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TAX ALERT 2020-03

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A PUBLICATION FROM THE TAX DIVISION

**Technical Amendments to the 2011
Puerto Rico Internal Revenue Code and
Complementary Act to Address the
Effects of the Puerto Rican Economy
Caused by the COVID-19 Emergency**



On April 16, 2020, the Puerto Rico Governor signed into law Act 40-2020 (“Act 40”) which incorporates technical amendments to the 2011 Puerto Rico Internal Revenue Code, as amended (the “PRIRC”) and other tax statutes. In addition, on June 14, 2020, the Governor signed Act 57-2020, known as the Complementary Law to Address the Effect of the COVID-19 Emergency on the Puerto Rican Economy (“Act 57”). Some of the most significant changes introduced by both acts are discussed below.

Individuals

- Married couples who enter into postnuptial agreements will be treated as if their marriage had terminated on the effective date of the agreement. Deemed transfers of property as a result of such termination will not result in gain or loss recognition (under PRIRC Section 1034.04(b)(7)).
- For taxable years commencing **after** December 31, **2019**, the regular income tax payable by an individual whose gross income does not exceed \$100,000 is reduced to 92% of the tax determined. The tax payable by individuals whose gross income exceed \$100,000 continues to be 95% of the tax determined. In addition, for purposes of the Alternate Basis Tax (“ABT”), individuals with a volume of business of less than \$1 million will be allowed to deduct all of their ordinary and necessary business expenses if they elect to file with the income tax return, in lieu of the agreed-upon procedures or compliance attestation report, a due diligence checklist form sworn by an Authorized Tax Return Preparer¹.
- Excluded Income – the cancellation of debt and the amounts received for any subsidy or federal stimulus package under the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) will be excluded from the gross income for income tax purposes, including the ABT, and from the income subject to the Volume of Business Declaration (“Patente” in Spanish). Other stimulus granted under any other federal or local legislation to attend COVID-19, including reimbursable tax credits, and other financial aid provided in Act 57 will also be considered excluded for Income and Municipal Tax purposes. Moreover, Act 57 allows taxpayers to claim as a deduction from net income the ordinary and necessary expenses incurred in the operation of the business, even when said expenses are paid with

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

Tel. (787) 725-1600

Lucy Martínez

Partner

lmartinez@vgmmcpa.com

Idsa Ramos

Partner

iramoss@vgmmcpa.com

Sofía Benítez Arraiza

Partner

sbenitez@vgmmcpa.com

Yahaira Feliciano Ramos

Partner

yfeliciano@vgmmcpa.com

Please contact us at (787) 725-1600 or at **fsosa@vgmmcpa.com** if you would like to subscribe or unsubscribe from these publications.

¹ An Authorized Tax Return Preparer (“ATRP”) is a new category of tax professional created by Act 40. The ATRP must comply with certain minimum formal and continuing education requirements. CPAs registered as tax preparers are automatically considered ATRPs.

- Optional Tax –
 - › Individuals that derived at least 80% of gross income from the rendering of services will be allowed to avail of the Optional Tax.
 - › The Optional Tax will be available for each married individual married filing a joint return to the extent that each spouse complies with the provisions under the PRIRC.
 - › The distributive share in the income of a partnership or corporation of individuals that elects the Optional Tax cannot be considered as part of the Adjusted Gross Income in determining the maximum amount of mortgage interest that may be deducted during the year.
 - › For taxable years **2019** and **2020**, taxpayers may opt for the Optional Tax even when he/she has a tax balance payable if the balance due is paid not later than the due date for filing the income tax return, without extensions.
- For taxable years beginning after December 31, **2019**, the income tax exemption for compensation derived by eligible investigators and scientists is repealed. The historic zones rent exemption is also repealed.
- For taxable years commencing after December 31, **2018**, the capital loss carryover is limited to 90% (increased from 80%) of the capital gains for the taxable year.
- Act 40 repealed the provision that disqualified from the Earned Income tax Credit taxpayers that have reached 65 years of age.
- The following changes were made to deductions allowed to reduce gross income subject to ABT:
 - › Act 40 clarifies that deductions with respect to insurance, telecommunications, internet access, television by cable or satellite, and advertising are allowed if reported in informative returns;
 - › For tax year **2019**, Act 57 allows the deduction of all the ordinary and necessary expenses for ABT purposes without the submittal of an Agreed-upon Procedures Report (an "AUP");
 - › Personal exemptions and dependent deductions are allowed for computing the ABT.
- COVID-19 Losses ("C-19L") – Act 57 allows a carry-back period of two years for losses incurred during the tax year beginning after December 31, 2019 resulting from the COVID-19 emergency, ("COVID-19 Losses", or "C-19L"). This provision is applicable to taxpayers with a volume of business of up to \$10 million for tax year 2020. The carry-back program is not available for *Large Taxpayers*, as defined in Section 1010.01(a)(35) of the PRIRC.

The maximum amount of C-19L is \$200,000; the maximum refund for income tax paid in previous years is \$50,000. The C-19L may also be used for ABT. The net operating loss limitation of 90% will not apply to C-19L. ACT 57 also establishes the order for the carryback application. The carryforward of C-19L will be available for tax years after 2020 only when other net operating losses have been extinguished. Treasury is expected to provide further guidance in connection with these provisions.

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Individuals (continued)

- For taxable years commencing after December 31, **2018**, taxpayers whose only source of income is derived from salaries reported in W-2s or pensions are not subject to the ABT. In addition, Act 40 adds the following to the list of items excluded from gross income subject to the ABT:
 - › Living allowance to priests and ministers;
 - › Certain internship fees to medical students;
 - › Government and qualified plan pensions;
 - › Government employees' summer and Christmas bonus;
 - › Unemployment compensation;
 - › International banking entity income;
 - › Cost of living allowance received by federal Government employees working in Puerto Rico;
 - › The first \$40,000 of income received by youngsters;
 - › Taxpayers under \$40,000 youth personal service income.

Legal Entities

- Limited Liability Companies - the effective date of the election to be taxed as a partnership by a corporation that converts into a limited liability company will be the first day of the tax year the conversion becomes effective.
- For taxable years beginning after December 31, **2018**, the due date for the filing of the income tax return of following entities will be the 15th day of the 6th month following the close of the taxable year:
 - › Non-profit entities;
 - › Insurance companies²;
 - › Corporations with a grant of tax exemption under special acts (not applicable to pass-through entities).

Any tax due is payable on the due date of the income tax return.

- Non-profit Entities – Act 40 adds to the definition of non-profit entities secondary entities that form an integral part of the operations of other non-profit entity, subject to certain provisions listed on Section 1101.01 of the PRIRC.
- Act 57 extended the due date for all income tax returns that were originally due between March 15 and June 15, 2020 to **July 15, 2020**. Also, it eliminates the imposition of interest, surcharges and penalties if the return is filed and the amount due is paid on or before July 15, 2020. Furthermore, taxpayers with economic hardships may apply for a payment plan in connection with their income tax liability. To qualify for the payment plan, taxpayers should not have outstanding debts with the PR Treasury ("Treasury"). If the taxpayer pays the income tax subject to the payment plan on or before March 31, 2021, Treasury will eliminate all related interests, surcharges and penalties. Treasury is expected to provide further guidance on this program.

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Legal Entities (continued)

- Trusts and Estates - the automatic extension for filing the returns will be granted for 6 months if the taxpayer requested the extension on or before the due date for the filing of the return. The extension will also apply to the filing of the required information report.²
- Employee-Owned Special Corporations – returns must be filed on or before the 15th day of the 3rd month following the close of the year². The extension will also apply to the filing of the required information report.
- Requirement to Submit Financial Statements - for taxable years beginning after December 31, **2019**, taxpayers will be required to include with the income tax return financial statements audited by a Certified Public Accountant licensed in Puerto Rico (“a CPA”) and supplementary information if their volume of business is \$10 million or more. Taxpayers with a volume of business between \$3 million and less than \$10 million may elect to include with the income tax return audited financial statements, an AUP or a Compliance Attestation Report prepared by a CPA.³
- Requirement to Submit Financial Statements for Groups of Related Entities - for taxable years beginning after December 31, **2019**, all the entities with a volume of business of \$1 million or more that belong to a related entity group with an aggregate volume of business of \$10 million or more will be required to include financial statements audited by a CPA.³
- Excluded Income – the cancellation of debt and the amounts received for any subsidy or federal stimulus package under the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) will be excluded from the gross income for income tax purposes, including the Alternative Minimum Tax (“AMT”), and from the income subject to the Volume of Business Declaration. Other stimulus granted under any other federal or local legislation to attend COVID-19, including reimbursable tax credits, and other financial aid provided in Act 57 will also be considered excluded for Income and Volume of Business Tax purposes. Moreover, Act 57 allows taxpayers to claim as a deduction from net income the ordinary and necessary expenses incurred in the operation of the business, even when said expenses are paid with funds received from any such state and/or federal subsidy.
- COVID-19 Losses (“C-19L”) – Act 57 allows a carry-back period of two years for losses incurred during the tax year beginning after December 31, 2019 resulting from the COVID-19 emergency, (“COVID-19 Losses”, or “C-19L”). This provision is applicable to taxpayers with a volume of business of up to \$10 million for tax year 2020. The carry-back program is not available for *Large Taxpayers*, as defined in Section 1010.01(a)(35) of the PRIRC.

² For taxable years beginning after December 31, 2016, the automatic extension for filing the return will be granted for six months if the taxpayer requested such extension on or before the due date for the filing of the return.

³ Neither Act 40 nor Act 57 amended the requirements in connection with the filing of the Volume of Business Declaration nor the Annual Corporation Report (filed with the State Department).

The maximum amount of C-19L is \$200,000; the maximum refund for income tax paid in previous years is \$50,000. The C-19L may also be used for AMT. The net operating loss limitation of 90% will not apply to C-19L. Act 57 also establishes the order for the carryback application. The carryforward of C-19L will be available for subsequent tax years only when any previous years' net operating losses have been extinguished. Treasury is expected to provide further guidance in connection with these provisions.

- Optional Tax –
 - › Entities that derived at least 80% of gross income from the rendering of services will be allowed to avail of the Optional Tax.
 - › For tax years **2019** and **2020**, taxpayers may choose the Optional Tax even when the entity has a tax balance payable if the balance due is paid not later than the due date for filing the income tax return, without extensions.
- Alternative Minimum Tax ("AMT") – amendments related with the calculation of the AMT include the following:
 - › The AMT of \$500 will not be effective for tax year **2019**;
 - › Act 40 clarifies that deductions with respect to insurance, telecommunications, internet access, television by cable or satellite, and advertising are allowed if reported in informative returns;
 - › For tax year **2019**, Act 57 allows the deduction of all the ordinary and necessary expenses for AMT purposes without the submission of an AUP.

Informative Returns and Tax Withholding at Source

- The informative return reporting requirement is eliminated for payments for **water and electricity**.
- Informative returns for payments received on advertisements, insurance, telecommunications services, internet access, and cable and satellite television are deferred for payments received after December 31, **2019**. For calendar year **2019**, taxpayers not filing audited financial statements nor AUP may file the informative return on their own in order to be allowed the corresponding deduction for ABT and AMT. The taxpayer should file this informative return no later than the income tax return deadline, including extension. Treasury will not impose penalties to the taxpayer for filing said information return after its extended deadline, which was May 31, 2020. For calendar year **2020** onwards, this return will only be required for commercial clients. Other clients may request to the providers, on or before January 31, that they issue an annual informative.
- The withholding tax on indemnification payments in lawsuits or extrajudicial claims paid to nonresident individuals, nonresident aliens and nonresident foreign corporations will be 20%, 29%, and 29%, respectively.

- The following payments are exempt from withholding at source:
 - › All payments for professional services issued **between March 23 and June 30, 2020**;
 - › Remuneration paid **on or after January 1, 2019** for agricultural labor, domestic services, church minister services, and compensation for dismissal from employment;
 - › Payments made for continuing education.

Other Provisions

- Act 57 grants a temporary exemption on the 4% Business-to-Business and designated professional services Sales & Use Tax invoiced during the period from **April 1 to June 30, 2020**.
- Grantees under the Incentives Code of Puerto Rico that have not complied with the following tax exemption terms and conditions due to the COVID-19 emergency will be granted automatic compliance:
 - › Gross income (volume);
 - › Job creation/retention;
 - › Investment in machinery & equipment.

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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