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Global Tax Alert

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Puerto Rico proposes tax reform

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Executive summary

On 16 April 2018, Puerto Rico's House of Representatives proposed House Bill 1544 (HB 1544), which would amend the Puerto Rico Internal Revenue Code of 2011 (PR Code). This draft legislation has been 18 months in the making and, if approved, would modify the way individuals and corporations are taxed in Puerto Rico.

A noteworthy feature of HB 1544 is the requirement that income tax rate reductions for corporations and individuals depend on meeting certain revenue-based fiscal tests. Namely, total revenues to the Puerto Rico general fund must exceed the budgeted amounts for fiscal year 2017-2018 by 2% and for the first period of fiscal year 2018-2019 by 3%. If these tests are not met, any income tax rate reductions would be limited to tax revenues collected in excess of the Government's budget amounts for those periods.

Similarly, HB 1544 would also require the elimination and reduction of certain sales and use taxes to be financed by a special account that would be funded by the reduction of subsidies and tax credits established in special laws (i.e., tax incentive laws) and previously included in the budget for fiscal year 2017-2018.

These fiscal test provisions highlight the contingent nature of the income tax rate reductions that are discussed in further detail later.

HB 1544 is currently in the legislative process, with hearings taking place to allow for comments from various interested parties and stakeholders, such as trading, commercial and professional associations, among others.

The Puerto Rico Government has publicly commented that it intends to have the bill enacted on or before 30 June 2018, which is the end of the current legislative session and also the deadline established by the Fiscal Oversight and Management Board (FOMB) for approving the 2018-19 budget. The budget contains tax revenue projections and estimates that are based on some of the proposed amendments included in HB 1544.

Detailed discussion

Individuals

HB 1544 would significantly reduce individual income tax rates. It also would increase from US\$9,000¹ to \$12,500 the amount of income that would be exempt from tax. This provision would be effective for tax years beginning after 31 December 2018.

Regular tax on individuals for tax years commencing after 31 December 2018

Current		Proposed	
Net taxable income:	Tax will be:	Net taxable income:	Tax would be:
Not over \$9,000	0%	Not over \$12,500	0%
Over \$9,000, but not over \$25,000	7% of the excess over \$9,000	Over \$12,500, but not over \$21,000	.9%
Over \$25,000, but not over \$41,500	\$1,120 plus 14% of the excess over \$25,000	Over \$21,000, but not over \$45,000	\$77 plus 9% of the excess over \$21,000
Over \$41,500, but not over \$61,500	\$3,430 plus 25% of the excess over \$41,500	Over \$45,000, but not over \$58,000	\$2,237 plus 19% of the excess over \$45,000
Over \$61,500	\$8,430 plus 33% of the excess over \$61,500	Over \$58,000	\$4,707 plus 31% of the excess over \$61,500

Commencing after 31 December 2018, HB 1544 would revise the existing gradual adjustment rules. It would impose a 5% gradual adjustment (i.e., additional tax) on individual taxpayers whose adjusted gross income exceeds \$200,000. Under HB 1544, the gradual adjustment amount would never exceed \$13,273.

Alternative basic tax (ABT)

HB 1544 also would modify the current ABT structure by further breaking down the levels of taxable income and the applicable rates. It would apply an ABT of 1%, up to a maximum of 24%. The ABT would apply to individual taxpayers whose alternative minimum net taxable income exceeds \$25,000.

Current		Proposed	
If the alternative minimum net taxable income is:	Tax will be:	If the alternative minimum net taxable income were:	Tax would be:
\$150,000 or more but not over \$200,000	10%	Over \$25,000 but not over \$50,000	1%
Over \$200,000 but not over \$300,000	15%	Over \$50,000 but not over \$75,000	3%
Over \$300,000	24%	Over \$75,000 but not over \$150,000	5%
		Over \$150,000 but not over \$250,000	10%

In calculating alternative minimum net taxable income, HB 1544 would establish limits on deductions and expenses that may be claimed by individuals who engage in a trade or business. If an Agreed Upon Procedure Report or Compliance Attestation Report, prepared by a Certified Public Accountant (CPA) who is licensed in Puerto Rico and belongs to a peer-review program, is filed with the Secretary of the Treasury, the limits would not apply. Filing one of these reports would allow individuals to deduct all ordinary and necessary expenses related to their trade or business.

HB 1544 would allow individuals to claim a credit, subject to certain limitations, for ABT paid for a tax year commencing after 31 December 2018.

Optional tax for self-employed individual taxpayers

For tax years beginning after 31 December 2018, HB 1544 provides that self-employed individuals, whose only source of income comes from their business, may opt to use a fixed tax rate schedule to determine their income tax liability as follows:

Gross revenue:	Tax would be:
Not over \$100,000	5%
Over \$100,000, but not over \$200,000	10%
Over \$200,000, but not over \$500,000	15%
Over \$500,000	20%

To make this election, the self-employed individual would have to: (i) engage in a trade or business in which gross revenue is derived from the rendering of services; and (ii) include the gross income on an information return. Additionally, the entirety of the gross income would have to be subject to withholding at source or estimated tax payments. The Secretary may waive the annual tax return filing requirement for an individual who opts for this fixed rate.

Tax on individuals, estates and trusts with respect to interest paid or credited on deposits in interest-bearing accounts

Under current law, financial institutions must deduct and withhold 10% or 17%, as applicable, on the amount paid or credited as interest, over the first \$500 accumulated in each quarter. HB 1544 would require financial institutions to deduct and withhold these same amounts, but in excess of a lower threshold of the first \$25 accumulated in each quarter. This would be effective for tax years 2019 and thereafter.

Special tax on variable annuities in separate accounts

For tax years commencing after 31 December 2017, HB 1544 would allow taxpayers to elect, subject to certain requirements, to apply a 15% flat income tax rate, instead of the regular tax rates, on the total amount paid during the tax year under a variable annuity contract issued by an eligible insurance company.

Additional proposed changes applicable to individuals

HB 1544 also would:

- ▶ Increase the tax exemption amount allowed under certain types of pension plans (includes both public and private plans) from \$11,000 under the current PR Code provisions to \$20,000 and from \$15,000 to \$25,000 for pensioners that are over the age of 60 for tax years commencing after 31 December 2018
- ▶ Limit the losses claimed by a shareholder of a corporation or a partner in a partnership or special partnership to 90% of the distributable share for tax years commencing after 31 December 2018 (losses incurred for tax years commencing after 31 December 2014 and before 1 January 2019, will continue to be limited to 80% of the distributable share)
- ▶ Limit the mortgage interest deduction by reducing the cap for individuals from \$35,000 to \$20,000 for tax years beginning after 31 December 2018
- ▶ Change the deadline for making a yearly Individual Retirement Account (IRA) contribution from 15 April of the following tax year to no later than the last day of the tax year for which the deduction is being claimed for tax years beginning after 31 December 2018
- ▶ Eliminate the personal exemption (\$1,500 single/ \$3,000 married) and dependent exemption (\$2,500) for tax years commencing after 31 December 2017, and replace them with a tax credit of \$200 per dependent, which would be capped at \$600 for three or more dependents

Additionally, HB 1544 would reinstate the earned income credit. The earned income credit would be effective for tax years 2018 and forward and available only to individuals who are residents of Puerto Rico for the full year and who generate earned gross income. The credit would be 5%, 7.5%, 10% or 12.5% on the earned gross income, depending on the number of dependents and the level of income. HB 1544 would establish new requirements for married taxpayers to be able to claim the credit. Also, in line with other proposed amendments under HB 1544, it would require the earned gross income, which would give rise to the eligibility for the credit, to be properly reported in an information return or wages withholding statement.

Corporations

HB 1544 would reduce corporate income tax rates for tax years commencing after 31 December 2018, as follows:

Current rates		Proposed rates
Normal tax rate	20%	19%
Surtax rate	5%-19%	5%-12%
Maximum tax rate	39%	31%

The following table illustrates how the surtax would apply:

Current surtax		Proposed surtax	
If the surtax net income is:	Surtax will be:	If the alternative minimum net taxable income were:	Tax would be:
Not over \$75,000	5%	Not over \$75,000	5%
Over \$75,000 but not over \$125,000	\$3,750 plus 15% of the excess over \$75,000	Over \$75,000 but not over \$425,000	\$4,500 plus 11% of the excess over \$75,000
Over \$125,000 but not over \$175,000	\$11,250 plus 16% of the excess over \$125,000	Over \$425,000	\$39,500 plus 12% of the excess over \$425,000
Over \$175,000 but not over \$225,000	\$19,250 plus 17% of the excess over \$175,000		
Over \$225,000 but not over \$275,000	\$27,750 plus 18% of the excess over \$225,000		
Over \$275,000	\$36,750 plus 19% of the excess over \$275,000		

HB 1544 would reduce the alternative minimum tax (AMT) rate to 19% for taxpayers that are not required to accompany their tax returns with audited financial statements. If audited financial statements are required, the applicable AMT rate would be 23%. The AMT would be the higher of \$500 or the tax resulting from imposing the applicable rate (19% or 23%) to the alternative minimum net taxable income.

For purposes of calculating the alternative minimum net taxable income, HB 1544 would establish limits on deductions and expenses to be claimed by corporate taxpayers. A corporate taxpayer that files an Agreed Upon Procedure Report, Compliance Attestation Report, or Audited Financial Statements with the Secretary would not be subject to the limitations. Filing one of these reports would allow the corporate taxpayer to deduct all ordinary and necessary expenses related to its trade or business in order to arrive at its alternative minimum net taxable income. The report must be prepared by a CPA who is licensed in Puerto Rico.

Optional tax for corporate taxpayers carrying out a trade or business as service providers

HB 1544 would allow corporate taxpayers engaged in a trade or business in which income is derived from services and subject to withholding at source to elect to use a fixed tax rate to determine their income tax liability. The fixed rate would apply to the gross income derived from the rendering of services.

Gross revenue:	Tax would be:
Not over \$100,000	5%
Over \$100,000, but not over \$200,000	10%
Over \$200,000, but not over \$500,000	15%
Over \$500,000	20%

To make this election, the corporation would have to: (i) be engaged in a trade or business in which gross revenue is derived from the rendering of services; and (ii) include the gross income on an information return. Additionally, the entirety of the gross income would have to be subject to withholding at source.

Life insurance companies

The special additional tax on separate accounts maintained by life insurance companies would increase from .10% to .20% for tax years commencing after 31 December 2017.

Large taxpayers

The definition of a large taxpayer would include entities whose operations: (i) are covered under a tax exemption decree issued under Act 73-2008 (or similar predecessor acts such as Act 135-1998), Act 74-2010, Act 225-1995, Act 20-2012, Act 52-1989, Act 83-2010, or Act 273-2012; and (ii) are required to submit audited financial statements.

In addition, HB 1544 would establish a new rule for related entities of a controlled group in order to determine if those entities are considered large taxpayers. Under HB 1544, the aggregate volume of all related entities would be considered for purposes of the \$50 million volume test. If at least one entity within the group is considered a large taxpayer, then all the entities within the group would be considered large taxpayers for all subsequent tax years.

Under HB 1544, once a taxpayer met the requirements for being considered a large taxpayer for one tax year, the taxpayer would remain a large taxpayer for all subsequent tax years. HB 1544 would allow the taxpayer to request an administrative decision from the Secretary, allowing it to be removed from the large taxpayer category for subsequent tax years.

HB 1544 also would require taxpayers to pay a fee of \$1,000 to register as a large taxpayer with the Large Taxpayers' office and make an annual contribution of an unknown amount to support the office.

Additional proposed changes

HB 1544 also would include the following provisions:

- ▶ For tax years commencing after 31 December 2018, a business with \$3 million or less in volume could elect to depreciate, amortize or deplete certain machinery, equipment, personal property, appliances or any other fixed asset over a useful life of two years; currently, the useful life of assets ranges from 3 to 20 years.
- ▶ For tax years commencing after 31 December 2018, the deduction for net operating losses (NOLs) would be limited to 90% (rather than 80% currently) of net income.
- ▶ The 51% disallowance for related-party transactions would no longer apply for tax years commencing after 31 December 2017, provided a transfer pricing study prepared under Section 482 of the US tax code is provided.
- ▶ For tax years commencing after 31 December 2018, the 50% disallowance for deductions related to meals and entertainment expenses would increase to 75% and be further limited to a maximum of 25% of gross income for the tax year.
- ▶ For tax years commencing after 31 December 2017, a deduction would not be allowed for settlement payments made on account of sexual harassment cases that include a non-disclosure clause.
- ▶ For tax years commencing after 31 December 2017, an employer could claim a 150% deduction for salary paid to each college student hired to work at least 20 hours per week for nine months or a minimum of 800 hours and making at least \$10 per hour.
- ▶ The salary deduction would be 200% for students hired under an internship with the Puerto Rico Treasury Department.

Sales and use tax (SUT)

The statement of motives for HB 1544 indicates that the 4% SUT applicable to certain business-to-business services and designated professional services (the 4% Special SUT) would be repealed. The 4% Special SUT would be phased out as follows:

- ▶ 3% from 1 January 2019
- ▶ 0% from 1 January 2020

An apparent oversight in the text of HB 1544, however, states that a 2% rate would apply from 1 July 2018 and a 0% from 1 July 2019.

HB 1544 also would exempt from the SUT surcharge of 4.5% prepared foods sold by restaurants, bringing the total applicable SUT rate to 7%. For this exemption to apply, the restaurant would need to obtain a certification from the Secretary of Treasury (Secretary). The statement of motives provides the reduced SUT rate on prepared foods will only apply when payment is made through electronic methods (i.e., credit card).

Return filing obligations and due dates

For tax years 2019 and forward, HB 1544 would eliminate the minimum threshold of \$5,000 (gross income net of exemptions) for filing a Puerto Rico income tax return. Therefore, HB 1544 would require resident and non-resident individuals to file an income tax return, regardless of the level of Puerto Rico gross source income, unless the tax obligation is satisfied through income tax withholding at source. Also, in line with the proposed amendments to the ABT provisions, an individual would be required to file a return when the net income subject to ABT equals or exceeds \$25,000.

HB 1544 would exempt corporations from the tax return filing requirement if the tax on the total gross income of the entity has been paid through withholding at source. HB 1544 also would require only one signature on the return from any of the currently authorized officials.

In addition, HB 1544 would require the corporate income tax return to be signed as prepared or revised by a Puerto Rico licensed CPA who participates in a peer-review program. This requirement would apply when the return must be accompanied by audited financial statements. These rules would be effective starting with tax year 2018.

HB 1544 would increase the automatic extension of time to file the individual and corporate income tax returns from three months to six months for tax year 2017 and subsequent years. For partnerships, special partnerships and corporations of individuals (conduit entities), HB 1544 also would lengthen the automatic extension time from one month to six months, effective with tax year 2017 and forward.

Audited financial statements requirements

HB 1544 would require professional certifications to be included with the tax filings. Also, HB 1544 would require the Puerto Rico CPA issuing the reports to be part of a peer-review program.

Audited financial statements (AFS) requirements

Volume of business	2011 PR Code	HB 1544	
		Tax year 2018	Commencing after December 31, 2018
Less than \$1m	No AFS required.	No AFS required.	ABT and AMT limitations do not apply if AUP or CA* are voluntarily submitted. CPA must belong to a peer-review program.
Equal to or greater than \$1m but less than \$3m	No AFS required; corporations voluntarily submitting AFS may obtain a full waiver of 7% withholding tax; others may obtain a partial waiver.	No AFS required; entities voluntarily submitting AFS may obtain a full waiver of 7% withholding tax; others may obtain a partial waiver. CPA must belong to a peer-review program.	ABT and AMT limitations do not apply if AUP or CA* are voluntarily submitted. CPA must belong to a peer-review program.
\$3m or more	AFS required.	AFS required. CPA must belong to a peer-review program.	AFS required. CPA must belong to a peer-review program.

*AUP – Agreed upon procedures report; CA – Compliance Attestation Report

Audited financial statements (AFS) requirements for members of a consolidated or combined group

Consolidated group's volume of business	2011 PR Code	HB 1544	
		Tax year 2018	Commencing after 12/31/2018
\$3m or more	Members – volume of business less than \$1m, no AFS required.	Members – volume of business less than \$1m, no AFS required. CPA must belong to a peer-review program.	Members – AUP or CA required. CPA must belong to a peer-review program.
	Members – volume of business equals \$1m or more, stand-alone AFS required, listing in the notes all related entities ETB* in Puerto Rico.	Members – volume of business equals \$1m or more, stand-alone AFS required, listing in the notes all related entities ETB in Puerto Rico. CPA must belong to a peer-review program.	Members – volume of business equals \$1m or more, stand-alone AFS required, listing in the notes all related entities ETB in Puerto Rico. CPA must belong to a peer-review program.

*ETB– Engaged in trade or business

Supplemental information (SI) schedules

HB 1544 would maintain the SI schedules requirement. For tax year 2019 and thereafter, however, it provides that the schedules could be revised to request different information. In this case, the CPA issuing the AFS accompanying the SI schedules would have to belong to a peer review program.

New uncertain tax position (UTP) schedule

HB 1544 would require, together with the filing of the tax return, a UTP schedule to report and describe any UTP as provided under accounting for income taxes guidance (US ASC 740). The new reporting requirement, which is similar to existing rules at the federal level, would be effective for tax year 2019 and onwards.

Income tax withholding

Withholding on wages

HB 1544 would change the manner in which the employer would withhold on wages. The changes would be effective for tax year 2019. The proposed changes in income tax withholding may include having the employer estimate the annual salary. HB 1544 also would deny the deduction to the employer if proper reporting is not made.

Withholding on judicial and extrajudicial settlements

HB 1544 would increase the withholding at source from 7% to 10% for payments made after 31 December 2017. Also, HB 1544 would consider the payment made to the legal representative who advises on these settlements as taxable income, and subject to withholding as services and reporting. HB 1544 would not allow a deduction for expenses claimed on account of these payments if the payments were not properly reported.

Withholding on services rendered

HB 1544 would increase the withholding rate on payments on account of services rendered from 7% to 10% for those made after 31 December 2018. Also, HB 1544 would introduce an option for the individual to increase the withholding rate to the maximum rate under the optional flat tax rate method. Additionally, HB 1544 would modify certain definitions of items subject to the withholding, and eliminate the \$1,500 exempt amount for payments made after 31 December 2018. HB 1544 also would amend the existing rules to obtain a partial or full waiver from the withholding.

HB 1544 would establish a new quarterly reconciliation return requirement to report payments made, tax withholding withheld and deposited, and payment of any unpaid balances. The new return requirement would be effective as of the same date as the increase in the rate (i.e., tax year 2019 and onward).

Withholding on non-Puerto Rico residents

Similar to existing rules that deny the deduction for a payment made if the related withholding is not remitted to the Puerto Rico Treasury Department, HB 1544 would apply this rule to non-Puerto Rico residents. It would further require the payment to be reported on an information return.

Income tax withholding on the sale of interest in a partnership

HB 1544 would impose a new 15 withholding tax on the gain from the sale of the partnership interest that constitutes Puerto Rico-source income.

Closing agreements

HB 1544 would temporarily repeal most of the limitations put on the Secretary's powers to enter into closing agreements until 31 December 2020. After that date, the current limitations would apply once again. To enter into a closing agreement, the Secretary would have to ensure that the following criteria are met:

- ▶ There may be a benefit for the Department of the Treasury in concluding a case, controversy or possible controversy permanently.
- ▶ The taxpayer demonstrates, to the satisfaction of the Secretary, that there are sufficient and valid reasons to formalize a closing agreement.
- ▶ The Secretary determines that the agreement does not create a disadvantage for the Government of Puerto Rico and:
 - The payments made under the closing agreement are not related to future taxes that are not owed by the taxpayer at the moment of granting the closing agreement.
 - The tax rate applicable to the transaction covered under the closing agreement is not less than the rate prevailing in the PR Code or a special law at the moment of granting the closing agreement.

Partnerships

HB 1544 would no longer treat a partnership as terminated within 12 months of a sale or exchange of 50% or more of the total interest in a partnership's profits and capital.

HB 1544 would create a new source-of-income rule for a sale of a partnership interest. The rule would be effective for transactions taking place after 31 December 2017. This new rule would replace the current rule of place of organization or residency of the seller. Under the new rule, HB 1544 would treat the sale of a partnership interest as from sources within Puerto Rico as if the partnership would have sold the assets. The purchaser would be required to withhold 15% on the Puerto Rico-source income gain.

Other relevant provisions

HB 1544 also would:

- ▶ Incorporate the rules and restrictions promulgated and imposed under pertinent executive orders and resolutions issued by the Government and the committee named by the Fiscal Agency and Financial Advisory Authority (AAFAF), with respect to the use of granted credits and the approval of those in process as of 7 March 2017, as well as new ones
- ▶ Provide that the resolutions and determinations of the committee with respect to the use of granted credits will prevail over the provisions of the PR Code, as amended, and any other special law, when a discrepancy exists between them
- ▶ Authorize the Secretary to enter into agreements with government suppliers that have pending invoices with the Government to credit such amounts to tax debts or convert them into tax credits for future periods
- ▶ Prevent taxpayers that do not comply with filing of required information returns from claiming related deductions (e.g., interest)
- ▶ Require a new annual information return from entities dedicated to processing payments through electronic methods, including payment processing of credit and debit cards through a network (the information return must include the total amount of processed payments credited to the participating merchant)
- ▶ Amend the provisions related to qualified retirement plans and IRA distributions to reflect guidance issued by the Secretary through administrative guidance related to disasters
- ▶ Authorize the Secretary to request an Agreed Upon Procedures Report that is certified by a local CPA and validates compliance with the eligibility requirements under the PR Code when nonprofit entities apply for exemption under the PR Code
- ▶ Impose a new special tax on nonprofit entities that pay employees or officials salaries over \$250,000 (tax would be determined using the maximum corporate rate (31%))
- ▶ Establish the term “successor taxpayer,” which provides for joint tax liability in certain cases in which operations or assets are transferred
- ▶ Include restitution of unpaid taxes as a remedy in certain misdemeanor and felony convictions
- ▶ Authorize the Secretary to impose a penalty between 25% and 100% on taxpayers that claim non-business personal expenses as deductions
- ▶ Authorize the Secretary to require electronic filing of many of the tax filings

Implications

The summary presented in this Tax Alert is intended to highlight certain key provisions and rules being proposed under HB 1544. However, it is not intended to fully capture every change or detail of the various proposed changes.

We will monitor the progress of HB 1544 and issue subsequent updates, including more detailed and specific discussion of certain subject matters as pertinent.

The effects of the legislative budget approval process and the determination of the Fiscal and Oversight Board under PROMESA law on the budget could certainly impact the approval and further modifications to the provisions included in HB 1544.

Endnote

1. Currency references in this Alert are to US\$.

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