

May 21, 2015

Tax Update

New Revenue Raising Measure Bill Filed

Further to our Legal Update of [May 15, 2015](#), House Bill No. 2482 (“HB 2482”) was filed on Monday with the Puerto Rico Legislative Assembly in an attempt to raise the revenues needed to approve a balanced budget for the Puerto Rico Government’s fiscal year 2015-2016.

Different from the tax reform bill filed in March, House Bill No. 2329 (“HB 2329”), HB 2482 proposes to amend the Puerto Rico Internal Revenue Code of 2011 (the “Code”). In general, HB 2482 would modify the income tax provisions in the Code, increase the current sales and use tax (“SUT”) and impose a new SUT on previously exempt services. In addition, similar as HB 2329, HB 2482 intends to implement a value added tax (“VAT”) in substitution of the SUT, as further explained below.

HB 2482 is currently being evaluated by the Puerto Rico Legislative Assembly and it is expected to be fast-tracked; it has become the object of intense negotiations between House, Senate and the Executive Branch.

The following summarizes the most important amendments proposed by the HB 2482.

Income Taxes

Tax on Self-Employment Income

The 2% tax on self-employment income is eliminated for taxable years commenced on or after January 1, 2015.

Alternative Minimum Tax

The tentative minimum tax (“TMT”) for purposes of the determination of the alternative minimum tax (“AMT”) is currently the greater of:

- a. 30% of the AMT income; or
- b. The sum of:
 - i. 20% of payments to a related party and/or 20% of costs allocated from a “home office” to the Puerto Rico branch, if such amounts are attributable to a Puerto Rico business and not subject to Puerto Rico income tax in the taxable year in which they are paid or incurred (“Related-Party Charges”); and



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- ii. 2% (or other applicable special rate) of the value of personal property purchased from a related party or transferred to a Puerto Rico branch from its "home office ("TMT Property Component").

HB 2482 would amend the Code to increase the amount of income subject to the AMT by decreasing the allowable net operating loss ("NOL") deduction for purposes of determining such income from 80% to 70% of the alternative minimum taxable income for taxable years commenced after December 31, 2014.

Regarding the TMT Property Component, with respect to taxable years commenced after December 31, 2014, the generally applicable rate increases from 2% to a range that goes from 2.5% to 6.5%. The increased rates will impact purchasers with gross receipts derived in the conduct of a Puerto Rico trade or business of at least \$10 million and the maximum 6.5% rate becomes applicable when such income is at least \$2,750.

The rate applicable for the TMT Property Component with respect to vehicles subject to excise tax is reduced from 1.5% to .5%.

Although waivers can be requested to exclude Related-Party Charges from the 20% TMT computation, the waiver, which would also exclude such charges from the 51% deduction disallowance, can only cover up to 60% of the same. In other words, 40% of Related-Party Charges will in any event be subject to the 20% TMT computation and the 51% deduction disallowance.

Regarding the TMT Property Component, waivers will no longer be available for taxable years after December 31, 2014. Waivers already issued will continue in effect for the taxable years covered thereunder. To the extent such waivers cover years commenced after December 31, 2014, the applicable rate will be the one set forth in the Code or in the waiver, at the option of the taxpayer. The Secretary of the Treasury ("Secretary") is expressly prohibited from issuing administrative determinations or closing agreements in connection with the TMT Property Component for taxable years commenced after December 31, 2014.

Limitations on Deductions and Losses

For taxable years commenced after December 31, 2014, a shareholder's or partner's share in losses of corporation of individuals, special partnerships and partnerships, will be limited to 80% of such shareholder's or partner's distributive share in the aggregate net income of such entities.

Related-Party Charges will be disallowed in determining an NOL. Exempt entities enjoying tax benefits under the provisions of Act 73-2008, Act 74-2010, Act 83-2010, Act 20-2012 and similar prior and subsequent tax incentives legislation, would not be subject to this limitation.

The NOL carryover will be limited to 80% of the taxpayer's net income for taxable years commenced after December 31, 2014.

In the case of individual taxpayers reporting a business loss for 3 consecutive years, the amount of the loss to be carried over to the third taxable year that commences after December 31, 2014 and subsequent taxable years, will be limited to 50% of the loss incurred in such year. For purposes of applying this limitation, each business will be treated as a separate business and the rental of real property will not be considered a business.

For taxable years commenced after December 31, 2014, charitable contributions by individuals will only be deductible if made to nonprofit entities qualified by the Secretary as such. In order to be qualified under the Code, a nonprofit organization will be required to demonstrate that it renders services in Puerto Rico.

Expenses incurred or paid in connection with services rendered by a nonresident person are disallowed when the taxpayer receiving such services has not paid the SUT or VAT, as applicable, on such services. Similarly, depreciation associated with a good or taxable item will be disallowed if the taxpayer has not paid the SUT or VAT on such item, as applicable.

Corporations would be allowed to offset capital losses against capital gains up to 80% of such gains for taxable years commenced after December 31, 2014. For individuals, the 90% limitation is eliminated and they will be able to fully offset capital losses against capital gains.

For taxable years commenced after December 31, 2014, the capital loss carryover is limited to 80% of capital gains generated in the taxable year to which the loss is carried over and the capital loss shall be considered a short-term capital loss for such taxable year.

Extension of Tax Credit Moratorium

HB 2482 would extend the moratorium on certain tax credits until December 31, 2017.

“Large Taxpayers”

A category of “large taxpayers” is created and defined as a taxpayer that is at least one of the following:

- a. commercial bank or trust company;
- b. private bank;
- c. brokerage house;
- d. insurance company;
- e. telecommunications company; or
- f. an entity which volume of business was \$50,000,000 or more during the preceding taxable year.

For taxable years commenced after December 31, 2014, “large taxpayers” shall file their income tax returns with an office to be designated by the Secretary or by electronic means, if the Secretary so requires through regulations, administrative determination, circular letter or informative bulletin of general application.

Consumption Taxes

As HB 2329 did, HB 2482 intends to substitute the current SUT for a VAT. The transition would be carried out in stages, first with changes to the SUT that would generally take place either from July 1, 2015 or October 1, 2015, and afterwards with the introduction of the VAT from April 1, 2016.

Below is a summary of the most relevant aspects of the SUT changes in Subtitle D of the Code and the VAT provisions that would be part of the new Subtitle DD of the Code.

Transitory Provisions Modifying the SUT

HB 2482 proposes to increase, effective July 1, 2015, the current 7% combined SUT rate to 11.5% for a period of 9 months, as we transition to a state level 10.5% VAT scheduled to become effective on April 1, 2016. The 11.5% increased SUT would be comprised of a 10.5% state level SUT and a 1% municipal level SUT.

In addition, effective October 1, 2015, a 4% SUT on “services rendered to other merchants” and designated professional services would be imposed. Note that such tax would be imposed on services currently exempt from SUT. Those business-to-business services currently subject to SUT at a 7% rate would continue to be subject to SUT at the increased 11.5% rate effective July 1, 2015.

Because the 4% tax on services would be imposed under the currently applicable SUT system, it would not be creditable until the transition to a VAT is completed. In addition, the Code would be amended to provide that, in the case of the rendering of services subject to the SUT by a nonresident person to a resident of Puerto Rico, the person responsible for the payment of the SUT shall be the person receiving the service in Puerto Rico.

Sales covered by contracts and bids related to taxable items which are executed or awarded prior to July 1, 2015, will be subject to the SUT rate applicable to such items as of June 30, 2015. This grandfather provision will apply to contracts related to the rendering of taxable services if payment under such contracts is received prior to July 1, 2015.

HB 2482 would further amend the Code to allow resellers to take a credit for SUT paid on inventory items of up to 100% of the SUT liability reflected in the corresponding SUT return.

During the transition period, a Municipal SUT of 1% will continue to be imposed by municipalities. As drafted, HB 2482 does not impose the 1% municipal SUT on services rendered to other merchants nor designated professional services. That is, it seems that these services will only be subject to the state level 4% SUT.

Commencement of the VAT

a. In general

Effective April 1, 2016, (i) the introduction to Puerto Rico of taxable items and (ii) the sale or transfer of taxable goods and services and combined transactions (“Taxable Transactions”) will be subject to either a 10.5% or 0% VAT (in addition to a 1% municipal SUT as applicable under Subtitle D of the Code).

A 0% VAT (“Zero-rated”) will apply to the following Taxable Transactions occurred after March 31, 2016:

- The sale of goods for export, and
- The rendering of export services.

b. Exempt Items and Transactions

The following items and transactions will be exempt from the VAT:

- Financial services, except those in which bank charges apply;
- The import and sale of prescription medicines including bottles, security caps, labels and bags inherent to the dispatch of prescription medicines;
- Import and sale of items for the treatment of health conditions;
- Import and sale of items and equipment for physical or physiological deficiencies when the purchaser can acquire them at zero-rate;
- The import of any item, the sale of any good or any service rendered that is paid or reimbursed by Medicare, Medicaid or the Puerto Rico Government's health insurance;
- Items introduced to Puerto Rico by, and the sale of goods and services to, agencies or instrumentalities of the United States Government, any of its states, District of Columbia or the Puerto Rico Government;
- Import and sale of gas, aviation fuel, gas oil, diesel oil, crude oil, partially elaborated and finished products derived from oil and other hydrocarbon mixtures to which excise taxes apply;
- Lease of property subject to the room tax;
- Import and sale of food and food ingredients;
- Sale of goods purchased with funds received by the Federal Nutritional Assistance Program (PAN, for its Spanish acronym) or the Special Supplemental Nutrition Program for Women, Infants and Children (WIC);
- Sale of real property;
- Lease of real property that constitutes the principal residence of the lessor, including student and elderly housing;
- Commercial leases, including payments for office or sales spaces, storage and parking;
- The cost-free transfer of goods and the services rendered by not-for-profit entities that have received tax exemption from the PR Treasury Department;
- Import of machinery, medical/surgical materials, items, equipment and technology by, and their sale to, any hospital unit with an Exempt Purchases Certificate;
- Agriculture items imported by or sold to bona fide farmers;
- Occasional sales by churches and religious organizations;
- Import and sale of goods by a merchant dedicated to a tourist business with an Exempt Purchases Certificate;
- Educational services and child care services;
- Manufacturing items introduced to Puerto Rico by or sold to a Manufacturing Plant with a duly issued Manufacturing Plant Exemption Certificate;
- Import and sale of text books;
- Import and sale of vehicles, boats and heavy equipment subject to excise taxes; and
- Health and hospital services.

c. VAT Payment and Reporting

i. Items Introduced to Puerto Rico

Similar as under the current SUT regime, merchants will generally pay the applicable VAT prior to taking possession of imported items. Bonded importers may, however, remit their VAT payment along with the Tax on Imports Monthly Return, described below, on or before the 10th day of the month following the introduction of the items. VAT payments on items imported by air carriers or electronic means will be remitted with the Tax on Imports Monthly Return as well.

ii. Taxable Transactions

The VAT will generally be paid along with the VAT Monthly Return, described below, on or the 20th day of the month following the taxable transaction.

iii. Accounting Methods under the VAT

As under the SUT regime, for VAT purposes a merchant must use the same accounting method used for income tax purposes. However, an important exception is made available for merchants that render designated professional services. In these cases, merchants will be able to use the cash basis method of accounting for VAT purposes.

iv. Reporting

The following declarations and returns will be filed with Treasury:

- *Imports Declaration* – to be filed by all importers of items;
- *Tax on Imports Monthly Return* – to be filed by all importers of items on or before the 10th day of the month following the introduction of items to Puerto Rico. Such return shall contain detailed information of all items imported to Puerto Rico by any means during the prior month;
- *VAT Monthly Return* – to be filed on or before the 20th day of the month following the collection of VAT. Such return shall include the amount of VAT to be remitted and the amount of credit to be claimed. Small Merchants will not be required to file this return.
- *Annual Declaration for Small Merchants* – to be filed within 60 days of the Small Merchant's income tax return due date including any extension of time to file. The declaration shall contain the total value of the goods and services sold during the preceding tax year.

d. Fiscal Vouchers

In general, purchasing merchants will be able to request a Fiscal Voucher from the selling merchant that withheld VAT. The Fiscal Voucher shall be requested within 30 days of receipt of the goods or services and shall be issued by the selling merchant within 30 days from the request. The Fiscal Voucher shall include information such as: name, address and merchant registration number of the seller and purchaser, date, sequence number, description of the goods, sales value, VAT amount and total invoice amount.

Debit Notes and Credit Notes will be issued by the selling merchant in cases where the sales value of the goods described in a Fiscal Voucher is upward or downward adjusted, respectively.

e. VAT Credit and Refund of Overpayments

Merchants, except Small Merchants, may claim a credit in the VAT Monthly Return for the VAT paid during a particular month.

The following amounts may be credited:

- VAT paid upon import of items to Puerto Rico as reported in the Tax on Imports Monthly Return that are directly or indirectly related to the sale of taxable goods or services, whether subject to the 10.5% tax rate or Zero-rated;

- VAT paid on purchases of goods and services as reflected in the Fiscal Vouchers, that are directly or indirectly related to the sale of taxable goods or services;
- VAT paid by a merchant for receiving services from a non-PR resident as reflected in a VAT Monthly Return.

Special rules apply in cases in which the VAT paid cannot be traced directly to a particular good. In these cases, the VAT to be credited will be limited to the amount equivalent to the proportion of total taxable sales over total sales. An exception to this rule applies to merchants that are principally dedicated to sale of prepared foods and supplies and merchants that are principally dedicated to the sale of prescription medicines, medicines, or items for the treatment of health conditions.

An overpayment of up to \$10,000 generated due to the excess of adjustments or credits may be applied in the VAT Monthly Return of the month following the month in which the overpayment arises. A refund may be requested by merchants that accumulate an overpayment in excess of \$10,000 provided that such merchant is an Eligible Merchant, described below, or the merchant has generated overpayments for three consecutive months.

The Secretary of Treasury must issue its determination denying or approving such refund no later than 30 days after the request is filed. Should the request be approved, it shall be refunded to the merchant no later than 5 business days after its approval date.

f. Merchant's Registry, Exemption Certificates and Eligible Merchants Certificates

A merchant registration certificate ("MRC") similar to the one under the current SUT regime will be required for any person conducting a business in Puerto Rico. Small Merchants may, however, request a Small Merchant Registration Certificate in lieu of the MRC.

The proposed VAT provisions include the following two exemption certificates that will relieve a merchant from paying the VAT:

- Exempt Purchases Certificate ("EPC") – will allow a person to import items or purchase goods and services exempt from the VAT. The EPC will be available to the United States Government and any of its states, the District of Columbia, the Puerto Rico Government, hospital units, merchants dedicated to a tourism business and bona fide farmers.
- Manufacturing Plant Exemption Certificate – will allow Manufacturers to import manufacturing items and purchase goods and services exempt from the VAT.

An Eligible Merchant Certificate will be available to merchants whose annual sales volume during the 3 years preceding its determination exceeds \$500,000 and 80% of their total sales are Zero-rated. Such certificate will allow the Eligible Merchant to claim a refund for excess VAT payments.

g. Municipal VAT

Under the current SUT regime municipalities are required to impose a SUT of 1% using the same base, exemptions and limitations provided therein. Upon the effectiveness of the VAT, the SUT of 1% would continue to be imposed by municipalities. A municipal VAT would not be imposed. Instead, Treasury would

be required to allocate 0.5% of the 10.5% VAT to municipalities and deposit such amounts with the Municipal Development Fund, Municipal Redemption Fund and Municipal Improvements Fund, which are administered under the Municipal Administration Fund Act.

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