

Act 257 Amends the Puerto Rico Internal Revenue Code of 2011

ATTORNEYS

- Isis Carballo-Irigoyen
- Yamary I. González-Berríos
- Rubén Muñiz-Bonilla
- Lillian Toro-Mojica
- Esteban R. (Ricky) Bengoa
- Mariana M. Contreras-Gómez
- Rafael Fernández-Suárez
- Leyla González-Ibarría
- Xenia Vélez
- Carlos J. Villafañe-Real

PRACTICE AREAS

- Tax

An McV Tax Alert

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Today Governor Ricardo Rosselló signed into law Act No. 257 (the “Act”) to amend the Puerto Rico Internal Revenue Code of 2011, as amended (the “Code”). The Act states that it seeks to address imperfections in our tax system so as to stimulate economic growth and promote voluntary compliance with tax laws. The Act also seeks to redistribute the tax burden and implement mechanisms to combat tax evasion.

We note, however, that the Financial Oversight and Management Board for Puerto Rico (the “Board”) has expressed reservations indicating that portions of the Act could be inconsistent with the Government’s Fiscal Plan. We will continue to monitor further developments in the event that the Board challenges all or part of the provisions of the Act.

This Tax Alert updates our Tax Alert of April 24, 2018 regarding HB 1544, and is the first of two Alerts discussing some of the most important aspects of the Act. This Tax Alert focuses on individuals, corporations and partnerships, while the second will focus on employee benefits. Unless noted, the following changes will apply to taxable years beginning after December 31, 2018.

I. Individuals

A. Deductions, Credits and Exemption

- The current 50% limitation on the net operating loss (“NOL”) carryover for individuals with a net loss in a trade or business for three consecutive taxable years is eliminated, thus allowing a 100% NOL carryover.
- Contributions to Health Savings Account will not be allowed as deductions.
- The charitable contribution deduction will be allowed only if the contribution is made to a nonprofit entity that renders services to Puerto Rico residents.
- A refundable Earned Income Tax Credit will be available for individuals that reside in Puerto Rico during the entire year. Generally, the credit amounts to 5% of earned gross income up to a maximum of \$300, which can increase to up to \$2,000 depending on marital status, number of dependents, and adjusted gross income.

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- Taxpayers will be allowed to claim a foreign tax credit for income taxes paid to States of the Union.
- The exemption for interest on certain securities and mortgages is repealed.
- The exemption for the first \$2,000 of interest earned on deposits in interest bearing accounts in financial institutions is reduced to \$100.
- Indemnification payments received for mental anguish will be excluded from gross income.

B. Returns

- The obligation to file a Puerto Rico income tax return will be triggered when gross income minus the exemptions allowed under the Code is more than \$0, or if the net income subject to alternate basic tax is \$25,000 or more.

C. Income Tax Rates

- The Act establishes that an individual's total tax will be 95% of his total tax determined.

D. Alternative Basic Income Tax ("ABT") Rates

- The Act lowers the income thresholds to apply the ABT, as follows:

Net income subject to ABT

Tax

In excess of \$25,000 but not more than \$50,000

1%

In excess of \$50,000 but not more than \$75,000

3%

In excess of \$75,000 but not more than \$150,000

5%

In excess of \$150,000 but not more than \$250,000

10%

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In excess of \$250,000

24%

- The Act imposes new limitations on expenses allowable as a deduction to determine the net income subject to the ABT and establishes that an expense reconciliation statement must be submitted for certain deductions claimed by taxpayers using the accrual method.
- An individual may deduct without limitations all ordinary and necessary business expenses related to a trade or business if an Agreed Upon Procedures Report or Compliance Attestation Report prepared by a Puerto Rico licensed CPA certifying such expenses is attached to the income tax return.
- The Act clarifies that the credit for prior years' ABT liability may not be sold, transferred, or refunded. When determining the net income subject to ABT, this credit will be reduced by the portion of the ABT attributable to non-deductible expenses.
- The Act provides that the ABT will not be applicable to individuals whose only source of income is from salaries informed in a Withholding Statement.

E. New Optional Tax for Self-Employed Individuals Rendering Services

- Self-employed individuals whose income is derived substantially from the business of rendering services may elect to pay an optional tax on gross income instead of the income tax otherwise imposed by the Code on net income, as follows:

If gross income is:

The tax will be:

Not greater than \$100,000

6%

In excess of \$100,000 but not more than \$200,000

10%

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In excess of \$200,000 but not more than \$300,000

13%

In excess of \$300,000 but not more than \$400,000

15%

In excess of \$400,000 but not more than \$500,000

17%

In excess of \$500,000

20%

- The new optional tax is applicable for taxable years that commence after December 31, 2018. However, the Secretary of Treasury may postpone its effective date for taxable years that commence after December 31, 2019.

II. Corporations

A. Deductions

- **Net Operating Losses (“NOLs”)** – The limitation on the NOL carryover deduction increased from 80% to 90% of net income. A corporate partner that owns 50% or more of a capital interest, or of the interest on the benefits of a partnership or special partnership, cannot claim an NOL deduction against the distributable income of such partnership. Such corporate partner can neither deduct from the distributable income of a partnership or special partnership the losses generated during the current taxable year by the corporate partner in its business operations.
- **Intercompany Expense Allocation** – The amounts paid or incurred to a related party (including a branch and its home office) will continue to be subject to a 51% disallowance unless the taxpayer submits to the P.R. Treasury a Transfer Pricing Study in accordance with the provisions of US IRC Section 482 (as opposed to a waiver request under the Code). If the Transfer Pricing Study is submitted, the expenses incurred will be fully deductible (as opposed to 60% under the Code).
- **Charitable Contributions** – The charitable contribution deduction will be allowed only if the contribution is made to a nonprofit entity that renders

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services to Puerto Rico residents.

B. Normal Tax and Surtax

- The Act reduces the corporate normal tax from 20% to 18.5%. The highest corporate income tax rate is thus reduced from 39% to 37.5%.

C. Alternative Minimum Tax (“AMT”)

- The AMT of a corporation will be the greater of \$500 or 18.5% (instead of 30% under the current Code) of the amount by which the alternative minimum net income for the taxable year exceeds the exempt amount reduced by the AMT credit for foreign taxes paid. Corporations with a volume of business of \$3,000,000 or more that are required to file their income tax returns with audited financial statements will be subject to a 23% AMT rate instead.
- To compute the alternative minimum net income subject to the AMT, the following are the only deductions that will be allowed if the payments are directly related to the trade or business of the corporation and are duly reported in informative returns:
 - 125% of the salaries paid.
 - Amounts paid for services, including rental, telecommunications, internet access, regardless of the accounting method used by the taxpayer. To claim these expenses, taxpayers under the accrual method of accounting or with a fiscal year must submit with the return a reconciliation of the expenses as per their accounting books with the amounts reported in the informative returns (“Reconciliation”).
 - Contributions to employees’ health or accident plans.
 - Payments for electricity and water services.
 - Amounts paid for marketing and publicity. To claim these expenses, taxpayers under the accrual method of accounting or with a fiscal year must submit with the return a Reconciliation.
 - Amounts paid for property, contingency and malpractice insurance. To claim these expenses, taxpayers under the accrual method of accounting or with a fiscal year must submit with the return a Reconciliation.
 - Depreciation deduction using the straight-line method.
 - Payments for interest, taxes, uncollectible debts, contributions to retirement plans and charitable contributions.

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- Notwithstanding the above, the corporate taxpayer can determine the net income subject to AMT by claiming as deductions all ordinary and necessary expenses, provided the income tax return of the corporation is filed with audited financial statements or an Agreed Upon Procedure. Under the Act, corporate taxpayers that comply with the above requirements do not have to request a waiver from the PR Treasury to claim ordinary and necessary expenses in computing the alternative minimum income.

D. New Optional Tax for Corporations Engaged in Rendering Services

- Corporations whose source of income substantially relates to the business of rendering services may elect to pay an optional tax on gross income rather than the income tax on net income otherwise imposed by the Code, as follows:

If gross income is:

The tax will be:

Not greater than \$100,000

6%

In excess of \$100,000 but not more than \$200,000

10%

In excess of \$200,000 but not more than \$300,000

13%

In excess of \$300,000 but not more than \$400,000

15%

In excess of \$400,000 but not more than \$500,000

17%

In excess of \$500,000

20%

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- To qualify for the election, the taxpayer's gross income must be substantially attributable to services rendered, and the payment received must have been subject to withholding tax and reported in an informative return, or subject to the payment of estimated taxes.
- This optional tax will be effective for taxable years beginning after December 31, 2018. The Secretary, however, has the authority to postpone the effective date of this tax for taxable years beginning after December 31, 2019.

III. Partnerships

A. Distributive Share of Partnership's Items of AMT Adjustments

- In determining its AMT, each partner in a partnership must separately take into account its distributive share of the partnership's items of allowed deductions and adjustments required to determine the alternative minimum net income.

B. Charitable Contributions and Foreign Taxes Taken into Account in Determining Limitation on Allowance of Partner's Share of Loss

- A partner's distributive share of partnership loss is limited to the adjusted basis of the partner's interest in the partnership as of the close of the partnership's taxable year in which the loss occurred. Under the Act, this limitation will apply to a partner's allocable share of charitable contributions or foreign tax expenditures. As an exception, however, in the case of a charitable contribution of property whose fair market value exceeds the adjusted tax basis, the basis limitation will not apply to the extent of the partner's allocable share of this excess.

C. Technical Termination of Partnerships

- The Act repeals the technical termination rule, so that a partnership is treated as continuing upon the sale or exchange of 50% or more of the total interest in a partnership's capital and profits within a 12-month period.

D. Substantial Built-in Loss in the Transfer of Partnership Interest

- The Code provides for an adjustment to the basis of partnership property upon the sale or exchange of a partnership interest, provided the partnership has a Section 1075.04 election in effect, or where the partnership has a substantial built-in loss. The Code currently provides that a partnership has a

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substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in all of its property exceeds the fair market value of such property by more than \$250,000. The Act modifies the definition of a substantial built-in loss to add that a substantial built-in loss also exists if the transferee partner would be allocated a loss in excess of \$250,000 upon a hypothetical disposition by the partnership of all the partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

E. Sale of Partnership Interest

- Gain on the sale of partnership interests will constitute Puerto Rico source income to the extent the partnership would have derived Puerto Rico source income upon the sale of all of its assets at fair market value, regardless of the residence of the selling partner. If the selling partner is a non-resident individual or foreign corporation not engaged in trade or business in Puerto Rico, the purchaser will be required to withhold a 15% income tax from the portion of the gain constituting Puerto Rico source income.

IV. Business Deductions

A. Depreciation

- An entity with a volume of business of \$3,000,000 or less may depreciate machinery and equipment, furniture and fixtures, or any other asset used in the trade or business (except real property, motor vehicles, computer systems and ground transportation equipment) using a useful life of 2 years, rather than depreciation rules of the Code.

B. Use of Motor Vehicles

- For tax years started after December 31, 2017, real costs incurred in the use and maintenance of motor vehicles, rather than being determined on the basis of a standard mileage rate, will be deductible subject to limitations to be established through regulations.

C. Meals and Entertainment

- The meals and entertainment expense deduction will be reduced to 25% of the amount incurred, rather than 50% under the present Code.

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D. Travel Expenses

- Travel expenses will no longer be fully deductible, and instead will be subject to a 50% limitation.

E. Indemnity Payments due to Harassment Cases

- No deduction will be allowed for payments of damages on account of harassment claims, including legal fees, if the settlement includes a non-disclosure agreement.

F. Wages Paid to College Students

- Private employers will be allowed a 150% deduction for salaries paid to college students if certain requirements are met. If the employee participated in the P.R. Treasury internship program, the deduction increases to 200%.

G. Foreign Tax Credit

- Taxpayers will be allowed to claim a foreign tax credit for income taxes paid to States of the Union.

V. Tax Credits

A. Tax Credits Subject to Moratorium

- The Act extends the period of the moratorium for the issuance and use of certain tax credits indefinitely. For taxable years beginning after December 31, 2016 and before January 1, 2018, the use of tax credits subject to moratorium has been further restricted to reduce the taxpayer's tax liability up to 25% instead of 50%. The use of these credits in prior and subsequent taxable years will be limited to 50% of the tax liability.

B. Elimination of Credits – Only the following credits are eliminated effective for tax years that start before January 1, 2018:

- The credit for investment in, and for loss from, securities of qualified businesses.
- The 3% credit for investments in buildings and structures used in manufacturing, claimable against the income tax on dividends from industrial development income.

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- The credit for contributions to the *Patronato del Palacio de Santa Catalina* for the restoration of the Governor's mansion.
- The credit under the Code for increasing purchases of Puerto Rico agricultural products.
- The credit under the Code for purchases of products manufactured in Puerto Rico.

C. Credits Approved by the Disbursement Authorization and Tax Concession Committee (“Committee”)

- The provisions of Administrative Order OA-2018-10 issued by the Fiscal Agency and Financial Advisory Authority of Puerto Rico are incorporated in the Code to provide that the use limitations in various Resolutions issued by the Committee continue in effect for certain tax credits during tax years that commenced in 2017, but not thereafter. Any waiver request regarding these use limitations must be filed by December 31, 2018.

VI. Source of Income

1. The Act modifies the source of income rules for services to provide that services rendered to any agency or instrumentality of the Government of Puerto Rico, public corporation, the Legislative and Judicial branches, and municipalities will be considered Puerto Rico source income even if the services are rendered outside Puerto Rico.

VII. Nonprofit Entities

A. The Act codifies the administrative practice that nonprofit organizations intending to operate as exempt entities under the Code must request a determination letter from P.R. Treasury. To grant the exemption, the Secretary may require an Agreed Upon Procedure Report or a Compliance Attestation Report prepared by a Puerto Rico licensed CPA.

B. In general, a special tax of 37.5% will be imposed on any nonprofit organization exempt under Section 1101.01 of the Code on the compensation paid to an employee, director or officer for services rendered to such entity under the following circumstances:

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Compensation Paid

Volume of Business of Nonprofit Entity

In excess of \$250,000

Less than \$25,000,000

In excess of \$500,000

\$25,000,000 but less than \$50,000,000

In excess of \$750,000

\$50,000,000 but less than \$75,000,000

In excess of \$1,000,000

\$75,000,000 or more

The above will not apply to nonprofit entities that can prove to the Secretary that the compensation paid is adequate taking into account the services rendered

C. Nonprofit entities will have to submit their returns with audited financial statements only if income derived from the non-exempt activities is \$3 million or more.

D. A special tax of 37.5% will be imposed on indemnity payments made by nonprofit entities on account of harassment claims if the settlement includes a non-disclosure agreement.

VIII. Registered Investment Companies (“RIC”)

A. To determine the tax treatment of Puerto Rico resident shareholders of a RIC, a RIC or real estate investment trust created or organized under the laws of the United States of America or of any state of the United States will no longer be required to comply with the requirements of the Puerto Rico Investment Act of 2013 to be considered a RIC if it complies with the applicable federal requirements.

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VIII. Internal Revenue Licenses

A. Commencing on July 1, 2018, taxpayer applying for new or renewing internal revenue licenses can elect for such licenses to be valid for two years, instead of one year. In this case, the license fee will be equal to 2.5 times the current applicable fee.

B. For purposes of determining the applicable license fee on coin operated machines, the Act now defines the terms “adult entertainment machines” and “Games of Chance Machines” as follows:

- Adult entertainment machines are electronic video game machines operated with coins, cards, or tokens that have violent or sexual content, or content for persons of more than 18 years of age, when the abilities of the players significantly affect the final result of the game. These are not machines that contain devices that are distinctive to the Games of Chance Machines.
 - Entertainment machines for the exclusive use of children and young adults are excluded from the definition of adult entertainment machines. “Entertainment machines for the exclusive use of children and young people” are, in turn, machines that do not reward the player, or that reward the player with toys or tickets to be exchanged for toys or other prizes that are not cash.
- Games of Chance Machines are, generally, machines that use a chance element to pay prizes and that are subject to the provisions of the Games of Chance Machines Act of 1933, as amended.

Effective January 1, 2019, the license fee imposed on coin operated machines will be as follows:

- For each juke box and pool table – \$300
- For each coin operated machine that is not an adult entertainment machine – \$100
- For each coin operated machine that is an adult entertainment machine – \$3,000
- For each coin operated machine that is not included in any of the prior categories and is not a Game of Chance Machine – \$1,500

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X. Individual Retirement Accounts (“IRA”)

A. Effective for IRA distributions made after December 31, 2017, the tax rate on the portion attributable to interest income will be reduced from 17% to 10%.

B. The Act codifies administrative determinations regarding eligible distributions from Puerto Rico IRAs to Puerto Rico resident individuals affected by Hurricane Maria. These provisions will apply to “Declared Disasters,” as defined in the Code. The Act clarifies that amounts withheld from IRA distributions by reason of a Declared Disaster must also be paid or deposited with the Secretary on or before the 15th day of the month following the month in which the distribution is made.

XI. Definitions

A. Limited Liability Company (“LLC”)

- The Act amends the definition of an LLC to include Series LLCs. In addition, the Act requires that only non-P.R. LLCs that are treated as partnerships under foreign laws must be treated as partnerships for Puerto Rico income tax purposes, thus allowing P.R. LLCs to be treated differently for Puerto Rico and non-Puerto Rico tax purposes.

B. Large Taxpayer

- The Act as enacted does not include in the definition of a “Large Taxpayer” certain entities that hold a tax incentives grant under Act 73-2008 (Manufacturing), Act 74-2010 (Tourism), Act 225-1995 (Agriculture), Act 20-2012 (Export Service), Act 52-1989 (International Banking), Act 83-2010 (Green Energy), and Act 273-2012 (International Finance). The Act clarifies that the aggregate volume of all related entities will be considered to determine if an entity has a volume of business of \$50,000,000 or more to be considered a Large Taxpayer.

C. Tax Return with Omitted or Objected Information – The Act provides a definition for the term “Tax Return with Omitted or Objected Information.”

D. Engaged in Industry or Business in Puerto Rico – The Act specifies that for certain purposes this term does not include trading in securities through an independent broker or for the taxpayer’s own account if the taxpayer does not have an office in Puerto Rico.

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E. Group of Related Entities – The Act expands the definition of “group of related entities” to include not only corporations, but also LLCs, partnerships, special partnerships, and corporations of individuals.

XII. Extension of Time to File Returns

A. For taxable years commenced after December 31, 2016, the Act increases the automatic extension of time to file a corporation or partnership income tax return from 3 months to 6 months. The 1-month automatic extension to file the informative returns for the partners of a partnership will be extended to 6 months if the entity was granted the automatic extension to file its income tax return.

XIII. Audited Financial Statements (“AFS”)

A. Taxpayers not required to file AFS can submit with their tax return an Agreed Upon Procedures Report or a Compliance Attestation Report issued by a P.R. licensed CPA to fully deduct expenses for ABT and AMT purposes.

B. Taxpayers required to file AFS will have to submit an Uncertain Tax Positions Schedule with the return explaining any uncertain tax position taken under U.S. GAAP.

XIV. Withholding and Informative Returns

A. Certain Wages

- Wages paid for agricultural, domestic or religious services rendered by an authorized minister are no longer exempt from withholding tax.

B. Severance Payments

- A severance payment, regardless of whether it represents the mandatory severance payment under Act 80, is treated as taxable wages subject to withholding tax.

C. Judicial and Extra-Judicial Payments

- The withholding tax on judicial or extra-judicial payments increases from 7% to 10% for payments made after December 31, 2018. The Act also provides that the withholding tax should be deposited with the PR Treasury no later than the 15th day following the month in which the withholding tax was

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made.

D. Services Rendered in Puerto Rico

- The withholding tax on services rendered in Puerto Rico will increase from 7% to 10% for payments made after December 31, 2018. If the entity does not owe any taxes, the withholding tax will be increased from 3% to 6% for payments made after December 31, 2018, provided the entity files with the return an Agreed Upon Procedures Report or certified financial statements. Various exceptions are repealed, and the withholding exception for the first \$1,500 paid during the calendar year was reduced to \$500. The Act also introduces the requirements to file quarterly and annual returns to report payments made, taxes withheld and deposited, and the identity of the service provider.

E. Failure to File Informative Returns

- A taxpayer that fails to file informative returns to report withholding tax payments made during the year will be precluded from claiming said payments as deductible expenses. If a taxpayer is using the accrual method or has an economic year, it may claim such deduction even if such expenses are not reported in an informative return, provided he submits with his tax return an expense reconciliation between the amount claimed as a deduction and the amount reported in the informative return.

F. New Informative Return for Certain Payment Processors

- Certain electronic payment processors (“Payment Settlement Entity”) will be required to file informative returns of payments issued to participating merchants (“Participating Payees”), reporting the gross income settled through electronic means during the taxable year.

XV. Sales and Use Tax (“SUT”)

A. Club Fees

- Fees paid to private or membership clubs that allow members to purchase goods or services in exchange for a membership fee will be considered an admission fee taxable for SUT purposes.

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B. Prepared Foods

- For transactions after October 1, 2019, the 11.5% SUT on prepared foods, candy, carbonated beverages and pastry shop items will be reduced to 7% for restaurants that obtain a certification from the Secretary.

C. Business to Business Services

- Effective October 1st, 2019, the 4% SUT on services rendered to other merchants (business to business services) and professional designated services will not be applicable if the services are provided by merchants with a volume of business that does not exceed \$200,000.

D. Real Property Rentals

- The exemption for commercial real property rental payments will apply if the lessee maintains a fiscal terminal and provides evidence to the lessor when claiming the exemption.

E. Medical Supplies

- The exemption for machinery, equipment, medical-surgical materials, supplies, articles and technology acquired by an exempt hospital unit for exclusive use in human health services is extended to leases of such articles.

F. E-books

- The exemption for “printed books” is extended to electronic books (i.e., digital books, cyber-books, e-books or the digital version of a printed books) and leasing of printed or electronic books.

G. Feminine Hygiene Products

- Feminine hygiene products will be exempt from SUT.

XVI. Administrative Provisions

A. Successor Taxpayer

- The Act introduces the concept of the Successor Taxpayer. A taxpayer will be considered a Successor Taxpayer when said taxpayer acquires the assets or an interest in a business and there is substantial similarity in the operations

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and owners of both entities before and after the transfer. The successor taxpayer becomes jointly and severally liable for taxes with the person principally liable for the tax.

B. Closing Agreements

- The provisions in the HB 1544 that would have expanded the Secretary's authority to enter into closing agreements with taxpayers before January 1, 2021, were not enacted into law.
- The Act also authorizes the Secretary to enter into closing agreements with foreign entities operating in Puerto Rico to extend the tax benefits in tax treaties between the US and the foreign country for Puerto Rico tax purposes.

C. Offers in Compromise

- The Secretary is authorized to enter into offers in compromise for taxes that are determined (in addition to assessed taxes) by P.R. Treasury.

D. Government Vendors

- The Act authorizes the Secretary to enter into agreements with government vendors to offset any pending invoice against any outstanding tax debt other than the SUT. The Secretary is authorized to convert the amounts owed by the government into tax credits.

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