

June 12, 2015

**NEW TAX LAW INTRODUCING VALUE ADDED TAXES AND CERTAIN  
TRANSITION CHANGES TO THE SALES AND USE TAX SYSTEM**

**PART ONE: PHASING OUT THE SALES AND USE TAX**

On May 29, 2015, Governor Alejandro García Padilla enacted Act No. 72, the much-debated bill that introduces a value added tax (“VAT”) on consumption to replace the current sales and use tax (“SUT”) system of taxation. Other provisions of the Puerto Rico Internal Revenue Code of 2011, as amended (“Code”) were also amended.

The new VAT regime will become effective on April 1, 2016. However, Act No. 72-2015 introduces certain temporary changes to the SUT for the transition into the VAT. These changes will become effective during the period of July 1, 2015 through March 31, 2016.

This is the first of a series of newsletters describing the changes introduced by Act No. 72. Below are some salient aspects of Act No. 72:

**Income Taxes**

**Individuals**

1. The regular tax rates applicable to taxable years commencing after December 31, 2014 will be, as follows:

<b><u>Taxable Income</u></b>	<b><u>Tax</u></b>
Up to \$9,000.00	0%
\$9,000.01 to \$25,000.00	7% on excess over \$9,000.00
\$25,000.01 to \$41,500.00	\$1,120 plus 14% of excess over \$25,000.00
\$41,500.01 to \$61,500.00	\$3,430 plus 25% of excess over \$41,500.00
Over \$61,500.00	\$8,430 plus 33% of excess over \$61,500.00

2. The statute appears to have intended to retain the gradual adjustment for tax rates below 33% and the personal exemption for dependents for tax years beginning after December 31, 2014; however, the statutory language is unclear.
3. The 2% special tax on self-employed individuals was eliminated for tax years commencing after December 31st, 2014.
4. For taxable years commencing after December 31, 2014, the expenses deductible in the calculation of the net income of a 50% or more shareholder in a Corporation of Individuals – and, presumably, of a partner owning 50% of the equity in a partnership or special partnership – may not exceed 60% of the deductible expenses paid to such shareholder or partner.
5. The Code provides special rules to determine the amount that an individual may claim as a deduction on account of his/her distributive share in the losses of a “Corporation of Individuals,” a “partnership” or a “special partnership”. In general, an individual’s distributive share in the losses of any of these entities in a taxable year may be deducted to the extent of the individual’s distributive share of the aggregate net income generated by other of these entities in the taxable year.

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Act No. 72 modifies these rules by stating that for taxable years beginning after December 31, 2014, the maximum amount of an individual's distributive share in the losses of any of these entities that the individual may deduct against the individual's distributive share of the aggregate net income generated by other of these entities is 80%.

6. Act No. 72 amends the rules for individuals that have net operating losses ("NOLs") incurred in the individual's principal trade or business. Act No. 72 states that if an individual incurs in NOLs during three consecutive taxable years, only 50% of the NOLS incurred in the third consecutive year commencing after December 31, 2014 and thereafter may be claimed as a deduction.
7. The Code was amended in 2014 to provide that the amount of a capital loss incurred by an individual after June 30, 2014 that may be claimed as a deduction is limited to 90% of capital gains plus the individual's net income or \$1,000, whichever is less.

Act No. 72 reinstates the rules that were in existence prior to the 2014 amendment to provide that capital losses derived in a taxable year may be deducted against capital gains generated in the taxable year and that if the capital losses exceed capital gains, the amount of the excess that may be claimed as a deduction is an amount equal to the individual's net income or \$1,000, whichever is less.

## Corporations

### 1. *Large Taxpayer*

Act No. 72 establishes a new category of taxpayers referred to as "Large Taxpayers." A taxpayer will fall within this category if it is:

- a. A commercial bank or trust company;
- b. A private bank;
- c. A broker-dealer;
- d. An insurance company;
- e. Engaged in the telecommunications business; or
- f. An entity whose volume of business was \$50 million or more during the preceding taxable year.

The implication of being a Large Taxpayer is that for taxable years beginning after December 31<sup>st</sup>, 2014, Large Taxpayers are required to file their income tax returns electronically, or in such office as Secretary of the Treasury (the "Secretary") may establish by regulation, administrative determination, circular letter or informative bulletin of a general nature. Failure to comply with this requirement will cause the return to be deemed not filed.

### 2. *Alternative Minimum Tax*

- a. One of the items that is taken into account in determining a corporation's "tentative minimum tax" is an amount equal to 20% of the total expenses paid accrued to certain related persons and, in the case of branch operations, expenses allocated from a home office that is not located in Puerto Rico. The Code provides that the Secretary may recognize exceptions and exclude from the base of this computation those expenses that the Secretary determines to be eligible to be excluded (the "Exception").

Act No. 72 amends the Exception; it now states that the maximum amount of expenses that may be excluded under the Exception may not exceed 60% of the total expenses otherwise subject to the 20% computation.

- b. Another item that is taken into account in determining a corporation's "tentative minimum tax" is a percentage (the "Applicable Percentage") of the amount of purchases of tangible personal property from certain related persons and, in the case of branch operations, tangible personal property transferred from a home office that is not located in Puerto Rico. The current general Applicable Percentage is 2%. The Code

authorizes the Secretary to recognize exceptions from the application of these rules and providing for a lower Applicable Percentage in cases in which the purchase price of the tangible property is similar to or less than the price charged by the related person to third parties (the “Applicable Percentage Exception”)

Act No. 72 amends the Applicable Percentage rules in two ways. First, for taxable years commencing after December 31, 2014, the Applicable Percentage for corporations that have gross receipts of \$10 million or more, is as follows:

<u>Gross receipts (in millions)</u>	<u>Applicable Percentage</u>
Between \$10 and less than \$500	2.5%
Between \$500 and less than \$1,500	3%
Between \$1,500 and less than \$2,000	3.5%
Between \$2,000 and less than \$2,750	4.5%
\$2,750 and over	6.5%

Second, except for taxpayers that are covered by a waiver, ruling or Closing Agreement, the Applicable Percentage Exception will not be available for taxable years beginning after December 31, 2014.

- c. The net operating loss deduction that may be claimed for purposes of determining the amount of a corporation’s “alternative minimum taxable income” (“AMTI”) was reduced from 80% of AMTI to 70% of AMTI for taxable years commencing after December 31, 2014.

### 3. *Disallowance of Deductions*

- a. For taxable years beginning after December 31<sup>st</sup>, 2014, the Secretary’s authority to waive the 51% disallowance of deductions for expenses paid or accrued to nonresident related persons or home offices is limited to 60% of the total expenses paid to such related persons or home offices.
- b. No deduction is allowed with respect to expenses paid or accrued for services rendered by a nonresident unless the taxpayer has paid SUT or VAT with respect thereto.
- c. No depreciation or other deduction is allowed with respect to any goods or taxable items unless the taxpayer has paid SUT or VAT with respect thereto.

### 4. *Net Operating Losses*

- a. For taxable years commencing after December 31, 2014, the amount of an NOL that may be carried over as a deduction to subsequent taxable years is reduced from 90% to 80% of the taxpayer’s net income, as determined in accordance with the special rules that are provided for these purposes (“Adjusted Net Income”).
- b. Furthermore, Act No. 72 provides that in computing the Adjusted Net Income for a carryover year, no deduction will be allowed for expenses paid or accrued to a related person or home office, except to the extent allowed as a deduction for regular income tax by the Secretary.

### 5. *Capital losses*

For taxable years beginning after December 31<sup>st</sup>, 2014, capital losses, including capital loss carryovers, may only offset up to 80% of a corporate taxpayer’s capital gains.

### 6. *Distributive share of losses in partnerships and special partnerships*

The Code provides special rules to determine the amount that a corporation may claim as a deduction on account of its distributive share in the losses of a “partnership” or a “special partnership”. In general, the corporation’s distributive share in the losses of any of these entities in a taxable year may be deducted to the extent of the corporation’s

distributive share of the aggregate net income generated by other of these entities in the taxable year.

Act No. 72 modifies these rules by stating that for taxable years beginning after December 31, 2014, the maximum amount of a corporation's distributive share in the losses of any of these entities that the corporation may deduct against its distributive share of the aggregate net income generated by other of these entities is 80%.

7. *Moratorium on Tax Credits*

- a. The moratorium on issuance and use of tax credits was extended to taxable years commencing prior to January 1<sup>st</sup>, 2018.
- b. Special rules apply for credits under Acts 212-2002, 183-2001 and 98-2001.

**Excise Taxes**

1. The fuel used by grantees of tax exemption under Act No. 73-2008 is be exempt from the additional excise taxes of \$9.25 and \$6.25 per barrel (or fraction thereof) imposed by Act 1-2015 if used for: (a) the cogeneration of electric power for their own use (or for use by their affiliates); and (b) energy efficient equipment properly certified by the Energy Affairs Administration.
2. The excise tax on "All Terrain Vehicles" or "Four Tracks" is increased from 10.0% to 11.5%.

**Sales and Use Taxes**

1. The SUT rate payable to the Commonwealth (as opposed to the municipalities) will increase from 6.0% to 10.5% commencing on July 1, 2015 and will apply through March 31, 2016. Combined with the municipal SUT, the total SUT rate will be 11.5%.
2. A new 4% SUT on "designated professional services" and on "services rendered to other merchants" (i.e., business-to-business transactions) becomes effective on October 1, 2015 and through March 31, 2016. However, the 4% SUT will not apply to:
  - a. Bank charges on commercial accounts;
  - b. Collection services;
  - c. Security services, including armored vehicle services;
  - d. Cleaning services;
  - e. Laundry services;
  - f. Non-capital repair and maintenance services;
  - g. Telecommunication services;
  - h. Operating leases for vehicles.
  - i. Waste disposal services;
  - j. Services rendered by the government of Puerto Rico;
  - k. Educational service, including costs of tuition;
  - l. Interest and other charges for the use money and charges for services provided by financial institutions;
  - m. Insurance commissions and services;
  - n. Health or hospital medical or veterinary services;
  - o. Services rendered by persons whose annual volume of business does not exceed

\$50,000; and

- p. Services rendered by a person or for a person that is a member of a controlled group for the production of income in Puerto Rico.

3. Other Taxable services

- a. The following services will continue to be subject to the 6% SUT rate through June 30, 2015 and will be subject to the 10.5% rate from July 1, 2015 through March 31, 2016, whether or not rendered to a business:

- i. Bank charges on commercial accounts;
- ii. Collection services;
- iii. Security services, including armored vehicle services;
- iv. Cleaning services;
- v. Laundry services;
- vi. Non-capital repair and maintenance services;
- vii. Telecommunication services;
- viii. Waste disposal services; and
- ix. Operating leases for vehicles.

- b. The following services will not be subject to either the regular 6% or 10.5% on services:

- i. Services rendered by the government of Puerto Rico;
- ii. Educational service, including costs of tuition;
- iii. Interest and other charges for the use money and charges for services provided by financial institutions;
- iv. Insurance commissions and services;
- v. Health or hospital medical or veterinary services;
- vi. Services rendered by persons whose annual volume of business does not exceed \$50,000;
- vii. Services rendered by a person or for a person that is a member of a controlled group for the production of income in Puerto Rico.

4. Sales of taxable property after July 1, 2015 in the case of preexisting contracts and auctions:

- a. Sales of tangible personal property after July 1, 2015 that relate to contracts or bids executed prior to July 1, 2015 are taxable at the SUT rate applicable for sales of tangible personal property on June 30, 2015 for the shortest of a 12-month period or the duration of the contract. This treatment will be applicable to sales of taxable services only if such services were prepaid prior to July 1, 2015.
- b. Construction contracts. Contracts for commercial, industrial or residential construction that have complied with certain requirements by May 30, 2015 may be eligible for registration in a construction contracts registry which may enable the acquisition of certain taxable items related to the performance of the contract at the SUT rate applicable on June 30, 2015.

5. SUT collections on transactions registered during July of 2015. The SUT on sales by merchants whose gross sales for 2014 did not exceed \$1 million are to be deposited as follows:

- a. 55% of the SUT collections will be due no later than August 20, 2015;

- b. the remaining 45% of the SUT collections may be paid in three equal installments not later than the 20<sup>th</sup> of September, October and November of 2015.
6. The 75% limitation on the amount of tax credits that the merchants are entitled to claim has been increased to 100% for periods commencing after June 30, 2015.



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

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