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New Disclosure Requirements for Financial Statements Filed with Puerto Rico Tax Authorities

On December 25, 2013, Governor García Padilla signed Act 163-2013, which imposes specified disclosure requirements with respect to financial statements filed with various government agencies, as well as other changes to the Puerto Rico Internal Revenue Code of 2011, as amended (the Code).

DISCLOSURE REQUIREMENTS

Act 163-2013 requires that financial statements filed in connection with a taxpayer's municipal license tax, property tax, and Puerto Rico income tax return include certain tax disclosures, as follows:

Municipal License Tax Return

- **Sales Volume in excess of \$3,000,000.00 per year** – Return must include audited financial statements, as well as the following supplementary information:
 - Total gross income derived from services rendered, sales of goods (gross sales) or from any other business activity;
 - Breakdown of amounts included in “other income;”
 - Stores and other commercial outlets: total returns;
 - Gas stations: gallons of gasoline sold, in addition to the aforementioned; and
 - Businesses operating under a tax exemption grant or concession: detailed breakdown of income items derived from the exempt operations, as well as those derived from any taxable business.
- The auditing certified public accountant (CPA) must be licensed in Puerto Rico and must subject the supplementary information to the same auditing procedures applicable to the financial statements.
- Since Act 163-2013 is effective immediately upon enactment, the supplementary information requirement applies to the municipal license tax returns to be filed April 22, 2014.
- **Sales Volume of \$3,000,000.00 or less per year**-
Act 163-2013 did not change the filing requirements.

Municipal Personal Property Tax Return

- Every corporation, except not-for-profit corporations and those without capital stock or whose volume of business does not exceed \$3,000,000.00 per year, must submit with its municipal personal property tax return, along with its financial statements, the following supplementary information:
 - Inventory amount for every month of the calendar year, determined under United States Generally Accepted Accounting Principles (GAAP) or other valuation method accepted for purposes of the Municipal Property Tax Act of 1991, as amended (other than the method known as Last-In-First-Out);

- Breakdown of inventory reserve amounts, if any, for every month of the calendar year, as well as every month of the taxable year, if not a calendar year taxpayer;
- Inventory adjustments, if any, for every month of the calendar year, as well as every month of the taxable year, if not a calendar year taxpayer;
- Balance of cash in bank as of January 1st, as well as the amount of cash deposited in a financial institution before January 1st, but credited to the account after January 1st; and
- Businesses operating under a tax exemption grant or concession: detail of the value of assets that, as of January 1st, are not being used in the exempt operation.
- As in the case of the supplementary information to be submitted with the municipal license tax return, the auditing CPA must be licensed in Puerto Rico and must subject the supplementary information to be filed with the municipal personal property tax return to the same auditing procedures applicable to the financial statements.
- Since Act 163-2013 is effective immediately upon enactment, the supplementary information requirement applies to the municipal personal property tax returns to be filed May 15, 2014.

Puerto Rico Income Tax Return

- **Financial Statements** – The requirements to submit financial statements with the Puerto Rico income tax return have been substantially modified. If the taxpayer’s volume of business for the taxable year is:
 - Less than \$1,000,000: taxpayer is **not** required to include financial statements with the return;
 - \$3,000,000 or more: taxpayer **must** include with the return financial statements audited by a Puerto Rico-licensed CPA pursuant to United States Generally Accepted Auditing Standards (US GAAS);
 - Between \$1,000,000.00 and \$2,999,999.99: although the statutory language is silent in this regard, the interplay between the various sub-sections would suggest that in this case, the taxpayer must include with the return unaudited financial statements prepared under GAAP.
- **Supplementary Information**
 - Obligation to submit: businesses – including corporations, partnerships, “special partnerships”, limited liability companies (LLCs), insurance companies, registered investment companies, individuals (DBAs), cooperatives, real estate investment trusts (REITs) and any other entity engaged in trade or business or in the production of income in Puerto Rico – may be required to submit supplementary information depending on their volume of business for the taxable year, as follows:
 - *Less than \$1,000,000*: taxpayer is **not** required to include supplementary information with the return;
 - *\$3,000,000 or more*: taxpayer **must** include the supplementary information with the return;
 - *Between \$1,000,000.00 and \$2,999,999.99*: taxpayer may opt to submit the supplementary information, in order to be entitled to total or partial waiver of withholding tax on payments for services rendered pursuant to Code §1062.03(g), provided the other requirements established therein are met.
 - Information to be submitted: the supplementary information submitted must establish:
 - Compliance with the wage withholding and deposit requirements in §1062.01;
 - Compliance with the withholding and deposit requirements with respect to payments for services rendered pursuant to §1062.03;
 - That the business has deposited all taxes withheld from payments to non-residents, as required by Subchapter B of Subtitle A of the Code;
 - That the business has met all reporting and deposit requirements with respect to use taxes pursuant to Subtitle D of the Code;
 - That the reporting and deposit of sales taxes, as reduced by any credit for sales taxes paid on tangible personal property acquired for resale, have been made in compliance with Subtitle D of the Code;

- With respect to credits from the acquisition of tangible personal property for resale, the total amount generated, the amounts claimed in the monthly returns, and the balance of unused credits as of the beginning and the end of the year, as required by Subtitle D of the Code;
- That the expense accounts as reported in the accounting books and records do not include personal expenses of partners, shareholders, members, owners, employees or relatives thereof;
 - The certified public accountant must determine, in the exercise of his/her professional judgment and considering the particular trade or business under consideration, which expense accounts are more likely to be used to record personal expenses not related to the business.
 - The accounts to be analyzed include, but are not limited to:
 - ♦ Maintenance;
 - ♦ Repairs;
 - ♦ Representation expenses;
 - ♦ Seminars, training and education;
 - ♦ Reimbursements;
 - ♦ Automobiles and transportation;
 - ♦ Travel; and
 - ♦ Miscellaneous expenses (others).
- If personal expenses are included in the business's accounts, a breakdown of the personal expenses so included, the amount thereof and the account in which included must be prepared.
- If the taxpayer has disposed of tangible personal property at a loss, in exchange for a maintenance or service agreement, that the applicable use tax has been paid;
- The amount of salaries reported in Form 499R2/W2PR, as well as other payments, reimbursements or compensation to the owners, shareholders, partners or members, including any payments made on their behalf, if any;
- That the amount of salaries paid during the year agrees with the amount reported in Form W-3PR; if the close of the taxable year is not December 31st, the information shall be validated with the quarterly returns;
- A reconciliation of the amount claimed as expense for services rendered, and (1) the amounts reported in Form 480.6 submitted to the Department of the Treasury (Treasury), (2) payments for services rendered of less than \$500.00;
- A reconciliation of rental expenses with the Forms 480.6 submitted to Treasury;
- Year-end balance of loans to partners, members or shareholders, or if applicable, to related parties or members of the controlled group;
- *Businesses operating under a tax exemption grant or concession*: compliance with the requirements of the grant or concession, including, but not limited to, employment, investment, and sales volume requirements, as well as that the income reported as exempt in the return was derived from the activity covered by the grant or concession;
- *Construction businesses*: with respect to contracts in excess of \$1,000,000:
 - That the sales and use tax on purchases of construction materials has been paid;
 - The accounting method used and whether such method is authorized for the taxable year;
 - If using the percentage of completion method, that the completion percentages for each project have been certified by an engineer;
 - When applicable, that the amount shown as retainage in the books and records represent the total amounts retained with respect to unfinished works or projects;

- *Hospitals operating under Act No. 168 of June 30, 1968, as amended, known as the "Hospital Facilities Tax Exemption Act" (Act 168):*
 - That the amount reported as Eligible Payroll meets the criteria of Act 168; and
 - That the credit claimed in the hospital's return meets the requirements in §1(a) of Act 168;
- *Financial institutions:*
 - That the interest expense claimed as a deduction in the return does not include interest allocable to exempt obligations acquired after December 31st, 1987;
 - That deductible expenses, other than interest, do not include expenses attributable to exempt income; and
 - A detailed description of the method used to determine non-deductible expenses (other than interest).
- The auditing CPA must be licensed in Puerto Rico and must subject the supplementary information to the same auditing procedures applicable to the financial statements.
- Treasury will establish mechanisms so that the CPA can file the supplementary information electronically.
- Although Act 163-2013 provides that the supplementary information requirement applies for taxable years beginning after December 31st, 2012 (that is, the returns to be filed by April 15, 2014, for calendar year taxpayers), on December 27, 2013, Treasury issued Administrative Determination 13-22 to postpone the effective date of **some, but not all**, of the items of supplementary information required, to taxable years commencing after March 31st, 2013. The postponed items are:
 - That relating to expense accounts not including personal expenses of partners, shareholders, members, owners, employees or relatives thereof;
 - Compliance by businesses operating under a tax exemption grant or concession with the terms of the grant or concession;
 - The accounting method used by construction companies, and engineer certification of completion percentage for those under the percentage of completion method;
 - The requirements applicable to hospital units operating under Act 168; and
 - In the case financial institutions, that the interest expense claimed as a deduction does not include interest allocable to exempt obligations acquired after December 31st, 1987, and disclosure of the method used to determine non-deductible expenses (other than interest).
- The Code, as amended by Act 163-2013, enumerates the duties, rights and responsibilities of any CPA issuing an opinion on supplementary information and provides fines and penalties, including criminal liability, in the case of fraud and collusion to provide false supplementary information.
- The Code, as amended by Act 163-2013, imposes on a taxpayer a penalty equal to 50% of the deficiency that is attributable to false supplementary information.

OTHER CHANGES TO THE CODE

Cancellation of Indebtedness

• Exclusion from Gross Income

- No income is required to be recognized in connection with the restructuring of a mortgage loan on a taxpayer's "qualified residence" located in Puerto Rico, provided the original amount of the mortgage loan did not exceed \$1,000,000.00.
- A "qualified residence" is one described in §1033.15(a)(1)(D), that is, the taxpayer's principal residence or a second residence with respect to whose mortgage the taxpayer claims an interest deduction.
- The amount of the cancelled debt that was excluded from gross income will reduce the tax basis of the qualified residence, but not below zero.

• **Information Return on Cancellation of Indebtedness**

- Any creditor that claims as a deduction a loss related to the cancellation of indebtedness is required to deliver, no later than February 28th of the year following the cancellation, an information return to the debtor whose debt was cancelled.
- The information return shall contain such information, and shall be in such form, as the Secretary may establish by regulation, circular letter, bulletin, or any other general communication method.
- Failure to furnish the information return to the debtor will result in disallowance of any applicable deduction.

Payments to Home Office, Non-Resident Affiliates and more 50% or more owners

- The 51% disallowance with respect to expenses incurred by a foreign corporation engaged in trade or business in Puerto Rico through a branch and payable to its Home Office outside of Puerto Rico, is extended to corporations having an election under Subchapter E of Chapter 11 (§1115.01 *et seq.*), known as Corporaciones de Individuos in Spanish. Even though It seems that the new rule is also intended to apply to entities taxed as partnerships under Chapter 7 and entities having an election under Subchapter D of Chapter 11 (§1114.01 *et seq.*), known as “Special Partnerships”, the language triggers the limitation only if the paying or incurring entity is a corporation.
- Act 40-2013 provided that no deduction is allowed to a pass-thru entity with respect to amounts paid or incurred to a 50% or more owner if the amounts are not subject to Puerto Rico income tax. Act 163-2013 appears to modify this total disallowance rule by limiting it to 51%.
- No deduction is allowed under §1033.01 of the Code with respect to certain amounts payable to related persons (as defined in §1010.05) that are “foreign or non-resident not engaged in trade or business in Puerto Rico” until such time as the amounts are actually paid.
 - The disallowance applies to otherwise deductible amounts described in §§1091.01(a)(1)(A)(i) and 1092.01(a)(1)(A)(i), that is, interest, rents, royalties, wages, compensation, fees, capital gains and other items of fixed and determinable, annual or periodical income (other than dividends).

Authorization to Sub-contract Audit Functions

- The Code now allows the Secretary to hire contractors to examine taxpayer books and records, as well as to provide technical assistance to Treasury personnel. In addition of being trained in tax matters, the contractors must be:
 - Duly qualified to conduct technical tax analysis;
 - A Puerto Rico-licensed CPA; and
 - Included in a public registry of contractors to be established by the Secretary.

Authorization to Publish Lists of Delinquent Taxpayers

- The Secretary is authorized to publish a list or lists of taxpayers, including withholding agents, with outstanding debts.
- Treasury must establish, through regulations, criteria and parameters for publication, as well as the notification process to the delinquent taxpayer, in order to guarantee due process and protection of the taxpayer’s rights.

Closing Agreements

- All Closing Agreements must expressly state that those matters related to or applicable taxable events occurring after the signing of the Agreement are subject to any amendment to the law approved after such signing.
- The Secretary will establish a registry of Closing Agreements identifying each Agreement by taxpayer. Each taxpayer may have access only to those Agreements that the taxpayer has executed with the Department of the Treasury.

Effective Date

- Except as otherwise noted, all changes are effective immediately.



If you have any questions or comments, or would like additional information about this matter, please contact any of our tax attorneys:

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