

2015 Tax Reform Act

TAX ALERT

June 2015

Act No. 72 of May 29, 2015 (the "2015 Tax Reform Act" or the "Act") amends the Internal Revenue Code of 2011 (the "2011 Code"). Among other things, the 2015 Tax Reform Act increases the existing sales and use tax and provides for a value added tax system to substitute the Commonwealth sales and use tax, subject to certain conditions described below. The Act also amends certain income tax and excise tax provisions of the 2011 Code.

Income Taxes

- Taxpayers with volume of business exceeding \$50MM or belonging to certain industries (such as banking and insurance) will be classified as "large taxpayers" and will have to file their PR income tax returns with a special office of the PR Treasury Department and follow instructions to be provided.
- The Alternative Minimum Tax computation remains under the current 2011 Code formula, which looks at the highest of 30% of alternative minimum taxable income or the sum of the following: (i) 20% of expenses incurred or paid to a related person or to the home office if the payment is not subject to PR income taxes; and (ii) a percentage of personal property purchased from related parties. For taxable years commencing after December 31, 2014, the percentage on personal property purchases from related persons will range from 2.5% to 6.5%, depending on the buying entity's volume of business. For example, the applicable percentage for a business with volume ranging between \$500MM and \$1,500 MM is 3%.

AMT on intercompany purchases is increased so that it ranges from 2.5% to 6.5% depending on the volume of business of the buying entity.

The Act limits the Secretary of the Treasury's authority to waive the 20% charge on to related party expenses so that the waiver may not exceed 60% of such expenses. **The Secretary's authority to reduce the percentage tax on purchases of personal property from related parties is eliminated for taxable years commenced after December 31, 2014.**

- The net operating loss allowed in the determination of alternative minimum tax income ("AMTI") is reduced from 80% to 70% of such AMTI.

- Net operating loss carry-overs are limited to 80% of net income. In the determination of the net operating loss, the deduction for certain payments to related parties not resident of Puerto Rico is disallowed. This disallowance is not applicable with respect to operations covered by a tax exemption grant.
- The existing 51% deduction disallowance for regular tax purposes relating to payments to related parties for services rendered outside PR and not subject to PR income taxes is maintained. The Secretary may still provide waivers or relief against this disallowance but this authority will be limited to 60% of the expenses for such services. This disallowance does not apply to operations covered by a tax exemption grant.
- Deduction for expenses related to services is disallowed if the PR person has not paid the applicable sales and use tax or value added tax under the 2011 Code. There is no exception for operations covered by a tax exemption grant.
- Deduction for the cost of property or depreciation deduction relating to property is disallowed if the applicable sales and use taxes or value added taxes have not been paid. There is no exception for operations covered by a tax exemption grant.
- In the case of corporate taxpayers, net capital losses may be carried over to future years, but the amount to be carried over is limited to 80% of capital gains for the year and the carried-over loss is to be treated as a short-term capital loss.
- The moratorium with respect to utilization of certain tax credits is extended, but this does not apply to certain tax credits including the credits under Act 73 of May 28, 2008 ("Act 73") and Act 74 of July 10, 2010 ("Act 74").
- Other income tax changes:
 - Individuals will not see a reduction in their tax rates. The gradual adjustment that was supposed to be eliminated for taxable years commenced after December 31, 2014 will remain at 5% over net taxable income exceeding \$500,000.
 - Deductions relating to losses from conduit entities will be limited to 80% of the aggregated income of other conduit entities.

Waiver of disallowance of deduction for expenses paid to related parties for services rendered outside Puerto Rico is limited to 60% of such expenses.

- To qualify as a non-profit entity and the charitable deduction to be allowed for individuals, a determination of the Secretary of the Treasury will be required.
- For individuals with net operating losses (NOLs) for three consecutive years, the amount of the loss to be carried forward in the third taxable year, which commenced after December 31, 2014, and any subsequent taxable year will be limited to 50% of the NOLs of such years.

Excise Taxes

- The applicable excise tax rate for all terrain vehicles and four tracks is increased from 10% to 11.5%.
- An exemption from the crude oil tax is added for fuel used by Act 73 exempt businesses in the cogeneration of electric power for its own use or for the use of its affiliates, and for energy efficient equipment properly certified by the Energy Affairs Administration.

Sales and Use Taxes (SUT)

- Starting July 1st, 2015, transactions currently subject to the 7% SUT will be subject to a 11.5% Commonwealth (10.5%) and municipal (1%) SUT. However, note changes below relating to SUT on certain business to business and designated professional services, effective October 1st, 2015.
- SUT will apply until March 31, 2016, unless the Secretary of Treasury extends the effectiveness of the SUT for an additional 60 days period.
- Effective for periods commencing after June 30, 2015, merchants with a Reseller Certificate may claim 100% credits for SUT paid on their inventory against SUT collected on their sales without the 75% limitation currently in place.
- Starting October 1st, 2015 and until March 31st, 2016:
 - Business to business services that are currently taxable will be subject to an 11.5% SUT.
 - Business to business services and designated professional services (e.g., accountants, lawyers, engineers) that were previously exempt from SUT will be subject to a Commonwealth SUT of 4%. No municipal SUT will apply to services subject to the 4% SUT.

Sales and use tax is increased from 7% to 11.5% effective on July 1st, 2015.

*Business to
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4% from
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to
March 31st, 2016.*

- The following services are exempt from SUT: services offered by the Government of PR, education, interest and other charges, insurance, health and hospital services, services offered by persons with a volume of business not exceeding \$50,000.
- Services rendered by members of the same group of controlled corporations will be exempt from SUT only if both the entity rendering the service and the one receiving the service are engaged in trade or business in Puerto Rico.
- In the case of services rendered by a non-resident, the recipient in Puerto Rico of the service will be the party responsible for remitting the SUT to the Treasury Department.
- Contracts and biddings entered into prior to July 1st may be protected against these increases under certain circumstances. The protection applies for 12 months or the expiration of the contract, whichever occurs first; and in the case of contracts consisting of services, if the payment for such services is made before July 1st, 2015.

Value Added Tax (VAT)

- Transactions occurring after March 31, 2016 (or the extended sunset date of the SUT), will be subject to a new VAT of 10.5% plus a 1% municipal SUT.
- VAT will apply on the introduction into PR of taxable articles, and on taxable transactions, which are: the sale in PR of goods and services by a merchant, the rendering of a service by a non-resident to a person in PR, and combined transactions.
- Exempt articles (thus, no VAT on introduction of such articles) include:
 - Articles for manufacture (raw materials and machinery and equipment for manufacture) introduced into PR by a Manufacturing Plant with a Certificate of Exemption;
 - Prescription medicines;
 - Unprepared food and food ingredients;
 - Articles for the treatment of health conditions, including medical devices;
 - Articles to provide for physical deficiencies;
 - Articles paid by, or that qualify for reimbursement by, Medicare, Medicaid and PR government health plans;
 - Articles introduced by the Government of PR or the US;

*A 10.5% VAT
will be effective
on April 1st,
2016, and the 1%
Municipal SUT
will remain.*

- Gasoline, aviation fuel, gas oil or diesel oil, crude oil, unfinished oils and end products derived from oil, and any other hydrocarbons mixture;
 - Equipment and other articles used by hospital units for the treatment of patients;
 - Articles for agriculture imported by a bona fide farmer;
 - Articles to be used in the tourism business, imported by a merchant that possess a Certificate of Exempt Purchases; except for inventory acquired principally for sale in the ordinary course of business, and certain other exceptions;
 - Printed books; and
 - Vehicles, boats and heavy equipment.
- Exempt transactions (thus, no VAT on such transactions occurring in PR), include:
 - Financial services, including insurance;
 - Sale of prescription medicines and articles for the treatment of health conditions;
 - Sale of articles to provide for physical deficiencies;
 - Sale of any good or service paid or reimbursed by Medicare, Medicaid or PR government health care;
 - Sale of goods and services to the PR or US governments;
 - Sale of gasoline, aviation fuel, gas oil or diesel oil, crude oil, unfinished oils and end products derived from oil, and any other hydrocarbons mixture;
 - The rent or lease of property subject to the room tax imposed by the PR Tourism Company;
 - Sale of unprepared food and food ingredients;
 - Sale of real property;
 - Leasing of real property for residential use or for commercial purposes;
 - Sale of articles for agriculture to a bona fide farmer;
 - Educational and child care services;
 - Sale of machinery and other materials to hospital units that possesses a Certificate of Exempt Purchases;
 - Sale of printed books;
 - Sale of vehicles, boats and heavy equipment;
 - The sale of goods to a merchant engaged in the tourism business that possesses a Certificate of Exempt Purchases; except for inventory purchased primarily for resale, and certain other exceptions; and
 - The rendering of health or hospital services.

- The sale of articles for manufacture to a Manufacturing Plant with a Certificate of Exemption and Zero Rate for Manufacturing Plants will be a taxable transaction subject to a zero rate.
- The sale of goods or services for export will be a taxable transaction subject to a zero rate.
- The following services are excluded from the definition of “services”, and therefore, not subject to VAT:
 - Services rendered to a person that is part of a controlled group of corporations or a controlled group of related entities if both related persons are engaged in trade or business in Puerto Rico;
 - Services provided by the Government of Puerto Rico;
 - Services provided as an employee;
 - Air and sea carrier services;
 - Electricity generated by PREPA or any other electricity generator plant; and
 - Water supplied by PRASA (AAA).
- In sales made to merchants, the merchant purchaser may request the merchant seller to provide within certain time-frame a Fiscal Statement which contains certain information. There is no obligation to provide a Fiscal Statement if the goods or services sold were: exempt, or sold at retail. We understand that the fiscal statement does not have to be provided to a “Small Merchant” (those with gross sales of less than \$125,000 in the prior year) but the law appears to have a technical error.
- The time line for filing and payment of the VAT follows the same deadlines and procedures as the SUT. The monthly VAT on imports return must be filed by the 10th day of the month following importations. VAT on sales must be declared by the 20th day of the month following sales.
- A credit will be available for the VAT paid on the acquisition of goods and services that are attributable directly or indirectly to taxable transactions (including zero-rated transactions). However, merchants dedicated principally to the sale of unprepared food; prescription drugs, medicines, or articles for the treatment of health conditions; or motor vehicles may claim a credit in their monthly return for the VAT paid or accrued on the acquisition of goods and services up to the total amount of VAT paid or accrued during such month.

A credit will be available for the VAT paid on inputs directly or indirectly related to the sale of taxable or zero rated goods or services.

- A credit will be allowed for VAT paid to foreign countries by related parties that render services to the PR merchant. No deduction will be allowed for income tax purposes.
- Overpayments of VAT must be credited in the following month unless there are three consecutive months of overpayments in excess of \$10,000 or Eligible Merchant (80% of its sales are zero rated), in which case a refund may be requested.
- No refunds for sales and use taxes will be allowed unless claimed before March 31st, 2016. After that date only credits will be allowed, if included in the SUT Monthly Return to be filed on or before April 20, 2016.
- The Act contemplates the possibility of the imposition of excise taxes instead of a VAT under statutes to be approved upon recommendations to be issued by a newly created Commission to Consider Alternatives to Transform Consumption Taxes. This imposition will require additional legislation.



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