

2018 Puerto Rico Tax Reform (Act No. 257 of 2018)

TAX ALERT

December 2018

The following summarizes the major provisions of Act No. 257 of December 10, 2018 (previous H.B. 1544) (the “Act”), which amends several provisions of the Puerto Rico Internal Revenue Code of 2011 (“Code”).

Definitions

- **Limited Liability Companies (“LLC”)** – Series LLC’s are included in the definition of LLC. The election by an LLC to be treated as a partnership will be due with the income tax return of the year for which it will be effective. Only non-Puerto Rico LLC’s taxable as pass-through or disregarded in the U.S. or foreign jurisdiction are required to be taxed as pass-through in Puerto Rico.
- **Large Taxpayer** – The determination must be made taking into consideration the aggregate volume of business of all the members of the group of related entities. The taxpayer may request a ruling from the Secretary to be excluded from this category. Tax exempt entities are not automatically included in definition of large taxpayers.
- **Trade or business** – The term “trade or business” in Puerto Rico will not include the trading in securities by a foreign person through an independent resident agent (e.g. broker or resident agent) or for its own benefit.
- **Group of Related Entities** – The terms “group of related entities” and “related person” will include entities other than corporations, including foreign entities.

Individuals will have a reduction of 5% of their tax liability for taxable years commencing after December 31, 2018

Taxation of Individuals

- **Regular Tax** – For taxable years commencing after December 31, 2018, individuals must determine their income tax based on the current progressive tax rates of up to 33%, but the tax liability will be 95% of that computation.
- **Alternative Basic Tax (“ABT”)**
 - For taxable years commencing after December 31, 2018, the ABT rate of individuals will be between 1% and 24% and will apply to individuals with net income subject to ABT in excess of \$25,000. The 24% rate is applicable to net income in excess of \$250,000.

- The Act amends the list of deductions that may be considered to determine the net income subject to ABT and provides that no other deductions may be claimed for that purpose.
 - The deduction for ordinary and necessary expenses of the taxpayer's trade or business will be allowed only if the taxpayer submits an Agreed Upon Procedure Report or Compliance Attestation prepared by a CPA with license in Puerto Rico.
 - The ABT provisions will not apply to individuals whose only source of income is from salaries reported in a W-2 Form.
- **Optional Tax for Self-employed Individuals**
 - Subject to certain conditions, individuals that are mainly engaged in the rendering of services will be able to elect, in lieu of the regular income tax rate and the ABT, an alternative flat tax rate ranging from 6% to 20% of gross income.
 - This option would be available for taxable years commencing after December 31, 2018, unless the Secretary postpones it for one year.

Maximum Tax Rate for Corporations is reduced from 39% to 37.5% for taxable years commencing after December 31, 2018

Taxation of Corporations

- **Regular Tax and Surtax** – For taxable years commencing after December 31, 2018, the maximum regular corporate income tax will be reduced from 39% to 37.5% (18.5% normal tax (instead of 20%) plus up to 19% surtax).
- **Alternative Minimum Tax (“AMT”)**
 - For taxable years commencing after December 31, 2018, the AMT will be the greater of \$500 or 18.5% (23% if volume of business exceeds \$3MM) of the AMT taxable income, instead of 30% under the current law.
 - To calculate AMT taxable income, taxpayers may only claim the following deductions (unless the return is accompanied by audited financial statements certified by a Puerto Rico licensed CPA or an agreed upon procedures or compliance attestation is prepared by a CPA with a Puerto Rico license):
 - 125% of salaries paid as reported in withholding statements;
 - Payments for services reported in informative returns;
 - Rental payments reported in informative returns;
 - Contributions to certain employee accident and health plans;
 - Payments for water and electricity;
 - Payments for advertising, promotion and marketing reported in informative returns;
 - Payments for property, contingency, and malpractice insurance reported in informative returns;
 - Depreciation expense using straight-line method; and
 - Deductions allowed under Sections 1033.03, 1033.04, 1033.06, 1033.09, 1033.10, and 1033.12 of the Code for interest, taxes, bad debts, contributions to pension plans, charitable contributions, and agricultural exemption deduction, respectively.

The AMT for Corporations is reduced from 30% to 23% for corporations with volume of business over \$3 million, but deductions are limited

- ***Optional Tax for Service Corporations***
 - Subject to certain conditions, corporations that are mainly engaged in the rendering of services will be able to elect to be taxed, in lieu of the regular income tax rate, surtax and the ABT, at an alternative flat tax rate from 6% to 20% of gross income.
 - This option would be available for taxable years commencing after December 31, 2018, unless the Secretary postpones it for one year.

Determination of Net Income

The 51% disallowance of expenses paid to non-resident related parties may be waived with a Section 482 transfer pricing study

- ***Exclusions for Gross Income***
 - Indemnity payments for mental anguish will be excluded from gross income.
 - Certain qualified payments to employees or independent contractors, loans to employees and distributions from qualified retirement plans or individual retirement accounts (IRAs) to assist during the recovery from a disaster declared by the Governor of Puerto Rico are excluded from gross income.
- ***Exemptions***
 - The exemption on interest from accounts in cooperatives, savings associations, commercial and mutual banks or in any other organization of a banking nature will be limited to \$100 per taxpayer (instead of \$2,000 under the current law).
- ***Deductions***
 - Taxpayers with volume of business of \$3 million or less can use a useful life of 2 years to determine the depreciation expense of certain personal property, including machinery and equipment.
 - Taxpayers can elect to claim the actual costs for the use and maintenance of vehicles or an amount based on standard mileage rate. The standard mileage rate shall not be below the rate established by the Internal Revenue Service.
 - Charitable contribution deduction will be disallowed if the charitable organization does not provide services in Puerto Rico.
 - The 51% disallowance of expenses or costs paid to non-resident related parties or home office will be waivable if taxpayer submits a transfer pricing study in accordance to the requirements under Section 482 of the U.S. Internal Revenue Code or the Organisation for Economic Co-operation and Development (OECD) when none of the members of the group of related entities do business in the United States.
 - Meals and entertainment expense deduction will be limited to 25% of actual expenses incurred or paid (instead of 50% under current law), up to a maximum of 25% of the gross income of the taxpayer.
 - Travel and lodging expense deduction will be limited to 50% of actual expenses incurred or paid.

- Deductions for payments made to settle sexual harassment claims will be disallowed.
- For taxable years commencing after December 31, 2018, employers may deduct 150% of salaries paid to college students (200% in the case of college students who are from the Department of Treasury's internship program).
- For taxable years commencing after December 31, 2018, the limitation for capital loss deductions will be increased from 80% to 90% of the net capital gains generated during the year.
- For individuals to claim the deduction for interest paid or accrued upon residential property the taxpayer must accompany the income tax return with a sworn statement with certain information.

The limitation on NOL deduction is increased from 80% to 90% of normal tax net income for taxable years commenced after December 31, 2018

- ***Losses and Net Operating Losses ("NOLs")***
 - The limitation in the use by the shareholders or partners of the pro rata share in the losses of a corporation of individuals, partnership or special partnership is increased from 80% to 90% of the distributive share in the aggregate net income of the corporations of individuals, partnerships or special partnerships.
 - For taxable years commencing after December 31, 2018, the limitation for NOL deduction will be increased from 80% to 90% of the normal tax net income.
 - Corporate partners cannot use their NOLs against their distributive share of the income of 50% or more owned partnerships or special partnerships. In addition, the corporate partners would not be able to claim their current losses against the income from the partnership or the special partnership.

Preferential Tax Rates

- For years commencing after December 1, 2018, a taxpayer may elect to pay, in lieu of any other income tax, a special tax of 15% on the lump sum payments from variable annuities if certain conditions are met.

Source of Income Rules

- Payments for services rendered to any agency, dependency, or instrumentality of the Government of Puerto Rico, public corporation, as well as the Legislative Branch, the Judicial Branch, and the Municipalities or any other entity created by state or federal law whose funds comes from the General Fund, will be considered Puerto Rico source income, even if the services are rendered outside of Puerto Rico.
- For taxable years after December 31, 2018, the gain from the sale of a partnership interest in a partnership that earns Puerto Rico source income will be considered Puerto Rico source income to the extent the partnership would have derived Puerto Rico source income if it had sold all of its assets at market value, regardless of the residence of the partner. If the partner is a non-Puerto Rico resident or an entity not ETB-PR, then the purchaser must withhold a 15% tax at source on the portion of the gain that constitutes Puerto Rico source income.

Tax Credits

- For taxable years commencing after December 31, 2017, many income tax credits will be eliminated or their use will be limited via the reactivation of the tax credits moratorium.
- For taxable years commencing after December 31, 2017, credits will no longer be subject to limits imposed by the Committee for Tax Disbursements and Concessions.
- New income tax credit for donations made to ex-governor's foundations.
- New refundable earned income tax credit of up to \$2,000 for individuals depending on the income and dependents of individual taxpayer.

Income Tax Returns

- Only one signature of an officer will be required in corporate income tax returns.
- Corporate income tax returns of large taxpayers must be certified as prepared or revised by a CPA licensed in Puerto Rico, regardless of the volume of business of the large taxpayer.
- The term of the automatic extensions to file the income tax returns of corporations and partnerships is extended from 3 months to 6 months. The automatic extension to file the informative returns to the partners is also extended to 6 months.
- Any entity that is required to file audited financial statements must include a schedule together with the income tax return of the entity detailing any Uncertain Tax Position, in accordance with US GAAP.

Income Tax Withholding

- For taxable years commencing after December 31, 2018, the term "salaries" subject to income tax withholding will include agriculture work services, housekeeping services (domestic workers), minister services, and compensation for dismissal from employment.
- Payments made after December 31, 2018 for services rendered in Puerto Rico by residents of Puerto Rico will be subject to a 10% income tax withholding (increased from 7%).
- The payment of insurance commissions is subject to income tax withholding at source.
- The first \$500 (instead of \$1,500) of payments made for services rendered in Puerto Rico by residents of Puerto Rico is exempt from the 10% income tax withholding.
- Payments made by a partnership, special partnership or corporation of individuals to an individual that is a partner or stockholder of such entity for services rendered to the entity are exempt from the income tax withholding.
- There are new rules regarding income tax withholding waivers. The tax required to be withheld with partial waiver is increased from 3% to 6%.

Withholding on payments for services rendered in Puerto Rico is increased from 7% to 10% effective for payments made after December 31, 2018

Persons who make payments subject to withholding and reporting must file informative returns in order to be allowed deduction for such payments

- The withholding on settlement payments is increased from 7% to 10% for payments made after December 31, 2018.
- Persons who make payments subject to withholding and reporting must file informative returns in order to be allowed deduction for such payments.
- The sale of a partnership interest by a nonresident is subject to withholding of 15% of the gain attributable to Puerto Rico sources.
- The deposit of certain withholding at source payments (e.g. payments for services rendered in PR and settlement payments) will be due the 15th day following the close of the calendar month (instead of the 10th day).

Informative Returns

- Effective January 1, 2019, the informative return on extension of credit transactions will be required for each request or extension of credit in excess of \$100,000 or \$200,000 in the case of mortgage loans (instead of \$200,000 or \$500,000 in the case of mortgage loans).
- Effective January 1, 2019, electronic payment processors must file a new annual informative return regarding the total amount of payments processed for their commercial clients.

Partnerships

- New special rules to determine loss limitation for partnerships.
- Partnerships will not be deemed terminated if more than 50% of the partnership interest is transferred.
- Partnerships will be treated as having a substantial built-in loss if (A) the adjusted basis of the partnership in its assets exceeds by more than \$250,000 their fair market value of those assets, or (B) if the sale of the assets of the partnership for cash at their fair market value would cause a loss in excess of \$250,000.

Nonprofits

- Nonprofits may be required to submit an Agreed-Upon Procedure Report or a Compliance Attestation issued by a PR licensed CPA as a prerequisite for a tax exemption determination from Treasury.
- Nonprofits will be subject to a special 37.5% tax on the following payments:
 - Executive compensation generally exceeding \$250,000; and
 - Indemnity payments and related expenses in harassment cases which are pursuant to agreements that include non-disclosure provisions.
- Audited financial statements are required only if non-exempt income exceeds \$3,000,000.

Registered Investment Companies

- Registered Investment Companies will include companies not meeting the requirements under the Puerto Rico Investment Companies Act of 2013, as amended, if they meet all applicable requirements imposed under federal or state laws and regulations to such companies and trusts.

AMT and Pass-through Entities

- Members of partnerships, special partnerships and employee-owned special corporations must take into consideration separately their distributable share of the AMT deductions and adjustments (*see* AMT discussion above).

Internal Revenue Area Licenses

- For years commencing January 1, 2019, the categories of coin operated machines or devices subject to licenses are restructured and a new set of annual license fees is established. Some of the machines that were subject to the \$300 or \$3,000 license fees are decreased to \$100 and \$1,500, respectively.
- Holders of coin operated machines or liquor licenses may elect to renew their licenses for a 2 years period if they pay a fee of 2.5 times the normal annual license fee.
- Schools, churches, religious centers, or rehabilitation centers may consent to the issuance of new liquor licenses for establishments that are located within 100 meters from them.

Sales and Use Tax ("SUT")

- ***Beginning March 1st, 2019***
 - Designated professional services and services rendered to other merchants (Business to Business Services) rendered by a person whose annual volume of business does not exceed \$200,000 will not be subject to the 4% Special SUT.
- ***Beginning October 1st, 2019***
 - Prepared foods, carbonated beverages, pastries and candies sold in restaurants will be subject to a reduced 7% SUT provided certain requirements are met.
- ***Exemptions from SUT***
 - The Special SUT exemption for legal services is no longer limited to the practice of the legal profession and services which cannot be provided by other professionals.

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- The SUT exemption provided for machinery, medical-surgical material, supply, article, equipment and technology used to render health services will also apply to the rental of such items.
- Purchase and rental of e-books are exempt from the SUT.
- Feminine hygiene products are exempted from SUT.
- SUT exemption on lease payments for commercial real estate will only be available to merchants that prove to the lessor they are in compliance with the requirement to install, maintain and use an SUT fiscal terminal (if so required).
- **Miscellaneous**
 - Membership fees paid for shopping establishments –physical or web-based– that allow for the acquisition of goods, services and benefits will now be considered “admission rights” for SUT purposes will be subject to the 11.5% SUT.

Additional authorization is given to the Secretary to carry out fiscal measures through electronic means

Administrative Provisions

- **The Secretary is authorized to:**
 - Issue notices of deficiencies electronically (without being required to physically mail said notice) in cases where the taxpayers have filed their tax return by electronic means. A notice of deficiency will be valid if sent to the taxpayer’s email on file with Treasury;
 - Use electronic means for requesting information and other notifications to taxpayers;
 - Adopt informal administrative procedures before Treasury;
 - Execute agreements with government suppliers to whom payments are due in order to credit such balance against the supplier’s tax liability and granting tax credits for other tax periods; and
 - Establish programs for the rehabilitation and voluntary disclosure for noncompliant taxpayers.
- **Penalties, Additions and Criminal Provisions**
 - Taxpayers claiming personal expenses as deductions not related to the conduct of trade or business will be subject to a penalty of:
 - No more than 25% of the claimed deduction in the event of an initial infraction; and
 - 100% of the deduction claimed by repeat offenders.
 - Persons willingly and knowingly failing to withhold, report and/or remit withheld income taxes or SUT collections will incur in a felony.
 - Criminal actions are subject to a 5 year statute of limitations.
- **Miscellaneous**
 - The Act introduces the concept of a “successor taxpayer” which will impose joint and several liability on such successor taxpayer with respect to the payment of any taxes or withholding obligations incurred by the succeeded responsible person.

- In general, a successor taxpayer is a person or entity that replaces the original taxpayer in the operation of an existing business, either due to the transfer of the operation or the transfer of assets from the original taxpayer to the successor taxpayer, provided there is substantial similarity in the operation of the business and continuity in the identity of the taxpayer or the owners.
- The Secretary may not reject amended returns filed after the statute of limitation has expired. However, the taxpayer may not claim for refund or credit as a result of the amendment.
 - In these cases the Secretary is provided 4 years from the date of filing of the amended return to assess any additional taxes.
- The 10-year statute of limitations for the assessment of taxes required to be collected or withheld by a person other than the taxpayer (trust fund taxes) is eliminated.
- Taxpayers may specify the liability to which a partial payment is to be credited in cases where the taxpayer has several liabilities with Treasury.

Video Lottery (“VLT”) Machines

- The Act introduces a new regime regarding the operation of VLT Machines that use an element of chance in the determination of their prize. The Fiscal Oversight Board has publicly expressed some concerns regarding these provisions.

Because of the general nature and informative purpose of this newsletter, nothing herein should be considered as legal advice or a legal opinion. For further information about the contents of this newsletter, or should you need further assistance in connection with these matters, please contact any of the attorneys of the firm's Corporate Tax Group.

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