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TAX ALERT

Substantial Amendments Proposed by the Governor to the Economic Incentives for the Development of Puerto Rico Act and the Green Energy Incentives Act

HB 1919 proposes to amend the Puerto Rico Internal Revenue Code of 2011 ("Code"), Act 73-2008, also known as the "Economic Incentives for the Development of Puerto Rico Act" ("Act 73") and Act 83-2010, also known as the "Green Energy Incentives Act" ("Act 83"). HB 1921 seeks to provide individuals between the ages of 16 and 26 with certain tax exemptions and establish a series of government programs designed to facilitate and promote the professional and entrepreneurial development of this group on the Island.

Below we summarize the provisions of HB 1919 and HB 1921.

HB 1919

Amendments to Tax Incentives Acts

- Small or Medium Size Business under Act 73

HB 1919 would amend Section 2(i) of Act 73 to provide that the gross income of the members of an exempt business' controlled group, will be considered to determine if an exempt business is a small or medium size business ("PYMEs" for its Spanish acronym) under Act 73. This amendment would limit the amount of businesses that would be eligible to be classified as PYMEs, the cash investment on which is eligible for the Investment Credit (see below).

- Credit for Investment in Research and Development under Act 73

HB 1919 would amend Section 5(c) of Act 73 to require all exempt businesses that intend to claim the credit for investment in research and development, clinical trials, toxicological tests, infrastructure, renewable energy, or intangible property ("R&D Credit"), to annually obtain a certificate from the Puerto Rico Industrial Development Company ("Certificate"), endorsing the exempt business' activities in Puerto Rico, as eligible activities to claim the R&D Credit. The Certificate should be obtained on or before the filing date of the income tax return, including any extensions, for the taxable year in which the eligible investment was made, and is to be submitted with such return as a requirement for claiming the R&D Credit.

From a practical standpoint, the requirement to obtain the Certificate does not represent a significant change as a similar procedure is currently implemented as a matter of administrative practice.

In addition, HB 1919 would impose a cap of \$300 million to the amount of R&D Credits the Government of Puerto Rico will be authorized to grant per fiscal year.

- Industrial Investment Credit under Act 73

HB 1919 would amend Section 6(e)(2) of Act 73 to provide that the credit generated with respect to cash contributed in exchange for stock in the establishment of a small or medium size exempt business ("Investment Credit"), will also be subject to the 10-year recapture that currently applies solely to the tax credit generated in connection with the eligible cash investment made in exchange for stock or assets of an exempt business ceasing operations in Puerto Rico. The recapture on the Investment Credit would not apply if the exempt business maintains operations for at least 10 years.

- Green Energy Fund Allocations

HB 1919 would amend Article 2.2(a) of Act 83 to reduce the amount allocated to the green energy fund to \$20 million for fiscal years 2014-2015 through 2019-2020. Current amounts assigned to such fund are \$30 million, \$35 million, and \$40 million for fiscal years 2014-2015, 2015-2016, and 2016-2017 through 2019-2020, respectively.

Amendments to the Code: Income Taxes

- Deemed Dividend/Investment in Foreign Property Tax

HB 1919 proposes to add a new Section 1062.13 to the Code, to impose a 4% prepaid tax on the deemed dividend amount ("Dividend Amount"), considered to have been received by a foreign owner (individual or corporation owning at least 50% of the ownership interests in the entity, by vote or value) of an entity taxed as a corporation under the Code, without regard to any deduction or credit ("Deemed Dividend Tax"). The Deemed Dividend Tax is akin to a controlled foreign corporation's current income inclusion with respect to certain investments of earnings in United States property, pursuant to Section 956 of the United States Internal Revenue Code of 1986, as amended.

The Dividend Amount would be the lesser of the average value of certain "assets held outside Puerto Rico," or the accumulated earnings and profits at the end of the taxable year ("Year-End E&P"). Assets held outside Puerto Rico would include tangible property located outside of Puerto Rico, stock of a foreign corporation, obligations of a foreign corporation or a Puerto Rico non-resident and certain intangibles acquired or developed by a domestic corporation for use outside of Puerto Rico.

HB 1919 provides that for determining the Dividend Amount, Year-End E&P would be reduced by earnings and profits from:

1. income generated under tax incentives acts such as Act 73, Act 74-2010, Act 225-1995, Act No. 52 of August 11, 1989, or other similar incentives acts; and
2. the Deemed Dividend Tax paid.

Not for-profit entities under Section 1101.01 of the Code, International Insurers under Section 61.040(4) of the Puerto Rico Insurance Code, and International Financial Entities as defined in Act 273-2012, will not be subject to the Deemed Dividend Tax.

- Additional Gross Receipts Tax

Amendments made by Act 40-2013 and Act 117-2013, added an additional gross receipts tax ("Gross Receipts Tax"), as a component of the Alternative Minimum Tax ("AMT") for corporations and the alternate basic tax for individuals.

HB 1919 would amend Section 1023.10 of the Code to provide that, for purposes of the Gross Receipts Tax, gross income will exclude payments or cash-flow received by duly certified voluntary chains, as such term is defined in Act No. 77 of June 25, 1964, as amended, from its members, as a result of transfers of inventory or goods under a common negotiations program.

- Alternative Minimum Tax (Corporations)

HB 1919 would also limit the amount of the tax credit available with respect to the AMT paid in prior years that may be claimed against the current year regular tax ("AMT Credit") to 25% of the current net regular tax over the AMT for such taxable year. HB 1919 provides that the AMT Credit may be claimed until exhaustion, but sets a limit on the taxable years to be used to determine the amount of the AMT Credit, as explained below. Currently, the AMT Credit has no limit, nor is it subject to a sunset provision.

The AMT Credit is currently determined based on (i) the sum of the net AMT for all prior taxable years over (ii) the AMT Credit for such taxable years. Should HB 1919 be enacted into law, the AMT Credit will be based on (i) the sum of the net AMT for all taxable years that commenced prior to January 1, 2014 over (ii) the sum of the AMT Credit for such taxable years, effectively eliminating the AMT Credit for taxable years commenced on or after January 1, 2014. Thereafter, taxpayers will be subject to either the regular tax net income-based regime or the AMT regime (which includes gross receipts and intercompany purchases components).

- Alternate Basic Tax (Individuals)

HB 1919 would amend Section 1021.02 of the Code to modify the alternate basic tax ("ABT") brackets for individuals, for taxable years commencing on January 1, 2014, as follows:

From \$150,000 to \$200,000 (Currently \$150,000 to \$250,000)	10%
Over \$200,000, but less than \$300,000 (Currently Over \$250,000, but less than \$500,000)	15%
In excess of \$300,000 (Currently In excess of \$500,000)	24%

As in the case with the AMT Credit, HB 1919 would also limit the amount of the tax credit available with respect to the ABT of prior years that may be claimed against the current year regular tax ("ABT Credit") to 25% of the current net regular tax over the ABT for such taxable year. Furthermore, HB 1919 provides that the ABT Credit may be claimed until exhaustion, but sets a threshold on the taxable years to be used to determine the amount of the ABT Credit. Currently, the ABT Credit has no limit, nor is it subject to a sunset provision.

The ABT Credit is currently determined based on (i) the sum of the net ABT for all prior taxable years that commenced after December 31, 2008 over (ii) the sum of the net regular tax for all prior taxable years that commenced after December 31, 2008. Should HB 1919 be enacted into law, the ABT Credit will be based on (i) the sum of the net ABT for all prior taxable years that commence after December 31, 2008 and end prior to January 1, 2014 over (ii) the sum of the net regular tax

for all prior taxable that commence after December 31, 2008 and end prior to January 1, 2014, effectively eliminating the ABT Credit for taxable years commenced on or after January 1, 2014, thus establishing two separate regimes as in the case of corporations.

- Branch Profits Tax

HB 1919 would also amend the Code to exclude (i) loans or credit transactions between affiliates, except banking entities or when such transactions arise from the sale or transfer of property from Puerto Rico Assets and Puerto Rico Liabilities, as applicable, and (ii) cash held in a banking institution or brokerage firm located outside of Puerto Rico that is not used exclusively by a branch located in Puerto Rico from Puerto Rico Assets, for purposes of determining the Puerto Rico net assets as part of the computation of the dividend equivalent amount of foreign corporations subject to the branch profits tax imposed by Section 1092.02 of the Code.

- 2% Tax on Self-Employed Individuals

HB 1919 proposes to amend Section 1021.05 of the Code to exclude agricultural income (as defined in Section 1023.10(g)(1)(F)(i) of the Code (this reference seems to be a typographical error since agricultural income for purposes of Section 1023.10 of the Code is defined in paragraph (g)(1)(F)(ii) or covered under Act 225-1995) from the 2% surtax applicable to self-employed individuals whose gross income exceeds \$200,000.

- Income Tax Withholding on Services

HB 1919 would amend Section 1062.03 of the Code to (i) include insurance contracting payments as payments subject to income tax withholding and (ii) clarify that income or gains generated by direct salespersons of consumer products, will not be subject to income tax withholding. In this context, HB 1919 would clarify that the term "direct salespersons" would exclude any person that receives commissions or other payments that represent, in whole or in part, income or gain generated by a direct salesperson or other type of vendor under the supervision, control, management, or is a member of the distribution network of such person.

- Special Rates on Net Long Term Capital Gains, Interest on Certain Deposit Accounts and Dividends

HB 1919 would amend Sections 1023.02, 1023.03, 1023.04 and 1023.06 of the Code to increase the tax rates on, (i) net long term capital gains of individuals, estates or trusts and corporations, (ii) interest from certain deposit accounts, and (iii) dividends from certain corporations received by individuals, estates or trusts, as follows:

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|---|-----------------|
| 1. Net long term capital gain rate available to individuals, estates or trusts | from 10% to 15% |
| 2. Net long term capital gain rate available to corporations | from 15% to 25% |
| 3. Non-exempt interest from deposit accounts from certain banking entities based in Puerto Rico | from 10% to 17% |
| 4. Dividends | from 10% to 15% |

The proposed 15% net long term capital gain rate applicable to individuals, estates or trusts, as well as the 25% net long term capital gain rate applicable to corporations, would apply with respect to

net long-term capital gains “generated” after HB 1919 is enacted into law. The increased tax rates applicable to certain interest and dividends would be effective for taxable years commencing on or after January 1, 2014.

HB 1919 does not include proposed amendments to the withholding tax provisions related to net long term capital gains and receipt of dividend or interest income of non-resident individuals or corporations not engaged in the conduct of a trade or business in Puerto Rico have not been amended. Therefore, non-resident withholding on these items of income would remain as follows:

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|--------------------------------------|----------------------------|
| 1. Capital gains and interest income | 29% or 20% if a US citizen |
| 2. Dividends | 10% |

- Holding Period, Limitations and Carry-forward on Capital Gains and Losses

HB 1919 would also amend the holding period on capital assets under Section 1034.01 of the Code, for purposes of determining short or long term capital gains or losses. The holding period of capital assets, for short term capital gains or losses would be increased from not more than six (6) months to not more than one (1) year and for long term capital gains or losses would be increased from more than six (6) months to more than one (1) year.

HB 1919 would also amend Section 1034.01 of the Code to provide that capital gains may be offset by capital losses up to a maximum of 90% of such capital gains, with respect to corporations. Individuals would continue to be allowed to offset ordinary income with up to \$1,000 of capital losses. However, they would also be subject to the 90% limitation on the capital gains that may be offset by capital losses. Currently, in the case of both corporations and individuals, capital gains may be offset by capital losses without limitation.

In addition, HB 1919 would increase the net capital loss carry-forward period from 5 to 7 years.

- Interest Exemption from Gross Income

HB 1919 proposes to amend Section 1031.02 of the Code to increase the income tax exemption on eligible interest income received by individuals, from \$2,000 to \$4,000 for individuals and married taxpayers filing separately and from \$4,000 to \$8,000 to married taxpayers filing jointly.

- Earned Income Credit and Low Income Credit for the Elderly

The earned income credit available to certain individuals under Section 1052.01 of the Code would be eliminated for taxable years commencing on or after January 1, 2014.

HB 1919 also intends to reduce the \$400 tax credit available to individuals of 65 years of age with gross income of less than \$15,000, under Section 1052.02 of the Code from \$400 to \$200, for taxable years commencing on or after January 1, 2014. The credit may be increased back to \$400 if certain government budgetary projections are met.

- Urban Center Revitalization Credits during Moratorium

Act 40-2013 amended the Code to establish certain limitations with respect to the usage and issuance of tax credits under various tax incentives acts (“Moratorium”), including urban center revitalization projects under Act 212-2002 (“Urban Projects”). Please refer to our Tax Alerts from [July 3, 2013](#) and [October 18, 2013](#).

HB 1919 intends to amend Section 1051.12 of the Code to reduce the maximum allocation of tax credits that may be granted to an Urban Project during the Moratorium. In such event, the current \$15 million maximum that may be allocated to an eligible Urban Project during fiscal years 2013-14 through 2015-16, would be available only for allocations during fiscal year 2013-14 and reduced to \$5 million per Urban Project, for allocations made during fiscal years 2014-2015 and 2015-2016. The aggregate \$40 million available for the government to authorize tax credits for Urban Projects tax credits per fiscal year would remain unchanged.

Sales and Use Taxes

HB 1919 would amend Section 4010.01(a) of the Code to exclude the following items from the term “food and food ingredients,” effectively making them taxable for sales and use tax purposes or clarifying their current taxability.

- nutritional bars;
- energy bars;
- popcorn;
- nuts, hazelnut, almonds, pistachios, and other similar products (fresh, dried, sugared, salted, among others);
- any non-alcoholic beverages, except water (without any added ingredient), milk (including soy milk, almond milk, and other substitutes of regular milk), juices (defined as a non-carbonated beverage with no less than 5% of fruit or vegetable content);
- total or partial pre-cooked frozen food (including ice cream); and
- potato chips, corn chips, pork rinds (“chicharrones”), and other similar products.

HB 1921

If and when enacted into law, HB 1921 would be known as the Incentives and Financing Act for Young Entrepreneurs (the “Act”). According to HB 1921, the Act will establish a public policy to facilitate the creation of new businesses by the local young population; the goal is to promote economic development, job creation and provide a secure socio-economic environment for the citizens of Puerto Rico. To further these ends the following measures are proposed:

Incentives Plan for Young People

Section 1031.02 the Code would be amended to establish a gross income exemption for the first \$40,000 of income earned from salaries, services rendered, and/or independent work by young residents of Puerto Rico (aged 16 – 26). Any amount earned over \$40,000 by this group will be taxed regularly.

The Puerto Rico Economic Development Bank (“EDB”) will establish a plan to allow for refinancing of student loans at a preferred rate, generally subject to a commitment to remain and work in Puerto Rico for at least 3 years.

Incentives Plan for “New Businesses”

As defined by HB 1921, a “New Business” is one created by a young professional (a resident of Puerto Rico between the ages of 16 and 26) that commences operations following the signing of a Special Agreement for the Creation of Business (an “Agreement”) with the Commerce and Export Company of Puerto Rico (“CEC”). This Agreement will set forth the terms of its effectiveness and will expire once the benefits provided therein have lapsed under the Act or the Agreement.

A “Youth Development Program” assigned to the Department of Economic Development and Commerce (“DEDC”), in coordination with the CEC and the EDB. must develop a Plan to Finance

the Development of Businesses of Young People in alliance with the instrumentalities of the Executive Branch in order to support young entrepreneurs. This plan will include guidelines about starting businesses in Puerto Rico; incentives available to young people and all necessary information to guide and facilitate the creation of new businesses by young businesspeople. HB 1921 establishes timely online publication requirements for this plan.

Under HB 1921 the CEC will be the agency responsible for certifying the eligibility of a new business created by a young entrepreneur before the Youth Development Program and the Bank. HB 1921 provides the following tax benefits for said new businesses:

- *Temporary income tax exemption* – exemption from income taxes to the first \$500,000 of gross income during the 3 economic years following the signing of the Agreement.
- *Temporary Municipal License Tax Exemption* – exemption from municipal license taxes during the 3 economic years following the signing of the Agreement.
- *Temporary Exemption for Personal Property* – exemption from personal property taxes during the 3 years following the signing of the Agreement.

These tax benefits will be limited to only one New Business per young entrepreneur.

Expedited Permits and Licenses

New Businesses that operate under an Agreement are eligible for an expedited procedure for registration and permits. The guidelines of this expedited program will be part of the Plan to Finance the Development of Businesses of Young People.

Inventory of Real and Personal Government Property

The Puerto Rico Industrial Development Company (“PRIDCO”) and the Land Authority will jointly create an inventory of real and personal property of the Government of the Commonwealth of Puerto Rico which may be offered to young entrepreneurs for the establishment of New Businesses.

Financing and Venture Capital

Subject to eligibility criteria established by the EDB, the Act will order it to develop a specialized program to deal with the financing and financial advising needs of young entrepreneurs. This program will establish parameters for granting discounts on charges and interest rates for the financing of New Businesses. The EDB will handle requests for financing filed by New Businesses with priority and in an expedited manner. The bank will also create a venture capital program to serve as an incentive for the development of New Businesses.

Database on the Profiles of Young Graduates in Puerto Rico

The Statistics Institute of the Commonwealth of Puerto Rico (the “Institute”) is ordered to create and maintain a database which identifies the profile and number of young graduates (or graduation candidates) from accredited institutions of higher education so that public entities offering benefits, incentives and financing under the Act may have a frame of reference regarding the profile of these young people. The Institute must keep the DEDC informed about the results and updates of this database.

Regulations and Effectiveness

If enacted, HB 1921 would authorize the Puerto Rico Treasury Department; the DEDC; the Department of Education; the Land Authority; PRIDCO; and the EDB to publish the necessary regulations, circular letters or administrative determinations to made the provisions and purposes of the Act effective. Any regulations which arise under the Act will not be subject to the provisions of Act 170-1988, known as the Puerto Rico Uniform Administrative Procedure Act.

The Act would become effective immediately upon its enactment.

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

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