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PUERTO RICO SUPREME COURT ISSUES OPINION ON TAXATION OF SEVERANCE PAYMENTS – PR TREASURY ISSUES RELATED GUIDANCE

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On December 18, 2009, the Puerto Rico Supreme Court (“Supreme Court”) issued a 57-page opinion (not including two concurring opinions) in the case of *Orsini García v. Secretario de Hacienda*, 2009 T.S.P.R. 191. In *Orsini*, the Supreme Court held, among others, that severance payments made to discharged employees pursuant to Act No. 80 of May 30, 1976 (“Act No. 80”) are not subject to Puerto Rico income tax, and as such, not subject to Puerto Rico income tax withholding.

The Facts

After several years of employment, in 2003, Orsini was discharged by his employer and was offered an amount in exchange for signing a release agreement, which Orsini accepted. Following applicable guidance from the Puerto Rico Treasury Department (“PR Treasury”), the employer withheld Puerto Rico income tax from the payment, and reported the payment and tax withheld to the PR Treasury.

Orsini originally included the payment in his Puerto Rico income tax return as taxable wages. He subsequently filed an amended tax return to exclude said amount from income and to request a refund of the tax withheld, on the basis that the severance payment did not constitute taxable income. The PR Treasury denied the refund requested.

Orsini filed a claim against the PR Treasury before the Puerto Rico Court of

First Instance alleging that the amount received did not constitute taxable income, as it was not remuneration for work performed or services rendered, nor was it a substitute for his salary. Orsini argued that the payment was for damages, which is excluded from the definition of gross income under Section 1022(b)(5) of the Puerto Rico Internal Revenue Code of 1994, as amended (“PR Code”), at the time of the dismissal, excluded from gross income payments made on account of damages, including mental anguish. On the other hand, the PR Treasury alleged that the payment was not made under Act No. 80, but instead, a separation or severance payment and, as such, it was a payment of wages subject to Puerto Rico income tax.

Eventually, the matter reached the Supreme Court. The Supreme Court concluded that the separation payment received by an employee as a result of a dismissal is not subject to Puerto Rico income tax because the purpose of said payment is to compensate for the damages caused to the employee by the loss of employment. Specifically, the Court determined that payments received under a separation agreement that provides a release of unjust dismissal claims under Act No. 80 is to be presumed, despite express contractual language to the contrary, a payment for unjust dismissal under Act No. 80. Further, the Court held that payments made on account of unjust dismissal under Act No. 80 are intended to compensate for the “mental and physical” damages caused

by the loss of employment. Lastly, that payments for mental and physical damages are excludable from gross income pursuant to Section 1022(b)(5) of the PR Code,¹ thus exempt from Puerto Rico income taxation. The Supreme Court took into account the

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fact that the amount received by Orsini was the same amount as the severance payment he would have received under Act No. 80.

With this opinion, the Supreme Court appears to be revoking PR Treasury's Administrative Determinations 05-02 and 07-01, which provide guidance regarding the specific content of settlement agreements and the various Puerto Rico income tax consequences of severance and settlement payments, respectively.

And Now, What?

On March 8, 2010, the PR Treasury issued Informative Bulletin 10-08 ("IB 10-08") providing that Orsini does affect PR Treasury's Administrative Determinations 07-01, 08-04, and 08-13, regarding the taxability of Act No. 80 severance payments, the tax exemption of payments for emotional damages resulting from a physical injury and the tax exempt treatment for certain voluntary special payments for discharge with just cause under Act No. 80, as amended by Act No. 278,² respectively. The PR Treasury concluded that after amendments to PR Code Section 1022(b)(5) effective July 4, 2006, only severance payments made on account of a physical injury or physical illness are exempt from Puerto Rico income taxes (*i.e.*, that PR Code Section 1022(b)(5), as amended, does not exclude non-physical damages). In light of the foregoing, and assuming that a severance payment is not made on account of physical injury, it might be advisable for employers to report payments for unjust dismissal under Act No. 80 as taxable wages in a form 499R-2/W-2PR for Puerto Rico income tax purposes, although no Puerto Rico income tax withholding would be made.³

On the other hand, IB 10-08 does not address the Supreme Court's position that payments made pursuant to separation or settlement agreements mentioning Act No. 80 within their general release provisions, even if expressly rejecting the commission of any act covered under Act No. 80, will be presumed to be payments covered under Act No. 80. Thus, PR Treasury Administrative Determination 05-02 on the subject seems to have been rendered inapplicable in such situations.

What About FICA?

Although Orsini cited the Supreme Court's decision in Alvira v. SK & F Laboratories, 142 D.P.R. 803 (1997),⁴ it did not specifically address whether the payment is subject to withholding of the Social Security and Medicare tax (collectively, "FICA"). At least two decisions have been issued by the U.S. District Court for Puerto Rico ("District Court") after Alvira holding that payments under Act No. 80 are wages for FICA tax purposes. (Cancio de Jesús v. Phillips Puerto Rico, Civil 98-1147, and Rivera v. Baxter, Civil No. 02-228; see also Treas. Reg. 26 C.F.R. 31.3401(a)-1(b)(4)). Absent clear and binding guidance as to FICA tax, it is advisable to report a payment under Act No. 80 (or a waiver or settlement payment for such claim) (including, if applicable, a "gross-up" of the employee portion of the FICA tax) as taxable wages in a form 499R-2/W-2PR for FICA tax purposes. The employer will have to decide whether to "gross-up" the FICA tax withholdings on a payment under Act No. 80. The decision to "gross-up" the special payment is a determination that should be based on the employer's position regarding the need to pay the total Act No. 80 payment for unjust dismissal with no withholdings after Orsini, and not on the taxable or tax free nature of the payment.⁵

Reduction in Force Programs After Orsini

Generally, payments made under a reduction in force program ("RIF") are within the scope of severance payments for dismissals with just cause under Sections (d), (e) and (f) of Article 2 of Act No. 80, as amended by Act 278⁶ ("Special Payments"). Special Payments are by law, and irrespective of the decision in Orsini, not subject to Puerto Rico income tax, and must be reported in a form 480.6D for Puerto Rico income tax purposes. Such severance payments are subject to FICA tax withholdings and must be reported in a form 499R-2/W-2PR for FICA tax purposes.

If, for labor and employment law reasons, it is decided that the amount of the Special Payment to be made under a RIF will be equivalent to, and should be treated as, the

amount payable for unjust dismissal under Act No. 80 ("mesada payment"), then the employer will have to decide whether to "gross-up" the FICA tax withholdings. Whether the employee must receive the total Act No. 80 payment for unjust dismissal with no withholdings in order to comply with Act No. 80 seems an issue still subject to debate after Orsini. The decision to "gross-up" the special payment is a determination that should be made by the employer on the basis of that need.

Conclusion

Orsini and IB 10-08 may seriously impact the negotiation and management of separation payments, severance programs, settlement agreements, and the withholding and reporting obligations under various statutes. Employers should revise all severance, separation, or settlement agreements to include specific language as to the nature of the payment(s) being made, the applicable tax withholdings and reporting requirements, and include a "hold-harmless" provision in favor of the employer regarding these matters. We strongly recommend employers to discuss this matter further on a case by case basis with labor and tax counsel. **M&V**

¹ It is worth mentioning that the severance payment in Orsini was made prior to the amendment of the PR Code Section 1022(b)(5), which, effective on July 4, 2006, included the word "physical" in the exclusion from gross-income for amounts received on account of physical injury or physical illness. See footnote 5.

² It remains unclear if the same treatment applies to a payment under a separation or settlement agreement which includes a payment in lieu of a payment for unjust dismissal under Act No. 80.

³ In Alvira, the Supreme Court concluded that payments for unjust dismissal under Act 80 constitute payments for damages which may not be subject to any withholdings.

⁴ It is noteworthy that the U.S. District Court for the Western District of Michigan recently concluded that severance payments "made because of the employees' involuntary separation from employment which resulted directly from a reduction in force or the discontinuance of a plant or operation" are not taxable for purposes of FICA taxes. (See In re Quality Strokes, Inc., et al., 2010 WL 679136 (W.D.Mich.)).

⁵ Act 278 of August 15, 2008, amended Act No. 80 to provide tax-free treatment for Puerto Rico income tax purposes to certain payments made to discharged employees to the extent the discharge is due to, among others, full, temporary or partial closing of operations of the establishment, changes in the design or nature of the product or in the services rendered by the employer, or a reduction of volume of production, sales or profits.

THE CLOCK IS TICKING ON ASSET TRANSFERS UNDER IRS REVENUE RULING 2008-40

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Background

Historically, multinational corporations operating in Puerto Rico allowed the participation of their Puerto Rico resident employees in the same retirement plans offered to their stateside employees. Although these retirement plans were established in the United States and the trusts funding the benefits were located in the United States (“US Trust”), because of the participation of Puerto Rican employees, such plans needed to meet the qualification requirements of the United States Internal Revenue Code of 1986, as amended (“US Code”) and the Puerto Rico Internal Revenue Code of 1994, as amended (“PR Code”).

Retirement plans qualified under the US Code and the PR Code are commonly referred to as “dual-qualified” plans. In these cases, the contributions made to the plan by or on behalf of Puerto Rican plan participants are sourced to Puerto Rico for U.S. tax purposes because they relate to services rendered by these employees in Puerto Rico. Therefore, upon distribution of the assets, Puerto Rican participants are not liable for U.S. income taxes on the contributions made to the plan. On the other hand, the investment earnings portion of such assets—which form part of a US Trust—are subject to U.S. income taxes upon distribution to the participant since, for U.S. tax purposes, the investment earnings of a trust are sourced to the place where the trust is located.

Through the years, in order to avoid the administrative burdens of maintaining dual-qualified plans as well as to limit the exposure to U.S. taxation upon distribution to a participant who is a resident of Puerto Rico, many employers established separate retirement plans in Puerto Rico for their Puerto Rico employees, funded through trusts located in Puerto Rico (“PR Trust”). Traditionally, it was well settled that if employers transferred assets from a US Trust funding a dual-qualified retirement plan to a PR Trust funding a retirement plan qualified only in Puerto Rico, that transfer would be considered a taxable event for U.S. income tax purposes with respect to the earnings component of the assets transferred from the US Trust. Consequently, a transfer from a US Trust to a PR Trust would cause the investment earnings component of the transferred assets to be taxable to plan participants at the time of the transfer. See US Code Section 402(b)(1). Such transfers could also jeopardize the transferor plan’s qualified status under the US Code.

Despite the above, the U.S. Internal Revenue Service (“IRS”) issued at least three Private Letter Rulings (“PLRs”) allowing transfers of assets from US Trusts funding dual-qualified plans to PR Trusts funding plans qualified only in Puerto Rico. In one of the PLRs, the IRS concluded that the earnings component of the transferred assets would be considered from sources within Puerto Rico, and, thus, not subject to U.S. income tax upon distribution from a PR Trust. This prompted a land-slide of plan spin-offs along with the corresponding assets transfers, causing the IRS to take a closer look at such trend and the need to control it. Since PLRs are not of general application, the IRS thereafter hinted that the referenced PLRs should not be relied upon as a basis to conduct any future transfers and advised that guidance on the topic was forthcoming.

Revenue Ruling 2008-40

After a couple of years considering the issues, in July 2008, the IRS issued Revenue Ruling 2008-40 (“Rev. Rul. 08-40”) confirming that the asset transfers described above would in fact trigger a federal taxable event as to the earnings component of the assets transferred, and could also jeopardize the qualified status of the transferor plan under the US Code. Rev. Rul. 08-40, however, established a relief period (expiring on December 31, 2010) during which such transfers will be allowed, and clarified that with respect to the transfers made during the relief period, the earnings component of the transferred assets will be considered from sources within Puerto Rico when they are subsequently distributed from the PR Trust, and, thus, not subject to U.S. income tax upon distribution.

Because the December 31, 2010 deadline seems distant, many companies who may benefit from Rev. Rul. 08-40 have not yet begun the transfer process. However, because a plan spin-off is a time consuming ordeal, employers should get started before time runs out. Among the multiple tasks to be completed when conducting these transfers are the following:

1. Determining if it is convenient to establish a separate retirement plan for Puerto Rico employees; the type of plan to be established; and the design for the plan. Meetings will likely be held between local and corporate management in order to make these decisions, and corporate resolutions and other documentation

must be drafted and executed in order to authorize the actions to be taken.

2. Determining whether trustees, investment advisors or other service providers will be retained. If so, the employer must contact potential service providers and request proposals for services. This may include receiving presentations and materials from potential service providers, as well as subsequent meetings and discussions between local and corporate management to evaluate the proposals and determine which providers will be engaged.
3. If the plan will be individually designed (as opposed to adopting a master/prototype plan), legal counsel will need to draft the plan document, summary plan description and deed of trust for the new plan.
4. Determining whether the existing transferor plan is currently in compliance with the PR Code qualification requirements and whether Puerto Rico qualification must be retroactively obtained or updated. Several documents must be compiled and/or prepared as part of the filing.
5. Submitting the new plan to the Puerto Rico Treasury Department for a favorable determination letter. Several documents must be compiled and/or prepared as part of the filing.
6. Coordinating the transfer of the assets between the trustee of the existing plan and the trustee of the new plan. If the transferor plan is a defined benefit plan an actuary will need to determine the amounts to be transferred. Further, prior to allowing the transfer of assets, the trustee of the new plan may require a favorable determination letter from the Puerto Rico Treasury Department as to the current plan’s qualified status under the PR Code or an opinion from the plan’s attorneys in connection with the qualified status of the current plan.

It is evident from this list (which is intended as an example and does not include all required tasks) that employers interested in taking advantage of the tax benefits provided by Rev. Rul. 08-40 need to begin the process immediately to ensure that all is in place by December 31, 2010. **M&V**

¹ IRS Revenue Rulings 79-388, 1979-2 C.B. 270; 79-389, 1979-2 C.B. 281; and 72-149, 1972-1 C.B. 218.

² PLR 200317042, PLR 200352016 and PLR 200521012.

RECENT AMENDMENTS AND CORRECTIONS TO THE PUERTO RICO INTERNAL REVENUE CODE OF 1994

by: *Carlos E. Serrano*¹
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On December 22, 2009, Governor Fortuño signed into law Act No. 194 (“Act 194”), amending the Puerto Rico Internal Revenue Code of 1994 (“PR Code”), and Act No. 255 of October 28, 2002 (“Act 255”). These amendments bring notable changes in the Alternative Basic Tax, the Estimated Tax Declaration, the Sales and Use Tax, Tax Specialist Registration, the license to traffic alcoholic beverages, several penalties and the treatment of financial instruments issued under Act 255. Act 194 modifies some of the provisions introduced by Act No. 7 of March 9, 2009 (“Act 7”) and Act No. 37 of July 10, 2009 (“Act 37”).

Below we highlight some of the major changes introduced by Act 194:

1. Alternative Basic Tax (“ABT”)

As you may remember, Act 7 and later Act 37, substantially modified individual taxation by essentially converting the ABT into a system akin to the alternative minimum tax under the U.S. Internal Revenue Code of 1986, as amended (“US Code”). These changes apply for taxable years commenced after December 31, 2008.

Admittedly by error, Act 37 stated that net income subject to the ABT under Section 1011 of the PR Code, was taxed according to the following brackets:

If the Net Income Subject to the ABT is:	The applicable tax will be:
Of \$75,000, but not greater than \$125,000	10%
In excess of \$125,000, but not greater than \$175,000	15%
In excess of \$175,000	20% of the excess over \$125,000

Act 194 eliminates the highlighted language effective for tax years commenced after December 31, 2008. Thus, “net income subject to the ABT” will be taxed as originally established in Act 7, that is, under the following brackets:

If the Net Income Subject to the ABT is:	The applicable tax will be:
Of \$75,000, but not greater than \$125,000	10%
In excess of \$125,000, but not greater than \$175,000	15%
In excess of \$175,000	20%

Further, Act 194 modifies two provisions enacted under Act 7 but later eliminated or modified in Act 37. First, Act 194 amends Section 1011 to tax the profits or losses in the shares of each of the partners of certain special partnerships using the percentage-of-completion method instead of the completed contract method of accounting. Second, Act 194 reinstates the limit of 30% of the Adjusted Gross Income on the home mortgage interest deduction.

2. Tax Return Due Dates and Extensions

The PR Code provides an automatic filing extension for most taxpayers. Previously, individuals were entitled to an extension of up to 30 days, while corporations and partnerships were entitled to a 90 day extension. In the case of individuals, a reasonable extension of time for filing the returns in addition to the automatic extension of time could have also been granted under the rules and regulations prescribed by the Secretary of Treasury (“Secretary”). This additional extension could not exceed 60 days, except in the case of taxpayers residing abroad, in which case the additional extension of time could not exceed 150 days.

As amended by Act 194, for tax years commenced after December 31, 2008, the automatic filing extension is converted to a standard 3 month extension for all individuals, corporations, partnerships, trusts and estates. It should be noted that Act 194 eliminates the use of specific

number of dates and establishes the use of months to calculate the new filing date.

3. Annual Return for Sales and Use Tax (“SUT”)

Section 2603 of the PR Code, introduced during 2006 together with the SUT, required that by the third month after the close of the taxable year, every merchant doing business in Puerto Rico file, in addition to the twelve (12) monthly SUT returns, an annual SUT Return. Via regulation, the Puerto Rico Treasury Department postponed the filing of this return, so that its filing was not required for 2007 and 2008.

During 2009, taxpayers were required to file the annual SUT return; a filing that was generally found to be cumbersome and redundant. In view of this, and to simplify compliance to merchants, Act 194 eliminated Section 2603 of the PR Code. Consequently, for tax years commenced after December 31, 2008, merchants are no longer required to file an annual return for SUT.

4. Tax Specialists Exempt from SUT

Act 194 amended Section 2301 of the PR Code to treat professional services rendered in the preparation and revision of income tax returns, declarations or refund claims under the PR Code or the US Code as exempt services not subject to SUT.

This provision covers registered tax specialists even if they are not Certified Public Accountants, which were considered “designated (i.e., exempt) service” providers for SUT purposes. The change is effective for tax years beginning after December 31, 2009.

5. Streamlining of Requirements for Internal Revenue Licenses

In general, Act 194 simplified the statutory requirements with which a taxpayer must comply for the Secretary to issue licenses such as those for Wholesale Distributors of Alcoholic Beverages and Distilled Spirits. Effective immediately, most requirements will be set via regulations, administrative determinations or other pronouncements by the Secretary. These provisions have the effect of easing some of the documentary burden typically associated with an internal revenue license application and grant the Secretary the ability to swiftly modify such requirements administratively, without the need for the approval of legislation.

In the case of duty free stores, Section 2046 of the PR Code established that the Secretary shall not grant any license for a duty free business or store at airports or marine ports unless, in addition to complying with the applicable requirements of Section 2041 of the PR Code, the applicant presents a certified copy of an authorization granted by the Tourism Company to establish that type of business or store. Act 194 eliminated this requirement. However, Act 194 did not specify the effective date of this change.

6. Elimination of Estimated Tax Declaration

Sections 1059 and 1062 of the PR Code required that individual and corporate, respectively, taxpayers file an Estimated Tax Declaration. Act 194 amends these provisions and, for tax years commenced after December 31, 2009, taxpayers will not be required to file the declaration. As amended, taxpayers shall compute their estimated tax liability and make their payments, generally in four equal installments as follows:

The first payment will be due on the fifteenth day of the fourth month of the tax year. The second payment will be due on the sixth month of the tax year. The third payment will be due on the ninth month of the tax year. The fourth and last payment will be due on the fifteenth day of the first month of the following tax year. As before, there are several exceptions in cases that the payment obligation is determined at some point after the last day of the third month of the taxable year.

As amended, for tax years commenced after December 31, 2009, the PR Code imposes a ten percent (10%) penalty on the unpaid balance, either total or partial, of the Estimated Tax when the payment is not made by its due date. For purposes of this penalty, the tax liability will be the lesser of: (a) ninety percent of the tax for said year in case of individual taxpayers not engaged in the agricultural business or sixty six percent in case of taxpayers in the agricultural business, or (b) the total amount of income tax determined shown in the income tax return for the previous year.

As always, you should individually assess the impact that these changes may have on your PR tax liabilities. **M&V**

¹ The autor acknowledges the assistance of Jorge Obén in the research and preparation of this article.

THE NEWLY IMPOSED SPECIAL TAX ON REAL PROPERTY USED FOR RESIDENTIAL OR COMMERCIAL PURPOSES: DO YOU REALLY HAVE TO PAY IT?

by: Carlos E. Serrano
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As covered by Rubén Muñiz in our Tax Perspectives Spring 2009 edition, with the enactment of Act No. 7 of March 9, 2009, ("Act 7") the Puerto Rico Internal Revenue Code of 1994, as amended ("PR Code") was amended to include newly created Sections 3701 through 3708. These sections imposed a special tax on real property used for residential purposes, to be managed by the Puerto Rico Treasury Department ("PR Treasury").

The tax, as then enacted, was of a transitory nature, to be levied for fiscal years 2009-10, 2010-11, 2011-12 and 2012-13 or until \$690 million were collected, whichever came first. Also, instead of creating an additional procedural framework, all administrative and procedural aspects applicable to the regular real property tax levied by municipalities under the Municipal Property Tax Act of 1991 ("MPTA") would be followed by the PR Treasury in the administration of this tax.

At the time, although the tax constituted an average increase of approximately 70% of the real property tax liability of individual taxpayers, the tax did not immediately constitute a direct burden on businesses in Puerto Rico. Nonetheless, with the enactment of Act No. 37 of July 10, 2009, amending Act 7, those newly created sections 3701 through 3708 of the PR Code were amended. Relevant changes included: (1) shortening the life of this special tax by one year (thus to be levied for fiscal years 2009-10, 2010-11 and 2011-12); (2) the inclusion of a definition of

"residential property" for purposes of the tax; and (3) extending the tax to undefined "commercial property".

Also, instead of creating an additional procedural framework, all administrative and procedural aspects applicable to the regular real property tax levied by municipalities under the Municipal Property Tax Act of 1991 ("MPTA") would be followed by the Puerto Rico Treasury Department in the administration of this tax.

On August 28, 2009, the PR Treasury issued Circular Letter No. 09-07 ("CC 09-07") to shed some light on the administration of the tax and, most importantly, to define what constitutes commercial property subject to the tax. Briefly, the PR Treasury defined "commercial property" for purposes of the tax as "all property that does not constitute property used for residential purposes". With that one statement, the PR Treasury opened up a fascinating discussion on Puerto Rico property taxation.

One notable distinction between the special property tax and the real property tax imposed by the MPTA is that the real property tax, instead of specifying the type of real property subject to the tax, is levied on "all real property" in Puerto Rico. On the other hand, the special property tax was levied, originally on a single, specific type of real property. Then, as amended, the tax was expanded onto what seemed to be a second, but also specific type of real property. Nonetheless, the definition in CC 09-07 seemed to imply a broad tax, levied on all real property in Puerto Rico.

Hence the initial question: Do you really have to pay it? Is your property commercial property subject to the tax? Is all real estate in Puerto Rico either residential or commercial? Herein, we will give you a glimpse of an extensive research conducted on the subject and that forms the basis of several challenges to the tax which, following the procedural framework for Sections 3701 through 3708 of the PR Code,

One notable distinction between the special property tax and the real property tax imposed by the MPTA is that the real property tax, instead of specifying the type of real property subject to the tax, is levied on “all real property” in Puerto Rico. On the other hand, the special property tax was levied, originally on a single, specific type of real property. Then, as amended, the tax was expanded onto what seemed to be a second, but also specific type of real property.

we expect will very shortly reach our local courts.

This new special tax was enacted as a transitory measure and thus, its drafters did not intend to create a complete procedural and normative structure. After all, Puerto Rico already had a property tax system in place and the sole intent of the measure was to raise \$690 million by requiring taxpayers already subject to the property tax to pay an additional tax. A main difference was that the PR Treasury would be the agency receiving the revenues instead of municipalities through the Municipal Revenue Collection Center (“CRIM”). Thus, the drafters leveraged from the MPTA’s provisions with phrases such as “...following the same procedure and subject to the same limitations and rights set forth in the [MPTA]...” or “...the terms used herein shall have the same meanings set forth in the [MPTA]...” In this context, can the PR Treasury, by enacting CC 09-07 define commercial property as “all property that does not constitute property used for residential purposes”? What is the MPTA’s definition of “commercial property”?

To the surprise of no one knowledgeable on the subject, the MPTA does not define “commercial property.” Why would it? Different from what the PR Code does, the property tax under the MPTA is of general application; the levy covers all real property. There is no need for statutory classification of property subject to the tax in the MPTA.

Classification of real property for purposes of the MPTA is relevant for and exists for purposes of valuation and assessment of all real property already subject to the tax. Thus, upon review of the valuation and assessment guidelines still in use by the CRIM we find that, dating as far back as 1951, when the scientific assessment

project was undertaken by the agency then in charge of property taxes, the PR Treasury, several classes and subclasses of real property were identified according to their use. Among those subclasses of real property still in use for purposes of the MPTA we find classifications such as: industrial, commercial, recreational, semi-commercial or mixed use and agricultural.

Skipping a lengthy discussion on statutory construction and hermeneutics, with the enactment of the special tax on real property used for residential or commercial purposes we are faced with a tax imposed in a very targeted fashion. A tax levied on one specific class and one specific subclass of real property, namely on residential property and on commercial property. The PR Code, as amended, does provide a definition of one of the objects of the tax; residential property, saving us the effort of determining what property is subject to the tax. We are then left only with the task of defining commercial property within meanings set forth in the MPTA.

CC 09-07 attempts to fill that void by stating that commercial property is “all property that does not constitute property used for residential purposes.” This definition necessarily includes industrial, recreational, semi-commercial or mixed use and agricultural real property within the concept of commercial property subject to the tax. From our perspective, CC 09-07 over-extended the scope of the tax levied by the PR Code. In our view, by following the meanings set forth in the MPTA and used for purposes of the MPTA, real property in classifications such as industrial, recreational, semi-commercial or mixed use and agricultural do not constitute commercial property subject to the special tax on real property used for residential or commercial purposes. **M&V**

REAL PROPERTY TAX'S ADMINISTRATIVE AND JUDICIAL REVIEW PROCEDURE: A CHALLENGE IN ITSELF

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Due to the additional economic burden caused by the recently enacted Temporary Special Real Property Tax, many taxpayers are increasingly looking for alternatives to reduce their real property tax obligation. To achieve this goal, taxpayers will likely be required to follow a statutory review procedure fraught with uncertainties that could overcome the main objective, unless careful evaluation and planning is observed.

Act No. 7 of March 9, 2009 ("Act 7"), as amended by Act No. 37 of July 10, 2009 ("Act 37"), amended the Puerto Rico Internal Revenue Code of 1994 (the "PR Code") to impose a new special tax of 5.91% over the assessed value of all real property used for residential and commercial purposes (the "Special Real Property Tax"). Although the Special Real Property Tax and the regular real property tax imposed by the Municipal Property Tax Act of 1991 ("MPTA") constitute separate tax levies, the procedure to request administrative or judicial review for both is that provided by Article 3.48 of the MPTA.

A taxpayer that is not in agreement with the notice of tax levy issued by the Municipal Revenue Collection Center ("CRIM", by its Spanish acronym), in the case of the regular real property tax, or by the Puerto Rico Treasury Department ("Treasury"), in the case of the Special Real Property Tax, may request in writing the administrative review within 30 days from the mailing date of the notice. Unlike the income tax deficiency procedure provided by the PR Code, which only requires to post a surety bond along with the request for reconsideration, under the procedure

provided by the MPTA, the taxpayer must pay the total annual tax notified or that portion of the tax that it is in agreement plus 40% of that portion of the tax with which it is in disagreement.

Beside the possible constitutional arguments against a statutory procedure that does not provide a payment alternative to a taxpayer without the economic means to challenge a wrongly imposed tax, the procedure provided by the MPTA lacks guidance in the case the notice for tax levy is issued by CRIM or by Treasury for the taxable year following the one for which a taxpayer already presented a request for administrative or judicial review.

Once an administrative review is requested, it is very probable that the tax levy notice for the following year is issued before the matter is finally resolved. For example, the procedure requires that the request for administrative review is presented within 30 days from the issuance of the notice of the tax levy, then CRIM or Treasury will have 60 days to issue a determination. If no determination is issued within such 60 days, the tax levy is deemed as confirmed by the taxing authority. Then, taxpayers must file a complaint before the First Instance Court within 30 days and the taxing authority will have 60 days from the service of process to answer the complaint. That is approximately 180 days before commencing discovery procedures.

Under this scenario, is the taxpayer required to present another request for administrative review and pay the tax for the following years until the first review request is finally adjudicated?

Unfortunately, neither the MPTA nor the regulations issued thereunder provide specific guidance on this matter. A literal and comprehensive reading of the pertinent statutory provisions tends to indicate that the response should be in the affirmative. However, it results in a contradiction that, if the tax for the following year is imposed in the same valuation that it is being challenged, the taxpayer must file another administrative review request and be forced to commence the procedure again based on the same arguments and on the same tax.

A taxpayer in this situation may be tempted not to pay the tax as notified for the following years, or to pay only the amount with which it is in agreement, all without presenting another request for administrative review. Although in theory, a favorable ruling in the review request for the first year should be applicable to following years, provided that the tax has been imposed on the prior year valuation, the taxing authority may refuse to revise the tax levy for the following years based on the fact that for those specific years, the taxpayer did not follow the procedure provided by the MPTA.

Because of the uncertainty caused by the lack of guidance on this matter, a taxpayer may end in a procedural swamp that could defeat its main objective. Since the course of action to be followed in this situation is not clear, an informed decision should be taken based on a careful factual analysis of the specific case, cash flow considerations, and the grade of risk the taxpayer is willing to accept. **M&V**

ALL IS NOT QUIET ON THE LEGISLATIVE FRONT

by: *Luis G. Hidalgo*
Legislative Consultant, McConnell Valdés LLC
Government Affairs Practice Team

On January 11th, the Legislative Assembly reconvened for its Third Ordinary Session, which will last until June 30th of this year. As expected, the evaluation and approval of the operational budget of the Government of Puerto Rico for Fiscal Year 2011 will command much of the public attention for the next few months and lay the foundation for many of the initiatives to be undertaken by the Fortuño Administration. At the same time, the Budget debate will allow the Government to ponder upon and determine if the fiscal stabilization policies carried out in accordance with Act No. 7 of March 9, 2009 have been effective in achieving their goals.

Amidst this setting, there is an ever growing sense of urgency and expectation for the Government to jump start the economy with a comprehensive tax reform that would lessen the burden on individuals and corporations. Still, much is yet unknown at this stage, aside from the one-liners and press releases regarding the desired priorities and objectives of this initiative. Therefore, the importance of monitoring the Administration's Tax Reform Committee, as well as the Speaker of the House of Representatives' Working Group on this matter.

By means of Senate Bill 1355, Senate President Thomas Rivera-Schatz has staked his position on the issue of Tax Reform. This measure, which intends to provide for a more equitable distribution of the tax burden, proposes the imposition of a 10% surtax on net income generated by companies with gross profits of over \$10 million.

Meanwhile, there are two other important pieces of legislation by the Administration which would provide much needed incentives to important sectors of our economy.

First, there is Senate Bill 1126, which provides for a new Tourism Development Act and the establishment of a new public policy which includes (1) converting Puerto Rico into a world class tourism destination, (2) promoting adequate conditions to ensure the continuous development and competitiveness of the Puerto Rico hotel industry, (3) providing the environment for the continuous development of local and foreign capital to be invested in tourism projects, (4) adjusting the incentives offered to the Puerto Rican tourism industry for the advancement of better tourism products, overcome the challenges encountered and to take advantage of the opportunities that are currently available, and (5) leveling the high costs of construction and of operating tourism businesses in Puerto Rico. This measure is currently in Conference Committee between the Senate and the House of Representatives.

Second, within the next few days or weeks the Administration will be submitting an Energy Reform Bill which, among other things, will provide incentives to promote the development of projects that would generate energy through renewable sources.

Nonetheless, there are several other bills dealing with this same subject. For example, there is House Bill 1482, filed by the Speaker and the House Majority Leader, which proposes the extension of tax incentives for three additional years for the development of solar energy as provided for by Act No. 248 of August 10, 2008. This measure is currently before the Senate Committee on the Treasury. There is also House Bill 1692, which amends Act No. 73 of May 28, 2008, in order to facilitate local capital investment for renewable

energy projects. House Bill 1692 has been approved by both legislative bodies and only lacks the signature of the Senate President for it to be sent to the Governor for his signature or veto. Finally, there is Senate Bill 1042, co-sponsored by Senate President Thomas Rivera-Schatz which proposes the granting of tax credits in order to promote the development and use of renewable energy sources for the generation of electric power. This bill is currently under consideration by the Senate Committee on the Treasury.

Senate Bill 1305, introduced by Senate President Thomas Rivera-Schatz and Senator Norma Burgos, proposes to amend the Puerto Rico Motion Picture Arts, Sciences and Industry Development Corporation Act and the Puerto Rico Internal Revenue Code of 1994, in order to provide wider ranging incentives to the film making industry in Puerto Rico. This measure is currently before the Senate Committee on Economic Development and Planning and was recently subject to two public hearings.

Then there is House Bill 2334, recently filed by the House Majority Leader, which proposes a "Christmas Toys Tax Free Holiday" for the second Friday of December. This bill was referred to the House Committee on the Treasury on January 19th of this year.

All in all, this is just a glimpse of many of the bills currently before the Senate and the House of Representatives which pertain to tax matters. Nonetheless, once public discussion begins on the issue of tax reform, everything else will give way and the attention of both legislative chambers and their respective committees will center on that issue. **M&V**

TAX CALENDAR

PUERTO RICO FILINGS: March – June 2010

by: Janelle A. Reyes
Associate, McConnell Valdés LLC
Tax Practice Group

MARCH 2010

- 1**
- Form W-3 PR – Transmittal of Withholding Statement Annual Reconciliation of FICA Tax Withheld.
 - Form 480.5 – Summary of Informative Returns.
 - Form 480.6A – Informative Return - Income Not Subject to Withholding.
 - Form 480.6B – Informative Return - Income Subject to Withholding
 - Form 480.6B.1 – Annual Reconciliation Statement Income Subject to Withholding
 - Form 480.6D – Informative Return – Exempt Income
 - Form 480.7C – Informative Return – Retirement Plans and Annuities

- 10**
- Form SC 2225 – Monthly Excise Tax Return and payment of excise tax.
 - Form 480.9A – Deposit of income tax withheld from services rendered.
 - Form SC 2915 – Sales and Use Tax Monthly Return and payment.

- 15**
- Form 480.9 – Deposit of Income Tax Withheld at Source on dividends, distributions, and interest.
 - Form 480.9A – Payment of Income Tax Withheld on distributive share of special partnerships income. May request a 30-day extension.
 - Form 480.31 – Deposit of Income Tax Withheld at Source from Nonresidents during previous month.
 - Form 499 R-1-A – Employer’s Monthly Deposit of Income Tax Withheld for the month of February.*
 - Form SC 2935 – Sales and Use Tax Annual Informative Return (Calendar year entities.)
 - Form 1120 – U.S. corporation income tax return. May request a six-month extension.
 - Deposit 10 percent tax withheld on capital investment fund distributions.
 - FICA Deposits for monthly schedule depositors.**

* Note that the due dates will vary for employers required to make bi-weekly or quarterly deposits.

**Taxpayers must determine their deposit schedule based on the total tax liability reported on Form 941 during the previous four-month quarter lookback period.

- 31**
- Form 480.6SP – Informative return to partners of special partnership. May request a 30-day extension.
 - Form 480.6CI – Informative return to shareholders of corporation of individuals. May request a 30-day extension.
 - Form 940PR – Employer’s Annual Federal Unemployment (FUTA) Tax Return

APRIL 2010

- 12**
- Form SC 2915 – Sales and Use Tax Monthly Return and payment.
 - Form 480.9A – Deposit of income tax withheld from services rendered.
 - Form SC 2225 – Monthly Excise Tax Return and payment of excise tax.

- 15**
- Form 1040 – United States Individual Income Tax Return. May request a four-month extension.
 - Form 1040 ES – First installment U.S. individual estimated income tax.
 - Form 1065 – United States Partnership Return of Income. May request a three-month extension.
 - Form 8109 or EFTPS – Deposit the first installment of U.S. corporate estimated income tax.
 - Annual Corporation Report (domestic and foreign corporations). May request a 90-day extension.
 - Form 480.9 – Deposit income tax withheld at source on dividends, distributions, and interest.
 - Form 480.9A – Deposit first installment of income tax withheld on estimated net share income and distributable profit.
 - Form 480.10-(E); 480.10; 480.20; 480.20(I); 480.30(II); 480.40(D); 480.40(F); 480.70(OE); 480.80; 481 and 482 – Short and Long forms.
 - Form 480.30 – Nonresident annual return for income tax withheld at source.
 - Form 480.31 – Deposit Income Tax withheld from non residents.
 - Form 480.5 – Summary of informative returns.
 - Form 480.6C – Informative return of income subject to withholding—nonresidents.
 - Form 480-E and 480-E-1 – Declaration and first installment estimated income tax - corporations and individuals.
 - Form 499 R-1-A – Employer’s Monthly Deposit of Income Tax Withheld for the month of March.*

TAX CALENDAR

APRIL 2010

- 15**
- Form AS 2644 – Individuals, Corporations, partnerships, special partnerships and corporation of individuals PR income tax returns May request a 90-day extension. Individuals may request a 30-day extension.
 - Form AS 2650 – Request for extension of time to file the Estimated Tax Declaration.
 - Form TSCH-1 – Quarterly payment Chauffeur's Social Security.
 - Form OCAM PA-O1 – Volume of business declaration. May request a 6-month extension (payment with 5 percent discount).
 - FICA Deposits for monthly schedule depositors.**

* Note that the due dates will vary for employers required to make bi-weekly or quarterly deposits.

**Taxpayers must determine their deposit schedule based on the total tax liability reported on Form 941 during the previous four-month quarter lookback period.

- 30**
- Form 499-R-1B – Employer's quarterly return of income tax withheld (Quarter January – March).
 - Form 941PR – FICA quarterly return and payment (Quarter January – March).
 - Form 8109 Federal Tax Deposit Coupon or EFTPS – Deposit FUTA.
 - Form PR-UI-10 and PR-UI-10A – Puerto Rico Unemployment Insurance and Puerto Rico Disability Benefits—(Quarter January – March).
 - FUTA deposits – if the undeposited FUTA tax is more than \$500.00 on March 31st.

MAY 2010

- 10**
- Form SC 2225 – Bonded importers and manufacturers excise tax monthly return.
 - Form 480.9A – Deposit of income tax withheld from services rendered.
 - Form SC 2915 – Sales and Use Tax Monthly Return and payment.

- 17**
- Form 480.9 – Deposit income tax withheld at source on dividends, distributions, and interest.
 - Form 480.31 – Deposit income tax withheld from nonresidents.
 - Form AS 29-1 – Personal Property tax return. Corporations may request a 90-day extension, taxpayers other than Corporations may request a 30-day extension.
 - Form 481.0 or 482.0 – P.R. individual income tax return

extended due date—30 days. Additional 60-day extension may be requested.

- Form 480.80 – Fiduciary Income Tax Return (Estate or Trust) extended due date - 30 days. Additional 60-day extension may be requested.
- Form 499 R-1-A – Employer's Monthly Deposit of Income Tax Withheld for the month of April.*
- Exempt Corporations Annual Report. For calendar years corporations—Due date is 30 days after filing the income tax return.
- FICA Deposits for monthly schedule depositors.**

* Note that the due dates will vary for employers required to make bi-weekly or quarterly deposits.

**Taxpayers must determine their deposit schedule based on the total tax liability reported on Form 941 during the previous four-month quarter lookback period.

JUNE 2010

- 10**
- Form SC 2225 – Bonded importers and manufacturers excise tax monthly return.
 - Form 480.9A—Deposit of income tax withheld from services rendered.
 - Form SC 2915 – Sales and Use Tax Monthly Return and payment.

- 15**
- Form AS 29.1 – Personal Property Tax Return extended due date for taxpayers other than Corporations - 30 days. Additional 60-day extension may be requested.
 - Form 480.9 – Deposit income tax withheld at source on dividends, distributions, and interest.
 - Form 480.9A – Deposit second installment of income tax withheld on estimated net income and distributable profit.
 - Form 480.31 – Deposit income tax withheld from nonresidents.
 - Form 480-E-1 – Second installment estimated income tax.
 - Form 499 R-1-A – Employer's Monthly Deposit of Income Tax Withheld for the month of May.*
 - Form 8109 or EFTPS – Deposit second installment of U.S. corporate estimated income tax.
 - Form 1040 ES – Second installment U.S. individual estimated income tax.
 - FICA Deposits for monthly schedule depositors.**

* Note that the due dates will vary for employers required to make bi-weekly or quarterly deposits.

**Taxpayers must determine their deposit schedule based on the total tax liability reported on Form 941 during the previous four-month quarter lookback period.

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