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TAX ALERT

New and Increased Taxes Proposed to Reduce Puerto Rico Government's Budget Deficit

The Administration has filed House Bill 1073 ("HB 1073")(and its Senate counterpart SB 544) as a revenue raising measure in support of its FY14 budget proposal. Significant changes to the Puerto Rico Internal Revenue Code of2011, as amended ("2011 Code") and other revenue raising laws are contemplated in the proposed legislation. Careful analysis should be made of the proposed changes, particularly by service providers and persons holding grants or concessions of tax exemption or incentives to fully assess the impact of such changes on their Puerto Rico operations.

Below we have classified the relevant provisions of HB 1073 impacting income taxes, the issuance and use of tax credits, sales and use taxes, and taxes on insurance premiums.

Income Taxes

- <u>2% Tax on Self-Employed Individuals</u>

HB1073 would increase the income taxes payable by certain "self-employed individuals," a term not defined in HB 1073 or in the 2011 Code, by adding a new Section 1021.05 to the 2011 Code imposing a 2% surtax on self-employed individuals whose gross income exceeds $200,000.This additional tax would be imposed on gross income (<u>i.e.</u>, net sales minus cost of goods sold) from the rendering of services or from an industry or business of the individual, and would not be subject to payment of the estimated tax.

- <u>Mortgage Interest Deduction</u>

HB 1073 would amend Section 1033.15 of the 2011 Code to limit the total deduction for mortgage interest on residential property to a maximum of $35,000.

- Surtax Exemption

HB 1073 would increase corporations' income tax liability by reducing the $750,000 deduction to compute the surtax imposed by Section 1022.02 of the 2011 Code. The current deduction would be reduced from $750,000 to an amount ranging from a maximum of $250,000 (when net taxable income is less than $500,000) to $25,000 (when net taxable income is in excess of $2,000,000). The amount of the deduction would be allocated among the members of a controlled group of corporations.

- Alternative Minimum Tax

HB 1073 would increase the amount of income subject to the alternative minimum tax ("AMT") by amending Sections 1022.04(b) and (d) of the 2011 Code. Section 1022.04(b) would increase the book income adjustment from 50% to 60%, and Section 1022.04(d) would decrease the net operating loss deduction ("NOL") from 90% to 80%.

For taxable years commenced after December 31, 2012, HB 1073 would amend Section 1022.04 of the 2011 Code to eliminate the disallowance of the deduction for payments to nonresident related parties for services rendered outside of Puerto Rico. The effect of this provision would be to reduce the amount of income subject to the AMT.

HB 1073, however, would add a new Section 1022.07 to the 2011 Code, which would require that corporations (and other entities taxable as corporations) pay a new 20% surtax on the amount of the deduction claimed for payments to nonresident related entities for services rendered outside of Puerto Rico that were not subject to withholding tax in Puerto Rico. The 20% surtax would also apply to foreign corporations operating in Puerto Rico through a branch that claim a deduction for payments for services made to a home office located outside of Puerto Rico.

This 20% surtax would not apply to corporations operating under any of Puerto Rico's tax incentives laws or as bona fide agricultural businesses, but only with respect to the deduction attributable to the operations covered by the tax incentives grant or concession.

- Tentative Minimum Tax for AMT Computation

Another change that would impact the AMT computation, relates to the tentative minimum tax ("TMT") that is determined as a percentage of the value of purchases from a related person. HB 1073 would increase the currently effective 1% TMT to 2%, and the term "personal property" would include alcoholic beverages, gasoline and crude oil products which are currently excluded from this computation. The purchases of these products, however, would be subject to a reduced rate of 0.5% in the case of alcoholic beverages and 1% in the case of gasoline and crude oil products.

Purchases of motor vehicles would continue to be considered for TMT, but would be subject to a reduced TMT rate of 1.5%. For purposes of applying the TMT, purchases to a related person would also include purchases to the home office by a branch of a foreign corporation doing business in Puerto Rico.

The gross receipts threshold for purposes of determining which purchasers are subject to the TMT is reduced from $50,000,000 to $10,000,000, and “gross receipts” would be defined as the total amount received or accumulated from the sale of property held for sale in the ordinary course of a trade or business and income derived from all other sources.

Exempt entities enjoying the benefits of a tax grant under the provisions of Act 73-2008, as amended, or other similar tax incentives legislation, would still be excluded from this computation of the TMT but only to the extent that the personal property purchased from the related person is used in their exempt operations.

HB 1073 would preserve a modified version of the exclusion granted to purchases from a related person when the value of the property purchased is the same or substantially the same as the value for which the related person sells such property to an unrelated person. This “comparable” value concept would no longer be limited to purchases made by an unrelated person in Puerto Rico; thus, a comparable value paid by purchasers outside Puerto Rico could be used to establish that purchases are made at “the same or substantially the same” value as those made by a local purchaser. HB 1073, however, would still require the Secretary of the Treasury (“Secretary”) to make a determination as to when such value should be considered similar or substantially similar to a comparable value, generating uncertainty as to whether transfer pricing agreements between related parties already in place, not necessarily based on comparable prices but on other internationally accepted “arm’s length” standards, can be used to support claiming an exemption from, or a reduced, TMT. Further, the Secretary could simply opt to impose a TMT computation at a rate lower than 2%.

A new provision is added to exclude purchases of tangible personal property from an entity engaged in trade or business within Puerto Rico from the TMT computation.

- <u>Net Operating Losses</u>

HB 1073 would amend Section 1033.14 of the 2011 Code to modify the net operating loss (“NOL”) carryover and deduction rules in an effort to tax more income currently.

- For taxable years commencing after December 31, 2004 and before January 1, 2013, the NOL carryover period would be extended from 10 to 12 years.

- For taxable years commenced after December 31, 2012, the NOL carryover period would be 10 years. Furthermore, the NOL deduction for entities taxable as corporations would be limited to 90% of the net income for the year in which the deduction is claimed, regardless of the year when the loss was incurred.

- Pass-Through Entities

With respect to pass-through entities, HB 1073 would add a paragraph to Section 1033.17 of the 2011 Code to disallow deductions for payments to nonresident partners, shareholders or members that own 50% or more of the interests in the pass-through entity in Puerto Rico, provided the payments are not subject to income or withholding tax in Puerto Rico (i.e., payments for services rendered outside of Puerto Rico).

Tax Credit Moratorium

HB 1073 would reactivate the moratorium previously enacted by Act 7-2009, as amended by Act37-2009, with some modifications.

-Limitation on Use of Certain Credits

All credits listed below, granted or acquired before April 26, 2013, may be used during the period of the moratorium up to the limits provided for their issuance, but such credits may not be used by a taxpayer to reduce its tax liability under Subtitle A of the 2011 Code by more than 50%.

1. Solid waste credits under the Investment in Facilities for the Reduction, Disposition and/or Treatment of Solid Waste Tax Incentives Act and under the Puerto Rico Solid Waste Authority Act;

2. Venture capital credits under the Capital Investment Funds Act of1999;

3. Theater district credits under Special Act for the Creation of the Santurce Theatre District Development;

4. Conservation credits under the Puerto Rico Conservation Easement Act;

5. Urban centers revitalization credits under the Urban Center Revitalization Act;

6. Social interest housing credits under the New Construction or Rehabilitation of Social Interest Housing Tax Credits Act;

7. Housing infrastructure credits under the Tax Credits for Investment in Housing Infrastructure Act; and

8. Credit for purchase of articles manufactured in Puerto Rico under Section 1051.09 of the 2011 Code.

-Period of Credits Moratorium

The moratorium period would cover taxable years commencing after December 31, 2012 and before January1, 2016.

-<u>Limitation on Issuance of Additional Credits</u>

No additional tax credits subject to the moratorium could be granted by any agency, public corporation, instrumentality, municipality or dependency of the Commonwealth of Puerto Rico during the three year moratorium period. All such agencies, corporations or instrumentalities would be prohibited from evaluating, processing or issuing any tax credit or any transaction that results or may result in the generation of tax credits subject to the moratorium except for urban center revitalization credits under the following circumstances:

a. Urban center revitalization projects that have presented eligibility certificates before Treasury up to the date of enactment of this legislation, for which a maximum of $40 million in credits may be issued annually during the government's fiscal years 2013-2014, 2014-2015 and 2015-2016, with no more than $15 million to be assigned to a particular project;

b. Urban center revitalization projects that are related to a "tourist activity" as such term is defined in the Puerto Rico Tourism Development Act of 1993; and

c. Urban center revitalization projects that are related to social interest housing projects, including elderly facilities.

-<u>Rules Applicable to Credits to be Issued During Moratorium</u>

Special annual limitations would be established for the use of credits subject to the moratorium that may be issued during fiscal years 2013-2014, 2014-2015 and 2015-2016.

<table>
<tr><th>Year credit is granted</th><th>Maximum amount per year of credit</th><th>Credit may be used in:</th></tr>
<tr><td rowspan="3">Fiscal year 2013-14</td><td>50%</td><td>Taxable years commencing after December 31, 2013 and before January 1, 2015.</td></tr>
<tr><td>50%</td><td>Taxable years commencing after December 31, 2014 and before January 1, 2016.</td></tr>
<tr><td colspan="2">Any excess may be carried over to future taxable years.</td></tr>
<tr><td rowspan="3">Fiscal year 2014-15</td><td>50%</td><td>Taxable years commencing after December 31, 2014 and before January 1, 2016.</td></tr>
<tr><td>50%</td><td>Taxable years commencing after December 31, 2015 and before January 1, 2017.</td></tr>
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Fiscal year 2015-16	50%	Taxable years commencing after December 31, 2015 and before January 1, 2017.
	50%	Taxable years commencing after December 31, 2016 and before January 1, 2018.
	Any excess may be carried over to future taxable years.	

-Informative Return

Taxpayers would be required to file an informative return on or before July 31, 2013 to inform of credits issued by June 30, 2013. Such information would include the credits subject to the moratorium, as well as other tax credits; such as, tourism investment tax credits and certain other credits under various tax incentives laws. The return would be filed under penalties of perjury and must contain such additional information as required by the Secretary. A taxpayer would not be allowed to claim any credits that are not listed in this informative return.

Sales and Use Taxes

The proposed changes to the sales and use tax ("SUT") provisions of the 2011 Code can be classified in four groups: (a) rate and municipal interplay; (b) eliminating the reseller's exemption certificate; (c) curtailing of exemptions or exclusions; and (d) imposing the SUT on various services, including intermediate services for the production of income.

- Rate and Municipal Interplay

Currently, the SUT is imposed at a combined 7% rate (5.5% state level plus 1.5% municipal level) of which the Treasury manages 6% and municipalities (other than Participating Municipalities) collect the remaining 1%. HB 1073 would reduce the municipal portion of the tax to 1% for a combined rate of 6.5% (5.5% state level plus 1% municipal level).
Municipalities would continue to have the option to individually collect the SUT or become Participating Municipalities. Also, municipalities would continue to have the option to tax food and food ingredients.

- Eliminating the Reseller's Exemption Certificate

A reseller's use of a certificate for exempt purchases (currently Form SC 2916) would be eliminated. Nonetheless, such resellers could obtain a newly created Reseller Certificate instead of the Certificate of Exemption (currently Form SC 2919).

In lieu of SUT exemption on purchases, resellers holding a Reseller Certificate would be entitled to claim a credit for the combined 6.5% SUT paid on purchases of taxable items acquired for resale. Although resembling a VAT system, the credit would be generally limited to 50% of the taxes paid by the reseller. The Secretary could, via regulation or other pronouncements, allow crediting of a higher percentage of the SUT paid. Excess credits could be carried forward until exhausted or may be refunded under certain circumstances.

Reseller inventories not previously subject to the SUT could continue to be exempt from the SUT while being stored for subsequent sale in the ordinary course of business. However, Senate Bill 507 ("SB 507" mentioned below), would repeal such exemption. Manufacturing plants or other persons so authorized by the 2011 Code to receive a Certificate of Exemption may continue to use such certificate and issue a certificate for exempt purchases.

Various SUT exemptions would be eliminated or modified:

i. The SUT exemption on leasing of commercial real property would be repealed.
ii. Exemption to day-care centers would be limited to the basic tuition and monthly charges, not educational or recreational services.
iii. Higher education institutions and universities operating in Puerto Rico would be subject to SUT on purchases of taxable items.
iv. Health service facilities enjoying exemption under either Act 168-1968, as amended (the Hospital Facilities Tax Exemption Act), or Section 1101.01(a)(2) of the 2011 Code would be subject to SUT on their purchases of equipment and supplies.
v. SUT exemption on purchases made during the back to school periods (if approved, there would be two periods, one in July and one in January) would be limited to uniforms, certain school supplies and text books.
vi. Cooperatives and credit unions authorized under Act 255-2002, as amended (Cooperative Savings and Credit Associations Act of 2002), and Act 239-2004, as amended (Puerto Rico General Cooperative Associations Act of 2004), would no longer enjoy exemption from the tax.

- <u>SUT on Services</u>

Services subject to the SUT would now specifically include the leasing of motor vehicles (which, by virtue of the definition of leases, should affect only operating leases of motor vehicles) and tax return preparation services.

A major change in taxation of services is the elimination of the currently applicable "business to business" exemption. This is a general exemption from taxation on the rendering of services in transactions that do not constitute the ultimate consumption of such services intended to avoid pyramiding of the tax.

Further to this change, other previously excluded services, known as "designated professional services" (those rendered by licensed attorneys, agronomists, architects, certified public accountants, brokers, draftspersons, real estate appraisers, geologists and engineers) and bank service charges would be subject to the SUT, but only when rendered to persons engaged in a trade or business or for the production of income.

Unlike the changes in connection with the reseller exemption, HB 1073 would not provide a VAT-like credit to businesses subject to SUT on their expenditures related to services, effectively taxing "business consumption" of such services.

Special Insurance Premium Tax

HB 1073 would also amend the Puerto Rico Insurance Code ("Insurance Code") to impose a special tax of 1% on insurance premiums, in addition to the insurance premium tax currently imposed by the Insurance Code and any taxes imposed by the 2011 Code. Such tax would be applicable for taxable years beginning after December 31, 2012 and with respect to premiums subscribed after June 30, 2013. The special tax would have to be paid to the Secretary through the Office of the Commissioner of Insurance on or before March 31st.

Pending revenue raising measures not incorporated into HB 1073

Below is a listing of additional measures that are pending consideration and could have an impact on certain Puerto Rico operations.

- <u>Act 154 Excise Tax</u>

Senate Bill 435 ("SB 435") would amend Section 2101(b)(4) of the Puerto Rico Internal Revenue Code of 1994, as amended, which imposes an excise tax on certain acquisitions by non-resident individuals, corporations or partnerships of products manufactured in Puerto Rico and of services related to said products by entities affiliated with the purchaser ("Excise Tax"). If enacted into law, SB 435 would increase the Excise Tax rate from the currently applicable 4% to 5% for periods beginning after September 30, 2013 and ending on or before December 31, 2017.

Two other bills propose an increase in the Excise Tax rate of up to 10% and either extend the effectiveness of the same or make it permanent.

Senate Bill 386 ("SB 386") would modify some of the tax credits available to offset the Excise Tax. More specifically, SB 386 would eliminate the credits for increasing employment applicable to companies that purchase over $4 billion annually, the credit for companies that have manufacturing facilities in 3 or more municipalities, the credit for purchases from critical industry suppliers, and the credit for investment in the Research and Development Corridor, and would substitute them with a credit for investments in certain eligible investments in eligible financial institutions in Puerto Rico, a credit for payroll, and a credit for payroll related to research and development activities.

- Excise tax on cigarettes

House Bill 896 ("HB 896") and Senate Bill 486 ("SB 486") would amend Section 3020.05 of the 2011 Code to increase the current excise tax rate on cigarettes. HB 896 proposes to increase such rate from the currently applicable $11.15 to $14.50, from July 1, 2013 through June 30, 2014 and to $16.73 effective July 1, 2014. SB 486 proposes to increase the rate to $11.90 effective 120 days after SB 486 is enacted into law.

Both HB 896 and SB 486 contain transitional provisions that would require the payment of the incremental excise tax rate with respect to cigarettes in inventory as of the date of effectiveness of the act.

Senate Bill 485 ("SB 485") would add Section 3020.05A to the 2011 Code to impose an excise tax on smokeless tobacco manufactured in or imported to Puerto Rico, in the amount of $.50 per pound or fraction thereof in the case of chewable tobacco and of $1.51 per pound or fraction thereof in the case of pulverized tobacco leaves ("snuff"). SB 485 contains transitional provisions that would require the payment of the new excise tax on smokeless tobacco products in inventory as of the date of effectiveness of the act.

- Special 10% excise tax on compulsory auto liability insurance premiums

House Bill 1070 would amend Act 253-1995 to impose a temporary 10% excise tax on compulsory auto liability insurance premiums. Such tax would have to be remitted by insurance companies to the Secretary on a monthly basis. This special excise tax would only be effective for fiscal years 2013-2014, 2014-2015 and 2015-2016.

- Expansion of SUT nexus scope: "Click-through nexus" approach and collaboration with Puerto Rico affiliate

House Bill 991 ("HB 991") would amend the definition of "merchant or retailer" for SUT purposes to expand the realm of situations in which a person will be deemed engaged in the sale of taxable items in Puerto Rico for purposes of determining whether such person is required to comply with the collection, reporting and remittance responsibilities related to the SUT.

In particular, HB 991 provides that a remote seller entering into an agreement with a Puerto Rico resident in which the resident, for a commission or other consideration, directly or indirectly refers potential customers, by a link on an internet website or otherwise, to the seller, will be deemed to have independent contractors, representatives or agents soliciting business on its behalf in Puerto Rico. This is a rebuttable presumption that would cause the remote seller to have nexus with Puerto Rico for SUT purposes unless rebutted by providing the documentation specified in HB991."Click-through nexus" provisions are applicable only if the total gross receipts from sales to customers in Puerto Rico who were referred to the remote seller are at least $10,000 in the preceding 12-month period.

HB 991 also includes provisions pursuant to which a remote seller with a Puerto Rico affiliate which sells similar products under the same or similar trade name as such seller, and which benefits from such affiliate's local employees, services, facilities, etc. in establishing a market for its products in Puerto Rico, would have nexus with Puerto Rico for SUT purposes.

- Other SUT Amendments

SB 507 would amend several provisions of the 2011 Code related to the SUT in a manner similar to the amendments proposed by HB 1073.

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