

# Puerto Rico adopts significant amendments to its income tax code

January 17, 2019

## In brief

The Governor of Puerto Rico on December 10, 2018 signed into law House Bill 1544 as Act 257-2018 (Act 257). Act 257 amends numerous provisions of the Puerto Rico Internal Revenue Code of 2011 (PRIRC), including reducing the corporate and individual income tax rates, introducing a new earned income credit, limiting certain deductions, subjecting the gain on the sale of a PR partnership interest to PR income tax, changing certain sourcing rules, and amending the information reporting requirements. Act 257 also amended certain sales and use tax (SUT) provisions. Various effective dates apply, as described below.

At the same time, the Financial Oversight and Management Board for Puerto Rico (the Oversight Board) created under the Puerto Rico Oversight, Management, and Economic Stability Act of 2016 (PROMESA) expressed concerns regarding certain provisions of Act 257. In particular, the Oversight Board indicated that it has not received enough evidence from the PR Government to conclude that Act 257 will not negatively impact the PR Government's Fiscal Plan. It is not yet determined whether Act 257 will be further amended to accommodate any mandate from the Oversight Board.

The Oversight Board issued a letter to the Governor of Puerto Rico on December 27, 2018 stating that Act 257 is not in compliance with PROMESA with respect to Articles 132 through 163, regarding the video lottery terminals (VLTs) that operate outside casinos in Puerto Rico. However, the letter provided that the Oversight Board accepted Articles 1 through 131 and 164-165, which do not deal with VLTs operated outside casinos in Puerto Rico.

## In detail

### Income tax amendments

#### Individuals

#### Regular tax liability

Act 257 reduces the effective income tax rate for individual taxpayers by providing that an individual's income tax liability for tax years beginning after December 31, 2018 will be equal to 95% of

such individual's total tax determined for the tax year -- i.e., effectively a 5% dollar-for-dollar reduction.

#### Alternate basic tax (ABT)

Act 257 amends the ABT provisions by lowering the tax brackets and rates at which the ABT will apply to individuals for tax years

beginning after December 31, 2018.

The new ABT rates range between 1% and 24%, and the ABT begins to apply once the individual's net income subject to ABT for the tax year exceeds US \$25,000.

Generally, an individual may not claim deductions already claimed for regular income tax purposes in arriving at net income subject to ABT. Instead, an individual may claim a limited amount of deductions for trade or business expenses, including 125% of wages paid and reported on a PR W-2 Form, 50% of the federal self-employment tax, and depreciation under the straight-line method, as well as payments for services, rents, utilities, marketing, insurance, health plan contributions, bad-debts, and other deductions applicable to individual taxpayers under PRIRC Section 1033.15. Some of these expenses must be reported in informative returns to be deductible for ABT purposes.

Notwithstanding, if the individual submits audited financial statements, an agreed-upon procedure, or a compliance attestation report issued by a PR-licensed Certified Public Accountant (PR CPA) certifying the expenses as ordinary and necessary with its income tax return (see below), the individual may claim the same deductions he or she claims for regular income tax for purposes of computing his or her income subject to ABT.

For tax years beginning after December 31, 2018, the ABT will not apply to an individual taxpayer whose only source of income of which is salary reported on a PR W-2 Form.

**Observation:** Although individual taxpayers currently may claim all ordinary and necessary business expenses in their income tax returns for regular income tax purposes, going forward they must submit audited financial statements, an agreed-upon procedure, or a compliance attestation report, unless they choose the optional method discussed below where applicable, or they may become ABT payers due to the limited amount of deductions

allowable for computing the net taxable income subject to ABT.

#### Optional income tax computation method for individuals

Effective for tax years beginning after December 31, 2018, a new optional income tax computation method, in lieu of the regular income tax and ABT, is available to individual taxpayers whose main source of income is earned from self-employment activities.

As the name suggests, individual taxpayers will have to elect to apply this optional method to compute their tax liability for the year in question. In addition, the income tax liability would be determined based on taxpayer's gross receipts for the tax year rather than on net income, at rates ranging between 6% and 20%. This means that the electing taxpayer cannot claim any expenses in computing its income tax liability for the year.

The tax under this optional income tax computation shall be satisfied via withholding at source or through estimated payments, and the gross income must be reported in an informative return. Lastly, under this option, the taxpayer must pay 100% of the total tax determined for the year in question (i.e., the 5% dollar-for-dollar tax reduction would not apply).

**Observation:** Individual taxpayers who elect to be subject to this income tax computation method will not be subject to the regular income tax and ABT rules, and will not be required to submit an agreed-upon procedure or compliance attestation report issued by a PR CPA. This is an annual election.

#### Gross income exclusions and exemptions

Act 257 establishes new items of income that are excluded from gross income, namely:

- compensation for mental distress
- qualified payments made for assistance to overcome a disaster for tax years beginning after December 31, 2016
- interest-free loans made by employers to employees or independent contractors to overcome a disaster, to the extent such loans do not exceed US \$20,000 per employee or independent contractor
- distributions from an Employee Trust or Individual Retirement Account due to a disaster, with certain limitations
- earned income credit payment received by a taxpayer.

Act 257 also modifies certain gross income exemptions for tax years beginning after December 31, 2018, as follows:

- The exemption on interest income earned on deposit accounts from institutions located in Puerto Rico was reduced from US \$2,000 to US \$100 per individual (or from US \$4,000 to US \$200 for married taxpayers filing jointly)
- The US \$11,000 or US \$15,000 exemptions, as applicable, on pension income were extended to life annuity payments made to pension plan participants, or their beneficiaries

Act 257 further amends the PRIRC to repeal the gross income exclusion that applied to interest income from certain mortgages of residential property located in Puerto Rico.

#### Severance payments

According to Act 80 of May 30, 1976, as amended (Act 80), severance payments made to employees on account of their dismissal, whether for

just cause or not, are excluded from the definition of gross income, and are not subject to Puerto Rico income taxes (i.e., regular and alternative basic taxes). However, any severance payments made in excess of the Act 80 amount are taxable in Puerto Rico.

Act 257 amends the definition of wages to include severance payments made pursuant to Act 80 as wages subject to withholding tax, effective for Act 80 severance payments made after December 31, 2018, despite the fact that such amounts are excluded from the definition of gross income.

**Observation:** Although Act 257 amends the definition of wages to include Act 80 severance payments, Act 80 still provides that severance payments will not be subject to income tax withholding. We expect the PRTD to issue guidance to treat the Act 80 severance payments as exempt wages not subject to withholding tax.

#### **Income received by a minor**

For tax years beginning after December 31, 2018, all income earned by or on behalf of a minor, including interest, dividends, donations, pensions, and prizes, is treated as gross income of the minor's parents or legal guardian, except for income earned from services rendered by the minor, which will continue to be included in the minor's gross income.

Act 257 also provides that a minor means an individual who is under the age of 18 and who is not emancipated.

#### **Cafeteria plans**

Act 257 repeals PRIRC Section 1032.06 relating to flexible benefits plans (i.e., cafeteria plans), effective immediately after the date of enactment of Act 257.

**Observation** We expect the PRTD to issue guidance on how to treat contributions to cafeteria plans prior to and after the enactment of Act 257 with respect to what amounts would be deductible from wages as pre-tax contributions, and how such amounts would be reported for tax year 2018.

#### **Other deductions**

##### *Charitable contributions*

For tax years beginning after December 31, 2018, charitable contributions are allowed as a deduction to the extent they are made to charitable organizations organized under the laws of Puerto Rico, the United States, or any US Possession, which are qualified by the Secretary of the Puerto Rico Treasury Department (PRTD) and which provide services to residents of Puerto Rico.

For tax years ending before January 1, 2019, charitable contributions are deductible to the extent the recipient charitable organizations are qualified by the Secretary of the PRTD or the Internal Revenue Service, whether or not they provide services to residents of Puerto Rico.

##### *Government pension or retirement systems*

For tax years beginning after December 31, 2018, contributions to government pension or retirement systems are treated as a reduction of taxable wages instead of a deduction against taxable wages on the income tax return.

##### *Health savings accounts*

The deduction for contributions made to Health Savings Accounts is not available for tax years beginning after December 31, 2018.

#### **Earned income credit (EIC)**

Individual taxpayers between the ages of 27 to 65 who are residents of

Puerto Rico for the entire tax year, and who meet other requirements, can claim the EIC for taxable years beginning after December 31, 2018.

The amount of the EIC will depend on the individual's filing status and number of dependents and will range between US \$300 and US \$2,000.

#### **Corporations**

##### **Regular tax**

Act 257 reduces the regular corporate tax rate from 20% to 18.5%.

Therefore, the maximum statutory tax rate applicable to corporate taxpayers will decrease from 39% to 37.5% for tax years beginning after December 31, 2018, taking the surtax into consideration.

##### **Alternative minimum tax (AMT)**

The AMT rate is reduced from 30% to 18.5%, or 23% in the case of taxpayers required to submit audited financial statements with their income tax returns. Generally, for AMT purposes, a corporation cannot claim the same deductions it claimed for regular income tax purposes. Instead, a corporation may claim a limited amount of deductions such as wages, rents, utilities, marketing, depreciation, insurance, health plan contributions, charitable donations, bad-debts, and certain taxes. In this regard, some of these expenses must be reported in informative returns to be deductible for AMT purposes.

Notwithstanding, if the corporation submits audited financial statements, an agreed-upon procedure, or a compliance attestation report issued by a PR CPA certifying the expenses as ordinary and necessary with its income tax return (and as explained in more detail below), the corporation may claim the same deductions it claims for regular income tax for purposes of computing its income subject to AMT, subject to AMT

limitations on depreciation and net operating losses, among others.

**Observation:** Although corporate taxpayers may claim all ordinary and necessary business expenses in their income tax returns for regular income tax purposes, going forward they must submit audited financial statements, an agreed-upon procedure, or a compliance attestation report by a PR CPA (or unless where applicable they choose the optional method discussed below), or they may become AMT payers due to the limited amount of deductions allowable for computing the net income subject to AMT.

#### **Optional income tax computation method for corporations**

Similarly to its treatment of individual taxpayers, Act 257 provides an optional income tax computation method in lieu of the regular income tax and AMT for corporations that derive their main source of income from providing services.

Corporate taxpayers will have to elect, on a yearly basis, to apply this method to compute their tax liability for the year in question. As such, their income tax liabilities also would be determined based on the taxpayer's gross receipts for the tax year rather than on net income (i.e., no deductions allowed), at rates ranging between 6% and 20%.

The tax under this optional income tax computation will have to be satisfied via withholding at source or through estimated payments, and the gross income must be reported in an informative return.

**Observation:** Corporate taxpayers that elect to be subject to this optional income tax computation method will not be subject to the regular income tax and AMT rules, and will not be required to submit an agreed-upon

procedure or compliance attestation report issued by a PR CPA.

#### **Partnerships**

##### **Taxation of partners**

Act 257 further clarifies that each partner in a partnership must separately take into account his, her, or its distributive share of the partnership's items of allowed deductions and adjustments for purposes of computing income subject to ABT or AMT, as the case may be.

##### **Repeal of partnership technical termination rule**

Act 257 repeals the partnership technical termination rule, which had provided that if 50% or more of the total profit and capital interests in a partnership were sold or exchanged during a 12-month period, the partnership was deemed to be terminated for tax purposes.

##### **Sale of partnership interest by nonresident individuals and foreign corporations**

Act 257 amends the PRIRC to provide that the gain, benefit, or income earned on the sale of the interests of a partnership that is engaged in a PR trade or business will be treated as PR source income in the same proportion as if the partnership had sold all its assets at their fair market value as of the date of such sale, regardless of the residence of the selling partner(s).

If the selling partner is a nonresident individual or foreign corporation not engaged in trade or business in Puerto Rico, the seller will be subject to a 15% income tax withholding on the amount of the gain that constitutes PR source income.

**Observation:** Act 257 imposes the obligation to withhold on the buyer, which may result in technical and

practical issues for the buyer as to how to determine the amount of the gain subject to withholding tax. We expect the PRTD to issue regulations addressing that topic.

##### **Other income tax amendments**

##### **Agreed-upon procedures for tax years beginning after December 31, 2018**

Taxpayers engaged in trade or business in Puerto Rico, including individuals, corporations, LLCs, partnerships, insurance companies, registered investment companies, and corporations of individuals, with gross income of less than US \$3 million for the tax year, may choose to submit an agreed-upon procedure or a compliance attestation report issued by a PR CPA with their income tax returns in order to claim all of their ordinary and necessary trade or business expenses as deductions on their income tax returns for ABT or AMT purposes.

In the event their gross income is between US \$1 million and US \$3 million for the tax year, taxpayers may choose to submit audited financial statements with their income tax returns and claim all ordinary and necessary business expenses as deductions on their income tax returns for ABT or AMT purposes. Lastly, if their gross income is at least US \$3 million, taxpayers must submit audited financial statements with their income tax returns in order to claim all deductions on their income tax returns for ABT or AMT purposes.

**Observation:** Unless taxpayers elect to pay income tax under the optional income tax computation method, taxpayers that choose not to submit an agreed-upon procedure or a compliance attestation report may become subject to ABT or AMT.



## Deductions

### *Depreciation*

For tax years beginning after December 31, 2018, a small business may depreciate property (excluding real property, automobiles, computer equipment, and transportation equipment) acquired for its trade or business over a two-year period. A small business is defined as any business the gross income of which is US \$3 million or less.

### *Net operating losses (NOLs)*

Act 257 provides that the deduction for payments made to nonresident related persons is not required to be added back for purposes of computing the taxpayer's NOL deduction.

In addition, for tax years beginning after December 31, 2018, the NOL deduction limitation is increased to 90% of net tax income before NOLs as opposed to the 80% NOL limitation applicable for taxable years beginning after December 31, 2014 and ending before January 1, 2019.

Act 257 also provides that corporate partners that own 50% or more of a partnership are not allowed to use their current-year stand-alone NOLs as well as stand-alone NOL carryforwards to offset their distributive share of partnership income.

### *Meals and entertainment (M&E)*

For tax years beginning after December 31, 2018, the M&E deduction is limited to 25% of the amount incurred.

### *Travel expenses*

For tax years beginning after December 31, 2018, travel expenses are subject to a 50% limitation.

### *Motor vehicles*

For tax years beginning after December 31, 2017, the actual costs incurred in the use and maintenance of motor vehicles are allowed as a deduction, subject to limitations to be established by the Secretary.

### *Capital loss limitation*

For tax years beginning after December 31, 2018, the capital loss deduction are limited to 90% of the capital gains, instead of the 80% limitation applicable for tax years beginning after December 31, 2014 and ending before January 1, 2019.

### *Intercompany expense allocation*

Act 257 provides that the 51% disallowance with respect to expenses paid or incurred with a related person that is not engaged in trade or business in Puerto Rico may not apply if the taxpayer submits a transfer pricing study prepared pursuant to the provision of Section 482 of the US Internal Revenue Code of 1986, as amended (USIRC). If the taxpayer does not have operations in the United States, a transfer pricing study issued according to the provisions of the Organisation for Economic Co-operation and Development (OECD) may be accepted.

**Observation:** We expect the PRTD to issue regulations to implement this provision, including defining the arm's-length standard with respect to related-party cross-border transactions, using the technical guidelines issued under USIRC Section 482, the OECD, and any other local regulations.

### *Salaries paid to college students*

Employers will be allowed a 150% deduction for salaries paid to college students if certain requirements are met. The deduction may increase to

200% if the employee participated in an internship program with the PRTD.

### *PR foreign tax credits*

Act 257 amends the PRIRC to allow PR taxpayers to claim a foreign tax credit against their PR income tax liability for income and excess-profits taxes paid to any state of the United States. Prior to Act 257, such foreign tax credit was not available to PR taxpayers.

### *Withholding taxes and quarterly informative returns*

Act 257 increases the withholding tax rate for services rendered by PR residents from 7% to 10%. However, upon request by the service provider, the person making the payment may increase the withholding tax rate to as much as 20%.

Also, the aforementioned withholding taxes on services must now be deposited by the 15th day of the month following the month in which the tax was withheld. Prior to Act 257, such deposits were due on the 10th day of the following month.

In addition, the exemption with respect to payments for services in an amount equal to or less than US \$1,500 was reduced to US \$500.

Lastly, for tax years beginning after December 31, 2018, Act 257 requires taxpayers to file quarterly informative withholding reconciliation returns on or before March 31, June 30, September 30, and December 31 of each year.

**Observation:** Taxpayers need to consider how their internal processes and reporting systems may be affected by these new withholding taxes and exemption reductions.

### Informative returns for payment card and third-party network transactions

For tax years beginning after December 31, 2018, any entity that has the obligation to settle credit or debit card payments and to make payments to a participating payee of a third-party network organization must issue an informative return reporting the gross amount of payments settled through credit or debit cards and third-party network organizations during the calendar year to persons for which it processes such payments.

### Sourcing rules for providing services to the PR Government

Payments for services rendered to the PR Government are considered PR source income to the extent the payments are made with funds from the PR Government's General Fund, whether or not such services were physically provided in Puerto Rico.

**Observation:** Nonresident individuals and foreign corporations or partnerships not engaged in trade or business in Puerto Rico that provide services to the PR Government within or without Puerto Rico will be subject to a 29% withholding tax on the fees that are paid with funds from the General Fund. Moreover, foreign corporations engaged in trade or business in Puerto Rico that provide part of the services to the PR Government from outside Puerto Rico will be subject to PR taxation on 100% of those fees, which should be satisfied through estimated tax payments. Nonresident individuals and foreign corporations or partnerships that take the position that they are not engaged in trade or business in Puerto Rico may have to evaluate whether the activities they carry out in Puerto Rico give rise to a trade or business so they can file a PR income tax return and claim expenses associated to earning such PR source income.

**Observation:** This change in the PR sourcing rules presents a challenge at the US federal level with respect to foreign tax credits (FTC) that a US entity might claim on its US federal income tax return, as the taxes paid in Puerto Rico in connection with services provided in the United States will not be considered foreign source income in the formula to arrive at the allowable FTCs thereby potentially limiting the amount of FTCs that could be claimed.

### Affirmative statement of transactional amounts

For tax years beginning after December 31, 2018, the reporting threshold to file the Affirmative Statement of Transactional Amounts with the PRTD for approving loans, lines of credit, letters of credit, margin accounts, credit cards, mortgage loans, and motor vehicle financial leases, among others, during the month or other 30-day reporting period will be reduced from US \$500,000 to US \$200,000 for mortgage loans, and from US \$250,000 to US \$100,000 for non-mortgage loans.

### Limited liability companies (LLCs)

Act 257 amended the PRIRC to clarify that any series of a series LLC is a separate taxpayer for income tax purposes. Act 257 also amended the forced partnership election to provide that only non-PR LLCs that have an election to be treated as disregarded entities or partnerships under US federal tax law or foreign law will be treated as partnerships for PR income tax purposes and will not be able to make an election to be treated as corporations under the PRIRC.

**Observation:** A Puerto Rico LLC can now elect to be treated as corporation for Puerto Rico income tax purposes and as a disregarded entity for US federal income tax purposes. In

addition, companies with PR LLCs in their group that were treated as partnerships due to the PRIRC's forced partnership rule may elect to convert into corporations in order to simplify their tax compliance. We understand that further guidance is needed to clarify applicability and implications of this change in the transition year.

### Group of related entities

The term 'group of related entities' now includes partnerships, corporations of individuals (i.e., the PR equivalent of S-Corporations), and special partnerships.

### Extension of moratorium and repeal of certain income tax credits

Act 257 permanently extends the moratorium on certain income tax credits, and limits the use of such tax credits to 25% of their net income tax liability for tax years beginning after December 31, 2016 and before January 1, 2018, and to 50% for tax years beginning after December 31, 2018.

Effective for tax years beginning after December 31, 2018, Act 257 eliminates the following income tax credits:

- credit for products manufactured in Puerto Rico
- credit for incremental purchase of agricultural products
- credit for contributions to the Santa Catalina Palace Patronage or to the Patronage of the State Capitol of the Legislative Assembly
- 3% credit for increased investments
- credit for investment in securities of qualified business.

Also, Act 257 limits the granting of tax credits under the Urban Center

Rehabilitation Act of 2002, as amended, to projects that were in construction as of June 30, 2015 or that filed an eligibility report with the PRTD on or before June 30, 2016.

### **Sale and Use Tax (SUT) amendments**

Act 257 amends and introduces some relevant SUT definitions and exemptions, and lowers the SUT rate for prepared foods.

In the regard, the term “admission rights” was amended to include dues paid to access private clubs or membership clubs where goods and services can be acquired, whether through brick-and-mortar or online stores. Act 257 also amends the term “candy” to include cream candy.

Act 257 also amends the term ‘sales price’ with respect to coupons or rebates to provide that the manufacturer or distributor offering coupons or rebates on a taxable item will have the obligation to pay the sales tax on the amount reimbursed by such manufacturer or distributor.

Beginning on March 1, 2019, designated professional services and business-to-business services, which are subject to SUT at the rate of 4%, rendered by merchants of which the volume of business does not exceed US \$200,000 for the preceding

taxable year will not be subject to SUT. The current volume of business threshold for charging SUT on such services is US \$50,000.

**Observation:** Merchants that provide taxable services (i.e., services that are not designated professional services or business-to-business services) continue to be required to charge SUT on such services if their volume of business exceeds US \$50,000 at the rate of 11.5%.

In addition, Act 257 amends the SUT exemption on commercial real property rentals to provide that a lessee must provide evidence to the lessor that it has installed a fiscal terminal, to the extent the lessee is required to have a fiscal terminal, in order for the lessor to claim the SUT exemption.

Act 257 amends the SUT exemption on the purchase of machinery, medical-surgical materials, supplies, articles, and equipment and technology used to render health services to include the leasing of such property.

Act 257 expands the SUT exemption on books to include electronic book (e-books). Similarly, the SUT exemption for legal services was expanded to include legal consulting

services, provided by attorneys duly authorized to practice law in Puerto Rico by the PR Supreme Court, as well as attorneys duly authorized to practice law by the competent authority in their specific jurisdictions, whether or not such services can be provided by professionals who are not licensed attorneys.

Act 257 also introduces an exemption for feminine hygiene products.

Lastly, beginning on October 2, 2019, the applicable SUT rate for prepared food will be lowered from 11.5% to 7%. For purposes of this reduction, the term ‘prepared food’ means any food that is sold hot or that is heated by the vendor, or two or more food ingredients mixed or combined by the vendor to be sold as an article or product; or food sold by the vendor with food utensils by the vendor such as dishes, knives, forks, glasses, cups, handkerchiefs, or straws.

### ***The takeaway***

Companies should monitor the current interactions between the Government of PR and the Oversight Board concerning Act 257 and its impact on the PR approved Fiscal Plan, as they might result in changes to Act 257.

## **Let's talk**

For a deeper discussion of how this might affect your business, please contact:

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