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TAX ALERT

Technical Amendments to the Puerto Rico Internal Revenue Code of 2011

On December 22, 2014, the Governor of Puerto Rico signed Senate Bill 1189 into law, which became Act 238-2014 ("Act"). Below is a summary of the most significant amendments to the Puerto Rico Internal Revenue Code of 2011, as amended ("Code").

I. Income Taxes

A. **Alternate Basic Tax (Individuals)**

For taxable years commencing after December 31, 2012 and before January 1, 2014, the Alternate Basic Tax ("ABT") will include the Additional Tax on the individual's distributable share of the gross income of a partnership, special partnership or corporation of individuals.

B. **Low-Income Credit for the Elderly**

Section 1052.02 of the Code was amended to provide that individual taxpayers residents of Puerto Rico who are 65 years or older, and are generating no more than \$15,000 of gross income during a taxable year (\$30,000 in the aggregate in the case of married taxpayers), can claim a credit as follows:

- \$400 for taxable years that started before January 1, 2014; and
- \$200 for taxable years starting after December 31, 2013.

C. **Additional Gross Receipts Tax**

The amendments to Section 1023.10A clarify that the stand alone tax imposed on the gross income ("Patente Nacional" or "Additional Tax") applies, in the case of entities that are subject to taxation as corporations, for taxable years starting after December 31, 2013, and in the case of taxpayers subject to taxation as partnerships, special partnerships, and corporations of individuals (collectively referred to as "Pass Through Entities"), for taxable years starting after January 1, 2013 and ending after December 31, 2013.

The Additional Tax should also be determined distinctly and in addition to the regular tax applicable to individuals, the normal tax and the additional tax applicable to corporations, the basic alternate tax applicable to individuals, and the alternative minimum tax applicable to corporations. The Additional Tax, however, can be claimed as a deduction in the computation of the net income of the

taxpayer, including those taxpayers that have elected to be subject to taxation under the provisions of the Puerto Rico Internal Revenue Code of 1994, as amended.

For purposes of computing the gross income subject to the Additional Tax, the partners, members and shareholders of the Pass Through Entities will exclude their distributable share in such entities' gross income.

It is also clarified that the Additional Tax will not apply for taxable years starting after December 31, 2014 in the case of entities subject to taxation as corporations, and for taxable years starting after January 1, 2014 in the case of Pass Through Entities.

- *Transitional Provisions*

In the case of Pass Through Entities, for taxable years that commenced after January 1, 2013 and ended on or before November 30, 2014, the following rules will apply:

- Must file a Supplementary Return for the computation of the Additional Tax. If the entity already filed its Informative Returns, Forms 480.1(E), 480.1(S) or 480.2(I), before December 31, 2014, it must file the Supplementary Return on or before January 31, 2015. If the Informative Returns have not been filed by December 31, 2014, then the Supplementary Return should be filed as an attachment to the Informative Return.
- The Additional Tax must be paid at the time required to file the Supplementary Return.
- In determining the estimated tax that should be withheld by the Pass Through Entities for the taxable year starting after January 1, 2013 and ended on or before November 30, 2014, such entities should take into account the deduction allowed for the Additional Tax.
- The Pass Through Entities must compare the computation of the estimated tax with the amount that was withheld and remitted to Treasury for such taxable year before filing the Supplementary Return. If the amount withheld and remitted exceeds the required estimated tax, the entity may use such excess to satisfy its Additional Tax liability. Conversely, if the amount withheld and remitted is less than the entity's Additional Tax liability, the entity must satisfy its liability with the filing of the Supplementary Return.
- The Pass Through Entities can take a deduction for the Additional Tax liability that was satisfied with the amount remitted in excess or paid with the Supplementary Return pursuant to the prior paragraph.
- The Pass Through Entities that at the time of filing the Supplementary Return have already filed the Informative Returns for their partners, members or shareholders, must amend such returns to show the correct net income's distributable share and amount withheld.
- If the Pass Through Entities have already paid their Additional Tax for taxable years starting after January 1, 2014, such payments will be considered withheld and remitted

during the prior taxable year for purposes of calculating in the Supplementary Return the amount remitted in excess or under-remitted.

D. Increase in Tax Rates

The Act amends Code Sections 1023.06 and 1062.08 to increase from 10% to 15% the tax withholding rate on the following: (i) dividends distributed to nonresident individuals, (ii) payments to nonresident U.S. citizens in the acquisition of real property or stock, and (iii) dividend distributions made to individual taxpayers by a domestic corporation or a foreign corporation of whose gross income for the three prior taxable years is at least 80% effectively connected with a Puerto Rico trade or business ("Foreign Resident Corporation"):

The new withholding tax rates apply to dividends or payments made after October 31, 2014.

The Act also increased from 10% to 15% the tax on dividend distributions to non-resident alien individuals. This increase seems to be effective as of the date of the approval of the Act (December 22, 2014).

E. Capital Gains and Losses

The following are the most significant amendments to the statutory provisions in the Code related to capital assets:

- The Act clarifies that the capital loss carry forward reverts to 7 years for taxable years commencing after December 31, 2012
- Section 1032.09 of the Code clarifies that in computing the gross income of an individual taxpayer derived from his artistic work or invention, a gain would be considered from the sale of a capital asset if the asset was held for at least one year. The increase in the holding period from six months to one year was effective for sales taking place after June 30, 2014.
- The Act amends the partnership provisions in Section 1071.02 of the Code relating to items to be reported separately with respect to gains or losses arising from the sale or exchange of capital assets. Gain or loss arising from the sale or exchange of capital assets held by a partnership for no more than 6 months, if the sale or exchange took place before July 1, 2014, or from the sale or exchange of capital assets held by a partnership for no more than 1 year, if the sale or exchange took place after June 30, 2014, are to be reported separately. Gain or loss arising from the sale or exchange of capital assets held by a partnership for more than 6 months, if the sale or exchange took place before July 1, 2014, or from the sale or exchange of capital assets held by a partnership for more than 1 year, if the sale or exchange took place after June 30, 2014, are to be reported separately.
- The Act also amends the special partnership and corporation of individuals' provisions in Sections 1114.06 and 1115.04 of the Code, to specifically define the new holding period to be used in determining whether gains or losses arising from the sale or exchange of capital assets should be reported as a long or short term capital gain or loss. In this regard, the distributable share of the partners and shareholders will include a short-term capital gain or loss if the capital asset was held for no more than 6 months and the sale took place before July 1, 2014, or if the capital asset was held for no more than 1 year and the sale took

place after June 30, 2014. In the same manner, the distributable share of the partners and shareholders will include a long-term capital gain or loss if the asset was held for more than 6 months and the sale took place before July 1, 2014, or if the capital asset was held for more than 1 year and the sale took place after June 30, 2014.

- Finally, the Act amends Section 1034.01 of the Code to further provide that property, for purposes of the involuntary conversion provisions and in the case of the sale or exchange of certain property used in a trade or business, shall consist of property held for more than 6 months, if the involuntary conversion or sale or exchange of the property occurred before July 1, 2014, or of property held for more than 1 year, if the involuntary conversion or sale or exchange occurred after June 30, 2014.

F. Deemed Dividend / Investment in Foreign Property Tax

The Act amended Section 1062.13 of the Code (the “Deemed Dividend Tax”) to provide that the 10% Deemed Dividend Tax is imposed on the Foreign Owner, and must be remitted, paid and deposited by the Corporation (used in this section as defined in Section 1062.13(b)(2) of the Code) on behalf of the Foreign Owner. The term Foreign Owner was amended to specifically include 1) non-resident individuals, estates and trusts, 2) non-resident entities that are not taxed as corporations, and 3) resident and non-resident entities taxable as corporations that generated less than 80% of their gross income for the prior three taxable years from Puerto Rico sources or treated as effectively connected with Puerto Rico.

The Act provides that the Deemed Dividend Tax will not be used when computing the estimated tax under Code Section 1061.23.

The Act clarifies that the Deemed Dividend Tax remitted, paid or deposited by the Corporation will be creditable against withholding taxes on future dividend distributions to any shareholder of the Corporation, regardless of whether the shareholder is a Foreign Owner at that time. Any Deemed Dividend Tax that cannot be used as credit in one taxable year can be used as a credit in future taxable years until exhausted, or can be refunded to the taxpayer pursuant to an agreement with the Secretary of the Puerto Rico Treasury Department.

Failure to withhold or deposit Deemed Dividends Tax will now result in the imposition of the penalty prescribed in Section 6041.01 of the Code.

G. Prepayment of Income Taxes on Capital Assets and Increase in Value of Certain Assets

Section 1023.21 of the Code has been amended to, among others:

- Extend the period to prepay at a reduced tax rate the income tax applicable to the accrued value of benefits in retirement plans (8% for qualified retirement plans and 15% for non-qualified retirement plans) from July 1, 2014 to October 31, 2014 to July 1, 2014 until January 31, 2015 (“Prepayment Period”);
- Clarify that in order to qualify for the reduced tax rate, non-qualified plans must have been adopted through a written agreement prior to November 1, 2014; and

- Clarify that lump-sum distributions from qualified retirement plans during the Prepayment Period will be subject to withholding and income taxation at the reduced tax rate if distributions are made on account of separation from service or plan termination. All distributions from non-qualified retirement plans during the Prepayment Period will also be subject to taxation at the reduced tax rate.

It is clarified that plans can be amended to allow distributions to prepay at the reduced tax rate, but subject to the rules and limitations applicable to deferred compensation plans, governmental plans, the Employee Retirement Income Security Act of 1974, as amended, and the U.S. Internal Revenue Code of 1986, as amended. The Act also requires including language in the amendment specifically identifying the obligation of the paying agent to issue the payment instrument (certified check, manager's check, money order) payable to the order of the Secretary of the Treasury.

Sections 1023.21(c)(v) and 1023.22 (c)(iv) and (v) were added to include within the definition of "included assets" that can be subject to the prepayment of taxes: (1) bonds, obligations, promissory notes or certificates, or other debt instrument, issued by any corporation, partnership or limited liability company including those issued by a government or a political subdivision, with interest coupons or in registered form, provided they are considered capital assets in the hands of the taxpayer, and, (2) in the case of an entity that elected to be taxed as a partnership, special partnership, or corporation of individuals, those capital assets subject to tax on implicit gains pursuant to Section 1115.08 of the Code.

The amendment to Section 1023.22 of the Code also extends to corporate taxpayers the period to prepay at the reduced tax rate the increase in value of long-term capital assets until January 31, 2015.

H. Prepayment of Individual Retirement Accounts

The Act amends Section 1023.23 of the Code to extend the tax prepayment payment of accrued and undistributed balances in individual retirement accounts ("IRA") until January 31, 2015. In addition, the penalty on IRA distributions to participants that have not reached 60 years of age and who have elected to prepay the tax is reduced from 30% to 15% of the distributed amount.

II. Excise Taxes

A. Taxes on Alcoholic Beverages

The Act amends various provisions of the Code related to taxes on alcoholic beverages, as follows:

- The definition of "wine" (Section 5001.01(a)(54) of the Code) is amended to expressly exclude the following wine classifications: substandard wine, concentrated must wine and tropical fruit wine.
- The definition of "substandard wine" is amended to incorporate a reduced annual wine and distilled spirits production cap, subject to a production aggregation rule. Section 5001.01(a)(57) of the Code provides that the annual production cap for the previous calendar year must be lower than 400,000 gallons measured. The new cap must be

determined taking into account the combined wine and distilled spirits production of the manufacturer and that of its “Related Persons” (within and without Puerto Rico). The term “Related Person” is defined in conformity with Section 1010.05 of the Code. If the total production cap is not met, then a current “substandard wine” could fall within the definition of “wine”, which is subject to a tax of \$12.05 per each gallon measured.

- An annual combined wine and distilled spirits production cap, including a production aggregation rule, is set forth in Section 5001.01(a)(55) of the Code with respect to the tropical fruit wine classification. Similar to the changes made to the substandard wine classification, to qualify as a “tropical fruit wine”, the total wine and distilled spirits production of the manufacturer and that of its “Related Persons” (within and without Puerto Rico) for the previous calendar year must be lower than 400,000 gallons measured. In this context, the term “Related Person” is defined in conformity with Section 1010.05(b) of the Code.

A new tax rule applicable to “distilled spirits” stored in bonded warehouses to be used in the production of cocktails is added to Sections 5021.01 and 5021.04 of the Code. A distilled spirit stored in an bonded warehouse authorized by the Secretary, within or without Puerto Rico, to be used in whole or in part in the production of cocktails (as defined in Section 5001.01(a)(15) of the Code) will pay the tax applicable to the distilled spirit -prior to the production of the cocktail-, provided the taxpayer (rectifiers, manufacturers and distillers) elects to pay such tax before removing the distilled spirit from the bonded warehouse. That is, the tax to be paid on a cocktail will be limited to the distilled spirit used in its production, excluding all other ingredients such as fruit juices, sodas, spices and flavors.

III. Sales and Use Taxes

A. Reseller’s Credit Control Account

Under Section 4050.04 of the Code, registered merchants with a Reseller Certificate are allowed to claim a credit for the sale and use tax (“SUT”) paid on the purchase or importation of merchandise for resale up to the amount shown in the Reseller’s Credit Control Account (“Account”).

The Account should be have been created by the Secretary for every registered merchant with a Reseller Certificate on or before July 31, 2014 or within the 10 day period following the issuance of such certificate to the reseller. The Act amends Section 4050.04 of the Code to recognize that the Reseller’s Credit Control Account System (the “System”) has not yet been created by the Secretary, thus deferring its implementation and operation until such time as the System is created by the Secretary.

This account will be managed and adjusted by the Secretary and the sellers of the taxable merchandise to the resellers entitled to claim the credit. However, if the sellers fail to make the adjustments required by Section 4050.04 to the Account, then, the Secretary or the resellers are allowed to make the required adjustments to the Account.

Generally, the Account will be:

- Increased:
 - By the amount of sales taxes paid by the reseller for the purchase of merchandise for resale before the creation of the System; and
 - By the amount of sales taxes paid by the reseller for the purchase of merchandise for resale on or after the creation of the System.

- Decreased:
 - By the amount of the tax credit claimed in the monthly SUT tax return for the use taxes paid by the reseller as to the importation into Puerto Rico of merchandise for resale;
 - By the amount of the tax credit claimed in the monthly SUT tax return for the sales taxes paid by the reseller as to the local purchases of merchandise for resale after the creation of the System;
 - By the amount of sales taxes paid as to the purchases of merchandise by the reseller that was subsequently returned to the seller; and
 - By the amount of the sales taxes paid as to the sales of merchandise for which the seller is claiming a credit for uncollectible sales or uncollectible accounts.

B. Sourcing of the Municipal SUT

The Act amends the SUT sourcing rules on services provided by Section 4020.03 of the Code with respect to the municipal portion of the SUT (“Municipal SUT”). Upon the enactment of the Act, the source of services rendered for Municipal SUT purposes will be the address of the facility from where the services are billed. For SUT and Municipal SUT purposes, telecommunications and cable or satellite television services continue to be sourced based on the address of the customer to whom the services are billed.

C. Storage of Taxable Items

The Act amends Section 4020.02 of the Code to provide that taxable items subject to the sales tax, as well as the storage, custody, retention or withdrawal from a warehouse of tangible personal property by the person that manufactures, processes or assembles such property, will not be subject to the use tax for use, storage or consumption (“Use Tax”). Section 4020.02 of the Code was also amended to provide that taxable items subject to the use tax at the time of import into Puerto Rico (“Imports Use Tax”), will not be subject to the Use Tax for storage or consumption by the same person that paid the Imports Use Tax.

D. Foreign-Trade Zones

The Act amends the term “introduction” in Section 4010.01(aaa) to consider articles introduced into foreign-trade zones (“FTZ”) as introduced into Puerto Rico when the merchandise loses its FTZ status and/or is considered introduced into the United States customs territory in Puerto Rico. The FTZ status of the imported articles must be evidenced by presenting Form 214, “Application for Foreign-Trade Zone Admission and/or Status Designation.”

E. Alcoholic Beverages SUT Exemption

The Act corrects the designation of paragraph (c) of Section 4030.04, since there were two paragraphs (d) when the Section was amended by Act 80-2014 (“Act 80”).

Act 80 amended Section 4030.04 to grant exemption from the use tax to alcoholic beverages introduced to PR and deposited in a bonded warehouse if the same are: (i) exported within 360 days, (ii) consigned to a person outside Puerto Rico and exported within 120 days or (iii) for consumption within PR and maintained in the bonded warehouse for no more than 360 days. These exemptions do not apply to alcoholic beverages introduced into a Foreign Trade Zone.

F. Declaration of Imports and Form AS 2915.1 D

The Act amends Section 4041.02 to reflect the new names of Form AS 2970.1, Declaration of Imports, and Form AS 2915.1 D, Tax on Imports Monthly Return. This Section was substantially modified by Act 80 to reflect the changes related to the payment of use tax upon the introduction into Puerto Rico of tangible personal property.

If you have any questions, you may contact any of the attorneys of our Tax Practice Group listed below:

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