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TAX ALERT 2017-05

November 20, 2017

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A PUBLICATION FROM THE TAX DIVISION

TAX RULES APPLICABLE TO ESSENTIAL SERVICES CONTRACTS RELATED TO PUERTO RICO RECOVERY PROCESS



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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On November 10, 2017, the Puerto Rico Department of Treasury (“the Department”) issued Administrative Determination 17-28 (“AD 17-28”) to establish the tax rules applicable to new contracts for essential services provided to the Government of Puerto Rico under contracts formalized during the period starting after September 19, 2017 until December 31, 2017. Essential services include, among others, electricity, water, construction, telecommunications, and health.

Foreign Contractors

Generally, income earned in Puerto Rico by foreign corporations or partnerships (“Foreign Contractors”, or “FCs”) not engaged in trade or business in Puerto Rico is subject to an income tax withholding at source of 29%¹. Under the provisions of AD 17-28, FCs may elect to be treated, (for purposes of income tax) as engaged in trade or business in Puerto Rico with respect to essential services rendered in Puerto Rico and instead be subject to an income tax withholding at source of 7%².

Said election shall be established in the contract and a copy thereof shall be submitted to the Department no later than 30 calendar days from the date of its execution. In addition, a copy of the contract, including the election along with an explanatory letter from the FC shall be submitted to the following email address: contratosgubernamentales@hacienda.pr.gov. A FC that formalized a contract before November 10, 2017 and that wishes to avail itself of said election, must amend the contract for these purposes and submit it along with the documentation mentioned above no later than December 10, 2017.

The FC that has elected to be treated as an entity dedicated to industry or business in Puerto Rico shall be required to file an income tax return and determine its tax liability in accordance with the provisions of Section 1061.02 of the Puerto Rico Internal Revenue Code (“the Code”), as amended. In said return, the FC may claim as a credit the 7% tax withheld at source on the payments received under the contract.

¹ Payments to nonresident individuals or trusts or to foreign corporations or partnerships not engaged in trade or business in Puerto Rico to whom a withholding of tax at source was made shall be informed by the payer in Form 480.6C Informative Return – Income Subject to Withholding – Nonresidents.

² These payments and the corresponding withholdings shall be informed by the payer in Form 480.6B Informative Return - Income Subject to Withholding.

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Nonresident Employees

Generally, compensation paid to an employee who is not a resident of Puerto Rico and is a US citizen, is subject to an income tax withholding at source of 20%¹. The provisions of AD 17-28 permit an income tax withholding at source of 10% on compensation paid to employees in connection with an essential service contract. Furthermore, by withholding at source 10% of the payments, the employee shall be deemed to comply with his/her tax liability under the provisions of Section 1061.01 (a)(2) of the Code. Consequently, said employee will not be required to file an Individual Income Tax Return. However, said employee will not have the right to claim any credit for the income tax withheld.

Nonresident Aliens

Compensation paid to a nonresident foreign employee for services rendered in Puerto Rico to perform work related to an essential service contract, shall not be considered as wages and shall be subject to all requirements set forth in Sections 1062.08 and 1091.07 in place of the requirements set forth in Sections 1062.01 and 1062.03 of the Code. Consequently, such payments will be subject to a 29% withholding at source¹.

Foreign Entity Subcontractor

Generally, income earned in Puerto Rico by a subcontractor that is a foreign entity not engaged in trade or business in Puerto Rico is subject to an income tax withholding at source of 29%¹ of said income. Under the provisions of AD 17-28, said foreign entities may elect to be treated, (for purposes of income tax) as engaged in trade or business in Puerto Rico with respect to essential services rendered in Puerto Rico and instead be subject to an income tax withholding at source of 7%². Said election shall be established in the contract and a copy thereof shall be submitted to the Department no later than 30 calendar days from the date of its execution. In addition, a copy of the contract, including the election along with an explanatory letter from the foreign entity shall be submitted to: contratosgubernamentales@hacienda.pr.gov.

The foreign entity subcontractor that has elected to be treated as an entity dedicated to industry or business in Puerto Rico shall be required to file an income tax return and determine its tax liability in accordance with the provisions of Section 1061.02 of the Code. In said return, the foreign entity may claim as a credit the 7% tax withheld at source on the payments received under the contract.

Compensation paid for essential services by foreign entity subcontractors to nonresident individual employees and nonresident aliens are subject to the same provisions, respectively, mentioned above.

Nonresident Individual Subcontractors

Payments made by a FC for services performed under an essential service contract to a nonresident individual subcontractor who is a US citizen will be subject to the provisions applicable to nonresident employees described above.

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Nonresident Alien Subcontractors

Payments made by a FC to a subcontractor who is a nonresident alien individual for services performed under an essential service contract, will be subject to the provisions applicable to nonresident aliens described above.

Local Subcontractor Entities and Individual Subcontractors (PR Residents)

Local subcontractors will continue to be subject to the applicable provisions of the Code, unless otherwise provided by the Department.

Merchant Registry

FCs, foreign entity subcontractors and nonresident individual subcontractors must enroll in the Merchant Registry (through the Unified Internal Revenue System, <https://suri.hacienda.pr.gov>) no later than 30 days after the execution of a contract or subcontract.

Exemptions on Tangible Personal Property and Services acquired by Governmental Agencies

Tangible personal property that will be used in the services included as part of a contract for essential services will be exempt from the excise taxes imposed by Subtitle C of the Code for a period of six months counted from the date of introduction. In addition, taxable items that will be used in the services included as part of the contract, and which will be re-exported within a period of six months counted from the date of introduction, will not be subject to sales and use tax ("SUT"). The exempt nature of the transaction must be documented in the Form SC 2916 Certificate of Exempt Purchases. An additional six-month extension may be requested.

Services provided to the government are not subject to the SUT. However, payments for services between a FC or a local contractor with a foreign entity subcontractor or individual subcontractor, will be subject to the Special SUT of 4%.

The provisions of AD 17-28 are effective immediately and will apply to contracts formalized from September 20, 2017 until December 31, 2017.

Valdés, García, Marín & Martínez, LLP is a Puerto Rico based firm of Certified Public Accountants and Consultants organized as a partnership for the practice of public accounting since 1975. Our 40 years of experience in public accounting support our commitment to excellence and professionalism.

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