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2018 PUERTO RICO TAX REFORM

On April 16, 2018, the Governor of Puerto Rico filed with the Puerto Rico House of Representatives and the Puerto Rico Senate a proposed Bill which seeks to amend the 2011 Puerto Rico Internal Revenue Code, as amended (PR Code) in order to set forth the administration's New Tax Model for Puerto Rico. As expressed by the Governor, the New Tax Model is based on best practices identified from other jurisdictions with the main objectives of simplifying tax compliance and to incentivize economic growth in Puerto Rico.

Following please find a summary of the proposed changes as introduced by House of Representatives Bill 1544 (H.B. 1544):

INDIVIDUALS:

Deductions:

- The Personal exemption and the dependent deduction are repealed. In lieu, of the dependent deduction, resident individuals with adjusted gross income of one hundred thousand ($100,000) dollars or less can claim a dependent tax credit of two hundred ($200) dollars per dependent up to a maximum credit of six hundred ($600) dollars.
- Mortgage interest expense deduction is further limited to thirty (30%) percent of Adjusted Gross Income up to a maximum mortgage interest deduction of twenty thousand ($20,000) dollars per year.
- IRA contributions must be made (contributed) on or before the last day of the calendar year in order to be deductible for such year.
- Earned Income Tax Credit (EITC): A new EITC refundable credit will be granted to those Puerto Rico resident taxpayers with earned income, ranging from three hundred ($300) dollars to two thousand ($2,000) dollars depending on the taxpayers marital status, number of dependents and level of adjusted gross income.

Regular Tax Rates: Regular Individual Tax Rates for taxable years commencing after December 31, 2018:

If net taxable income subject to tax is:	The tax shall be:
Up to $12,500	0%
In excess of $12,500 but not more than $21,000	.9%
In excess of $21,000 but not more than $45,000	$77 plus 9% of excess over $21,000
In excess of $45,000 but not more than $58,000	$2,237 plus 19% of excess over $45,000
More than $58,000	$4,707 plus 31% of excess over $58,000

A five (5%) percent gradual adjustment applies on the excess of net taxable income over two hundred thousand ($200,000) dollars, not to exceed thirteen thousand two hundred and seventy-three ($13,273) dollars.

Alternative Basic Tax (ABT): ABT rates are adjusted as follows:

If the alternative basic net taxable income is:	The tax shall be:
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%
More than $250,000	24%

Furthermore, for ABT purposes, there are new limitations regarding which expenses will be allowable (deductible) to arrive at Alternative Basic Net Taxable Income. However, those individual taxpayers who file an Agreed Upon Procedure Report or Compliance Attestation with the Secretary of the Treasury (Secretary) may claim as a deduction all ordinary and necessary expenses related to its trade or business.

H.B. 1544 re-establishes the credit for ABT paid in prior years.

Optional Tax Regime for Self-Employed Individuals rendering Services:

Flat Tax Rates: Self-Employed Individuals whose only source of revenue arises from rendering Services (Service trade or business) which are subject to withholding at source, may elect to pay a flat income tax on its gross income subject to certain conditions. The optional flat gross income rates are as follow:

If the gross revenue is:	The tax shall be:
Not more than $100,000	5%
In excess of $100,000 but not more than $200,000	10%
In excess of $200,000 but not more than$500,000	15%
More than $500,000	20%

CORPORATIONS:

Normal Tax and Surtax Rates: The normal tax rate is reduced to nineteen (19%) percent from (20%) percent. Furthermore, the surtax rates are adjusted as follows:

If net surtax income is:	The surtax shall be:
Not more than $75,000	5%
More than $75,000 but not more than $425,000	$4,500 plus 11% of the excess over $75,000
More than $425,000	$39,500 plus 12% of the excess over $425,000

Alternative Minimum Tax (AMT): The tax rate is reduced to nineteen (19%) percent or twenty-three (23%) percent to those corporations with volume of business of $3,000,000 or more. However, the AMT is the higher of five hundred ($500) dollars or the tax resulting from imposing the aforesaid rates to the Alternative Minimum Net Taxable Income.

Similar to the ABT provisions for individuals, H.B. 1544 introduces new limitations for AMT purposes applicable to corporate taxpayers, regarding which expenses will be allowable (deductible) to arrive at Alternative Minimum Net Taxable Income. Consequently, those corporate taxpayers that file Audited Financial Statements, an Agreed Upon Procedure Report or Compliance Attestation with the Secretary may claim as a deduction all ordinary and necessary expenses related to its trade or business to arrive at Alternative Minimum Net Taxable Income.

Optional Tax Regime for Corporate Taxpayers engaged in rendering Services:

Flat Tax Rates: Corporate taxpayers whose only source of revenue arises from Service trade or business which are subject to withholding at source, may elect to pay a flat income tax on its gross income subject to certain conditions. The optional flat gross income rates are as follow:

If the gross revenue is:	The tax shall be:
Not more than $100,000	5%
In excess of $100,000 but not more than $200,000	10%
In excess of $200,000 but not more than $500,000	15%
More than $500,000	20%

PARTNERSHIPS:

Further, H.B. 1544 introduces several changes applicable to Partnerships as follow:

- Partnership Losses: The amount allowed as a partner's loss will be limited to the partner's basis, which will consider the partner's distributable share including charitable contributions and taxes paid or accrued to foreign countries.
- Continuation of Partnership Entities: The sale or exchange of fifty (50%) percent or more of the interest in the Partnership will not be considered a Technical Termination.
- Sale of Partnership Interest: Gain from the sale of Partnership interest will be Puerto Rico source income to the extent the deemed sale of all of its Partnership assets at fair market value would be considered Puerto Rico source income.

DEDUCTIONS (APPLICABLE TO ALL TAXPAYERS):

In addition, to the changes highlighted above, H.B. 1544 introduces various amendments to the 2011 PR Code to modify the following deductions as follow:

- New Relief Provision for the Fifty-one (51%) percent disallowance on allocated expenses: Amounts paid or incurred to related persons (including between a branch and its home office) or partners, continue to be subject to the 51% disallowance **unless** the taxpayer files with the Secretary a Transfer Pricing Report pursuant to the provisions of US IRC Section 482.
- Depreciation: A business with a volume of business of less than $3,000,000 may depreciate machinery and equipment, furniture and fixtures or any other asset used in the trade or business, except for real property, using a useful life of two (2) years.
- Meals and Entertainment and Travel: The disallowance for meals and entertainment increases to seventy-five (75%) percent. In addition, the deduction for Travel expenses is limited to fifty (50%) percent of the amounts paid.
- Indemnification Payments in connection with harassment cases: Payments will now be fully disallowed.
- Wages Paid to College Students: Employers may claim as a deduction, one hundred and fifty (150%) percent of compensation paid to college students, if certain conditions are met.
- Losses: The net operating loss deduction (NOL) increases from eighty (80%) percent to ninety (90%) percent. Furthermore, the amount allowed for losses from Pass-through entities against the income from other Pass-through entities increases from eighty (80%) percent to ninety (90%) percent.

CHANGES TO GENERAL DEFINITIONS:

Large Taxpayers: The definition of a Large Taxpayer was expanded to include those taxpayers that enjoy the benefits of a Tax Exemption Grant. Further, H.B. 1544 creates and assigns the Large Taxpayer Office the task of monitoring and supporting Large Taxpayers on tax matters such as audits and closing agreements, among other matters. Large Taxpayers are required to complete a Registration before the new Large Taxpayer Office.

Group of Related Entities: The definition is being further expanded to include within the definition of related entities, those entities treated as Partnerships, Special Partnerships and Corporation of Individuals.

REQUESTS FOR EXTENSION OF TIME TO FILE:

H.B. 1544 seeks modify the Automatic Extension of Time to File Income Tax Returns. The current three (3) month extension is amended in order to grant an automatic six (6) month extension of time to file a return. This amendment applies for taxable years commencing after December 31, 2016.

AUDITED FINANCIAL STATEMENTS:

ABT and AMT Limitations: In connection with the changes highlighted above in the context of the new expense deductibility limitations for ABT and AMT purposes, those taxpayers not required to file Audited Financial Statements (taxpayers with less than three (3) million in volume) may choose to file an Agreed Upon Procedure Report or Compliance Attestation in order to fully deduct the expenses and to request a partial waiver certificate on services rendered.

Non-for-Profit Organizations: Non-for-Profit Organizations with unrelated business income (UBI) exceeding $3,000,000, will now have to file Audited Financial Statements with their corresponding tax returns. Furthermore, H.B. 1544 establishes a new special tax when compensation for services paid to employees, directors and officials exceeds two hundred and fifty thousand ($250,000) dollars.

Uncertain Tax Positions: Those Taxpayers who are required to file Audited Financial Statements must now file a schedule detailing the Uncertain Tax Positions (UTPs) with their corresponding income tax returns.

WITHHOLDING AT SOURCE AND INFORMATIVE RETURNS:

Services Rendered: The withholding at source rate increases from seven (7%) percent to ten (10%) percent. In addition, the partial waiver certificate increases from three (3%) percent to five (5%) percent. Consequently, various exceptions are repealed including the withholding exception applicable for first one thousand five hundred ($1,500) dollars paid during the calendar year. Further, H.B. 1544 establishes new Quarterly Reconciliation Statements.

Informative Returns: Failure to prepare informative returns to report payments made during the year, as required by the PR Code, will prevent the taxpayer from claiming them as a deductible expense.

New Informative Return Requirements for Payment Card and Third Party Network Transactions: A Payment Settlement Entity (PSE) must issue an informative return to a Participating Payee (PP) reporting the gross amount of payments settled thru credit or debit card and third-party network organizations during the calendar year. For these purposes, a PSE is an entity that has the obligation to settle credit or debit cards payments and to make payments to a participating payee of a third-party network organization. Further, a PP is a merchant that accepts card payments and from third-party network organizations.

SALES AND USE TAX:

Business to Business (BtoB): H.B. 1544 seeks to reduce the current four percent (4%) sales and use tax applicable to Designated Professional Services and BtoB transactions to a two (2%) percent SUT. This reduction will only be applicable to Merchants that pay for the services described above via electronic means. The reduction in SUT rate will commence for transactions taking place after June 30, 2018. Further, the rate is reduced to zero for transactions occurring after June 30, 2019.

(Important Notice: the text of H.B. 1544 is not in line with the public statements made by the Governor of Puerto Rico. The Governor has stated that the SUT reduction will take place in the following phases: initially the four (4%) percent SUT will be reduced to three (3%) percent for transactions taking place on January 1, 2019 and to zero for transactions from January 1, 2020 onwards).

Prepared Food: H.B. 1544 introduces a reduction of four point five (4.5%) percent on the SUT Rate applicable to prepared foods if payment is made and processed using electronic methods.

Exemption on Rental of Real Property: The SUT Exemption related to the lease of commercial property will only be applicable if the tenant complies with the Fiscal Terminal requirements set forth by the PR Code.

E-Books: H.B. 1544 introduces a new exemption for electronic books (e-books or digital books)

ADMINISTRATIVE PROVISIONS

Successor Taxpayer: H.B. 1544 introduces the new concept of Successor Taxpayer. A taxpayer will be considered a Successor Taxpayer when such person acquires the assets or an interest in a business and maintains substantial similarity in the operations and the identity of the owners. A Successor Taxpayer becomes jointly and severally liable for taxes imposed by the PR Code with the person principally responsible for the tax.

Closing Agreements: H.B. 1544 further amends the PR Code to state that the Secretary will have the authority to execute closing agreements if the following conditions are met:

- There will be a substantial benefit for the Puerto Rico Department of The Treasury in concluding the matter in controversy;
- The taxpayer proves there are sufficient and valid reasons to formalize the closing agreement;
- The Secretary must determine that the Closing Agreement does not create a disadvantage to the government; and
- Payments are not related to future tax liabilities that are not yet owed by the taxpayer;
- The applicable tax rate is not lower than the applicable tax rate enacted within the PR Code or Special Act;

Furthermore, H.B. 1544, grants the Secretary the authorization to allow for Puerto Rico Tax purposes, the benefits granted by a Tax Treaty entered into by a foreign country with the United States.

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