LOPEZ
SANCHEZ
PIRILLO &
HYMOVITZ

235 Federico Costa Street
Parque Las Américas I – Suite 310
San Juan, Puerto Rico 00918

PO Box 11917
San Juan, PR 00922-1917

Switchboard: (787) 522-6776
Web Site: www.lsphlaw.com

TO OUR CLIENTS AND FRIENDS

July 7, 2014

Tax Changes to Balance 2015 Budget

As part of the 2014-2015 Puerto Rico budget process, the Puerto Rico Legislature proposed, and the Governor has signed into law, Act 77-2014 ("Act 77"), which introduces a number of amendments to the Puerto Rico Internal Revenue Code of 2011, as amended ("2011 Code"), the Economic Incentives for the Development of Puerto Rico Act ("2008 EIDA") and the Puerto Rico Green Energy Incentives Act ("GEIA"), among other legislation, to increase revenues and reduce expenditures and credits.

Except as otherwise noted herein, Act 77 is generally effective immediately.

Below is a brief list of the most salient amendments affecting businesses:

A. <u>Amendments to the 2011 Code</u>

- **New "Deemed Dividend" Tax.**
  - For taxable years beginning after December 31, 2013, a "deemed dividend" tax is imposed on <u>any</u> corporation if: (1) 50% or more of its stock is owned by a "foreign person," that is, a natural or juridical person that is not a resident of Puerto Rico or engaged in trade or business in Puerto Rico (the "Foreign Owner"); and (2) it is not subject to branch profit tax.
  - The "deemed dividend" tax does not apply to: (a) International Insurers, as defined in Article 61.040(a) of the Insurance Code of Puerto Rico, (b) International Financing Entities, as defined in Act 273-2012, and (c) entities described in Section 1101.01 of the 2011 Code.
  - The tax is 10% of the lesser of (1) the average annual adjusted basis of the "foreign assets" held by the corporation during the taxable year; or (2) the corporation's earnings and profits ("E&P"). The average adjusted basis of the "foreign assets" held by the corporation is determined by adding the amount held by the corporation as of the end of each quarter (or part of the quarter) and dividing the resulting amount by four.
  - The term "foreign assets" includes, among others, tangible property located outside Puerto Rico, stock of foreign corporations, obligations of certain foreign corporations and nonresident individuals, and intangible property used or to be used outside Puerto Rico.

    The term excludes, however: (a) obligations of the United States, any State or territory of the United States, (b) amounts deposited in a banking institution or brokerage firm and held only in the name of the corporation for its exclusive use, (c) property located outside Puerto Rico that will be used by the corporation in Puerto Rico, (d) obligations of unrelated foreign corporations, (e) certain receivables of a Foreign Owner arising from the sale of property at fair market value, and (f) aircraft and other vessels (including containers) used in the transportation of persons or property in "foreign commerce" that are used "predominantly in Puerto Rico".

- In what appears to be a drafting oversight, the statutory language does not provide any tie-in to the source of income rules for dividends. Thus, on its face, the tax can be read as applying to the corporation's worldwide E&P instead of an amount of a "deemed dividend" that would be treated as being from sources within Puerto Rico under the source of income rules of the 2011 Code. It should be noted, however, that the E&P subject to the "deemed dividend" tax does not include income derived under various tax incentive laws, such as "industrial development income" under Act 73-2008, "tourism development income" under Act 74-2010 and income from qualified activities conducted by International Banking Entities.
- The "deemed dividend" tax will be creditable against the withholding tax on dividends paid to non-resident shareholders pursuant to Sections 1062.08 and 1062.11; any unused credit can be carried over to future years, until exhausted. A situation that the "deemed dividend" tax rules do not contemplate is the ability of a shareholder who is a resident of Puerto Rico to claim a similar credit.
- The accumulated E&P of a corporation are reduced for the amount of a "deemed dividend"

- **Tax on Gross Income**
  - The gross income tax ("GIT") imposed by Act 40-2013, as modified by Act 117-2013, remains in place for taxable years commencing **before** January 1, 2014.
  - For taxable years beginning **after** December 31, 2013, the GIT is modified as follows:
    - Businesses whose gross income is under $3,000,000.00 are not subject to the tax.
    - The tax rate schedule for most businesses is as follows:

Gross Income	Tax Rate
From $3,000,000.01 to $100,000,000.00	.35%
From $100,000,000.01 to $300,000,000.00	.50%
From $300,000,000.01 to $600,000,000.00	.70%
From $600,000,000.01 to $1,500,000,000.00	.80%
In excess of $1,500,000,000.00	1.00%

    - Taxpayers with gross incomes of less than $400,000,000.00 that are "principally engaged in the sale of provisions and unprepared foods" are subject to the following tax rates:

Gross Income	Tax Rate
From $3,000,000.00 to $300,000,000.00	.20%
From $300,000,000.01 to $400,000,000.00	.28%

    - For purposes of determining the applicable GIT rate, taxpayers must take into account the gross income of all members of the affiliated group (excluding financial institutions).
    - The GIT will no longer form part of the corporate alternative minimum tax ("AMT") computation and will be assessed as a separate tax that will be imposed **in addition to** the regular income tax and alternate base tax or AMT. The GIT must be paid together with the estimated tax payments.
    - The GIT, if actually paid by the due date of the return, is deductible in computing the taxpayer's net income. Accordingly, at the maximum marginal tax rate of 39%, the effective GIT rate, after taking into account the deduction, would be as follows:

Gross Income	Effective Tax Rate[1]
From $3,000,000.01 to $100,000,000.00	.214%
From $100,000,000.01 to $300,000,000.00	.305%
From $300,000,000.01 to $600,000,000.00	.427%
From $600,000,000.01 to $1,500,000,000.00	.488%
In excess of $1,500,000,000.00	.610%

[1] Assuming the taxpayer is profitable after the GIT and taxed on net income at the maximum marginal tax rate of 39%.

    - The only type of credits that may be claimed to reduce the GIT liability are those listed in Subchapter C of Chapter 5 of the 2011 Code, such as estimated tax payments and taxes withheld at source.
    - Financial institutions are subject to GIT under rules substantially identical to those applicable for taxable years beginning before January 1, 2014.
  - For all taxable years, whether beginning before or on or after January 1, 2014, the term "gross income" for purposes of the tax will not include payments received by voluntary chains duly certified under Act No. 77 of June 25, 1964, as amended, from their members with respect to transfers of goods or services pursuant to a common negotiation program.
  - The GIT will be redesigned as part of the proposed Tax Reform legislation that the Government is currently working on.

- **Alternate Base Tax ("ABT") on Individuals**
  - The income levels at which the various ABT rates apply are modified for taxable years beginning after December 31, 2013, as follows:

Net Income subject to ABT	Tax Rate
$150,000.00 to $200,000.00	10%
$200,000.01 to $300,000.00	15%
Over $300,000.00	24%

  - No credit will be allowed with respect to ABT paid in taxable years ending on or after December 31, 2013.
  - The credit for ABT paid in taxable years before 2014 is limited to 25% of the difference between (1) the taxpayer's net regular tax liability for the year, and (2) the taxpayer's net ABT for such year.

- **Prepayment of Tax with Respect to Certain Items**
  - An individual owner or beneficiary of a life insurance, endowment or annuity contract who exchanges said contract for an "eligible variable annuity contract" on or before December 31, 2014, or reinvests the proceeds of life insurance, endowment or annuity contract in an "eligible variable annuity contract" in accordance with the indirect transfer rules of Section 1034.04(b)(9) of the 2011 Code, may prepay the tax on the accumulated and undistributed income with respect to the cancelled or exchanged contract, at a 10% rate. The payment must be made on or before December 31, 2014.

    The term "eligible variable annuity contract" means a variable annuity contract issued on or before December 31, 2014 by an insurance company organized under the laws of Puerto Rico and that does not permit contributions to the contract after December 31, 2014.
  - From July 1, 2014 and through October 31, 2014, individuals, estates and trusts may elect to pay a special tax on a gain derived from the sale of capital assets and may also to prepay the tax on the total or partial increase in value of certain assets, as follows:
    - Capital assets: at an 8% rate.
    - "Included assets": at a 15% rate. "Included assets" are assets that generate ordinary income and are:
      - Stock in corporations and equity participations in limited liability companies and partnerships, whether domestic or foreign, including stock options;
      - Real property located in or outside Puerto Rico, including depreciable property;

- Fixed annuity contracts; and
- Participations in pension plans, whether qualified or not.

- In order to qualify for the reduced rate, the asset must have been held "long term"; the law does not indicate so, but we surmise the reference to "long term" relates to the holding period to classify a gain on the sale of a capital asset as long term or short term. Since the act also changed the cut-off period from six months to a year, it could be argued that in order to qualify for the reduced prepayment rates, the relevant asset(s) must have been held for more than twelve months.

- Similarly, from July 1, 2014 through October 31, 2014, corporations may elect to pay a special tax on a gain derived from the sale of capital assets and may elect to prepay the tax on the total or partial increase in value of certain capital assets, at a 12% rate. The capital assets qualifying for said treatment are:
  - Stock in corporations and equity participations in partnerships, whether domestic or foreign;
  - Real property located in or outside Puerto Rico, including depreciable property; and
  - Intangible property, including, but not limited to, patents and goodwill.
  - As in the case of prepayment of tax on appreciated property held by individuals, estates and trusts, in order to qualify for the reduced rates, the assets must have been held "long term."
- An individual taxpayer may also elect to prepay, at an 8% rate, the tax on taxable accumulations in individual retirement accounts ("IRAs"). The tax must be paid on or before October 31, 2014. However, the prepayment is not available with respect to IRA contributions made for taxable year 2014 and thereafter. If the taxpayer chooses to prepay the tax on an IRA, the penalty for early withdrawal therefrom (i.e., withdrawals before attaining 60 years of age) is increased to 30%.

- **AMT Credit**.
  - The amount of the AMT credit that may be claimed on any taxable year shall not exceed 25%.
- **Capital Gains**
  - For sales or exchanges effected after June 30, 2014:
    - The six month or less *vis a vis* more than six month holding period for purposes of determining whether a capital gain or loss is either short or long term is increased to one year or less, or more than one year, respectively.
    - The capital gains rate is increased from 10% to 15%, in the case of individuals, estates and trusts; and from 15% to 20%, in the case of corporations.
    - The amount that a corporation may deduct on account of a capital loss is limited to 90% of its capital gains.
    - The amount that an individual may deduct on account of a capital loss is limited to 90% of the year's capital gains, plus the lesser of the taxpayer's net income or $1,000.
  - The 5 carry forward period for net capital losses is increased to 7 years with respect to net capital losses incurred in taxable years beginning after December 31, 2013.
- **Tax on Certain Dividends Received by Individuals, Estates and Trusts**
  - The tax rate applicable to eligible dividends received by individuals, estates and trusts, is increased from 10% to 15%, effective for dividends distributed after June 30, 2014.

- **Other Changes**
  - In a distinct policy change, land and building developers are now allowed to determine their income under the "completed contract method" that is available under the 2011 Code for long-term contracts or any other method (excluding the percentage of completion method) that may be allowed by the Secretary of the Treasury.
  - Moratorium on Tax Credits: The allowable credits under the Urban Center Revitalization Act, Act 212-2002, as amended, are further limited to $5,000,000 per project ($15,000,000 for fiscal year 2013-14) and $40,000,000 per fiscal year in the aggregate.
  - For purposes of the 7% withholding tax on payments for services rendered in connection with the active conduct of a trade or business or for the production of income in Puerto Rico, the term "direct seller" no longer includes a person receiving commissions or other payments with respect to the income or earnings of other direct sellers under the supervision, or in the distribution chain, of the recipient.

    In addition, Act 77 also amended the meaning of the term "services" to: (a) eliminate an exclusion that existed for the contracting of insurance, and (b) excluding from the scope of the term the payment of insurance premiums.
  - Branch Profits Tax: The definition of "Puerto Rico Assets" and "Puerto Rico Liabilities" for purposes of computing a taxpayer's net equity in Puerto Rico is modified to exclude certain inter-branch transactions and offshore deposits.

B. Amendments to Tax Incentives Acts

- In order to claim the R&D Credit in EIDA Section 5, Grantees are now required to obtain a certification from PRIDCO as to the eligible activities subject to the credit. The R&D Credit is also limited to an aggregate $300 million per fiscal year, although this cap may be raised by the Executive Director, in consultation with the Puerto Rico Treasury Department.
- The EIDA is also amended to provide that the $10,000,000.00 volume cap to ascertain whether a business qualifies as "small or medium sized" must be determined on a "controlled group" basis, rather than on a separate company basis.
- The maximum amount to be deposited into the Green Energy Fund created under GEIA is reduced to $20,000,000.00 commencing on fiscal year 2014-2015 and through 2019-2020.

◆ ◆ ◆

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

Manuel López Zambrana	nolin@lsphlaw.com 787.641.7266
Pablo Hymovitz	pablo@lsphlaw.com 787.641.7267
Xenia Vélez Silva	xvelez@lsphlaw.com 787.522.1460
Janelle Reyes Maisonet	jreyes@lsphlaw.com 787.522.6776

LOPEZ SANCHEZ PIRILLO & HYMOVITZ