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House Bill 2329 Proposes a New Internal Revenue Code

By Yesenia Sánchez-Quiles

House Bill 2329 (the "Bill") was recently filed at the Puerto Rico House of Representatives to propose a new Internal Revenue Code which will change the current tax structure in Puerto Rico. The main purpose of the Bill is to move from a tax system that collects taxes mainly from income and production to one based on consumption. To achieve this goal, the Bill provides lower income tax rates on the individuals and corporations, and a higher consumption tax with a wider tax base.

This article summarizes the main changes proposed to the income tax provisions for individuals and corporations. We will explain the proposed changes to substitute the Sales and Use Tax with a Value Added Tax and other provisions of the Bill in separate newsletters.

Income Tax – Individuals

The proposed amendments intend to compensate the tax burden of the increase in the

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consumption tax to individuals by reducing significantly the individual income tax rates. One of the purposes of the Bill is to simplify the tax system with the expected result that many taxpayers will be subject to a lower income tax payment and that most will have no income tax liability at all. Besides the obvious benefits for the individual taxpayers, it shall also result in a reduction of processing costs to the Puerto Rico Treasury Department.

Reduction in Tax Rates in General

In previous years, with the exemptions allowed by the Puerto Rico Internal Revenue Code of 2011, as amended (the "Code") it was expected that all taxpayers with gross income in excess of $20,000 would be subject to income tax. The Bill, however, increases that amount to $40,000 for single taxpayers and $80,000 for married taxpayers. This results in many taxpayers not having any income tax responsibility for the year. Below please find comparative income tax rate tables under the Code and under the Bill.

Table 1

2014 tax rates under the Code (single and married taxpayers):

Taxable Net Income	Tax Thereon
$9,000 or less	0 %
In excess of $9,000, but equal to or less than $25,000	7 % of the excess over $9,000
In excess of $25,000, but equal to or less than $41,500	$1,120 plus 14 % of the excess over $25,000
In excess of $41,500, but equal to or less than $61,500	$3,430 plus 25 % of the excess over $41,500
In excess of $61,500	$8,430 plus 33 % of the excess over $61,500

Table 2

Proposed tax rates (single, married filing separately and married filing jointly individuals that elect the alternate computation):

Taxable Net Income	Tax Thereon
Less than $40,000	0 %
In excess of $40,000, but equal to or less than $125,000	15 % of the excess over $40,000
In excess of $125,000, but equal to or less than $200,000	$12,750 plus 20% of the excess over $125,000
In excess of $200,000	$27,750 plus 30% of the excess over $200,000

Table 3

Proposed tax rates (married taxpayers):

Taxable Net Income	Tax Thereon
Less than $80,000	0 %
In excess of $80,000, but equal to or less than $125,000	15 % of the excess over $80,000
In excess of $125,000, but equal to or less than $200,000	$6,750 plus 20% of the excess over $125,000
In excess of $200,000	$21,750 plus 30% of the excess over $200,000

Repealed Taxes

Besides the reduction in the income tax rate, the Bill also provides the benefit of eliminating the special 2% tax on self-employed individuals and the alternate basic tax. Both of these taxes mostly impacted individuals generating high amounts of income.

Deductions and Exemptions

On the downside, with the simplification of the system comes the modification or elimination of certain deductions and exemptions that allowed taxpayers to reduce their income tax burdens.

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She provides corporate tax and resolution services for clients in the manufacturing, service, wholesale, telecommunication, energy and retailing industries, among others. She also manages a government and corporate tax resolution practice specializing in tax audits from the Puerto Rico Department of Treasury, the United States Internal Revenue Service, and municipalities including, sales and use tax, volume of business, real and personal property resolution services for individuals and businesses. She also works to obtain licenses and permits required to operate regulated lines of business such as distribution or retail of alcohol, imports license, fire arms, public services such as maritime, road or air transportation, security services, certain energy production, distribution, retailing and communication services.

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In regards to the deductions, the most important is the proposed substitution of the mortgage interest deduction for a non-refundable tax credit. The credit is determined as a percentage of the mortgage interest paid for the year, but further limited depending on the amount of gross income of the taxpayer. The higher the gross income, the smaller the credit granted. As a requirement of the credit, both the first and second residences must be located within Puerto Rico.

The Bill also eliminates the personal exemption for single and married individuals, together with the additional exemption for war veterans and the exemption for dependents.

Preferential Tax Rates

The Bill basically eliminates the preferential tax rates on dividend and long-term capital gain by increasing them to the maximum income tax rate of 30%. The taxpayers are still allowed to treat the income as ordinary income and pay under the regular income tax rate if the tax liability is smaller than under the preferential rate.

The Bill also eliminates the preferential tax rates to certain interests paid by financial institutions.

The elimination of the preferential tax rates will mostly impact those taxpayers with significant amounts of passive income, which traditionally had benefited from the reduced rates and had planned their portfolio considering those tax savings.

Changes on Certain Exemptions

The Bill also proposes changes to some exemptions currently included in the Code. Among these is the exemption provided for the sale of a principal residence. After March 31, 2015, any sale of the principal residence will no longer be exempt from Puerto Rico income taxes. Nowadays, this exemption is less

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important since many properties have reduced their value below the actual costs.

Other exemptions that have been eliminated, that will impact a broad base of taxpayers, are the exemption on interests earned on certain interests bearing bank accounts and the exemption for the cost of living adjustment received by employees of the Federal Government working in Puerto Rico.

Income Tax – Corporations

Tax Rates in General

The Bill proposes an increase to most tax rates, including various preferential tax rates. The normal tax rate will increase from 20% to a flat rate of 30%. However, the progressive tax table used in the surtax computation will be eliminated. Although, the increase of the normal rate may suggest an overall tax rate increase, the fact that the surtax rates were triggered at low income levels and that the maximum tax rate (normal rate plus surtax) is 39% will result in a lower tax rate for most corporations.

In the particular case involving capital gains, interest and dividend transactions made after December 31, 2014, the preferential tax treatment will be eliminated, since the applicable tax rate will be 30%. The elimination of the preferential tax on dividends may cause the overall tax liability under the Bill (income tax to the corporation and dividend tax to shareholders) to be higher than under the current law.

Alternative Minimum Tax

The Bill modifies the computation of the Alternative Minimum Tax (AMT) and incorporates new items to consider when determining the applicable tax. With these changes, the calculation of the AMT will be the

higher of two separate Tentative Minimum Tax (TMT) computations:

1. First TMT Computation - The applicable Alternative Minimum Net Income times the applicable tax rate. The proposed tax rate is 25% instead of the current rate of 30%.

2. Second TMT Computation – The cost of goods sold attributable to inventory acquired from a related person or Home Office times the applicable tax rate. The general tax rate will be 1.5%. There will be an exemption to the general tax rate that will apply in the following cases:

   a. .375% of the purchases or transfers of alcoholic beverage;
   b. .375% of the purchases or transfers of gas, crude oil and products derived from oil;
   c. 1.25% of the purchases or transfers of vehicles.

The Bill also proposes to eliminate any reduction of the tax rates on the purchases or transfers of personal property from related parties or Home Office that were granted through waiver requests (known in Spanish as "Dispensas"). New waivers will not be issued and any waiver, administrative determination or closing agreement granted by the Secretary of the Treasury under the Code, will not be valid for taxable years beginning after December 31, 2014.

The proposed AMT calculation does not consider the amount corresponding to the 20% of the expenses incurred or paid to a related person or branch. Accordingly, such amount will be disallowed to determine the Alternative Minimum Net Income. Also, it is important to mention that even though the 51% disallowance on the deductions for expenses incurred or paid to a related person for purposes of computing the regular net income is maintained by the Bill, the waiver on such disallowance will also be eliminated.

Changes on Deductions

The Bill introduces changes to the methodology used for tax depreciation purposes. For taxable years commencing in 2015, the only allowable tax depreciation method will be straight-line basis. As such, no flexible or accelerated tax depreciation will be allowed for taxable years commenced after 2014. Furthermore, the Bill provides that if a taxpayer used a methodology other than straight-line to depreciate its assets for taxable years prior to 2015, the allowable tax depreciation of those assets shall be determined by applying the straight-line method to the adjusted basis of the assets as of January 1, 2015, provided that the remaining useful life of the assets shall be one under the original depreciation methodology.

The Bill does not modify the methodology used to amortize goodwill and intangible assets. Also, taxpayers with a volume of business of less than $3,000,000 may still opt to depreciate in one year certain computer equipment and in two years certain transportation equipment.

Following the issuance of Administrative Determination 15-01 (discussed in our Special Bulletin of February 2015), the Bill incorporates the recent determinations related to the deductibility for the use and maintenance of motor vehicles, allowing taxpayers to opt to deduct actual expenses paid or incurred for this concept.

The Bill also introduces two notable changes to the deduction for charitable and other contributions made by corporations ("donations"):

- The donations must be for the use in Puerto Rico (previously was extended to United States and its territories).

- The recipient must be duly certified by the Puerto Rico Treasury Department as an exempt organization under Section 1101.01 of the Code.

The Bill does not make changes to the taxable income limitation (10% without such benefit) nor to the carryover period for excess deductions (5 years).

Other Changes

In addition to the above, the Bill

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eliminated certain exclusions and exemptions from gross income, most of them related to interest derived from certain financial instruments.

The Bill reactivates the moratorium for the use and issuance of certain tax credits. With a few exceptions, the credits subject to the moratorium are the following:

- Act 159-2011 – Solid Waste.
- Act 46-2000 – Capital Investment Funds.
- Act 178-2000 – Santurce Theater District.
- Act 183-2001 – Conservation Easement.
- Act 212-2002 – Urban Center.
- Act 140-2001 – Low or Moderate Income Housing.
- Act 98-2001 –Extraordinary Housing Infrastructure.
- Section 1051.09 – Products Manufactured in PR.

The moratorium is applicable for the taxable years 2015 and 2016 and credits acquired prior to 2015 may be claimed up to 25% of the tax liability. In comparison with the last moratorium, no informative return to detail the available credits seems to be required.

In contrast with the Code, this Bill does not include a provision that allows taxpayers the option to be taxed under any previous Puerto Rico internal revenue code. As such, all taxpayers, including those being taxed under the provisions of the Puerto Rico Internal Revenue Code of 1994 (better known as "Option 94"), shall be taxed under the new provisions.

ATBA Comments

We encourage individual taxpayers to review the changes provided in the Bill to determine their possible impact. Many of the taxpayers will have reduced income tax liabilities; however, if you have a substantial portfolio of investments, you might be impacted by the proposed changes. Our recommendation is that you review your income tax planning strategy based on the proposed changes to see if it requires any modification.

In the case of corporations, the review of the impact should include the possibility of converting to a conduit (pass-through) entity due to the impact of the elimination of the preferential tax rate on dividends. We will provide more information on this topic in subsequent bulletins.

Please be aware that this Bill may be subject to substantial changes as part of the legislative process. We will be issuing a series of Special Bulletins to keep you informed of the latest changes.

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