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TAX ALERT 2015-05

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A PUBLICATION FROM THE TAX DIVISION



**LEGISLATIVE BILL
PROPOSES NEW
PUERTO RICO INTERNAL
REVENUE CODE**



On February 11, 2015, the Puerto Rico Legislature filed the Transformation to the Tax Code of the Commonwealth of Puerto Rico Bill ("the Bill", House of Representatives No. 2329; Senate No. 1304). The Bill proposes a new Puerto Rico Internal Revenue Code ("2015 Code").

This **TAX ALERT** provides a summary of some of the most significant aspects of the Bill, including relevant comments issued last week by the Puerto Rico Secretary of the Treasury during the public hearings conducted by both legislative Houses.

The Bill is currently under evaluation and may be subject to significant amendments.

EFFECTIVE DATE

As drafted, the Bill will become effective as follows:

- **Effective April 1st, 2015** – Elimination of the automatic relief of imported property for Non-bonded Merchants.
- **Effective the first day of the 2nd month after approval** - Provisions concerning changes related to the income tax of individuals and businesses; Value Added Tax ("VAT") provisions to all transactions of sale of goods and services currently covered by the provisions of the Internal Revenue Code of Puerto Rico of 2011, as amended ("IRC 2011") and a limited additional group of certain other goods and services. This includes, among other provisions:
 - Increase of the reseller credit claimed for taxes paid on goods for resale from 75% to 100% of the tax liability reflected in the Monthly Sales and Use ("SUT") Return;
 - Rate increase – from 7% to 16%; and
 - Revisions (decrease) of the income tax withholding on salaries in accordance with the proposed income tax rates.

Should the bill be approved in March, these provisions are expected to become effective on **May 1st, 2015**.

- **Effective January 1, 2016** – all other provisions of the VAT.

Please contact your account service partner should you have any questions or comments or if you need additional information regarding these matters.

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INCOME TAXES INDIVIDUALS

INCOME TAXES – INDIVIDUALS

New Income Tax Rates

IRC 2011 Tax Rates for Individuals and Married Filing Separately

| Taxable income | Tax |
|-------------------|--|
| Up to \$9,000 | 0% |
| \$9,001-\$25,000 | 7% excess over \$9,000 Maximum effective tax rate: 4.5% |
| \$25,001-\$41,500 | \$1,120 + 14% excess over \$25,000 Maximum effective tax rate: 8.3% |
| \$41,501-\$61,500 | \$3,430 + 25% excess over \$41,500 Max. effective tax rate: 13.7% |
| Over \$61,500 | \$8,430 + 33% excess over \$61,500 |

IRC 2015 Tax Rates for Individuals; Married Filing Separately; Married Filing Jointly who use Optional Method

| Taxable income | Tax |
|---------------------|---|
| Up to \$40,000 | 0% |
| \$40,001-\$125,000 | 15% excess over \$40,000 Maximum effective tax rate:10.2% |
| \$125,001-\$200,000 | \$12,750 + 20% excess over \$125,000 Max. effective tax rate:13.9% |
| Over \$200,000 | \$27,750 + 30% excess over \$200,000 |

IRC 2015 Tax Rates for Married Filing Jointly who do NOT use Optional Method

| Taxable income | Tax |
|---------------------|---|
| Up to \$80,000 | 0% |
| \$80,001-\$125,000 | 15% excess over \$80,000 Maximum effective tax rate: 5.4% |
| \$125,001-\$200,000 | \$6,750 + 20% excess over \$125,000 Max. effective tax rate: 10.9% |
| Over \$200,000 | \$21,750 + 30% excess over \$200,000 |

Other Provisions

| Description | IRC 2011 | IRC 2015 |
|---|----------|-----------------|
| Optional method for married filing jointly | Yes | Yes |
| Home mortgage interest deduction | Yes | No ¹ |
| Student loan interest deduction | Yes | Yes |
| Medical expenses deduction | Yes | Yes |
| Casualty property losses deduction | Yes | Yes |
| Deduction of contributions to IRA's, governmental and private retirement systems | Yes | Yes |
| Deduction on contributions to health savings accounts | Yes | No |
| Deduction of contributions to Educational Contribution Accounts (up to \$500 per dependent) | Yes | No |

¹ Instead, the Bill provides for a non-reimbursable tax credit, calculated as follows:

Gross revenues ("GR") up to \$125,000 - the lesser of 15% of interest paid or \$5,250
 GR in excess of \$125,000 up to \$140,000 - the lesser of 12% of interest paid or \$4,200
 GR in excess of \$140,000 up to \$155,000 - the lesser of 9% of interest paid or \$3,150
 GR in excess of \$155,000 up to \$170,000 - the lesser of 6% of interest paid or \$2,100
 GR in excess of \$170,000 - the lesser of 3% of interest paid or \$1,050

INCOME TAXES INDIVIDUALS (Continued)

| Description | IRC 2011 | IRC 2015 |
|--|---------------------------|--|
| Special personal deduction (up to \$2,350) | Yes | No |
| Charitable contributions deduction | Yes | Only for institutions providing services in PR |
| Personal exemption (\$3,500 individuals/\$7,000 married) | Yes | No |
| Dependents exemption (\$2,500 each) | Yes | No |
| Veterans exemption (\$1,500) | Yes | No |
| Exemption for taxpayers between 16-26 years old (\$40,000) | Yes | No |
| Alternate basic tax (ABT) | Yes | No ² |
| 2% special tax on self-employment | Yes | No |
| Exemption of income from literary, journalistic, scientific, artistic and agricultural and professional development awards | Yes | No |
| Tax rate on capital gains | 10%/15% | 30% |
| Tax rate on bank interest income | \$0-\$2K-0% +\$2K- 10% | 30% |
| Tax rate on dividend income | 15% | 30% |
| Additional tax on gross revenues (<i>patente nacional</i>) | No | No |
| Cost of living allowance (COLA) | Exempt | Taxable |
| Compensation from military licenses | Exempt | Taxable |
| Credit to individuals over 65 years old | \$200 | \$0 |

² ABT credit carryovers will be deductible up to 10% of the income tax liability.

INCOME TAXES CORPORATIONS

INCOME TAXES - CORPORATIONS

New Income Tax Rates

IRC 2011 Corporate Tax Rates

Normal tax – 20%

Surtax-

| Taxable income | Tax |
|---------------------|--------------------------------------|
| Up to \$75,000 | 5% |
| \$75,001-\$125,000 | \$3,750 + 15% excess over \$75,000 |
| \$125,001-\$175,000 | \$11,250 + 16% excess over \$125,000 |
| \$175,001-\$225,000 | \$19,250 + 17% excess over \$175,000 |
| \$225,001-\$275,000 | \$27,750 + 18% excess over \$225,000 |
| Over \$275,000 | \$36,750 + 19% excess over \$275,000 |

INCOME TAXES CORPORATIONS (Continued)

New Income Tax Rates (continued)

IRC 2015 Corporate Tax Rates

| Taxable income | Tax |
|----------------|----------------|
| Over \$0 | 30% fixed rate |

Other Provisions

| Description | IRC 2011 | IRC 2015 |
|--|-------------------------------|---|
| Capital gains tax rate | 15%/20% | 30% |
| Option 94 | Yes | No ³ |
| Alternative minimum tax ("AMT") rate | 30% | 25% ⁴ |
| Additional tax on gross revenues (<i>patente nacional</i>) | No | No |
| Depreciation expense methodology | Accelerated and straight line | Straight line |
| Partnerships; Limited Liability Companies (pass-through election); Corporations of Individuals; Special Partnerships | Yes | One type pass-through entity ⁵ |

³ Under IRC 2011, this option was available until the current year (2015).

⁴ Additional changes to the AMT calculation applicable to transactions **between affiliates** include the elimination of the 20% adjustment applicable to services, and a decrease of 25% to the rates applicable to transfers/purchases of personal property.

⁵ Existing corporations as of January 1st, 2015 that exercise the option to become pass-through entities during this year will benefit from a reduced conversion rate equal to 10% of retained earnings as of the conversion date, payable in 2 taxable years. Conversions after 2015 will be subject to additional conversion costs.

- The Bill extends the tax credits moratorium until year 2017.

VALUE ADDED TAX

VALUE ADDED TAX ("VAT")

- The Value Added Tax ("VAT") substitutes the Sales and Use Tax ("SUT").
- Applicable rate to taxable transactions - 16%.

Exempt Transactions

The following transactions will **NOT** be subject to the VAT:

- Provision of financial services (excluding bank charges);
- Import and sale of prescription drugs and items for the treatment of health conditions;
- Sales to handicapped persons of items and equipment to treat physical or physiological deficiencies, provided that the purchaser certifies qualification;

VALUE ADDED TAX (Continued)

Exempt Transactions (continued)

- Sale of goods and services paid or reimbursed by Medicare, Medicaid, or the health insurance program sponsored by the Government of Puerto Rico;
- Lease of any property subject to the room tax imposed by the Tourism Company of Puerto Rico;
- Transfer of goods and services provided by nonprofit entities that have obtained an exemption under Section 1101.01;
- Lease of real property which constitutes the principal residence of the tenant, including student and senior citizen's housing;
- Import and sale of food and food ingredients;
- Sale of goods purchased with funds received under the *PAN* or *WIC*;
- Sale of real property;
- Sale of goods and services to government agencies of the United States, any state, the District of Columbia and the Government of Puerto Rico;
- Import and sale of gasoline, aviation fuel, gas oil or diesel oil, crude oil, finished oil products, except propane gas and its derivatives or similar nature;
- Import and sale of machinery, medical and surgical equipment, supplies, equipment and technology by any hospital unit to be used **exclusively** in the provision of health services;
- Occasional sale of property by churches or religious organizations;
- Import and import of goods to *bona fide* farmers;
- Import and sale of goods by a merchant dedicated to the tourist business; and
- Import and sale of vehicles.

Excluded Transactions

- Utility services (water and power) provided by the *AAA* and the *AEE*, respectively;
- Any property of the United States government, its instrumentalities, and the Government of Puerto Rico;
- Any service provided by the Government of Puerto Rico; and
- Goods imported to Puerto Rico into a foreign trade zone.

Transactions Subject to a 0% VAT Rate

- Sales of goods for export;
- Provision of services for export; and
- Imports of items to be used by a manufacturing plant that possesses a Certificate of Exemption on Importations for Eligible Manufacturing Plants.

Imposition of VAT on Transactions/Services Exempt under IRC 2011

- Designated professional services: Agronomists; Architects; Landscape Architects; Certified Public Accountants; Attorneys; Brokers, Sellers and Real Estate Companies; Professional Draftsmen (*Delineantes*); Real Estate Professional Appraisers; Geologists; Engineers and Surveyors;
- Medical and hospital services;
- Childcare centers;
- Textbooks and school uniforms;

VALUE ADDED TAX (Continued)

Imposition of VAT on Transactions/Services Exempt under IRC 2011 (continued)

- Private education (primary, secondary and post-secondary);
- Lease of commercial property;
- Business-to-business transactions; and
- Fees and dues.

Reporting and Payment

- Every merchant that provides goods/services subject to VAT will be required to collect the VAT, except for Small Merchants (those with annual revenues up to \$75,000) who have a valid Small Merchant's Registration Certificate.
- Retail sales receipts shall not show the VAT separately from the cost of goods/services.
- Declaration of Imports- filed on the 10th day of every month, including corresponding payment, if applicable.
- VAT Monthly Return – filed on the 20th of every month, informing the VAT collected/paid in the preceding month and the corresponding payment, if applicable.
 - Merchants whose goods/services are subject to the VAT (except for Small Merchants) will be able to claim a credit for 100% of the VAT paid, provided they obtain a Fiscal Voucher ("FV") from the selling merchant showing the amount of VAT paid. The request shall be made within 30 days of receipt of the goods/services, the selling merchant shall issue the FV within 30 days from the request.
 - Professional service providers are allowed to collect/pay their VAT using cash basis instead of accrual basis.
 - Any overpayment will be credited in subsequent filings. Non-eligible merchants⁶ having overpayments of over \$10,000 for 3 consecutive months may request a refund from the Treasury.

⁶ Eligible Merchants are merchants with annual volume of business in excess of \$500,000 (for the previous 3 years) and that have 80% of their revenues taxed at a 0% VAT rate.

- Annual Declaration for Small Merchants – to be filed within 60 days of the income tax return due date (including extension period).

Regressivity Relief

- Certain individuals ("Eligible Consumers") will receive a refund for a determined amount of VAT paid ("RecIVA"). Such refunds will be issued in March, July and November of every year (starting in November, 2015).
- In order to qualify to receive the VAT refund, individuals must apply for and register with the Treasury Department. The criteria and amount of the refund will be determined by the Secretary based on the following:
 - Income level;
 - Age;
 - Number of household members;
 - Qualification in social assistance programs (*PAN*, *WIC*); and
 - Projected consumption levels.

VALUE ADDED TAX (Continued)

OTHER

Regressivity Relief (continued)

- Within 90 days after the approval of the Bill, the Secretary shall issue the applicable Regulations, Administrative Letters, Circular Letters, etc., describing the parameters, way and means of payment of the relief.

OTHER MATTERS

The following Subtitles did not show significant changes with respect to IRC 2011:

- Subtitle B- Estate Taxes
- Subtitle E – Alcoholic Beverages

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