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TAX ALERT

Tax Reform House Bill 2482

This is the second of two Tax Alerts on the recently unveiled House Bill 2482 (the "Bill") to amend the Puerto Rico Internal Revenue Code of 2011, as amended (the "Code"). Below is a summary of the most significant provisions of the Bill modifying current statutory provisions dealing with individual and corporate income taxes. The provisions dealing with the value added tax were discussed in a separate tax alert.

A. Regular and Alternate Basic Tax for Individuals

The Bill provides that the income tax rates that were in effect for taxable years that started after December 31, 2012 and before January 1, 2014 will be extended to all taxable years that start after December 31, 2012. The gradual adjustment is reinstated at 5% of the excess of net taxable income over \$500,000.

B. Special Tax on Self-Employed Individuals

The 2% special tax imposed on self-employed individuals is repealed for taxable years commenced on or after January 1, 2015.

C. Alternative Minimum Tax

The alternative minimum tax ("AMT") will be the higher of:

- 30% of the alternative minimum net income, or
- The sum of the following items:
 - o 20% of the expenses incurred or paid to a related party, or assigned to a home office, if such expenses are not subject to P.R. income or withholding tax in the year in which paid or incurred ("Related Party Expenses"); and
 - o The amount resulting from multiplying the following tax rates to the value of the purchases of personal property from a related party, or to the personal property transferred from a home office located outside Puerto Rico to a branch engaged in trade or business in Puerto Rico ("Tax on Purchases"):

- 2% for taxable years commencing before January 1, 2015
- For taxable years commencing after December 31, 2014, the rate will vary in accordance with the gross income derived from a Puerto Rico trade or business, as follows:
 - 2.5% if the gross income is \$10 million or more, but less than \$500 million
 - 3% if the gross income is \$500 million or more, but less than \$1,500 million
 - 3.5% if the gross income is \$1,500 million or more, but less than \$2,000 million
 - 4.5% if the gross income is \$2,000 million or more, but less than \$2,750 million
 - 6.5% if the gross income is \$2,750 million or more
- For taxable years commencing before January 1, 2015, the applicable rate will be 1.5% on purchases or transfers of motor vehicles subject to excise taxes under the Code.
- For taxable years commencing after December 31, 2014, the applicable rate will be .5% on purchases or transfers of motor vehicles subject to excise taxes under the Code.

In the case of Related Party Expenses, the taxpayer may request from the Secretary of the Treasury ("Secretary") a waiver to exclude certain expenses from the application of the 20% tax. Provided, however, that the exclusion of such expenses cannot exceed 60% of the total amount of the Related Party Expenses.

For taxable years commencing after December 31, 2014, the Bill repeals the possibility of requesting from the Secretary a waiver from the application of the Purchases Tax. However, any waiver, administrative determination or closing agreement already granted by the Secretary will remain in effect for the taxable years granted. If the waiver granted is applicable to taxable years commencing after December 31, 2014, the taxpayer can choose between the tax rate provided under the Bill and the one granted in the waiver.

D. Alternative Minimum Net Income

For taxable years ending after December 31, 2014, the deduction of net operating losses in computing the alternative tax cannot exceed 70% of the alternative minimum net income. This limitation is reduced from an 80% currently available under the Code.

E. Non-Deductible Expenses

The following items will be disallowed as a deduction when computing net taxable income:

- 51% of the Related Party Expenses. The taxpayer, however, may request a waiver to the Secretary to exclude certain expenses from such disallowance. The total amount of expenses that may be excluded through a waiver cannot exceed 60% of the total Related Party Expenses.
- Expenses paid or incurred for services rendered by a nonresident person if the taxpayer has not paid the sales and use tax ("SUT") or the value added tax ("VAT"), as applicable, on such services.
- The cost or the depreciation on any taxable good or item, as defined for SUT and VAT purposes, if the taxpayer has not paid the SUT or VAT on such items, even if such cost or depreciation is an ordinary and necessary expense of the business.

F. Losses – Corporations of Individuals, Partnerships and Special Partnerships (“Pass-through Entity”)

For taxable years beginning after December 31, 2014, the proportional amount of the participation of a shareholder/partner in the losses of a Pass-through Entity cannot exceed 80% of the distributable participation of such shareholder/partner in the aggregate net income of the Pass-through Entities in which the shareholder/partner holds an ownership interest.

G. Net Operating Loss Deduction

The amount of net operating losses to be carried over will be the excess, if any, of the amount of such net operating loss over the sum of (i) the net income for each of the taxable years beginning before January 1, 2013, (ii) 90% of the net for each of the taxable years beginning after December 31, 2012, and (iii) 80% of the net income for the taxable years beginning after December 31, 2014.

In the case of individual taxpayers showing a net loss from a trade or business for three consecutive taxable years, the amount of the loss that can be carried over in the third taxable year beginning after December 31, 2014 will be 50% of the loss incurred in such year. For these purposes, each industry or business will be considered separately and the real estate rental business will not be considered a trade or business.

For purposes of determining the net operating loss for any given taxable year, the Related Party Expenses will not be allowed. This disallowance will not apply to taxpayers operating under the provisions of a Tax Grant issued under Act 73-2008, Act 74-2010, Act 83-2010, Act 20-2012, or any similar act that grants tax exemption on income generated from operations covered by a grant or concession.

H. Capital Losses

1. Limitation on deductibility of capital losses by corporations

The deductible percentage of capital losses is decreased from 90% for taxable years ending before January 1, 2015, to 80% for taxable years commencing after December 31, 2014.

2. Limitation on deductibility of capital losses by taxpayers, other than corporations

Losses from the sale or exchange of capital assets may be allowed up to the amount of gains from the sale or exchange generated during the same taxable year. In the event the losses exceed the gains during a taxable year, the taxpayer will be able to reduce such excess up to the lower of: (i) the net income of the taxpayer (without consideration of such gains or losses), or (ii) \$1,000.

3. Capital Loss Carry forward

For taxable years commencing after December 31, 2014, capital losses may be carried forward to subsequent taxable years up to 80% of the net capital gain generated in the subsequent year to which the loss is carried forward. The amount of the carried forward loss allowed in a subsequent taxable year is considered a short-term loss in such subsequent taxable year.

I. Tax Credit Moratorium

The present tax credit moratorium on the use of tax credits is extended to include taxable years commencing before January 1, 2018.

- The right to use tax credits subject to the moratorium and issued during fiscal year 2016-2017 will be limited to 50% of such credits in taxable years commencing after December 31, 2016 and before January 1, 2018. Similarly, such credits may be claimed up to 50% in taxable years commencing after December 31, 2017 and before January 1, 2019, and any remainder in subsequent taxable years.
- The right to use tax credits subject to the moratorium and issued during fiscal year 2017-2018 will be limited to 50% of such credits in taxable years commencing after December 31, 2017 and before January 1, 2019. Similarly, such credits may be claimed up to 50% in taxable years commencing after December 31, 2018 and before January 1, 2020, and any remainder in subsequent taxable years.
- The tax credit carry forward limitation period is suspended until January 1, 2018 for any tax credit subject to the moratorium that is also subject to a carry forward use limitation period.
- Extends from taxable years commencing after January 1, 2016 to taxable years commencing after January 1, 2018, the moratorium on tax credits subject to the Informative Return requirement on tax credits issued as of June 30, 2013.

The present tax credit moratorium on the issuance of tax credits is extended to include taxable years commencing before January 1, 2018.

- The \$10 million annual limitation on the issuance of tax credits under Act 183-2001, as amended, is extended to fiscal years 2016-2017 and 2017-2018.
- The \$40 million annual limitation on the issuance of tax credits under Act 212-2002, as amended, is reduced to \$20 million for taxable years commencing after December 31, 2015, while the limitation per project remains at \$5 million for the extended moratorium period ending with fiscal year 2017-2018.
- The \$5 million annual limitation on the issuance of tax credits under Act 98-2001, as amended, applies during the extended moratorium period now ending with fiscal year 2017-2018

J. Filing of Tax Returns by “Large Taxpayers”

“Large taxpayers” will be required to file their tax returns at such location as the Secretary of the Treasury may establish by regulation, administrative determination, circular letter or informative bulletin. The Secretary may provide for the filing of tax returns by electronic means. Large taxpayers that do not submit the tax return as required will not be deemed to have filed the tax return and will be subject to the applicable non-filing penalties. A “large taxpayer” is defined as taxpayers engaged in trade or business in Puerto Rico that meet at least one of the following requirements:

- It is a commercial bank or trust company;
- It is a private bank;
- It is a brokerage house;

- It is an insurance company;
- It is an entity engaged in the telecommunications business; or
- It is an entity with a volume of business of at least \$50 million for the prior taxable year.

K. Not for Profit Entities

Certain tax exempt entities will be required to provide evidence that such entity renders services in Puerto Rico.

L. Excise Taxes

Effective on July 1, 2015, the excise tax on all terrain vehicles will increase from 10% to 11.5% on the taxable price in Puerto Rico.

If you have any questions, you may contact any of the attorneys of our Tax Practice Group listed below:

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