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# Puerto Rico Tax Alert – December 2018 – Number 6

## 2018 PUERTO RICO TAX REFORM

Further to our Tax Alert April 2018 - Number 2, on December 10, 2018, the Governor of Puerto Rico signed Act 257-2018 to introduce various amendments to the 2011 Puerto Rico Internal Revenue Code, as amended (PR Code).

Following is a summary of amendments introduced by Act 257-2018:

**INDIVIDUALS:**

Gross Income and Credits:

- Exclusions from Gross Income: Various exclusions from gross income are introduced such as: amount received by an individual related to the Earned Income Tax Credit (EITC); loans to employees or independent contractors and qualified payments to help with managing disasters declared by the Governor of Puerto Rico; payments for; certain compensation for injury or disease including mental suffering; and distributions of employee's trust or individual retirement account in connection with such disasters.
- Exemptions from Gross Income: For taxable years beginning after December 31, 2018 the exempt amount for deposits in interest bearing accounts held at cooperatives, savings associations, commercial banks and mutual funds is reduced to one hundred ($100) dollars for individual taxpayers or two hundred ($200) dollars for married taxpayers filling jointly.
- Services of a Minor: For taxable years beginning after December 31, 2018, passive income received by a minor (such as interest, dividends, donations, pensions, prizes, raffles, among others) is reported as gross income by the parents or guardian.
- EITC: For taxable years beginning after December 31, 2018, a new refundable credit, ranging from three hundred ($300) dollars to two thousand ($2,000) dollars, will be granted to qualifying Puerto Rico resident taxpayers with earned income.

Regular Tax Rates: For taxable years beginning after December 31, 2018, an individual’s tax is ninety-five (95%) percent of the sum of the regular and gradual tax adjustment.

Alternative Basic Tax (ABT): For taxable years beginning after December 31, 2018, ABT rates are adjusted as follows:

| | |
|---|---|
| **In excess of $25,000 but not more than $50,000** | 1% |
| **In excess of $50,000 but not more than $75,000** | 3% |
| **In excess of $75,000 but not more than $150,000** | 5% |
| **In excess of $150,000 but not more than $250,000** | 10% |
| **More than $250,000** | 24% |

Furthermore, for ABT purposes, there are new limitations regarding which expenses will be allowable (deductible) to arrive at Alternative Basic Net Taxable Income. However, those individual taxpayers who file an Agreed Upon Procedure Report (AUP) or Compliance Attestation (CA) with the Secretary of the Treasury (Secretary) may claim as a deduction all ordinary and necessary expenses related to its trade or business.

Act 257-2018 re-establishes the credit for ABT paid in prior years.

Optional Tax Regime for Self-Employed Individuals rendering Services:

Flat Tax Rates: Self-Employed Individuals whose source of revenue substantially arises from rendering Services subject to withholding at source, may elect to pay a flat income tax on its gross income subject to certain conditions. This regime is effective for taxable years beginning after December 31, 2018; however, the Secretary may postpone the effective date for 1 year. The optional flat gross income rates are as follow:

| | |
|---|---|
| **Not more than $100,000** | 6% |
| **In excess of $100,000 but not more than $200,000** | 10% |
| **In excess of $200,000 but not more than $300,000** | 13% |
| **In excess of $300,000 but not more than $400,000** | 15% |
| **In excess of $400,000 but not more than $500,000** | 17% |
| **More than $500,000** | 20% |

**CORPORATIONS:**

Normal Tax: For taxable years beginning after December 31, 2018, the normal tax rate is reduced to eighteen-point five (18.5%) percent from twenty (20%) percent. Therefore, the highest income tax rate for corporations is reduced from thirty-nine (39%) percent to thirty-seven points five (37.5%) percent.

Alternative Minimum Tax (AMT): For taxable years beginning after December 31, 2018, the tax rate is reduced to eighteen points five (18.5%) percent or twenty-three (23%) percent to those corporations with volume of business of three million ($3,000,000) dollars or more. Nonetheless, the AMT will be the higher of five hundred ($500) dollars or the tax resulting from imposing the aforesaid rates to the Alternative Minimum Net Taxable Income.

Like ABT provisions for individuals, Act 257-2018 introduces new limitations with respect to allowable expenses to arrive at the Alternative Minimum Net Taxable Income. Notwithstanding, corporate taxpayers that file either audited financial statements, AUP or CA with the Secretary may claim as a deduction all ordinary and necessary expenses related to its trade or business.

Preparation or Review by CPA: Large Taxpayers' corporate income tax returns must be certified as prepared or reviewed by a certified public accountant with a Puerto Rico license.

Optional Tax Regime for Corporate Taxpayers engaged in rendering Services:

Flat Tax Rates: Corporate taxpayers whose revenue substantially arising from Service subject to withholding at source, may elect to pay a flat income tax on its gross income subject to certain conditions. This regime is effective for taxable years beginning after December 31, 2018, however, the Secretary may postpone the effective date for one year. The optional flat gross income rates are as follow:

| | |
|---|---|
| **Not more than $100,000** | 6% |
| **In excess of $100,000 but not more than $200,000** | 10% |
| **In excess of $200,000 but not more than $300,000** | 13% |
| **In excess of $300,000 but not more than $400,000** | 15% |
| **In excess of $400,000 but not more than $500,000** | 17% |
| **More than $500,000** | 20% |

**PARTNERSHIPS:**

Partnership Losses: The amount allowed as a partner's loss will be limited to the partner's basis, which will consider the partner's distributable share of charitable contributions and taxes paid or accrued to foreign countries.

Continuation of Partnership Entities: The sale or exchange of fifty (50%) percent or more of the interest in the partnership will not be considered a termination of such partnership.

Sale of Partnership Interest: Gain from the sale of a partnership interest after December 31, 2018 will be treated as Puerto Rico source income to the extent a deemed sale of all the partnership's assets (at fair market value) generates Puerto Rico source income.

**DEDUCTIONS (APPLICABLE TO ALL TAXPAYERS):**

For taxable years beginning after December 31, 2018:

Fifty-one (51%) percent disallowance on allocated expenses: Amounts paid or incurred to related persons (including between a branch and its home office) or partners, continue to be subject to the fifty-one (51%) percent disallowance **unless** the taxpayer files with the Secretary a Transfer Pricing Report pursuant to the provisions of US IRC Section 482 and duly reviewed by the Internal Revenue Service. OECD reports will be accepted if none of the related entities have operations in the United States.

Depreciation: A business with a volume of business of less than three million ($3,000,000) dollars may depreciate machinery and equipment, furniture and fixtures or any other asset used in the trade or business, except for real property and automobile, using a useful life of two (2) years.

Meals and Entertainment and Travel: The disallowance for meals and entertainment increases to seventy-five (75%) percent. In addition, the deduction for travel expenses is limited to fifty (50%) percent of the amounts paid.

Indemnification Payments in connection with harassment cases: Payments will now be fully disallowed.

Wages Paid to College Students: Employers may claim as a deduction, one hundred and fifty (150%) percent of compensation paid to college students if certain conditions are met.

Losses: The allowable net operating loss (NOL) deduction increases from eighty (80%) percent to ninety (90%) percent. However, a partner holds a fifty (50%) percent or more of the interest in the capital or profits of a partnership may not claim an NOL deduction against the distributable share of net income of such partnership.

The allowable distributable share of net losses of a Pass-through entity against the net distributable share of net income from other Pass-through entities increases from increases from eighty (80%) percent to ninety (90%) percent.

Capital Loss: The allowable capital loss carryforwards from prior years increases from eighty percent (80%) to ninety (90%) percent.

**GENERAL CHANGES:**

Sources of Income: Services rendered to the Government of Puerto Rico, public corporations, Legislative Assembly, Judicial Branch, municipalities or any other entity created by state or federal law will be deemed income from sources within Puerto Rico to the extent the funds used to pay for such services come from the General Fund.

Trade or Business: The term "engaged to trade or business in Puerto Rico" was limited to exclude trading in securities by the taxpayer or by a resident broker, resident agent, resident custodian or any other independent resident agent. This exclusion only applies when the taxpayer does not have an office or other fixed place of business in Puerto Rico through which such trading operations are instructed or conducted.

Group of Related Entities: The definition is being expanded to include partnerships, special partnerships and corporation of individuals.

**REQUESTS FOR EXTENSION OF TIME TO FILE:**

Act 257-2018 extended the Automatic Extension of Time to File Income Tax Returns from three (3) months to six (6) months. This amendment applies for taxable years commencing after December 31, 2016.

**AUDITED FINANCIAL STATEMENTS:**

For taxable years beginning after December 31, 2018, taxpayers with a volume of business of a million ($1,000,000) dollars or more but less than three million ($3,000,000) dollars may elect to file audited financial statements, AUP or CA in order to request a partial waiver certificate on services rendered.

Non-for-Profit Organizations: For taxable years beginning after December 31, 2018, non-for-Profit Organizations with unrelated business income (UBI) exceeding three million ($3,000,000) dollars, will now have to file audited financial statements with their corresponding tax returns.

Uncertain Tax Positions: Taxpayers required to file audited financial statements must attach a schedule detailing the Uncertain Tax Positions (UTPs) to the income tax return for taxable years beginning after December 31, 2018.

**WITHHOLDING AT SOURCE AND INFORMATIVE RETURNS:**

Services Rendered: For taxable years beginning after December 31, 2018:

- The withholding rate increases from seven (7%) percent to ten (10%) percent;
- The partial waiver certificate increases from three (3%) percent to six (6%) percent;
- Various exceptions are repealed or modified including the withholding exception applicable to the first one thousand five hundred ($1,500) dollars that is reduced to five hundred ($500) dollars paid during the calendar year;
- To claim a deduction with respect to services incurred, a taxpayer must have filed the corresponding informative returns with PRTD and deposit the withholding tax. Accrual method or fiscal year taxpayers may claim as deduction amounts not reported in an informative return, due to differences in accounting method or accounting period, if a reconciliation of amounts claimed and reported is filed with the income tax return.

Further, Act 257-2018 establishes a new Quarterly Reconciliation Statements, and extends the due date to file and deposit the tax from the 10th day of the following month to the 15th day of the following month.

Informative Returns: Failure to file informative returns to report payments made during the year will prevent taxpayers from claiming such payments as deductible expenses. Accrual method or fiscal year taxpayers may claim as deduction amounts not reported in an informative return, due to differences in accounting method or period, if a reconciliation of amounts claimed and reported is filed with the income tax return. Furthermore, informative returns must be issued and filed with PRTD, even for less than five hundred ($500) dollars, to claim the deduction for ABT and AMT.

Informative Return Requirements for Electronic Payments Processor and Third-Party Network Transactions: For transactions completed after January 1, 2019, a Payment Settlement Entity (PSE) must issue an informative return to a Participating Merchant (PM) reporting the gross amount of payments settled thru credit, debit card or third-party network organizations during the calendar year. For these purposes, a PSE is an entity that has the obligation to settle credit or debit cards payments and to make payments to a participating payee of a third-party network organization. Further, a PP is a merchant that accepts card payments and payments from third-party network organizations.

Sale of Partnership Interest: A purchaser of a partnership interest must withhold fifteen (15%) percent at source on the gain resulting from the sale of a partnership interest constituting Puerto Rico source income from a nonresident individual partner. The new sourcing rule mentioned above must be followed.

**SALES AND USE TAX:**

Prepared Food: Effective October 1, 2019, prepared food will be subject to a seven (7%) percent SUT rate rather than eleven-point five (11.5%) percent rate, regardless of the payment method used. The Secretary may postpone the effective date for thirty (30) days.

Exemption on Rental of Real Property: The SUT Exemption related to the lease of commercial property will only be applicable if the tenant complies with the Fiscal Terminal requirements set forth by the PR Code.

E-Books and Personal Hygiene Products: Act 257-2018 introduces a new exemption for electronic books (e-books) and certain feminine personal hygiene products.

Admission Fees: Definition is being expanded to include fees paid to private or membership clubs for the purchase of goods and services, either in physical commercial locations or through internet.

Candy: The definition is modified to also include as taxable item spreads formed by the confection of sugar or any other sweetener combined with chocolates, fruits, nuts or other ingredients.

Sales Price: Act 257-2018 clarifies that if a product is sold with discounts from the manufacturer or wholesaler, who then reimburse the difference to the retailer, the manufacturer or wholesaler will be obliged to reimburse along with the discount, an amount equal to the sales tax that would result if said refund was a sale.

Designated Professional Service and Services Rendered to Other Merchants: Effective March 1, 2019, a merchant with an annual volume of business of two hundred thousand ($200,000) dollars, or less, (previously fifty thousand ($50,000) dollars) will not be required to collect the SUT on designated professional services, and services rendered to other merchants.

**ADMINISTRATIVE PROVISIONS**

Successor Taxpayer: A taxpayer will be considered a Successor Taxpayer when such person acquires the assets or an interest in a business and maintains substantial similarity in the operations and the identity of the owners. A Successor Taxpayer becomes jointly and severally liable for taxes imposed by the PR Code with the person principally responsible for the tax.

Rehabilitation and Voluntary Disclosure Programs: The Secretary has the authority to establish a rehabilitation and voluntary disclosure programs subject to the following requirements:

- Payment must be made only by direct debit from bank account;
- Secretary may require payment guarantees;
- Taxpayer must be in full compliance with the provisions of the PR Code for the following five (5) years; and
- Qualification for the programs will be available only once per taxpayers.

Licenses: A licenses request or renewal filed after July 1, 2019 may be issued for a period of two (2) years, and the license fee is two points five (2.5) times the license established by law.

**EFFECTIVENESS**

This Act is effective immediately, except when specifically provided otherwise, as mentioned above.

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