O'NEILL & BORGES LLC

Income Tax Provisions of Tax Reform Proposal

TAX ALERT

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On February 11, 2015, the Puerto Rico House of Representatives filed House Bill No. 2329 (the "Bill") proposing the adoption of the "Puerto Rico Internal Revenue Code of 2015" and the transitory repeal of the Puerto Rico Internal Revenue Code of 2011, as amended (the "2011 Code"). The Bill is an administration bill and it is expected to be seriously considered for approval. Among its provisions, the Bill proposes various changes to the income tax system, including changes in the income tax rates and the creation of a new Conduit Entity that would encompass all current entities with a pass-through income tax treatment. Below is a summary of the most relevant income tax provisions included in the Bill. Please refer to the Value Added Tax Proposal Tax Alert for a summary of the proposed provisions in the Bill related to the value added tax, which would substitute the current sales and use tax system, effective January 1, 2016.

General Income Tax Provisions

- **Elimination of certain income tax exemptions** - The Bill proposes to expand the basis of income subject to Puerto Rico income tax through the elimination of certain exclusions and exemptions, including, but not limited to interest income from certain previously exempted mortgages and loans (e.g. GNMAs).

The straight line method of depreciation would be the only method allowed

- **Depreciation -** The only depreciation method that would be allowed with respect to tangible property after December 31, 2014 is the straight-line method, no flexible or accelerated depreciation method would be allowed. If a different method was used, the adjusted basis of the property as of the closing date of the last taxable year commenced before December 31, 2014 would become the basis to compute the depreciation under the straight-line method.

- **Motor Vehicles** – The deduction for the use and maintenance of an automobile will be based on the actual expenses incurred or paid to conduct a trade or business. However, the Secretary is authorized to issue a regulation or official pronouncement to allow a deduction for the use and maintenance of an automobile based on a standard mileage rate in lieu of the actual expenses incurred or paid.

- **Tax Credits** - The moratorium on the use and granting of certain tax credits is extended until the taxable years commencing before January 1, 2017.

Income Taxation of Individuals

- **Exemptions and Deductions** – Certain individual income tax exemptions and deductions would be eliminated for taxable years commencing after December 31, 2014, including the personal exemption, the exemption for dependents and the special deduction for salaried individuals.

- **Interest Paid on Qualified Residence** - The deduction for interest paid or accrued upon debts incurred by reason of loans guaranteed by the property that constitutes a qualified residence of the taxpayer for the acquisition or refinancing of such property is substituted for a partial tax credit. The amount of the credit will depend on the taxpayer's net income and is phased out at a net income of $170,000.

- The Bill proposes the following tax brackets and tax rates for taxable year 2015 and thereafter:

The Bill provides for the exclusion of the first $40,000 in the case of single individual taxpayers and $80,000 in the case of married taxpayers filing jointly

  - Single Taxpayers or Married filing separately

Net Income	Tax Rate
Up to $40,000	0%
More than $40,000 up to $125,000	15% over $40,000
More than $125,000 up to $200,000	$12,750 + 20% over $125,000
More than $200,000	$27,750 + 30% over $200,000

  - Married Taxpayers filing jointly

Net Income	Tax Rate
Up to $80,000	0%
More than $80,000 up to $125,000	15% over $80,000
More than $125,000 up to $200,000	$6,750 + 20% over $125,000
More than $200,000	$21,750 + 30% over $200,000

- **Alternative Basic Tax** - The Alternative Basic Tax on Individuals is eliminated for taxable years commencing after December 31, 2014.

- The 2% special tax on self-employed individuals is eliminated for taxable years commencing after December 31, 2014.

- **Changes in Individual Preferential Tax Rates**

Capital gains and dividends will no longer enjoy a preferential tax rate

Type of Income	Previous Tax Rate	New Tax Rate
Long Term Capital Gain	15%	30%
Interest from deposits in banking institutions	10% or 17%	Ordinary Tax Rates
Interest from bonds, notes or other	10%	Ordinary Tax Rates

obligations of certain corporations or partnerships and from certain mortgages		
Dividend distributions received by an individual (resident or nonresident) estate or trust from a PR corporation or foreign corporations with more than 80% income effectively connected with a PR trade or business	15%	30% (subject to income tax withholding at source of 15% or 20%, depending on the distribution date)
The remuneration paid by sports teams of international associations or federations	20%	Ordinary Tax Rates
Total amount received from a variable annuity contract issued by an eligible insurance company	15%	Ordinary Tax Rates
Distribution received from individual retirement account assets	17%	Ordinary Tax Rates

Income Taxation of Corporations

Corporations will be subject to a flat 30% income tax rate

- **Changes in Corporate Tax Rates**
  - For taxable years commencing after December 31, 2014, the corporate tax rate is increased from 20% to 30% but the progressive surtax is eliminated.
  - Long Term Capital Gain Corporate Tax Rate is increased from 20% to 30%.

Capital Gain Corporate Tax Rate is increased to 30%

- **Changes in the Alternative Minimum ("AMT") Tax Computation**
  - The additional tax based on gross income is eliminated.
  - The Tentative Minimum Tax for taxable years commencing after December 31, 2014 will be the higher of:
    - 25% (previously 30%) of the of the alternative minimum net income over the exempted amount, reduced by the alternative minimum foreign tax credit for the taxable year, *or*
    - 1.5% or applicable rate of the value of purchases of personal property from related parties or the transfer of personal property by a home office located outside of Puerto Rico to a branch engaged in business in Puerto Rico.
  - Any waiver issued under the AMT provision of the 2011 Code will no longer be in effect and there is no option of requesting new waivers.
  - The amount corresponding to 20% of the expenses incurred or paid to a related person attributable to the conduct of a trade or business in Puerto Rico, or representing transfer of cost or allocation of expenses of a home office located outside of Puerto Rico to a branch (if such amount are not subject to income or withholding tax under the 2011 Code in the taxable year in which incurred or paid) is no longer a component of the alternative minimum tax. However, no part of such expenses or allocation will be allowed as a deduction to determine the alternative minimum net income for taxable years commencing after December 31, 2014.

- The 51% disallowance on the deduction for expenses incurred or paid to a related person, or representing transfer of cost or allocation of expenses of a home office located outside of Puerto Rico to a branch for purposes of computing the regular net income continues in place, but the Secretary of Treasury no longer has the authority to waive this disallowance.

Income Taxation of Conduit Entities

All existing entities with flow-through income tax status would be consolidated into a new Conduit Entity taxpayer category

- A new Chapter 7 is proposed under which a new Conduit Entity would be added as a taxpayer category with flow through status. This new Conduit Entity will substitute all existing conduit entities such as special partnerships, regular partnerships (including LLCs treated as partnerships) and corporation of individuals.
- In general, owners of a Conduit Entity will be deemed engaged in a trade or business in Puerto Rico.

- **Statutory Conversion of Existing Conduit Entities**
  - No new elections to be treated as a corporation of individuals, special or regular partnerships will be allowed for taxable years commencing after December 31, 2014.
  - The following entities will have a Statutory Conversion as of the first day of the taxable year commencing after December 31, 2014 to be subject to the provisions of the new Chapter 7:
    - Any partnership or LLC taxed under the provisions of Chapter 7 of the 2011 Code.
    - Exempt investment trusts that were taxed under the provisions of Chapter 7 of the 2011 Code. Any newly organized exempt investment trusts could elect to be taxed either as a regular corporation or as a Conduit Entity.
    - Special partnerships.
    - Corporations of individuals.
  - In those cases, the entity will be treated as having transferred its assets and liabilities to its owners in liquidation followed by a contribution by the owners of the distributed assets and liabilities to the Conduit Entity. The conversion should be effective as of the last day of the last taxable year commenced prior to January 1, 2015. No gain or loss or conversion cost shall be recognized by the entity and its owners as a result of the distributions resulting from this statutory conversion.

- **Voluntary Conversion**
  - For taxable years commencing after December 31, 2014, corporations will be allowed to be treated as a Conduit Entities, except in the case of foreign corporations that have elected to be treated as regular corporations in another jurisdiction, or certain ineligible corporations.
  - <u>Conversion in Taxable Year 2015</u> – If an existing entity taxed as a regular corporation is converted into a Conduit Entity under new Chapter 7 for the first taxable year commencing after December 31, 2014, the conversion shall be considered as a deemed liquidation followed by a deemed contribution effective as of the last day of the last taxable year beginning prior to January 1, 2015. No gain or

loss shall be recognized by the entity and its owners as a result of the deemed distributions resulting from this voluntary conversion. The entity will have to apply certain adjustments to the determination of the accumulated E&P but not to the determination of gross income, certain built-in gain provisions will apply and the accumulated E&P will be considered distributed during the first two taxable years. In this case, these distributions will be subject to a 10% preferential income tax rate on dividends.

- Conversion in Taxable Years after 2015 – If a corporation elects to be treated as a Conduit Entity for taxable years commencing after December 31, 2015, the conversion will also be considered as a deemed liquidation followed by a deemed contribution. In this case, no gain or loss shall be recognized by the entity and its owners as a result of the deemed distributions resulting from this voluntary conversion but the transaction will be subject to conversion costs, certain built-in gain provisions will apply, and the accumulated E&P will be considered distributed during the first two taxable years. In this case, these distributions will be subject to a 20% preferential income tax rate on dividends.

In general, owners of a Conduit Entity will be deemed engaged in a trade or business in Puerto Rico

- **Effect of the Conversions in the Owners**
  - The owners of a special partnership or corporation of individuals will not be considered engaged in a trade or business in Puerto Rico as a result of the Statutory Conversion of the entity to a Conduit Entity under new Chapter 7, *provided that the entity does not have a change in ownership*.
  - There are no specific provisions regarding the continuity of the existence of the conduit entity and how the entity will be deemed terminated.

The Bill is currently under evaluation and may be subject to changes during the legislative process.

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