El Comité de Asuntos Contributivos
de la Cámara de Comercio de Puerto Rico...

INFORMA

El pasado 30 de junio de 2013 el Gobernador de Puerto Rico, Hon. Alejandro García Padilla, firmó la Ley para la redistribución y Ajuste de la Responsabilidad Contributiva Núm. 40-2013. A continuación incluimos (1) Alerta emitido por nuestro socio y miembro del Comité de Asuntos Contributivos, Ernst & Young Puerto Rico LLC., sobre el tema para su conocimiento.

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State & Local Taxation

Puerto Rico approves tax bill as part of FY 2014 budget

Puerto Rico enacted Act 40-2013 on June 30, 2013, which includes significant changes to the Puerto Rico Internal Revenue Code of 2011, as amended, (2011 IRCPR), principally in the area of sales and use (SUT) and income taxes. Act 40-2013 resulted from substitute House Bill 1073 (Substitute Bill 1073 or the Bill). (See Tax Alert 2013-1207 in which we discussed the legislative history of Substitute Bill 1073.) As noted therein, Act 40-2013 is one of the various tax and nontax measures that the Governor of Puerto Rico approved for the government's budget for fiscal year 2014 and forward.
Act 40-2013 also amended the Municipal Property Tax Act of 1991 (1991 MPTA) to apply a special rule in the determination of the taxable value of inventory as a result of the changes in the reseller exemption certificate for sales tax purposes.

The amendments introduced by Act 40-2013, as finally approved, were in essence the same as those discussed in the June 24, 2013 Tax Alert on Substitute Bill 1073. The next section highlights major revisions made to the final version of Substitute Bill 1073, which were incorporated into Act 40-2013. The sections that follow it include a summary of the amendments approved by Act 40-2013 as discussed in previous Tax Alerts with pertinent explanations on key changes.

Act 40-2013 and Substitute Bill 1073 -Major differences

Some of the major changes are:

- Alternative minimum tax (AMT). Increases the original proposed AMT rate from 20% to 30%.
- Alternate basic tax (ABT). Increases the ABT rate for individuals with income in excess of $500,000 from 20% under the 2011 IRCPR to 24%.
- 2% tax on purchases from related parties. Provides a more beneficial minimum tax threshold that the Secretary can authorize on the computation of the AMT component related to the purchases from related parties. The minimum tax rate in this adjustment was reduced from .3% to .2%, except in the case of purchases of gasoline and crude oil products.
- Special tax on gross income, commonly known as the national gross receipts tax. Notes that it

is applicable to corporations and flow through entities, but not directly to individuals.

- Special tax on gross income. Imposes a minimum tax of .2% in cases in which the Secretary authorizes a reduction in the applicable tax rate under certain special economic circumstances. Excludes from the payment of this tax those entities subject to special rules under the effectively connected source income provisions.
- Moratorium of tax credits. Extends from April 26, 2013 to June 30, 2013 the limited use of credits under moratorium to those acquired or granted before such date.

Sales and Use Tax (SUT)

Business to Business (B2B)

Act 40-2013 generally maintained the business to business (B2B) exemption in the case of sale of taxable services between businesses with the exception of certain types of services. Also, the designated services category, which includes among others, those rendered by certified public accountants, lawyers, and engineers continues to be exempt services.

The following B2B services are subject to sales tax:

- Bank charges to commercial clients on deposits and certain other accounts.
- Collection services
- Security, cleaning, laundry, waste disposal and repair services
- Telecom services

A special rule applies to B2B services rendered among a controlled group of entities that are exempt from the payment of sales tax on those services.

In the case of the sale of repair services, Act 40-2013 specifically imposes the sales tax to those that are expensed. Furthermore, the merchant acquiring the services is responsible for paying the tax through the use tax mechanism. In other words, the seller is not required to act as withholding agent in such instances.

These changes are effective July 1, 2013.

Reseller exemption certificate and purchases for resale

Act 40-2013 modifies the reseller's exemption by eliminating the full exemption granted to resellers when acquiring taxable items for resale. Effective August 1, 2013, under the new regime, the reseller merchant will be required to pay sales tax on its purchases and then claim a credit against its monthly tax liability. The reseller can claim a credit in the monthly sales and use tax return for the sales tax paid on the purchase of taxable items for resale. The amount of credit to be claimed in the monthly return is limited to 70% of the reseller's tax obligation for that period. Any unused amount of the credit may be carried over until fully used without expiring. Act 40-2013 grants the Secretary of Treasury the authority to establish a reimbursement mechanism for the part of the credit balance that the merchant is reasonably not able to fully recapture.

As part of the increased focus on collection efforts by the PR government, Act 40-2013 grants authority to the Secretary of Treasury to require merchants to open demand deposit accounts. The purpose of this measure is for the Puerto Rico Treasury Department (PRTD) to be able to have access to the sales tax funds collected at the time of the sale rather than a month later under the existing deposit rules. While the elimination of the reseller exemption certificate is effective August 1, 2013, the demand deposit account requirement is effective a month earlier, July 1, 2013. Resellers that are in full compliance with the demand deposit account rules as will be promulgated by the PRTD will not be limited to the 70% rule but will be allowed to claim 100% of the sales tax paid on purchases for resale.

Wholesalers may be able to obtain a special waiver from the payment of sales tax on taxable items acquired from manufacturers. However, the manufacturers of the taxable items will be required to request the waiver directly with the PRTD. This special rule is effective July 1, 2013.

Eligible reseller certificate

Act 40-2013 includes an exception to the complete elimination of the reseller exemption certificate. Act 40-2013 introduces the eligible reseller status. The eligible reseller will be issued a certificate that will allow the acquisition of tangible personal property for resale without having to pay the sales tax when the sales are made to persons that are exempt from the payment of the sales tax. Similarly, purchases of items for export will also be exempted from the payment of the tax by the eligible reseller. Also, manufacturers generally will continue to have the ability to obtain and use exemption certificates for purchases of raw materials and other eligible equipment. This provision is effective July 1, 2013.

Exemptions

Act 40-2013 eliminates the following exemptions effective July 1, 2013:

- The tax exemption applicable to taxable items acquired by institutions of higher education.
- The exemption from the payment of the sales and use tax, as well as excise taxes, for cooperatives, subsidiaries and affiliates with the exception of housing cooperatives, which remain exempt.
- The exemption applicable to health units on the purchase of machinery, construction materials, materials, equipment furniture and office fixtures used in the administrative or commercial phase (including parking, medical offices and pharmacies), or for the maintenance of the physical facilities of the health units. The current exemption from sales and use tax on the acquisition of machinery materials, supplies, articles, equipment and technology exclusively used while rendering health services in the diagnosis and treatment of human diseases process of health service facilities or hospitals with a tax grant under the "Hospital Facilities Tax Exemption Act," as amended, or hospitals that enjoy a tax exemption under Section 1101.01(a)(2) of the 2011 IRCPR continues to be in effect.
- The exemption on educational or recreational services rendered by child care centers. However, tuition and monthly charges paid to licensed centers remain exempt from the payment of sales tax.

Prescribed medicines remain exempt from sales and use tax. However, Act 40-2013 expanded the exemption because the Act repealed the requirement that such medicines should be prescribed by a local doctor, issued by a local pharmacist, and given by a doctor, surgeon, dentist or podiatrist with a license or issued in a health unit as prescribed by a local doctor.

Reduction in sales and use tax rate

Act 40-2013 provides a mechanism for the legislature to defer further the effectiveness of the reduction of the .5% municipal rate from December 1, 2013 to February 2014.

Back-to-School sales tax holiday

Act 40-2013 modified the terms and duration of the back-to-school sales and use tax-free period from a one-time period of three days to a two-time period of two days, but only uniforms and school supplies are exempt from sales and use tax during those two-day periods in the months of July and January. Text books and notebooks on the other hand are exempt from sales tax at all times. See Tax Alert 2013-1298 recently issued for further details about the July 12 and 13 sales tax-free period in year 2013.

Income Taxes

Corporations

Computation of taxable income and regular tax liability

Act 40-2013 makes the following changes to the determination of taxable income and regular tax liability for tax years beginning after December 31, 2012:

- Disallows 51% of payments made to related parties not engaged in trade or business in PR, including those expenses between a branch and its home office. This limitation is not applicable to entities with tax grants under tax incentives laws. Also, the Secretary is authorized to waive fully or partially the disallowance provision through a formal ruling request procedure.

- Disallows the deduction related to the special gross income tax.
- Reduces the special deduction to determine taxable income subject to surtax from $750,000 to $25,000 which was the special deduction under the Puerto Rico Internal Revenue Code of 1994 (1994 PRIRC).
- Reverses the surtax rates to those in effect under the 1994 PRIRC as follows:

NET INCOME SUBJECT TO ADDITIONAL TAX	ADDITIONAL TAX (SURTAX)
Up to $75,000	5%
In excess of $75,000 up to $125,000	$3,750 plus 15% of excess over $75,000
In excess of $125,000 up to $175,000	$11,250 plus 16% of excess over $125,000
In excess of $175,000 up to $225,000	$19,250 plus 17% of excess over $175,000
In excess of $225,000 up to $275,000	$27,750 plus 18% of excess over $225,000
In excess of $275,000	$36,750 plus 19% of excess over $275,000

Alternative Minimum Tax (AMT) rate and AMT calculation

Act 40-2013 increases the AMT rate from 20% to 30% and eliminates the disallowance of the deduction for payments made to related parties for services rendered that are not taxable in PR. It also reduces from $50 million to $10 million the threshold of gross revenues to be excluded from the special AMT on purchases from related persons and increases the tax rate on purchases from related persons to 2%, but allows a reduced rate under certain circumstances to be approved by the Secretary. Additionally, Act 40-2013 includes an additional tax on gross income. Entities operating with tax grants issued under tax incentives acts, including agricultural businesses and not for profits entities, are not subject to this new special tax. Also, flow-through entities are subject to this new additional tax on gross income.

The AMT liability is based on the higher of the following two formulas:

- The sum of regular AMT (determined using the 30% rate) and the special tax on gross income or
- The sum of the following items:
  1. 20% on payments to related parties including allocated expenses from a home office to a branch, that have not been subject to tax in Puerto Rico
  2. 2% , or reduced applicable rate, of the purchases of personal property from a related party, including transfers of personal property from a home office to a branch engaged in trade or business in Puerto Rico
  3. Special tax on gross income

The special tax on gross income rate is applicable on the gross revenues as follows:

GROSS REVENUES	GROSS RECEIPTS TAX RATE
From $1 million up to $3 million	0.20%
In excess of $3 million up to $300 million	0.50%
In excess of $300 million up to $600 million	0.70%
In excess of $600 million up to $1.5 billion	0.80%
In excess of $1.5 billion	0.85%

Please note that financial institutions are subject to a special rate of 1%. However, they are allowed to credit against their regular or AMT up to 50% of the additional tax on gross income.

For purposes of the tax on purchases of personal property from related parties, Act 40-2013 eliminates from the definition of personal property the exemption for alcoholic beverages, gasoline and crude oil products and, instead, provides a reduced rate as follows:

AMT ON PURCHASES OF PERSONAL PROPERTY	RATE
General rule	2.0%
Alcoholic beverages	0.5%
Gasoline and crude oil products	0.5%
Vehicles	1.5%

The Secretary of the Treasury has the authority to reduce the tax rate, to no less than 0.2%, if the value of the purchases of personal property from a related person is equal or substantially similar to the value used for sale to an unrelated person. In the case of gasoline and crude oil products, the Secretary may fix a tax rate of less than 0.2%.

Purchases from related parties that are engaged in trade or business in Puerto Rico are excluded.

Net operating loss (NOL) deduction

Act 40-2013 extends the carry forward period for the utilization of NOLs, while the amount of the NOL deduction is limited, as follows:

	CURRENT STATUS	ACT 40-2013
TAX YEAR NOL INCURRED	NOL CARRY FORWARD PERIOD	
Tax Years Commencing before January 1, 2005	7 years	7 years
Tax years commencing after December 31, 2004 and before January 1, 2013	10 years	12 years
Tax years commencing after December 31, 2012	7 years	10 years
NOL deduction allowable for corporations	Up to the total amount of normal tax net income	Up to 90% of the normal tax net income (a)
Limitation on NOL carryforwards following ownership change	Allowable deduction of NOL carryforward is up to 100% of the post-change net income	Allowable deduction of NOL carryforward is up to 90% of the post-change net income

Partnerships

Similar to the disallowance rule of payments to related parties in the case of corporations, Act 40-2013 fully disallows the deduction of payments made to partners that own 50% or more of the partnership's interest to the extent those payments are not subject to withholding at source or taxation in Puerto Rico. This disallowance rule is not applicable, however, to entities with tax grants under the tax incentives laws. Also, a waiver mechanism is provided subject to the Secretary's evaluation and formal approval.

Act 40-2013 requires that the distributable share of the partner in the net income of the partnership include that part of the three components that are considered in the AMT calculation: expenses to a related party, purchases of personal property to related parties and the gross income subject to the special tax therein.

Also, the obligation of partnerships to make estimated tax payments on the distributable share of its partners at 30% is modified by Act 40-2013. The partnership is required for tax years that commence after December 31, 2012 to compare the 30% withholding with the distributable share of the partner on the additional tax on gross income and pay the higher amount.

These rules are also applicable in basically the same manner to partners in special partnerships and shareholders in corporations of individuals.

Individuals

Act 40-2013 imposes a special 2% tax to self-employed individuals with gross income in excess of $200,000. For this purpose, gross income is defined as gross revenues less cost of sales and it does not include income from services rendered as an employee. This special tax is not tax-deductible and is not subject to estimated tax provisions.

The deduction on mortgage interest is further limited to a maximum of $35,000.

Pursuant to Act 40-2013, the alternate basic tax (ABT) applicable to individual taxpayers includes the distributable share of the newly imposed special tax on gross income in the case of partners and members of partnerships, special partnerships and corporations of individuals.

These amendments are effective for tax years that commence after December 31, 2012.

Estimated tax payments

The computation of the estimated tax in the case of corporations includes the AMT if applicable. Also, the payment of estimated taxes for the first tax year of effectiveness of the additional tax on gross income under the AMT calculation is required to be made through the estimated tax installments remaining in the tax year commenced after December 31, 2012. The latter is applicable to corporate taxpayers and individuals who participate in pass through entities.

Option 94

Act 40-2013 allows taxpayers that elected to continue being subject to income taxation under the provisions of the 1994 PRIRC (Option 94), to opt out of such election for tax year beginning after December 31, 2012. The election is irrevocable and these taxpayers will be subject to the provisions of the 2011 IRC PR as amended by all the changes introduced under Act 40-2013.

Moratorium of tax credits

Under Act 40-2013, the moratorium on tax credits remains essentially the same as originally proposed in Substitute Bill 1073, except it extended the date used to allow the use of tax credits during the moratorium to those granted or purchased before June 30, 2013. Also, an exception was made to allow the concession of tax credits for projects related to investment in infrastructure for housing under Act 98 of August 10, 2001 and tax credits for projects related to conservation easements under Act 183-2001, which may be granted during the years under moratorium, but limited to $5 million and $10 million per year, respectively.

Act 40-2013 imposes a three-year moratorium on the following tax credits:

- Solid waste
- Venture capital funds
- Theater district
- Conservation easements
- Urban centers
- Social Interest housing
- Housing infrastructure
- Purchases of products manufactured in Puerto Rico (under Section 1051.09 of the 2011 IRCPR)

The moratorium period covers tax years beginning after December 31, 2012 and before January 1, 2016. The moratorium for the use of these credits applies to credits purchased or granted before June 30, 2013. These may be used during the moratorium period but limited to 50% of the tax liability during the moratorium period. There are additional limitations applicable for the use of certain credits purchased or granted during the moratorium period.

Act 40-2013 does not allow new credits to be approved during the moratorium period, except in certain cases and subject to specific conditions such as having filed before June 30, 2013, a duly and completed application for tax credits with the pertinent governmental agency.

An information statement is required to be filed by July 31, 2013 in order to claim the credits covered under the moratorium as well as certain others under tax incentives acts not covered but required by Act 40-2013 to be reported. This informative filing is required in order to allow the taxpayer to claim those credits permitted during the moratorium period and after the period expires.

New special tax on insurance premiums

A 1% premium tax is imposed on premiums subscribed by insurance companies after June 30, 2013. The tax is in addition to the premium tax imposed by the Puerto Rico Insurance Code, and will be paid on or before March 31 of the following year. The exemption provided by the Puerto Rico Insurance Code

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applicable to domestic insurers maintaining a home office in Puerto Rico will not apply to this special tax. Also, Act 40-2013 excluded from the payment of the 1% special tax the premiums generated from Medicare Advantage, Medicaid, "Mi Salud" program, and annuities.

Implications

It is expected that the PRTD will be issuing administrative guidance soon for various key changes made by Act 40-2013, particularly in the elimination of the reseller exemption certificate for sales tax purposes. The implications of the changes