from services rendered, if the amount received does not exceed \$ 4,800. A new credit of \$ 400 is added to the credit mentioned above for people over 65 years of age, whose gross annual income (including non-taxable income as a benefit from social security and other items excluded under Section 1031.01(b)) does not exceed \$ 15,000.

Another change included is the increase in the limits of contributions to qualified pension plans to encourage retirement savings. For fiscal years starting on January 1, 2011, 2012, and 2013, the maximum contributions allowed will be \$ 10,000, \$ 13,000 and \$ 15,000, respectively.

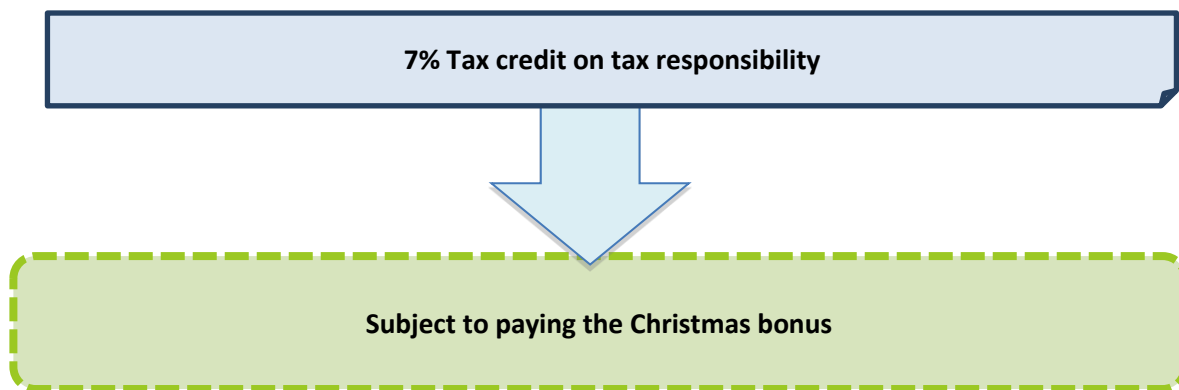
If an individual so desires, he/she has the option to calculate his/her contribution and file the form corresponding to fiscal year 2011 and during the next 4 taxable years, based on the dispositions of the 1994 Internal Revenue Code, as amended. The taxpayer will so choose in the fiscal year 2011 form and once the selection is made, it will be effective for the next 5 years and will be irrevocable.

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CORPORATIONS

Consistent with the tax reduction applicable to individuals, this Code contemplates a substantial reduction in the contributions paid by corporations.

During 2010, a tax credit was legislated for all non-exempt corporations, so that they could receive a 7% credit over their tax responsibility.

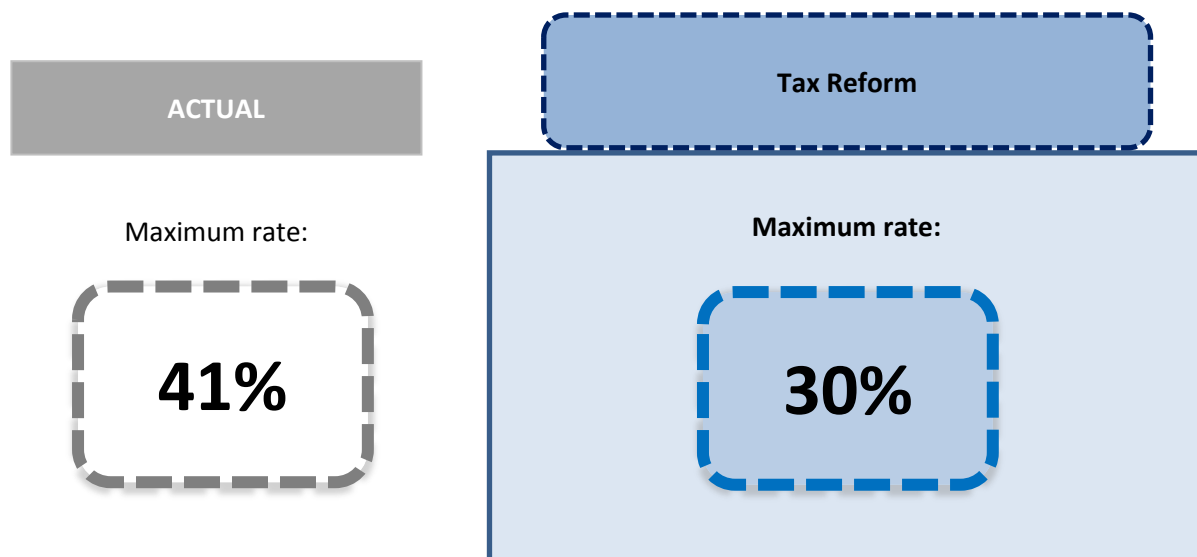


Also, as a measure to encourage economic development and the generation of new jobs, starting in 2011 tax reductions are granted to all non-exempt companies. The Code provides a corporate relief by reducing the rates of the additional contributions and broadening the ranges. The small and medium businesses, or Pymes, will significantly benefit from these changes.

For fiscal years starting in 2011, a corporation that generates a taxable net income of \$ 750,000 or less will pay a total contribution of 20%.

Additionally, the maximum rate of 39% –which today applies to incomes higher than \$ 300,000– will be reduced to 30% for incomes higher than \$ 2.5 millions.

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Specifically, reductions are attained by keeping the tax rate at the normal level, 20%, but reducing the additional “surtax” contribution. The new table of additional contribution, which applies to corporations that generate more than \$ 750,000 in gross taxable income, (“surtax”) will be as follows:

<i>If the gross income subject to additional contribution were:</i>	<i>The contribution will be:</i>
No more than \$1,750,000	5 per cent
In excess of \$1,750,000	\$87,500 plus 10 percent of the excess over \$1,750,000

For fiscal years started after December 31, 2013, the tax rate will be reduced to 25%.

In addition of this dramatic reduction in taxes and with the aim to help businesses during these years when the Island has suffered the impacts of the economic crisis, a temporary period is established in order to increase the period to carry over the net operational losses suffered by businesses. The new rules states that in the case of net losses incurred in fiscal years started after December 31, 2004, and before December 2012, the carry over period will be ten (10) years.

In summary, the initiatives in favor of corporations will provide an average annual relief of \$ 260 millions during the next six years and a relief of 30% in the tax load aiming to increase the creation of new jobs and encourage investment.

Also, the reform contains a series of measures to fight tax evasion. For example:

- Corporations’ principal officials or businesses that practice tax evasion will receive personal and criminal fines. This will include those who receive the IVU (Sales and Use Tax) and do not send it to the Treasury Department.

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- Financial institutions are obliged to file an informative form with the financial information (including income) submitted by any person (whether it is an individual or a corporation) in order to obtain a credit extension of more than \$ 250,000 (\$ 500,000 if the loan has a mortgage guaranty).
- An express prohibition for certain expenses that are presently claimed as ordinary and necessary expenses that are considered extravagant expenses and do not have the nature of an ordinary and necessary expense for a business operation. Some examples are the expenses related to the possession, operation and maintenance of boats, planes, and expenses related to the ownership, usage and maintenance of properties outside Puerto Rico.
- In order to refrain taxpayers' practice of alleging to conduct a real estate rental business, but employ the residence for their personal use, a disposition is included explaining that rental business can only deduct those expenses related to rents paid to third parties. Moreover, the technical amendments will include a disposition to clarify that only the businesses that rent to third parties qualify to be taxed as Special Partnerships and to establish that the personal use for more than 14 days during the year will cause the business' disqualification to operate as a Special Partnerships.
- Preferences to the term "corporations controlled group" and "related person" will be standardized in order to eliminate the confusion that having too many definitions of the same term created through the whole code.

Another important objective of the Reform is to facilitate doing business in Puerto Rico. With this aim, the dispositions for business partnerships attuned with the dispositions of the federal code, establishing that business partnerships do not pay taxes as separate entities from their partners. Also, in order to encourage the influx of more businesses to Puerto Rico, the new code establishes that the limited liability companies will be subject to taxation in the same manner and way as corporations; but, for tax purposes, they will be able to choose to be treated as business partnerships, under the rules applicable to business partnerships and partners.

Lastly, our Government is confident that these changes are for the good of everyone and that they improve the economic situation of all taxpayers. However, corporations as well as individuals can choose to be taxed under the actual code if they do not agree with these changes. Corporations or individuals that choose this option will have to stay with this decision for the next 5 years.