

June 2, 2015

Tax Update

Additional Amendments to the Puerto Rico Internal Revenue Code of 2011

Finally, after months of uncertainty as to Puerto Rico's tax landscape, House Bill No. 2482 ("HB 2482") was signed into Act No. 72-2015 ("Act 72"). As indicated in our Legal Update of [May 21, 2015](#), this law is intended to raise the revenues needed to approve a balanced budget for the Puerto Rico Government's fiscal year 2015-2016.

Act 72 amends the Puerto Rico Internal Revenue Code of 2011 ("Code") modifying income tax provisions, increasing the current sales and use tax ("SUT") and imposing a new SUT on previously exempt services.

An important change from the originally filed HB 2482 is that, despite including provisions to implement a value added tax ("VAT") in substitution of the SUT, as further explained below, a Commission for Alternatives to Transform the Consumption Tax ("CATIC" for its Spanish acronym) has been formed which may recommend that the VAT not be implemented as drafted in Act 72 and propose a different consumption tax scheme. Further information on the CATIC is below.

The following summarizes the most important amendments proposed by Act 72. For convenience, we have divided our summary into the following Sections:

- Income Taxes
- Excise Taxes
- Consumption Taxes
 - Transitory Provisions Modifying the SUT
 - Commencement of the VAT
 - Municipal SUT
- Additional Administrative Provisions

Income Taxes

Tax on Self-Employment Income

The 2% tax on self-employment income is eliminated for taxable years commenced on or after January 1, 2015.

Alternative Minimum Tax

The tentative minimum tax ("TMT") for purposes of the determination of the alternative minimum tax ("AMT") is currently the greater of:

- a. 30% of the AMT income; or
- b. The sum of:



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- i. 20% of payments to a related party and/or 20% of costs allocated from a “home office” to the Puerto Rico branch, if such amounts are attributable to a Puerto Rico business and not subject to Puerto Rico income tax in the taxable year in which they are paid or incurred (“Related-Party Charges”); and
- ii. 2% (or other applicable special rate) of the value of personal property purchased from a related party or transferred to a Puerto Rico branch from its “home office (“TMT Property Component”).

Net Operating Losses (“NOL”s) for AMT Net Income

Please note that, in the determination of the AMT income, the allowable NOL deduction has been decreased from 80% to 70% of the alternative minimum taxable income for taxable years commenced after December 31, 2014.

Related-Party Charges

Although waivers can be requested to exclude Related-Party Charges from the 20% TMT computation, the waiver, which would also exclude such charges from the 51% deduction disallowance, can only cover up to 60% of the same. In other words, 40% of Related-Party Charges will be subject to the 20% TMT computation and the 51% deduction disallowance.

TMT Property Component: The So-Called Transfer Pricing Provisions

Regarding the TMT Property Component, with respect to taxable years commenced after December 31, 2014, the generally applicable rate increases from 2% up to 6.5% as follows:

Gross Sales	Applicable Rate
\$10M ≤ but < \$500M	2.5%
\$500M ≤ but < \$1.5B	3.0%
\$1.5B ≤ but < \$2B	3.5%
\$2B ≤ but < \$2.75B	4.0%
≤ \$2.75B	6.5%

The applicable rate for the TMT Property Component with respect to vehicles subject to excise tax is reduced from 1.5% to 0.5% for taxable years commenced after December 31, 2014.

Although the TMT Property Component continues to be called a “transfer price provision” waivers of the tax when taxpayers can demonstrate adequate pricing methodologies will not be available for taxable years after December 31, 2014.

Waivers already issued will continue in effect for the taxable years covered thereunder. To the extent such waivers cover years commenced after December 31, 2014, the applicable rate will be the one set forth in the Code or in the waiver, at the option of the taxpayer. The Secretary of the Treasury (“Secretary”) is expressly prohibited from issuing administrative determinations or closing agreements in connection with the TMT Property Component for taxable years commenced after December 31, 2014.

Limitations on Deductions and Losses

Flow-throughs

For taxable years commenced after December 31, 2014, a shareholder's or partner's share in losses of corporation of individuals, special partnerships and partnerships, will be limited to 80% of such shareholder's or partner's distributive share in the aggregate net income of such entities.

NOLs

Except for entities enjoying tax benefits under the provisions of Act 73-2008, Act 74-2010, Act 83-2010, Act 20-2012 and similar prior and subsequent tax incentives legislation, Related-Party Charges will be disallowed in determining an NOL.

Further, the NOL carryover will be limited to 80% of the taxpayer's net income for taxable years commenced after December 31, 2014.

In the case of individual taxpayers reporting a business loss for 3 consecutive years, the amount of the loss to be carried over to the third taxable year that commences after December 31, 2014 and subsequent taxable years, will be limited to 50% of the loss incurred in such year. For purposes of applying this limitation, each business will be treated as a separate business and the rental of real property will not be considered a business.

Charitable Contributions

For taxable years commenced after December 31, 2014, charitable contributions by individuals will only be deductible if made to nonprofit entities qualified by the Secretary as such. In order to be qualified under the Code, a nonprofit organization will be required to demonstrate that it renders services in Puerto Rico.

Expensing Related-Party Charges

No deduction will be allowed for payments made to related parties not engaged in a trade or business in Puerto Rico if such payments are not subject to taxation or withholding in Puerto Rico.

Further, expenses incurred or paid in connection with services rendered by a nonresident person are disallowed when the taxpayer receiving such services has not paid the SUT or VAT, as applicable, on such services. Similarly, depreciation associated with a good or taxable item will be disallowed if the taxpayer has not paid the SUT or VAT on such item, as applicable.

Capital Losses

The amount of capital losses corporations will be allowed to offset against capital gains is reduced from 90% to 80% of such gains for taxable years commenced after December 31, 2014. For individuals, the 90% limitation is eliminated and they will be able to fully offset capital losses against capital gains.

For taxable years commenced after December 31, 2014, the capital loss carryover is limited to 80% of capital gains generated in the taxable year to which the loss is carried over and the capital loss shall be considered a short-term capital loss for such taxable year.

Tax Credit Moratorium

Act 72 extends the moratorium on issuance of certain tax credits until December 31, 2017.

In the case of Urban Center Rehabilitation Credits, usage will continue to be generally limited to 50% in the fiscal year of issuance and 50% in subsequent fiscal years up to December 31, 2019.

The informative return for credit holdings is required for credits issued under Act 78-1993, Act 74-2010, Act 362-1999, Sections 5(b) and 5A of Act 135-1997, Sections 5 and 6 of Act 73-2008, and Sections 4050.10, 1051.07, 1052.03 y 1052.04 of the Code.

“Large Taxpayers”

A category of “large taxpayers” is created and defined as a taxpayer that is at least one of the following:

- a. commercial bank or trust company;
- b. private bank;
- c. brokerage house;
- d. insurance company;
- e. telecommunications company; or
- f. an entity which volume of business was \$50,000,000 or more during the preceding taxable year.

For taxable years commenced after December 31, 2014, “large taxpayers” shall file their income tax returns with an office to be designated by the Secretary or by electronic means, if the Secretary so requires through regulation, administrative determination, circular letter or informative bulletin of general application.

Excise Taxes

Act 72 provides for exemption of the crude oil tax (“crudita”) to exempt businesses under Act 73-2008 with respect to fuel used for the cogeneration of electric power or in energy efficient equipment, properly certified by the Energy Affairs Administration. Please note that, different from other amendments affecting “exempt businesses” this exemption is limited to businesses holding a grant under Act 73-2008, not predecessor or successor acts.

This exemption is effective July 1, 2015.

Consumption Taxes

But for the creation of the CATIC and the potential for a recommendation to implement a different consumption tax scheme, Act 72 substitutes the current SUT for a VAT. The transition would be carried out in stages, first with changes to the SUT that would generally take place either from July 1, 2015 or October 1, 2015, and afterwards with the introduction of the VAT from April 1, 2016. Please note that the Secretary is empowered to delay the effectiveness of the VAT based on the recommendations from the CATIC.

Below is a summary of the most relevant aspects of the SUT changes in Subtitle D of the Code and the VAT provisions that would be part of the new Subtitle DD of the Code.

Transitory Provisions Modifying the SUT

Act 72 increases, effective July 1, 2015, the current 7% combined SUT rate to 11.5% for a period of 9 months, as we transition to a state level 10.5% VAT scheduled to become effective on April 1, 2016. The 11.5% combined SUT will be comprised of a 10.5% state level SUT and a 1% municipal level SUT.

In addition, effective October 1, 2015, a 4% SUT is imposed on “services rendered to other merchants” and designated professional services. Note that such tax is imposed on services currently exempt from SUT. Those business-to-business services currently subject to SUT at a 7% rate will continue to be subject to SUT at the increased 11.5% rate effective July 1, 2015.

Because the 4% tax on services is imposed under the currently applicable SUT, it will not be creditable. Merchants providing designated professional services will be allowed to file SUT returns on a cash basis.

In addition, the Code provides that, in the case of the rendering of services subject to the SUT by a nonresident person to a resident of Puerto Rico, the person responsible for the payment of the SUT shall be the person receiving the service in Puerto Rico.

For periods after June 30, 2015, resellers can take a credit for SUT paid on inventory items of up to 100% of the SUT liability reflected in the corresponding SUT return.

During the transition period, a Municipal SUT of 1% will continue to be imposed by municipalities. The 1% municipal SUT is not imposed on services rendered to other merchants nor designated professional services; thus they will only be subject to the state level 4% SUT.

Sales covered by contracts and bids related to taxable items which are executed or awarded prior to July 1, 2015, will be subject to the SUT rate applicable to such items as of June 30, 2015. This grandfather provision will apply to contracts related to the rendering of taxable services if payment under such contracts is received prior to July 1, 2015. A special registry is mandated in the case of construction contracts. Registration must be made within 90 days from May 30, 2015.

Commencement of the VAT

In general

Effective April 1, 2016, (i) the introduction to Puerto Rico of taxable items and (ii) the sale or transfer of taxable goods and services and combined transactions (“Taxable Transactions”) will be subject to either a 10.5% or 0% VAT (in addition to a 1% municipal SUT as applicable under Subtitle D of the Code).

A 0% VAT (“Zero-rated”) will apply to the following Taxable Transactions occurred after March 31, 2016:

- The sale of goods for export,
- The rendering of export services, and
- The sale of raw materials and equipment for manufacturing to a duly certified manufacturing plant.

Exempt Items and Transactions

The following items and transactions will be exempt from the VAT:

- Financial services, except those in which bank charges apply;

- The import and sale of prescription medicines including bottles, security caps, labels and bags inherent to the dispatch of prescription medicines;
- Import and sale of items for the treatment of health conditions and a vast range of medical devices;
- Import and sale of items and equipment for physical or physiological deficiencies when the purchaser can acquire them at zero-rate;
- The import of any item, the sale of any good or any service rendered that is paid or reimbursed by Medicare, Medicaid or the Puerto Rico Government's health insurance;
- Items introduced to Puerto Rico by, and the sale of goods and services to, agencies or instrumentalities of the United States Government, any of its states, District of Columbia or the Puerto Rico Government;
- Import and sale of gas, aviation fuel, gas oil, diesel oil, crude oil, partially elaborated and finished products derived from oil and other hydrocarbon mixtures to which excise taxes apply;
- Lease of property subject to the room tax;
- Import and sale of food and food ingredients;
- Sale of goods purchased with funds received by the Federal Nutritional Assistance Program (PAN, for its Spanish acronym) or the Special Supplemental Nutrition Program for Women, Infants and Children (WIC);
- Sale of real property;
- Lease of real property that constitutes the principal residence of the lessor, including student and elderly housing;
- Commercial leases, including payments for office or sales spaces, storage and parking;
- The cost-free transfer of goods and the services rendered by not-for-profit entities that have received tax exemption from the Puerto Rico Department of the Treasury ("Treasury");
- Import of machinery, medical/surgical materials, items, equipment and technology by, and their sale to, any hospital unit with an Exempt Purchases Certificate;
- Agriculture items imported by or sold to bona fide farmers;
- Occasional sales by churches and religious organizations;
- Import and sale of goods by a merchant dedicated to a tourist business with an Exempt Purchases Certificate;
- Educational services and child care services;
- Import and sale of printed books;
- Import and sale of vehicles, boats and heavy equipment subject to excise taxes;
- Health and hospital services including veterinary services; and
- The rendering of contingent fee legal services in medical malpractice cases or claiming physical and mental anguish.

VAT Payment and Reporting

i. Items Introduced to Puerto Rico

Similar as under the current SUT regime, merchants will generally pay the applicable VAT prior to taking possession of imported items. Bonded importers may, however, remit their VAT payment along with the Tax on Imports Monthly Return, described below, on or before the 10th day of the month following the introduction of the items. VAT payments on items imported by air carriers or electronic means will be remitted with the Tax on Imports Monthly Return as well.

ii. Taxable Transactions

The VAT will generally be paid along with the VAT Monthly Return, described below, on or before the 20th day of the month following the Taxable Transaction.

iii. Accounting Methods under the VAT

As under the SUT regime, for VAT purposes a merchant must use the same accounting method used for income tax purposes. However, an important exception is made available for merchants that render designated professional services. In these cases, merchants will be able to use the cash basis method of accounting for VAT purposes.

iv. Reporting

The following declarations and returns will be filed with Treasury:

- *Imports Declaration* – to be filed by all importers of items;
- *Tax on Imports Monthly Return* – to be filed by all importers of items on or before the 10th day of the month following the introduction of items to Puerto Rico. Such return shall contain detailed information of all items imported to Puerto Rico by any means during the prior month;
- *VAT Monthly Return* – to be filed on or before the 20th day of the month following the collection of VAT. Such return shall include the amount of VAT to be remitted and the amount of credit to be claimed. Small Merchants will not be required to file this return;
- *Annual Declaration for Small Merchants* – to be filed within 60 days of the Small Merchant's income tax return due date including any extension of time to file. The declaration shall contain the total value of the goods and services sold during the preceding taxable year.

Fiscal Vouchers

In general, purchasing merchants will be able to request a Fiscal Voucher from the selling merchant that withheld VAT. The Fiscal Voucher shall be requested within 30 days of receipt of the goods or services and shall be issued by the selling merchant within 30 days from the request. The Fiscal Voucher shall include information such as: name, address and merchant's registration number of the seller and purchaser, date, sequence number, description of the goods, sales value, VAT amount and total invoice amount.

Debit Notes and Credit Notes will be issued by the selling merchant in cases where the sales value of the goods described in a Fiscal Voucher is adjusted upward or downward, respectively.

VAT Credit and Refund of Overpayments

Merchants, except Small Merchants, may claim a credit in the VAT Monthly Return for the VAT paid during a particular month.

The following amounts may be credited:

- VAT paid upon import of items to Puerto Rico as reported in the Tax on Imports Monthly Return that are directly or indirectly related to the sale of taxable goods or services, whether subject to the 10.5% tax rate or Zero-rated;

- VAT paid on purchases of goods and services as reflected in the Fiscal Vouchers, that are directly or indirectly related to the sale of taxable goods or services;
- VAT paid by a merchant for receiving services from a non-PR resident as reflected in a VAT Monthly Return.

Special rules apply in cases in which the VAT paid cannot be traced directly to a particular good. In these cases, the VAT to be credited will be limited to the amount equivalent to the proportion of total taxable sales over total sales. Exceptions to this rule are as follows:

- Consumer sale of goods declared exempt by reason of being purchased with funds received by the Federal Nutritional Assistance Program (PAN, for its Spanish acronym) or the Special Supplemental Nutrition Program for Women, Infants and Children (WIC) will count as taxable sales, provided they were subject to import VAT.
- merchants that are principally engaged (70% or more) in the sale of:
 - prepared foods and supplies;
 - prescription drugs, medicines, or items for the treatment of health conditions; and
 - motor vehicles

will be able to credit the VAT up to the amount to be deposited in a monthly VAT Return.

An overpayment of up to \$10,000 generated due to the excess of adjustments or credits may be applied in the VAT Monthly Return of the month following the month in which the overpayment arises. A refund may be requested by merchants that accumulate an overpayment in excess of \$10,000 provided that such merchant is an Eligible Merchant, described below, or the merchant has generated overpayments for three consecutive months.

The Secretary must issue its determination denying or approving such refund no later than 30 days after the request is filed. Should the request be approved, it shall be refunded to the merchant no later than 5 business days after its approval date.

Merchants' Registry, Exemption Certificates and Eligible Merchant Certificates

A merchant's registration certificate ("MRC") similar to the one under the current SUT regime will be required for any person conducting a business in Puerto Rico. Small Merchants may, however, request a Small Merchant Registration Certificate in lieu of the MRC.

The proposed VAT provisions include the following two exemption certificates that will relieve a merchant from paying the VAT:

- Exempt Purchases Certificate ("EPC") – will allow a person to import items or purchase goods and services exempt from the VAT. The EPC will be available to the United States Government and any of its states, the District of Columbia, the Puerto Rico Government, hospital units, merchants dedicated to a tourism business and bona fide farmers.
- Manufacturing Plant Exemption Certificate – will allow Manufacturers to import manufacturing items and purchase goods and services Zero-rated.

An Eligible Merchant Certificate will be available to merchants whose annual sales volume during the 3 years preceding its determination exceeds \$500,000 and 80% of their total sales are Zero-rated. Such certificate will allow the Eligible Merchant to claim a refund for excess VAT payments.

Municipal SUT

Under the current SUT regime municipalities are required to impose a SUT of 1% using the same base, exemptions and limitations provided therein. Upon the effectiveness of the VAT, the SUT of 1% would continue to be imposed by municipalities. A municipal VAT would not be imposed. Instead, Treasury would be required to allocate 0.5% of the 10.5% VAT to municipalities and deposit such amounts with the Municipal Development Fund, Municipal Redemption Fund and Municipal Improvements Fund, which are administered under the Municipal Administration Fund Act.

Additional Administrative Provisions

Demand Deposit Accounts

A much criticized measure resurfaced with the enactment of Act 72. Merchants, whether or not having the obligation to deposit the SUT or VAT, will have to open demand deposit accounts where the SUT or VAT will be deposited. The Secretary is empowered to debit funds from this account. The Secretary shall issue regulations for this process.

Interagency Portal for the Oversight of Individual and Corporate Tax Responsibility

Act 72 creates a data repository to be managed by Treasury where information “issuing agencies” such as Treasury, the Property Registry, the Department of State, the Department of Natural and Environmental Resources, the Department of Transportation and Public Works, the Office of the Commissioner of Financial Institutions, the Municipal Revenues Collection Center, and municipalities, shall share taxpayer information.

Corporations and individuals that sell, donate, divide, finance, swap, inherit, segregate, group, transfer, or otherwise dispose of real estate shall file an informative return with the Secretary including an appraisal and a property plan with coordinates. No exemptions or benefits shall be allowed to the property by Treasury, the CRIM or municipalities in the absence of such filing. The Secretary shall issue regulations for this process.

Commission for Alternatives to Transform the Consumption Tax (“CATIC” for its Spanish acronym)

The CATIC was formed as an Administration compromise with VAT detractors allowing for the possibility of devising a different taxation scheme. It will be formed by the Secretary as president, the Secretary of Justice, the Director of the Office of Management and Budget, the Executive Director of the Ports Authority, two House representatives, two Senate representatives to be appointed by the presidents of each body, two private business representatives and a labor representative to be appointed by agreement among the presidents of the House of Representatives and the Senate.

The CATIC has 60 days from the enactment of Act 72 to study alternate consumption tax systems, including a general excise tax (such as the one repealed in 2006) and

issue recommendations for legislation to that effect. If the recommendations from the CATIC include transforming the current consumption tax into a general excise tax, legislation to such effect must be drafted no later than 10 days from the rendering of the CATIC report.

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