

February 18, 2015 www.mcvpr.com**TAX ALERT*****The Act to Transform the Tax System of the Commonwealth of Puerto Rico: Individual and Corporate Income Tax***

This is the third of a series of Tax Alerts on the recently unveiled House Bill 2329, known as “The Act to Transform the Tax System of the Commonwealth of Puerto Rico,” which will introduce a new tax code to be known as the Puerto Rico Internal Revenue Code of 2015 (the “Code”).

Below is a summary of the most significant provisions of the bill modifying current statutory provisions dealing with individual and corporate income tax, although we anticipate that these provisions will suffer changes in the legislative process. The provisions dealing with the value added tax and conduit entities were discussed in separate Tax Alerts.

I. Individuals**A. Regular and Alternate Basic Tax for Individuals**

- Single individual taxpayers with a net income of no more than \$40,000, and married taxpayers with a net income of no more than \$80,000, will not be subject to income taxation and will not be required to file the Individual Income Tax Return. Such taxpayers will be required to file an Informative Return.
- The highest individual rate will be 30% applicable on net income in excess of \$200,000.
- Individual taxpayers will not be subject to the alternate basic tax.

B. Special Tax on Self-Employed Individuals

The 2% special tax imposed on self-employed individuals is repealed.

C. Transactions Subject to Preferential Tax Rates

- The tax rate on dividend distributions made after December 31, 2014 to individual taxpayers by a domestic corporation or a foreign corporation with at least 80% of its gross income for the three prior taxable years effectively connected with a P.R. trade or business will increase from 15% to 30%, but the withholding tax rate will increase from 15% to 20% for dividend distributions made after March 31, 2015.

- The tax rate on dividend distributions to nonresident alien individuals will increase from 15% to 20% for distributions after March 31, 2015. The withholding tax rate will increase from 15% to 20% on 1) dividends distributed to nonresident individuals, and 2) payments to nonresident U.S. citizens on the sale of real property or stock after March 31, 2015.
- The tax imposed on amounts received by resident or non-resident individuals for personal services rendered in P.R. for international sports associations or federations will increase from 20% to 30%.

D. Prepayments

- The period to make an election to prepay at a reduced tax rate will be extended until March 31, 2015 for 1) the increase in value of long term capital gains, and 2) the accrued and undistributed balance in an IRA.
- During the period from February 1, 2015 until March 31, 2015, individuals can elect to prepay the undistributed balance in an educational account at an 8% tax rate.

E. Disallowance of Deductions

The following deductions will be disallowed:

- The personal deduction and the deduction for dependents;
- The mortgage interest paid or accrued on residential property;
- Contributions to Education Accounts; and
- Contributions to Health Savings Accounts.

F. Credit for Interest Paid or Accrued on Residential Property

The deduction for mortgage interest paid or accrued on residential property will be substituted for a tax credit. The amount of the tax credit will be limited based on the amount of gross income derived by the taxpayer, with the amount of the credit being reduced as gross income increases. Such credit cannot be reimbursed or carried over to future tax years.

G. Credit for Low Income Persons Aged 65 Years or Older

The credit available to low income persons aged 65 years or older will be eliminated.

II. Corporations

A. Corporations Regular and Additional Tax

The regular tax applicable to corporations will be increased from 20% to 30%. The progressive surtax, however, is repealed.

B. Corporations Alternative Minimum Tax

The alternative minimum tax will be the higher of:

- 25% of the amount by which the alternative minimum net income for the taxable year exceeds the exemption amount, reduced by the alternative minimum foreign tax credit for the taxable year, or
- The amount resulting from multiplying 1.5% by the *cost of goods sold* attributable to inventory acquired from a related person, or personal property that was transferred from a home office located outside of P.R. to a branch engaged in trade or business in P.R. The following transactions will be subject to a reduced tax rate:
 - .375% in the case of purchases or transfers of property subject to the tax imposed on alcoholic beverages, or to the excise tax or the crude oil tax imposed on fuel, crude oil, or petroleum derivative products, and
 - 1.25% in the case of purchases or transfers of property subject to the excise tax imposed on vehicles.

The Bill repeals the possibility of requesting from the Secretary of the Treasury (“Secretary”) a partial waiver on the application of the 1.5% (or other applicable rate). Any waiver, administrative determination or closing agreement that the Secretary may have executed granting relief on the application of the purchases component in the computation of the alternative minimum tax will not be applicable for taxable years beginning after December 31, 2014.

In determining the alternative minimum tax, the corporation will not be allowed to claim a deduction for the expenses incurred or paid to a related party, or assigned to a home office, if such expenses are attributable to a trade or business in P.R. (“Related Party Expenses”) and are not subject to P.R. income or withholding tax in the year in which are paid or incurred.

C. Tax of Act 154

The provisions of the effectively connected income rules and the Excise Tax of Act 154 in the Puerto Rico Internal Revenue Code of 1994 in effect on the date of approval of the Code will be incorporated by reference.

III. Corporations and Individuals

A. Repeal of Preferential Tax Rates for Certain Income

The preferential tax rates for certain income received by individuals, estates, trusts and corporations will be repealed, so that this income will be subject to taxation as ordinary income (30% rate):

- Net long-term capital gains;
- Interest paid or credited on deposits in accounts that bear interest received by individuals, estates or trusts;
- Interest on certain notes and mortgage loans under Section 1023.05; and

- Remuneration received by individuals as compensation for services rendered in P.R. from sports equipments that are members of international associations or federations.

B. Special Tax on Dividends and Deemed Distributions

Any dividend distribution or deemed distribution made between January 1, 2015 and March 31, 2015 will be subject to a 5% tax rate in lieu of any other tax imposed by the Code. If the dividend distribution or deemed distribution is made between January 1, 2014 (this appears to be an error) and June 30, 2015, the tax rate is 8%. The election and payment must be made by March 31, 2015 (this also appears to be an error). This section is separate and distinct from the 10% deemed dividend tax on foreign assets of Code Section 1062.13.

C. Gross Income Exclusions

The following gross income exclusions will be eliminated:

- Literary, journalistic, scientific and artistic awards, and awards for professional or agricultural development; and
- Plantation insurance.

D. Gross Income Exemptions

The following gross income exemptions will be eliminated:

- Interest on:
 - Certain obligations issued under the Agriculture Loan Act of 1971;
 - Certain mortgages guaranteed under the National Housing Act;
 - Certain mortgages on residential property located in P.R. guaranteed under the National Housing Act or the Servicemen's Readjustment Act;
 - Certain mortgages on residential property located in P.R. issued after July 31, 1997 and before January 1, 2014 for new construction;
 - Certain mortgages issued to provide permanent financing for the construction or acquisition of social interest housing;
 - Certain mortgages insured by the Secretary of Agriculture of the U.S. under the Bankhead-Jones Farm Tenant Act;
 - Certain obligations insured or guaranteed under the Servicemen's Readjustment Act;
 - Securities issued by certain cooperative associations;
 - Deposits in interest-bearing accounts in financial institutions, up to \$2,000 per individual taxpayer;
 - Certain loans made by financial institutions to a special workers' corporations;
 - Loans issued by financial institutions for the acquisition and payment of membership certificates in special workers' corporation;
 - Loans issued by financial institutions for the purchase of preferred shares in special workers' corporations;
 - Certain loans of up to \$250,000 issued to small or medium businesses; and

- Certain loans of up to \$250,000 issued to shareholders to capitalize small or medium businesses.
- Dividends received by corporations from industrial development income that constitute interest on:
 - Certain mortgages; and
 - Certain loans guaranteed by mortgages issued by certain pension or retirement plans.
- Amounts received as license from the U.S. armed or naval forces;
- Certain income received by news agencies or syndicates;
- Certain income related to the operation of special corporations owned by workers;
- The cost of living allowance received by U.S. Government employees;
- Income from certain sports games organized by certain international associations or federations;
- Income from the rental of certain property in historic zones in P.R., unless the lease contract was in place on February 15, 2015 (in which case the income will be exempt);
- Meal and travel amounts received by legislators;
- Certain compensation paid to nonresidents to produce film projects; these payments will be governed by Act 27-2011; and
- The first \$40,000 earned by youth 16-26 years of age.

E. Depreciation

Flexible and accelerated depreciation will not be allowed, and straight line will be the only allowed method of depreciation.

F. Automobile Expense Deduction

The Secretary is authorized to allow taxpayers to claim a deduction based on a standard mileage, rather than the actual amount incurred and paid for the use and maintenance of an automobile.

G. Charitable Deductions by Corporations and Individuals

Corporations and individuals will be able to deduct charitable contributions if the charitable entity is engaged in business in P.R. and the donated funds will be used in P.R.

H. Deduction for Related Party Expenses

The disallowance of 51% of the Related Party Expenses continues to apply in computing the net income subject to the regular tax, but the Secretary no longer will have the authority to waive this disallowance.

I. Moratorium on Certain Tax Credits

The moratorium for the concession of certain tax credits will be extended until taxable years commencing before January 1, 2017. There are special rules applicable to the tax credits granted under Act 212-2002, including a limitation on the amount of tax credits available and a tax credit limitation by project.

The limitation on the use of certain tax credits granted or acquired under the moratorium will be reduced from 50% to 25% of the income tax liability.

IV. Effective Dates

The income tax provisions of Subtitle A of the Code will be effective for taxable years that start after December 31, 2014, except that the withholding tax provisions will apply to payments made after the first day of the month after the approval of the Code.

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

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