Governor Presents Tax Code Overhaul Legislation

ATTORNEYS

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

PRACTICE AREAS

- Tax

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On April 16, 2018, the Governor of Puerto Rico filed House Bill 1544 (the "Bill") with the Puerto Rico House of Representatives and the Senate to amend the Puerto Rico Internal Revenue Code of 2011, as amended (the "Code"). The Bill states that it seeks to simplify our tax system, stimulate economic growth, and promote voluntary compliance with tax laws. The Bill indicates that this new tax model will be beneficial to taxpayers and revenue neutral to the Government of Puerto Rico because tax cuts will be offset with the elimination of approximately $300 million of certain existing tax incentives under a new Incentives Code soon to be presented.

This Tax Alert is the first of two discussing some of the most important aspects of the Bill. This Tax Alert will focus 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 Bill repeals the existing personal exemption and the deduction for dependents; it will replace the latter with a tax credit of $200 per dependent, up to a maximum of $600 for 3 dependents. The credit will be available only to Puerto Rico residents whose earned gross income does not exceed $100,000.
- 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.
- The mortgage interest expense deduction continues to be limited to 30% of adjusted gross income, but the current limitation of up to $35,000 per year is reduced to a maximum of $20,000 per year.
- IRA account and IRA Education Savings Account contributions must be made on or before the last day of the calendar year to be deductible for such taxable year.

- 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.
- 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.

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 Bill reduces the regular individual income tax rates as follows:

Net income subject to tax

Tax

Not greater than $12,500

0%

$12,501 to $21,000

0.9%

$21,001 to $45,000

$77 plus 9% of the excess over $21,000

$45,001 to $58,000

$2,237 plus 19% of the excess over $45,000

Over $58,000

$4,707 plus 31% of the excess over $58,000

- The Bill also lowers the threshold for imposition of the gradual adjustment of 5% (not exceeding $13,273) to adjusted gross income in excess of $200,000.

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

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

Net income subject to ABT

Tax

$25,001 to $50,000

1%

$50,001 to $75,000

3%

$75,001 to $150,000

5%

$150,001 to $250,000

10%

Over $250,000

24%

- The Bill imposes new limitations on expenses allowable as a deduction to determine the net income subject to the ABT.

- 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 Bill 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.

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

- Self-employed individuals whose only source of income is 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

5%

$100,001 to $200,000

10%

$200,001 to $500,000

15%

Over $500,000

20%

II. <u>Corporations</u>

A. Deductions

- **Net Operating Losses ("NOLs")** – The adjustments to net income for amounts paid or incurred to related persons to determine the NOL deduction are eliminated. In addition, the limitation on the NOL carryover deduction increased from 80% to 90% of net income.
- **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 services to Puerto Rico residents.

B. Normal Tax and Surtax

- The Bill reduces the corporate normal tax from 20% to 19%, and the surtax is adjusted as follows:

If net income subject to surtax is:

The tax will be:

Not greater than $75,000

5%

$75,001 to $425,000

$4,500 plus 11% of the excess over $75,000

Over $425,000

$39,500 plus 12% of the excess over $425,000

The highest corporate income tax rate is thus reduced from 39% to 31%.

C. Alternative Minimum Tax ("AMT")

- The AMT of a corporation will be the greater of $500 or 19% (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
  - Contributions to employees' health or accident plans
  - Payments for electricity and water services, subject to limitations established by the Secretary of the Treasury (the "Secretary")
  - Amounts paid for marketing and publicity
  - Amounts paid for property, contingency and malpractice insurance
  - Depreciation deduction using the straight-line method, subject to limitations established by the Secretary
  - Payments for interest, taxes, uncollectible debts, contributions to retirement plans and charitable contributions.
- If it is established to the satisfaction of the Secretary that the above limitations will cause undue hardship, the Secretary may allow the corporation to claim all ordinary and necessary expenses claimed in determining net income subject to the regular tax, provided the corporation submits an audited financial statement, an Agreed Upon Procedures Report or Compliance Attestation Report together with its income tax return.

D. New Optional Tax for Corporations Engaged in Rendering Services

- Corporations whose only source of income 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

5%

$100,001 to $200,000

10%

$200,001 to $500,000

15%

Over $500,000

20%

- To qualify for the election, the taxpayer's total gross income must be attributable to services rendered, and the payment received must have been subject to withholding tax and reported in an informative return.

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 Bill, 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 Bill 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 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 Bill 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

- The 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.

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. <u>Tax Credits</u>

A. Tax Credits Subject to Moratorium

- For taxable years beginning after December 31, 2016, 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%. In addition, any balance of this tax credit can be used for a maximum period of 4 taxable years commencing after December 31, 2016. Any remaining balance after the 4-year period cannot be claimed and will be lost.

B. Elimination of Credits - The following credits are eliminated:

- 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
- 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
- The credit for contributions to Ex-Governors' foundations or to Depositors of Archives and Keepsakes of Ex-Governors and Ex-First Ladies of Puerto Rico
- The credit for purchasing or transmitting programing made in Puerto Rico by independent producers.

C. Administrative Order OA-2017-01 issued by the Fiscal Agency and Financial Advisory Authority of Puerto Rico

- The provisions of Administrative Order OA-2017-01 are incorporated in the Code to provide that after March 7, 2017, certain tax credits no longer will be granted by any governmental agency, public corporation or municipality. Instead, the Disbursement Authorization and Tax Concession Committee ("Committee") will evaluate and grant tax credits if in the best interests of Puerto Rico. The tax credit pronouncements issued by the Committee will prevail over the provisions of the Code or special legislation.

VI. Nonprofit Entities

A. The Bill 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 31% will be imposed on any nonprofit organization exempt under Section 1101.01 of the Code that pays compensation in excess of $250,000 to any employee, director or officer for services rendered to such entity.

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, regardless of the entity's annual volume of business.

VII. 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.

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.

IX. 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 Bill 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 Bill 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.

X. Definitions

A. Limited Liability Company ("LLC")

- The Bill amends the definition of an LLC to include Series LLCs, and provides that each Series will be treated as a separate LLC for income tax purposes. In addition, the Bill 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 Bill expands the definition of a "Large Taxpayer" to include 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 Bill also 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. The Bill creates a Large Taxpayers Office within P.R. Treasury to establish audit plans, and to receive and process tax returns, forms, closing agreements and rulings, among other functions. The Bill will also impose a registration obligation for Large Taxpayers.

C. Group of Related Entities – The Bill expands the definition of "group of related entities" to include not only corporations, but also LLCs, partnerships, special partnerships, and corporation of individuals.

XI. Extension of Time to File Returns

A. For taxable years commenced after December 31, 2016, the Bill 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.

XII. 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.

XIII. 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, 2017.

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 5% 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, including the withholding exception for the first $1,500 paid during the calendar year. The Bill 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.

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.

XIV. 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.

B. Prepared Foods

- For transactions after June 30, 2018, 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

- The 4% SUT on services rendered to other merchants (business to business services) and professional designated services, will be reduced from 4% to 2% for transactions occurring from July 1, 2018 until June 30, 2019, and to 0% for transactions occurring after June 30, 2019. These reductions will apply solely to transactions in which the payment for the service and the SUT is made electronically or deposited in an account of a financial institution with operations in Puerto Rico. If the payment is not made electronically, the transaction will be subject to the 4% SUT.

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.

XV. Administrative Provisions

A. Successor Taxpayer

- The Bill 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 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

- For closing agreements entered into before January 1, 2021, the bill expands the Secretary's authority to enter into these agreements with taxpayers if the following conditions are met:
  - R. Treasury will benefit from concluding the case or controversy under consideration;
  - The taxpayer establishes valid reasons to enter into the agreement;
  - The Secretary determines that the agreement does not place the Government of Puerto Rico at a disadvantage;
  - The payments under the agreement are not for future taxes that are not yet owed; and
  - The applicable tax rate under the agreement is not lower than the applicable statutory rate.
  - Closing agreements entered into after December 31, 2020 will be subject to the existing requirements in the Code.
  - The Bill 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 (not assessed) by P.R. Treasury.

D. Government Vendors

- The Bill 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.