E–ALERT

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## TAX ALERT

### *Amendments to the Puerto Rico Internal Revenue Code of 2011, the Economic Incentives for the Development of Puerto Rico Act, the Green Energy Incentives Act of Puerto Rico and the Games of Chance Act are enacted into Law*

On July 1, 2014, the Governor of Puerto Rico signed House Bill 1919 into law, which became Act 77-2014 ("Act"). Below we have summarized the amendments to 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"), Act 83-2010, also known as the "Green Energy Incentives Act" ("Act 83") and Act 11 of August 22, 1933, also known as the "Games of Chance Act."("Act 11").

<u>Amendments to Tax Incentives Acts</u>

**Small or Medium Size Business under Act 73**

The Act amended 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 such exempt business is a small or medium size business ("PYMEs" for its Spanish acronym) under Act 73. This amendment limits 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**

The Act amended 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 was already implemented as a matter of administrative practice.

In addition, the Act imposes 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**
The Act amended 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 ("Cease of Operations Credit"). As in the case with the Cease of Operations, the recapture on the Investment Credit will not apply if the exempt business maintains operations for at least 10 years.

**Green Energy Fund Allocations**
The Act amended Act 83 to reduce the amount allocated to the green energy fund to $20 million for fiscal years 2014-2015 through 2019-2020.

<u>Amendments to the Code: Income Taxes</u>

**Deemed Dividend/Investment in Foreign Property Tax**
The Act imposes a 10% 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 Dividend Amount will 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 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.

The Act provides that for determining the Dividend Amount, Year-End E&P will 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, are not subject to the Deemed Dividend Tax.

**Branch Profits Tax**
The Act 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 the Code.

**Additional Gross Receipts Tax**
The Act eliminates the additional gross receipts tax (“Gross Receipts Tax”) as a component of the alternative minimum tax (“ AMT”) and of the alternate basic tax for individuals for taxable years commencing on January 1, 2014 and thereafter.

For taxable years commencing before January 1, 2014, the Act amended 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.

Effective for taxable years commencing after December 31, 2013, the Act adds a new Gross Receipts Tax which tax shall be in addition to the regular income tax, the AMT or the alternative basic tax of a particular taxable year. The tax shall be payable by corporations (or any other entity taxable as a corporation), partnerships (or any other entity taxable as a partnership), special partnerships and corporations of individuals engaged in a trade or business in Puerto Rico. The Gross Receipts Tax also shall apply to taxpayers who elected under Section 1022.06 to be taxed pursuant to the provisions of the Puerto Rico Internal Revenue Code of 1994, as amended.

The new Gross Receipts Tax shall be collected as part of the estimated tax payments. Certain tax credits will be allowed against the Gross Receipts Tax. However, tax credits acquired or generated by a taxpayer will not be creditable against the Gross Receipts Tax. The Gross Receipts Tax may be deducted in determining the net taxable income of the taxpayer so long as the taxpayer has paid the Gross receipts Tax on or before the due date for the filing of the income tax return for the taxable year.

For businesses other than non-prepared food retailers with gross income of less than $400,000,000 and financial businesses, the Additional Gross Receipts tax will be determined using the following rates:

- .35% if gross receipts are $3,000,000 but not greater than $100,000,000
- .50% if gross receipts are $100,000,000 but not greater than $300,000,000
- .70% if gross receipts are in excess of $300,000,000 but not greater than $600,000,000
- .80% if gross receipts are in excess of $600,000,000 but not greater than $1,500,000,000
- 1% if gross receipts are in excess of $1,500,000,000

In the case of non-prepared food retailers with gross income of less than $400,000,000, the Additional Gross Receipts tax will be determined using the following rates:

- .20% if gross receipts are $3,000,000 but not greater than $300,000,000
- .28% if gross receipts are $300,000,000 but less than $400,000,000

In the case of financial institutions, the applicable gross receipts tax rate will be 1%.

The new tax rates will not affect pending applications for rate reduction timely filed by a taxpayer for taxable years commencing before January 1, 2014. Taxpayers who have received a rate reduction have the option of determining the Gross Receipts Tax based on the lower approved rate or the rate, otherwise, applicable to the taxpayer as reflected above.

Similar to the prior Gross Receipts Tax, the new Gross Receipts Tax has special rules relating to, among others, a controlled group of corporations, or related entities.

**Alternative Minimum Tax (Corporations)**
The Act limits 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. The Act provides that the AMT Credit may be claimed until exhaustion.

**Alternate Basic Tax (Individuals)**
The Act amended 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:

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| - From $150,000 to $200,000 | 10% |
| - Over $200,000, but less than $300,000 | 15% |
| - In excess of $300,000 | 24% |

The Act also limits the amount of the tax credit to 25% of the current net regular tax over the ABT for such taxable year. Furthermore, the Act provides that the ABT credit accrued up to December 31, 2013 may be claimed until exhaustion. Before the enactment of the Act, the ABT credit had no limit, nor was subject to a sunset provision.

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.

**2% Tax on Self-Employed Individuals**
The Act amended the Code to exclude agricultural income (as defined in Section 1023.10(g)(1)(F)(i) of the Code from the 2% surtax applicable to self-employed individuals whose gross income exceeds $200,000. 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.

**Income Tax Withholding on Services**
The Act amended the Code to (i) include payments for insurance contracting 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, the Act clarifies that the term “direct salespersons” excludes 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**
The Act amended the Code to increase the tax rates on, (i) net long term capital gains of individuals, estates, 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% to15% |
| 2. Net long term capital gain rate available to corporations | from 15% to 20% |

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| 3. | Non-exempt interest from deposit accounts from certain banking entities based in Puerto Rico | from 10% to17% |
| 4. | Dividends | from 10% to 15% |

The 15% net long term capital gain rate applicable to individuals, estates or trusts, as well as the 20% net long term capital gain rate applicable to corporations, applies with respect to net long-term capital gains “generated” after July 1, 2014. The increased tax rates applicable to certain interest and dividends are effective for taxable years commencing on or after January 1, 2014.

**Holding Period, Limitations and Carry-forward on Capital Gains and Losses**
The Act also amended the holding period on capital assets, 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 was increased from not more than six (6) months to not more than one (1) year and for long term capital gains or losses was increased from more than six (6) months to more than one (1) year.

The Act also amended 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 will continue to be allowed to offset ordinary income with up to $1,000 of capital losses. However, they will also be subject to the 90% limitation on the capital gains that maybe offset by capital losses.

In addition, the Act increased the net capital loss carry-forward period from 5 to 7 years.

**Earned Income Credit and Low Income Credit for the Elderly**
The earned income credit available to certain individuals under the Code was eliminated for taxable years commencing on or after January 1, 2014.

The Act also reduced the $400 tax credit available to individuals of 65 years of age with gross income of less than $15,000, 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.

The Act amended 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 maximum that may be allocated to an eligible Urban Project during fiscal years 2014-15 and 2015-16, will be $5 million per Urban Project. The aggregate $40 million available for the government to authorize tax credits for Urban Projects tax credits per fiscal year remains unchanged.

**Long-Term Contracts**
The income from land and structure development is again eligible for the completed contract method.

**Prepayment of Income Taxes**

**Variable Annuity Contracts**
The Act allows the prepayment, at a reduced income tax rate of 10%, of the total accrued and undistributed amount of a life insurance contract, provided said life insurance contract is directly or indirectly exchanged for an "Eligible Variable Annuity Contract" (as such term is defined below) on or before December 31, 2014. For these purposes, an "Eligible Variable Annuity Contract" is a variable annuity contract issued on or before December 31, 2014 by a life insurance company organized under the laws of Puerto Rico. Any prepaid taxes must be remitted to the PR Treasury no later than December 31, 2014.

**Capital Assets and Increase in Value of Certain Assets**
The Act also allows individuals, estates and trusts to prepay, during an election period running from July 1, 2014 to October 31, 2014 ("Period"), the increase in value of a long-term capital asset at a reduced income tax rate of 8%, and at a reduced income tax rate of 15% the increase in value of (i) corporate stock or ownership interests in limited liability companies or partnerships, (ii) real property located within or without Puerto Rico, (iii) a fixed annuity contract; and (iv) participations held in an employee benefit plan, whether qualified or not in Puerto Rico.

Similar to individuals, corporations may elect during the Period to prepay at a reduced income tax rate of 12% the increase in value of long-term capital assets. For these purposes, long term capital assets include corporate stock or ownership interests in partnerships, real property located within or without Puerto Rico and intangible property.

The prepayment of income taxes can be made on the whole increase in value of the asset or on a portion of the same. This election will apply to the shareholders, members or partners of pass-through entities -partnership, special partnerships and corporations of individuals- with respect to the eligible assets of such entities.

The prepaid income tax amount will increase the tax basis of the asset.

**Individual Retirement Accounts**
Except for contributions made in taxable year 2014 and thereafter, individuals may elect to prepay at a reduced income tax rate of 8% all or part of their accrued and undistributed balances in individual retirement accounts ("IRA").

A penalty for early withdrawal of 30% -in lieu of the usual 10% penalty- will apply to any distribution from an IRA of prepaid amounts if the holder of the IRA or its beneficiary has not attained age 60. No penalty will apply to a distribution made from an IRA to prepay the 8% tax under the Act.

To the extent applicable, interest paid or accrued on an IRA after June 30, 2014 will continue to be subject to the 17% income tax rate.

The election to prepay income taxes referred to above must be made within the Period using the forms that the PR Treasury will provide for such purposes.

<u>Amendments to the Code: Tax on Alcoholic Beverages Provisions</u>

The Act amended the Code to define distilled spirits, wines and beers as a "Finished Product" for purposes of the tax on alcoholic beverages ("Alcohol Tax") and to incorporate the term Finished Product in the provisions relating to the timing of the imposition of the Alcohol Tax for distilled spirits, wines and beers.

Amendments to the Code and to the Games of Chance Act

The Act amended the Code and Act 11 to transfer regulatory and administrative powers from the Puerto Rico Treasury Department and the Secretary of the Treasury, to the Puerto Rico Tourism Company ("Company") and the Executive Director of the Puerto Rico Tourism Company ("Director"), respectively, in connection with the adult entertainment machines industry in Puerto Rico.

The Act now empowers the Company to regulate and oversee the adult entertainment machines business in Puerto Rico, including the issuance of licenses for the operation of adult entertainment machines ("Licenses") and the imposition of administrative fines up to $10,000.

The Act amended the Code to increase license fees for adult entertainment machines from $2,250 to $2,500 and to provide that the proceeds collected from such license fees will be equally allocated between the general fund and the Company. The Licenses will continue to be renewed annually.

Consistent with the transfer of authority to the Company, the Act eliminated the $5,000 administrative fine and License cancellation provisions from the Code imposed for operating adult entertainment machines that have been altered in violation of Act 11 or without the required License. In the same context, the Act increased criminal fines and imprisonment time to be imposed in connection with the introduction or use of games of chance machines (i.e., those not considered to be adult entertainment machines under Act 11) to a maximum of $20,000 and up to 1 year of imprisonment. Lesser fines and imprisonment may apply depending on the violation.

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


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