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CLIENT BRIEFING
May 12, 2005

Proposed Amendments

RE: P. de la C. 1579 - Proposed amendment to the Puerto Rico Internal Revenue Code of 1994 ("PR Code"), to impose an additional transitory tax over certain type of income of financial institutions engaged in business in Puerto Rico.

P. de la C. 1579 is a proposed bill which intends to amend the PR Code in order to impose a transitory tax of 4% over the "tax basis", as such term is defined in the proposed legislation (the "Tax Basis"), of persons engaged in providing financial services in Puerto Rico pursuant to several Puerto Rico laws regulating the financing industry. In case of insurance companies, the applicable tax is 0.4 cents for every premium dollar. This transitory tax would be payable by the institutions covered by the proposed legislation in addition to any other taxes payable by them under the PR Code.

The financial institutions that would be subject to the additional tax are the following: (1) commercial banks, (2) international banking entities, (3) small personal loans companies, (4) mortgage institutions, (5) investment companies, (6) companies dedicated to the lease of personal property, (7) financing companies regulated by the Retail Installment Sales Act, (8) broker-dealers, agents and investment advisors, (9) insurance companies, (10) trust companies and (11) money transfer businesses.

The Tax Basis that would be used to impose the new tax varies depending on the type of financial institution and is based on the income reported by the company in its audited financial statements filed with the Puerto Rico Department of Treasury, the Commissioner of Financial Institutions, or the Commissioner of Insurance, as applicable.

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The Tax Basis for each of the institutions covered is the following:¹

1. **Commercial banks and international banking entities:** the excess of interest income over the interest expense incurred during the year.
2. **Mortgage Institutions:** the excess of interest income over the interest expense incurred during the year, and the net gain on the sales of mortgages in the secondary market.
3. **Investment Companies:** the excess of interest income over the interest expense incurred during the year.
4. **Leasing Companies:** the excess of interest income over the interest expense incurred during the year, the service charge income, and the rent income.
5. **Financing Companies, trust companies and money transfer businesses:** the excess of interest income over the interest expense incurred during the year, and the service charge income.
6. **Broker-dealers, agents and investment advisors:** the excess of interest income over the interest expense incurred during the year, and the income derived from commissions.
7. **Insurance Companies:** the gross annual premiums from life, disability, health, property and casualty, miscellaneous and surplus lines insurance.

The proposed legislation provides that interest income derived from obligations of the United States and/or any of its political subdivisions, as well as interest income derived from obligations of the Commonwealth of Puerto Rico, its instrumentalities or political subdivisions, is excluded for purposes of determining the Tax Basis for the new tax. On the other hand, interest paid or accrued on debts incurred by financial institutions for purposes of purchasing or carrying obligations which interest is exempted from taxes will not be considered an "interest expense" for purposes of determining the Tax Basis for the new tax.

You should note that the proposed new tax is not applicable to those financial institutions that are not engaged in a trade or business in Puerto Rico, which are subject to the tax applicable to foreign corporations and partnerships under Section 1231(a) of the PR Code. The new tax is also not applicable to the Insurer's Syndicate to Underwrite the Medico-Hospital Professional Liability Insurance created by Act. No. 4 of December 30, 1986, as amended, nor to the Joint Underwriting Association of the Compulsory Liability Insurance created by the Compulsory Motor Vehicle Liability Insurance Act.

¹ The proposed legislation does not indicate the Tax Basis for small personal loan companies.

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Finally, according to the proposed legislation, if a taxpayer can demonstrate to the Secretary of the Treasury that complying with the new tax will result in a substantial prejudice to its operations, the Secretary may relieve said taxpayer from the payment of the tax, according to the regulations to be issued by the Secretary for this purpose.

If you need additional information about this proposed legislation or its possible impact on your operations, you may contact the following attorneys in the Corporate Department of O'Neill & Borges.

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