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TAX ALERT

Puerto Rico House Bill 1524 signed into Act No. 163-2013 and Administrative Determination 13-22 is issued to postpone its effectiveness

Despite fierce opposition from the private sector, on December 25, 2013 Governor Alejandro Garcia Padilla signed into law Act No. 163-2013, the "Effective Mechanisms for Tax Oversight Act". Act No. 163-2013 amends several local tax statutes including the Municipal License Tax Act, the Municipal Property Tax Act, the General Corporations Act and the Puerto Rico Internal Revenue Code of 2011 ("2011 Code"). The amendments impose additional reporting requirements on taxpayers to effectively require a tax compliance review as part of the preparation of their financial statements.

Further, Act No. 163-2013, substantively amends the 2011 Code to exclude from gross income cancellation of indebtedness income related to certain residential mortgage loans, extending certain expense disallowances to pass-through entities, require informative returns of cancellation of debt income and other matters as further discussed below.

Critics of the measure have indicated that it should have been vetoed by the Governor due to a lack of public debate on the measure, the excessive burden placed on the private sector to conduct tax audits of affected businesses and the existence of substantial technical errors that could render the measure unenforceable. In response to the critics, and notwithstanding the fact that Act No. 163-2013 is generally effective immediately after its enactment (with certain provisions effective for taxable years commenced after December 31, 2012), on December 27, 2013 the PR Treasury Department issued Administrative Determination 13-22 postponing the effectiveness of certain provisions of the Act. As indicated by Treasury, this allows time to issue guidance and propose technical amendments to the law.

Below is a summary of the additional reporting requirements and substantive amendments set forth by Act No. 163-2013:

- I. Additional Reporting Requirements
 - A. **Municipal License Tax Act**

Businesses with sales over \$3,000,000, in addition to furnishing financial statements (balance sheet, profit and loss statement and cash flow statement) audited by a certified public accountant licensed by the Commonwealth of Puerto Rico ("CPA"), must also submit the following:

- Notes to audited financial statements;
- Supplementary information and other records used in preparing audited financial statements demonstrating:
 - i. Total gross income from services rendered, gross sales or other business activity;
 - ii. A detail of items comprising other income;
 - iii. For retailers and wholesalers, the total amount of sales returns;
 - iv. For gas stations, the number of gallons sold as well as information required by (i) and (ii) above;
 - v. For businesses operating under a tax grant or concession of tax exemption, a detail of the income generated by the exempt operations and those generated by a taxable operation, if any.

Municipal Property Tax Act

All corporations with sales over \$3,000,000 – except non-profits and non-stock corporations– must submit returns reviewed by a CPA and which must be accompanied by the following:

- Financial statements (balance sheet, statement of cash flows and notes to financial statements) regarding the corporation's latest year of operations;
- Supplementary information and other records used in preparing audited financial statements which have themselves been audited by a CPA demonstrating:
 - i. Monthly inventory amount for each month of the calendar year in question, using any accepted method under US GAAP or the MPTA except the "Last In First Out" method.
 - ii. Monthly inventory reserve balance for the calendar or tax year in question
 - iii. Cash at December 31st, deposited before January 1st and credited on January 1st; in the case of business that operate under a tax grant or the concession of a tax exemption, a detail of the value of assets which at January 1st are not being used by the exempt corporation; and
 - iv. Monthly inventory adjustments for the calendar or tax year in question.

General Corporations Act

In addition to other requirements, corporations organized under the laws of the Commonwealth of Puerto Rico and foreign corporations authorized to do business in Puerto Rico must annually file the following:

1. A balance sheet prepared in accordance to GAAP showing the financial condition of the corporation at the close of its operations, duly audited by a CPA, along with the corresponding opinion of such CPA;
2. In the case of non-profit corporations and non-stock corporations as well as for-profit corporations whose business volumes do not exceed \$3,000,000, a balance sheet is required but does not have to be accompanied by an audit report prepared by a CPA.

Puerto Rico Internal Revenue Code of 2011

Section 1061.15 of the 2011 Code on the requirement to submit financial statements or other documents with returns is amended to provide as follows:

- When the volume of business for a tax year is less than \$1,000,000 the business will not be required to submit financial statements;
- Supplementary information and other records used in preparing audited financial statements which have themselves been audited by a CPA as follows: (Please note that Act No. 163-2013 states that these requirements are applicable for taxable years commenced after December 31, 2012, AD 13-22 generally postpones them to taxable years commenced after March 31, 2013).
 - i. When the volume of business during a tax year is equal to or more than \$1,000,000 but less than \$3,000,000, a business can choose to submit the supplementary information. Any business that is current in its tax obligations and chooses to include the supplementary information will be eligible to receive waivers from withholding on payments received for services rendered.
 - ii. When the business volume of a tax year is equal to or greater than \$3,000,000, the business will have to submit the supplementary information.

The supplementary information and other records used in preparing audited financial statements which have themselves been audited by a CPA must show, among other things the following:

- a. that withholdings on salaries and related deposits have been made as required by Section 1062.01 of the 2011 Code;
- b. that withholdings on services rendered and related deposits have been made as required by Section 1062.03 of the 2011 Code;
- c. that the business has deposited the tax withheld from payments to non-residents;
- d. that sales tax and related deposits have been made;
- e. the total sales tax credits (having eliminated the exemption certificates) generated by purchases of personal tangible property for re-sale, the amount of said credits used in monthly returns and the beginning and ending balance for the tax year of the remaining credits;
- f. that expense accounts as per the business' books do not include personal expenses of any partners, shareholders, members, owners, employees, or family members:
 - i. A CPA must determine - taking into consideration the particularities of the industry in question - which expense accounts are susceptible to be used to record non-business related personal expenses;
 - ii. Accounts which should be taken into such consideration include but are not limited to: maintenance, repairs, representation, seminars, training and education, reimbursements, cars and transportation, trips, and miscellaneous expenses; and
 - iii. In the case of any exceptions, a detail of the personal expenses included in the accounts must be provided, showing each amount and in which account it was included.
- g. that use tax has been paid when tangible personal property has been disposed of for less than its cost coupled with a service or maintenance contract;

- h. the amount of wages informed in Form 499R2/W2PR, as well as other payments, reimbursements or compensations to owners, shareholders, partners or members, including payments in their name, if any;
- i. that the amount of wages paid during a year match the amount informed in Form W-3 PR;
- j. the reconciliation of services rendered recognized as expenses with Form 480.6s submitted to the PR Treasury;
- k. Reconciliation of rental expenses with Forms 480.6 submitted to the PR Treasury;
- l. Balance of loans to partners, members, or shareholders, or, if applicable to members of a control group or a group of related entities;
- m. In the case of a business operating under a tax grant or concession, proof that the business is in compliance with the requirements of the grant or concession, including but not limited to the employment requirement, the investment requirement, and that the income reported as exempt on the return stems from the activity covered by the grant.
- n. In the case of construction businesses, with contracts over \$1,000,000:
 - i. That sales and use tax in the purchase of construction materials has been paid;
 - ii. The accounting method used and whether that method is authorized by the 2011 PR Tax Code;
 - iii. If the percentage of completion method is used, then all completion percentages must be certified by an engineer; and
 - iv. When applicable, that the amount shown as retained construction payments is not related to work accepted as completed by the owner or developer.
- o. In the case of hospital units operating under Act No. 168-1968, that:
 - i. the amount reported as "eligible payroll" complies with the definition of the term under said act, and
 - ii. the credit claimed on the return by the hospital unit complies with the requirements established in Section 1(a) of said act;
- p. In the case of financial institutions:
 - i. That the amount reported as interest expense on income tax returns does not include interest expenses attributable to exempt interest expense from exempt obligations acquired after December 31, 1987, as per Section 1033.17(f) of the 2011 Code and its regulations
 - ii. That the amount reported as expenses, which are not interest expenses, does not include expenses attributable to exempt income; and
 - iii. A detailed description of the methodology used to determine non-deductible expenses as per the provision ii, above.

The Secretary will establish a system where CPA's will be required to submit supplementary information electronically.

A new Section 1063.14 will be added to the 2011 Code requiring informative statements regarding cancellation of indebtedness to be filed by February 28 of the next calendar year in order for the creditor to be allowed a deduction.

II. Substantive Amendments to the 2011 Code

Section 1031.01 of the 2011 Code regarding gross income is amended to include under the heading of "Income derived from the cancellation of indebtedness" a cancelled debt that is the result of restructuring a mortgage loan guaranteed by a qualified residence of the taxpayer.

For the purposes of this provision said qualified residence must be located in Puerto Rico and the original mortgage must not exceed \$1,000,000.

Any sums excluded from gross income will directly reduce the tax basis of the qualified residence but never below zero.

Section 1033.17 of the 2011 Code regarding disallowance of expenses is amended to extend to partnerships, special partnerships and corporations of individuals the disallowance of 51% of certain expenses paid to:

- i. a partner, shareholder or member who has 50% or more interest in a partnership, corporate shares, or units of a limited liability company; and/or
- ii. a Home Office located outside of Puerto Rico, a foreign corporation who does business in Puerto Rico through a branch, if said costs are attributable to doing business in Puerto Rico and are not subject to income taxes or retention under the 2011 Code in the tax year these are incurred or paid.

Section 1040.04 of the 2011 Code is amended to disallow expenses for amounts owed to a related person (as defined to Section 1010.05 of the 2011 Code) who is a foreigner or non-resident not engaged in business in Puerto Rico, until that amount has been actually paid to any such related person.

Section 1040.04 of the 2011 Code is amended to allow the Secretary to hire certain third party contractors to examine taxpayer information, documents or witnesses in order to ascertain whether filings or statements made by taxpayers are correct.

Section 6051.07 of the 2011 Code is amended as follows:

- i. All closing agreements must establish that provisions related to or applicable to tax events that occur after the signing of the agreement will be subject to any statutory amendments approved after the date the agreement was signed.
- ii. The Secretary will create a registry of Closing Agreements which identifies each Agreement by taxpayer.

A new Section 6051.18 will be added to the 2011 Code on publication of information on delinquent Taxpayers.

Allowing the Secretary to publish lists regarding delinquent taxpayers and/or withholding agents. Late or default status will be determined according to internal rules set by the PR Treasury.

New Sections 6073.01 and following are added to the 2011 Code to further regulate CPAs regarding the supplementary information required under Section 1061.15 of the 2011 Code.

In order to provide an opinion regarding the supplementary information required under Section 1061.15, CPA's must:

- Retain for 4 years all records which support the opinion and its preparation;
- Respond to the Secretary's requests regarding such supplementary information within the time frame and according to the conditions he/she establishes for this purpose;
- Electronically submit to the PR Treasury Department all supplementary information required under Section 1061.15 of the 2011 Code.

The Secretary may revoke or suspend the privilege to prepare such reports to any CPA who intentionally and knowingly submits false supplementary information.

Further, severe fines and penalties are provided to any CPA who intentionally offers a false opinion on supplementary information or conspires with a taxpayer in the preparation and opinion on supplementary information.

For updates on this matter, you may contact any of the attorneys of our Tax Practice Group listed below:

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