

May 6, 2020

## Approval of Technical Amendments to the Puerto Rico Internal Revenue Code of 2011

On April 16, 2020, the Government of Puerto Rico enacted Act 40-2020 (“Act 40”) incorporating various technical amendments to the Puerto Rico Internal Revenue Code of 2011, as amended (“Code”), the Puerto Rico Incentives Code (“Incentives Code”), and other fiscal laws. Act 40 further created the Police Retirement Trust Act and the Private Capital Funds Act.

Through the enactment of Act 40, additional tax relief measures are afforded to taxpayers beyond those already established under Act 257-2018, also known as the Tax Reform Act (“Act 257”). These measures include a 3% reduction on income tax for individual taxpayers whose gross income does not exceed the \$100,000 threshold, in addition to the 5% reduction on individual income tax already afforded under Act 257.

Tax relief measures for small and medium businesses include the elimination of the sales and use tax on business-to-business service transactions for businesses with a volume of sales of \$300,000 or less. Additionally, the requirement to file audited financial statements has been waived for taxpayers with a volume of business below \$10,000,000 for taxable years beginning after December 31, 2019.

The following is a summary of some of the changes introduced by Act 40.

### Puerto Rico Internal Revenue Code

#### *Income Taxes*

#### Increase of Audited Financial Statements Threshold

For taxable years commenced after December 31, 2019, taxpayers will be required to include financial statements audited by a CPA licensed in Puerto Rico if their volume of business is \$10,000,000 or more. Taxpayers below such threshold but with a volume of business of at least \$3,000,000, may include any of the following with their income tax return: (1) audited financial statements, (2) an agreed-upon procedure report or (3) a compliance attestation report prepared by a CPA licensed in Puerto Rico.

#### Alternative Minimum Tax

For taxable years commenced after December 31, 2018, a deduction for AMT purposes will be allowed with respect to payments for services directly related to a trade or business, including rent, telecommunication, internet access, advertising, marketing, insurance and any other payment duly informed in the applicable



For more information on this Legal Update, please contact:

#### **Carlos E. Serrano**

[cserrano@reichardescalera.com](mailto:cserrano@reichardescalera.com)

787.777.8815

787.406.5257

#### **Alba I. Joubert Pereira**

[ajoubert@reichardescalera.com](mailto:ajoubert@reichardescalera.com)

787.777.8825

787.432.8356

#### **Ernesto J. Zayas García**

[ezayas@reichardescalera.com](mailto:ezayas@reichardescalera.com)

787.777.8813

787.354.4757

informative return. Amounts paid for electric power and water and sewage will be deductible for AMT purposes without having to be reported in an informative return.

Taxpayers have the option of submitting with their income tax return an audited financial statement with the required supplemental information, an agreed upon procedures report or an attestation report, in order to be able to take, for alternative minimum tax purposes, the same deductions available for regular income tax purposes.

#### Transfer Pricing Study to Avoid Related-Party Expense Disallowance

Section 1033.17(a)(17) of Code disallows deductions for 51% of the expenses incurred by a taxpayer and paid or to be paid to: (i) a related person not engaged in a trade or business in Puerto Rico, if such expenses are attributable to the conduct of a trade or business in Puerto Rico and not subject to tax or withholding at source under the Code in the taxable year in which they were incurred or paid, or (ii) a home office located outside of Puerto Rico, by a foreign corporation engaged in trade or business in Puerto Rico through a branch, when computing the net taxable income (“Disallowance Rule”). As a result of amendments introduced by Act 257, for taxable years commenced after December 31, 2018, taxpayers may avoid the application of the Disallowance Rule by filing, with their income tax return, a transfer pricing study prepared pursuant to Section 482 of the United States Internal Revenue Code of 1986, as amended, which includes the Puerto Rico operations. The Secretary of the Treasury (“Secretary”) is expected to issue regulations, circular letters or other administrative pronouncements regarding the implementation of this requirement.

Act 40 eliminates the requirement included in Act 257 to the effect that the transfer pricing study had to be revised by the United States Internal Revenue Service. It also eliminates the reference to transfer pricing studies prepared following OECD standards.

#### Informative Returns for Advertising, Insurance Premiums, Telecommunication, Internet Access and Cable or Satellite Television Services

Compliance with the issuance of this informative return is deferred for payments received after December 31, 2019 and it is clarified that the default issuance of such informative return will be limited to commercial clients.

Taxpayers who make payments related to their business through a non-commercial account and who will not submit audited financial statements or an agreed upon procedures report to support the related expense, may request the issuance of an informative return to the service provider. Such request must be made by January 31<sup>st</sup> of the year following the year the payment was made for the informative return to be issued on or before February 28<sup>th</sup> of such year. The service provider will have 45 days from a taxpayer’s request to issue the informative return.

For taxable years commenced during calendar year 2019, taxpayers not submitting audited financial statements, an agreed upon procedures report or any other documentation allowed to justify the underlying expense, may choose to file an informative return. In these cases, the service providers will be required to provide such taxpayers with their name, address and employer identification number.

#### Non-Applicability of Penalties for Failure to File Certain Informative Returns

No penalties will apply with respect to the following informative returns, even if filed after their corresponding due date: (1) informing payments of less than \$500, (2)

filed to substantiate expenses for purposes of alternate basic tax or alternative minimum tax deduction purposes, (3) informing payments for services rendered by nonresidents outside of Puerto Rico, (4) professional membership dues, (5) electric power and water and sewage services, (6) continuing education, (7) maintenance dues paid to condominium or residents' associations, (8) telecommunication, internet access and cable or satellite television, or a combination thereof, advertising and insurance premiums.

### Reorganization-Like Treatment for Partnerships, Special Partnerships and Corporations of Individuals

Certain exchanges made as part of transactions between partnerships, special partnerships and corporations of individuals will be eligible for non-recognition treatment to the extent such transactions would have constituted a tax-free reorganization under the Code had the entities involved been corporations. Also, Act 40 confirms that the liquidation of a special partnership or corporation of individuals followed by a contribution of all the assets and liabilities of the liquidated entity to a new or existing partnership, will be treated as a tax-free exchange of such assets and liabilities for interests in the transferee partnership.

### Effective Date of Partnership Treatment Election in LLC Conversions

The Code now provides that, in the case of corporations converted into limited liability companies ("LLC") under the Puerto Rico Corporations Act or analogous foreign legislation, the election of such LLC to be treated as a partnership for Puerto Rico income tax purposes will be the first day of the taxable year during which the conversion became effective.

### Capital Loss Limitation Increased to 90%

For taxable years commenced after December 31, 2018, capital loss carryovers will be limited to 90% (instead of 80%) of the capital gains realized during the taxable year to which the losses are carried over.

### Introduction of Secondary Tax-Exempt Entities Concept

Tax exempt status of primary entities is extended to secondary entities subject to the following: (1) potential secondary entities are subsidiaries, related to, or under close supervision of one or more primary entities, (2) the primary entities are described in paragraphs (1) and (2) of Section 1101.01 of the Code, (3) the secondary entities are engaged exclusively in activities that form an integral part of the primary entities' operations (including managerial and administrative services, investment management, etc.) and (4) the activities in which the secondary entities engage could have been validly undertaken by the primary entities.

### *Sales and Use Taxes*

#### Expansion of B2B Exemption

Effective July 1, 2020, business-to-business services where the service provider's volume of business does not exceed \$300,000, will not be subject to sales and use taxes ("SUT"). This amount is increased from \$200,000.

#### Cash Basis Method of Accounting for Merchants Engaged in Construction Projects

With respect to transactions taking place after June 30, 2020, merchants engaged in commercial, industrial or residential construction projects may use the cash

basis method of accounting for SUT purposes.

## Marketplace Provisions

Act 40 amends the Code to incorporate the concept of marketplace nexus, in addition to the click-through nexus and affiliate nexus provisions that had already been incorporated into our SUT regime. Pursuant to these provisions, if a marketplace facilitator is engaged in at least one of a group of activities listed in the Code, then it shall be responsible for withholding and remitting the SUT in the transactions it facilitates for the marketplace seller.

The term “marketplace facilitator” is defined as all persons, including related persons or entities, that facilitate the sale of tangible personal property, specific digital products or taxable services that meet certain requirements such as (1) owning, renting, making available or operating any electronic or physical infrastructure or any property, process, method, copyright, registered mark or patent that connects the marketplace sellers with the purchasers with the purpose of realizing retail sales of tangible personal property, specific digital products or taxable services and (2) providing payment processing services in the retail sale of tangible personal property, specific digital products or taxable services.

The term “marketplace seller” is, in turn, defined as a seller that realizes retail sales through any type of physical or electronic marketplace that is property of, operated or controlled by a marketplace facilitator, even if such seller did not have the obligation of collecting and remitting the sales and use tax if the sales had not been realized through such marketplace.

The above amendments became retroactively effective on January 1, 2020 upon the approval of Act 40. Nonetheless, House Bill 2482 seeks to change such effective date to September 30, 2020, while granting the Puerto Rico Department of the Treasury the authority to defer the implementation of the marketplace provisions for a period of up to 3 months.

## **Incentives Code**

### *Buy Back of Tax Credits*

Act 40 amends the Incentives Code in order to provide an option to exempt businesses with transferable tax credits of either using the same to satisfy their income tax liability or selling them in the open market. Generally, such exempt businesses will now also have the option to transfer said credits to the Government of Puerto Rico in exchange for a cash refund ranging from 80% to 90% of their face value.

The exempt business’ election is subject to acceptance by the Secretary and there is a cap of \$40,000,000 per fiscal year for paying these refunds. Upon acceptance by the Secretary and after discounting any outstanding tax liability of the exempt business at such time, the cash refund is to be paid in equal quarterly installments during a term not to exceed 3 years from the date the taxpayer’s election was made.

## **Other**

### *Limitation of Special Tax on Certain Services Rendered to Government*

The special 1.5% tax imposed pursuant to Act 48-2013 in connection with contracts for the rendering of certain services to the Government of Puerto Rico is eliminated with respect to contracts in effect as of April 1, 2020 in the case of

services rendered by individuals which aggregate contract amount does not exceed \$300,000.

*Individual Resident Investors*

The fee payable by Act 22-2012 grantees upon the filing of their annual report is increased from \$300 to \$5,000.

\*\*\*

This communication is for information purposes only and does not constitute legal advice. This communication may be based on authorities that are subject to change and is not a substitute for professional advice or services. You should consult a qualified professional advisor before taking any action based on the information herein. This communication does not create an attorney-client relationship between Reichard & Escalera and the recipient.

[Unsubscribe.](#)