Puerto Rico Tax NewsAlert

House Bill 2329 introducing the Puerto Rico Internal Revenue Code of 2015

Background

On February 11, 2015 the Governor of Puerto Rico introduced the anticipated tax reform through House Bill 2329 ("the Bill") to be known upon enactment as the Puerto Rico Internal Revenue Code of 2015 ("2015 Code"). The proposed tax regime intends to simplify the Puerto Rico taxation for individuals and corporations, as well as provide a relief in the income tax arena by reducing both corporate and individual tax rates. To compensate for the reduction in income taxes, the Bill replaces the current Sales and Use Tax ("SUT") with a Value Added Tax ("VAT"), increasing the tax rate on consumption from a 7% to 16%. Moreover, the VAT would have a broader basis, as most of the products and services are expected to be taxable.

This NewsAlert highlight the salient aspects of the proposed 2015 Code. As such, we encourage you to contact us to discuss the specific provisions of the Bill that may affect your business.

Income Tax – Individuals

For taxable year 2015 and thereafter, the Bill proposes the following reduced tax rates:

Tax rates for single, married filing separately and married filing jointly taxpayers that elect the "optional" method:

Taxable net income of:	Tax will be:
Less than $40,000	0 percent
In excess of $40,000 but equal to or less than $125,000	15% of the excess over $40,000
In excess of $125,000 but equal to or less than $200,000	$12,750 plus 20% of the excess over $125,000
In excess of $200,000	$27,750 plus 30% of the excess over $200,000

Tax rates for married taxpayers filing joint returns:

Taxable net income of:	Tax will be:
Less than $80,000	0 percent
In excess of $80,000 but equal to or less than $125,000	15% of the excess over $80,000
In excess of $125,000 but equal to or less than $200,000	$6,750 plus 20% of the excess over $125,000
In excess of $200,000	$21,750 plus 30% of the excess over $200,000

The following taxes are to be either eliminated or changed as follows:

Type of Tax	Current	Proposed
Interest	10% or 17% (IRA)	Ordinary rates
Dividends	10% or 15%	Ordinary rates
Long Term Capital Gain	10% or 15%	Ordinary rates
Alternate Basic Tax	10%, 15%, 24%, depending on income level	Eliminated
Special Tax on Self Employment	2%	Eliminated

Deductions

The following deductions would remain under the proposed tax reform:

1. Medical Expenses;
2. Charitable contributions;
3. Loss on personal property as a result of certain casualties;
4. Contributions to governmental pension or retirement systems;
5. Contributions to individual retirement accounts;
6. Interest paid on student loans;

The following deductions would be eliminated:

1. Casualty losses on principal residence;
2. Contributions to health savings account;
3. Mortgage interest: no longer a deduction, but instead it will be replaced by a "non-refundable" credit, which will be limited depending on taxpayer's gross income. If the gross income is $125,000 or less, the credit will be the lower of 15% of the interest paid or $5,250.

Exemptions

1. Personal and dependents' exemption would be eliminated;
2. Exemption on rental income from properties located in historical zones would be limited to those rental agreements entered into prior to February 16, 2015.
3. Exemption for cost of living adjustment (COLA) received by federal government employees who work in Puerto Rico will no longer be considered an exemption from gross income.

Income Tax – Corporation

The Bill is proposing few changes to the taxation of corporations, including, among others, the following:

- A flat corporate tax rate of 30%, instead of the gradual income tax rate of 39%.
- Surtax and recapture are expected to be eliminated.
- For taxable years commenced after December 31, 2014, taxpayers would have to depreciate assets using **<u>only</u>** the straight line method. Moreover, those assets placed in service in prior periods would have to be depreciated using the straight line method for their remaining useful live based on their tax basis as of such year.
- For Alternative Minimum Tax ("AMT"), the tax would be the higher of:
  - 25% of the alternative minimum taxable income ("AMTI") or
  - 1.5% of purchases or transfers of inventory from related persons or Home Office (certain items would continue to be subject to a reduced rate). No waiver would be available to further reduce the rate on this component.
- All expenses for services rendered or allocated from related persons or Home Office not subject to income tax in Puerto Rico will not be deductible in the determination of the AMTI.

- Net capital gains would no longer be subject to a reduced rate since the Bill is proposing a 30% rate.

- Dividend distributions to individuals, estates and trusts would be subject to a 30% tax.

- Dividend distributions to foreign entities would remain subject to a 10% withholding tax at source.

PwC Observation: The 51% disallowance on intercompany charges still remains for regular tax purposes. Moreover, the 100% disallowance on intercompany expenses and/or G&A allocations from related persons or Home Office for AMTI purposes, could significantly impact the effective tax rate of entities doing business in Puerto Rico subject to Puerto Rico tax under the regular or AMT scenarios. Companies affected by this provision should analyze its impact.

Income Tax – Conduit Entities

- The Bill proposes a new Chapter 7 whereas all flow through entity vehicles, i.e., special partnerships, regular partnerships (including LLCs treated as partnerships), and corporation of individuals will be treated as Conduit Entities.

- Existing special partnerships, regular partnerships (including LLCs treated as partnerships), and corporation of individuals as of December 31, 2014 will have a statutory conversion as of the first day of the taxable year commencing after December 31, 2014 to be subject to the new provisions. In those cases, the entities will be treated as having transferred its assets and liabilities to its owners in liquidation followed by a contribution by the owners of the distributed assets and liabilities to the conduit entity. The conversion should be effective as of the last day of the last taxable year commenced prior to January 1, 2015. No gain or loss or conversion costs shall be recognized by these entities and their owners as a result of the distributions resulting from this statutory conversion.

- Corporations would be allowed to be treated as conduit entities by making a voluntary conversion (except those corporations treated as regular corporations in another jurisdiction), subject to conversions costs such as built in gains and the payment of tax on accumulated E&P.

PwC Observation: The Bill is silent as to the impact of the statutory conversion for those partnerships in existence as of 1-1-11 that made an election under the 2011 Code to be treated as corporations. On the other hand, the election for regular corporations to be treated as conduit entities under the 2015 Code could represent a planning opportunity depending on the business structure and tax attributes.

Value Added Tax

The Bill is proposing to substitute the current SUT with a VAT regime effective January 1, 2016. Notwithstanding, as a transition mechanism, the SUT provisions of the 2011 Code, as amended, will still apply until December 31, 2015 by substituting the name SUT by VAT and increasing the tax rate to 16% effective April 1, 2015

General

The VAT will be imposed on taxable transactions, which include: (i) the import of goods to PR; (ii) the sale or transfer of goods and the rendering of services in PR by a merchant (including the business to business services - B2B); (iii) the rendering of services in PR by a nonresident to a person in PR; and, (iv) combined transactions.

The proposed VAT rate is 16%, whereas the following transactions would be subject to 0%: (i) the sale of goods for export; (ii) the rendering of services for export and (iii) the import of raw materials by a manufacturer holding an exempt certificate for eligible manufacturing plants.

VAT Exemptions

- Certain financial services;
- Sale and import of prescription drugs and articles for health condition treatments;
- Sale of articles and equipment to assist disabled persons;
- Sale of goods and services that qualify for reimbursement from Medicare, Medicaid and the health insurance plan of the PR Government;
- Sale of goods and services to the US (including any state) and the PR Government;
- The sale and import of gasoline, fuel and petroleum derivatives (except for propane gas and its derivatives or similar gases);
- Rent of any property subject to the room occupancy tax imposed by the PR Tourism Company;
- Sale and import of food and food ingredients;
- Sale of goods acquired using funds received by PAN and WIC;
- Sale of real property;
- Rent of real property used as principal residence, student housing and certain elderly homes;
- Transfer of goods or services rendered by certain non for profit entities;
- Sale and import of machinery, medical-surgical material, articles, equipment and technology to (or by) certain hospitals;
- Agriculture articles sold to or imported by bona-fide farmers;
- Sale of goods by churches or religious organizations;
- Sale and import of certain goods to or by certain merchants dedicated to the tourism industry;
- Sale and import of vehicles;

Payment, Withholding and Remittance of the VAT

The Bill proposes that every merchant that sells or render services that are considered taxable for VAT purposes is responsible of collecting and remitting the VAT. Duly certified small merchants (i.e., those with less than $75k of gross revenues) would be exempt from collecting the VAT.

Type of transaction	Responsible for VAT	Responsible for withholding & remitting
Import	Person that imports the goods	N/A
Sale of goods	Buyer	Seller
Services rendered by merchants	Person that receives the service	Merchant - service provider r
Services rendered by a nonresident	Person that receives the service	N/A

VAT on imports should be paid before taking possession of the goods or merchandise unless the items are imported by bonded merchants or by air carrier in which case the merchant should pay the tax with the monthly tax on imports return. The VAT applicable to the sale or transfers of goods and the rendering of services should be remitted to the PRTD with the monthly VAT return, based on the following due dates.

Returns and Declaration

- Declaration of Imports – Prior of taking possession of the merchandise
- Monthly Tax on Imports Return – Due on or before the 10th day of the month after the imports have been released
- Monthly VAT Return – Due on the 20th day following the month in which the tax was collected.
- Annual Declaration of Small Merchant – Due 60 days after the income tax return is filed.

Adjustments, credits and refunds

Considering that the timing to remit the VAT to the Puerto Rico Treasury depends in the accounting period of the merchant, the Bill contemplates an adjustment mechanism, called notes of credits and debits, which will be used to reflect any increases or decreases in the selling price of an item already included in a "Fiscal Statement".

Credit for Value-Added Tax Paid

In general terms, the amount of the credit will be computed based on the sum of the following items:

- VAT paid upon introduction of taxable items into Puerto Rico that are directly or indirectly related to the sale of taxable items and services, plus
- VAT paid by a merchant on the purchase of taxable items and services that are directly or indirectly related to the sale of taxable items or services, plus
- VAT paid by the merchant upon the service provided by a non-resident.

Merchants will be able to claim the credit only if the VAT paid during the corresponding month was reported in a Monthly Return of Imports or reflected in a "Fiscal Statement".

Overpayments

Overpayments up to $10,000 would only be allowed to be carried forward in the VAT monthly return whereas, subject to certain limitations, overpayments in excess of $10,000 could be refunded.

Payment for the relief of eligible consumers

The Secretary of the Treasury would be authorize to issue payments to certain taxpayers during the months of November, March, and July, starting in November 2015, that, due to their profile (e.g., age, income, family composition, among others) are considered to be eligible consumers for a VAT relief.

Merchant registry and certificates

Every merchant dedicated to a trade or business in Puerto Rico will be required to request a Merchant Certificate. Alternatively, small merchants (i.e., those with less than $75k of gross revenues), may request a Small Business Certificate that would further relief those merchants from collecting and remitting the VAT.

Certificate for manufacturing plants

Manufacturing plants enjoying the benefit to pay 0% of VAT, shall have a valid Certificate for Manufacturing Plants, which will be valid for three years.

Certificate of exempt purchases

Eligible persons which may acquire or import exempt items or receive exempt services will be required to have a valid Certificate of Exempt Purchases, which will be valid for three years.

Eligible Persons are the following:

1. The government of the United States of America, any of its states, the District of Columbia, and the government of Puerto Rico
2. Any hospital unit, as defined
3. Any version dedicated to the tourism activity, as defined
4. Bona fide farmers

Eligible merchant certificate

Merchants with a volume of sales in excess of $500,000 annually for the last three immediate years and whish 80% of its sales are subject to a 0% VAT tax rate may qualify for a Certificate of Eligible Merchant.

Multilevel businesses

Multilevel businesses could be allowed to remit the VAT on behalf of their independent distributors, subject to a closing agreement with the Puerto Rico Treasury.

For more detailed information, please contact:

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