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Revised Guidelines to the Statutory Requirement to File Audited Financial Statements with the Puerto Rico Tax Return

By: Elisa Vélez-Pérez

Puerto Rico is one of the very few jurisdictions that require certain taxpayers to file Audited Financial Statements (“AFS”) together with the income tax return. Generally, taxpayers in Puerto Rico, including individuals, corporations, and pass-through entities, are required to file AFS with the income tax return if the volume of business generated during the taxable year is \$3 million or more. However, a taxpayer that was not required to file AFS with the income tax return may now be required to comply with this provision following recent changes made by Act 257-2018 to the Internal Revenue Code of Puerto Rico of 2011, as amended (the “Code”). Furthermore, taxpayers below the volume of business threshold of \$3 million are now required to file “Agreed Upon Procedures Reports” (“AUP”) or “Compliance Attestation Reports” (“CA”) prepared by a Certified Public Accountant with a license in Puerto Rico (“CPA”) to claim certain expenses for Alternative Minimum Tax (“AMT”) and Alternate Basic Tax (“ABT”), in the case of corporate and individual taxpayers, respectively. In this issue of our newsletter, we explain the amendments provided by Act 257-2018, commonly referred to as the “Puerto Rico Tax Reform of 2018”, with regards to the requirement to file AFS with the income tax

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return. On Page 4, we also present a summary of the changes of Act 257-2018 with regards to the requirement to file AFS, AUP or CA reports with the Puerto Rico income tax return.

A. Application of the \$3 million volume of business threshold to a group of related entities.

Pursuant to Section 1061.15 of the Code, and Administrative Determinations Nos. 11-13 and 14-07 issued by the Puerto Rico Treasury Department (“PRTD”) on November 16, 2011, and March 12, 2014, respectively (“AD 11-13” and “AD 14-07”), taxpayers with a volume of business of \$3 million or more in a taxable year were required to file AFS with the income tax return of such year. In the case of a group of related entities, the volume of business threshold is determined by the sum of the volume of business of each entity member of the group. Assuming the aggregate volume of business of the *group of related entities* was or exceeded \$3 million, then all entities members of the group were required to include consolidated or combined AFS regardless of their individual volume of business. The requirement to file consolidated or combined AFS was waived if the entities that are members of such group with an individual volume of business equal to or in excess of \$1 million filed stand-alone AFS with their income tax return.

Prior to Act 257-2018, the term *group of related entities* included only corporations and entities taxed as corporations with certain thresholds of common ownership. For example, a wholly-owned subsidiary corporation and its parent corporation would be considered a group of related entities since the parent corporation owned 100% of the voting stock of the subsidiary corporation. However, pursuant to Article 1010.04-1(g)(2) of the Regulations issued under the Code, all pass-through entities (i.e. partnerships, special partnerships and

corporations of individuals) were considered “excluded members” and, therefore, not part of the group of related entities, even if the entity met the threshold of common ownership. So, the volume of business generated by a pass-through entity was not included in the aggregate volume of business to arrive at the \$3 million volume of business threshold.

Following the amendments to the Code under Act 257-2018, the rules stated in Section 1061.15 of the Code, AD 11-13, and AD 14-07 were not significantly modified. In fact, the PRTD’s administrative guidance provided under AD 11-13 and AD 14-07, which application has been in effect since the year 2011, was enacted and included in the Code by Act 257-2018 effective December 10, 2018 (which unless the PRTD issues specific guidelines to that regard, will have an impact on the issuance of AFS for the year 2018 for calendar year taxpayers). However, the definition of the term *group of related entities* was modified by Act 257-2018 to include, not only corporations, but also pass-through entities and foreign entities that, should they be engaged in a trade or business in Puerto Rico, would be considered corporations or pass-through entities subject to tax in Puerto Rico.

Therefore, entities under common ownership that include pass-through entities and/or foreign entities that were not subject to the requirement to file AFS with the income tax return need to re-evaluate if they now would be subject to this requirement. Following the change in the definition of the term *group of related entities* under the Code, the volume of business of the group, as determined under Section 1061.15 of the Code, may have increased beyond the \$3 million threshold subjecting all or some entities members of the group to the AFS requirement. The following examples show entities that will now be required to file AFS:

1. Members of a group of three pass-through entities wholly owned by the same corporation where the entities had each a volume of business between \$1

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Elisa has extensive experience in handling clients’ tax issues including planning and fiscal structuring; dealing with government agencies, providing the tax valuation over proposed or completed transactions, tax compliance and handling requests to oversee agencies, such as petitions for resolutions, closing agreements, exemptions and tax credits, among others.

Elisa has a Bachelor Degree in Business Administration, a Master’s in Business Administration and a Juris Doctor from the University of Puerto Rico. She is admitted to practice law in Puerto Rico and in the United States Court for the District of Puerto Rico. She is a member of the Puerto Rico Certified Public Accountants Society.

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million and \$3 million. In this case, before Act 257-2018 they were not required to file AFS with their income tax return since the volume of business threshold was determined separate for each entity (i.e. together they were not considered a *group of related entities*). Following the amendments of Act 257-2018, all entities would now be required to file AFS together with their income tax returns since the aggregate volume of business of the *group of related entities*, considering its modified definition, now exceeds \$3 million.

2. A corporation, with a volume of business that exceeds \$3 million, that owns a limited liability company taxed as a partnership with a volume of business between \$1 million and \$3 million. In this case, the partnership was not required to file AFS, but following the amendments of Act 257-2018, will be required to do so from the year 2018 and thereon.¹

The requirement to file AFS comes hand in hand with the requirement to file certain supplementary information certified by the same CPA that certified the AFS pursuant to Section 1061.15(b) of the Code and Administrative Determination No. 14-06 issued by the PRTD on March 6, 2014 (the "Supplementary Information Report"). Therefore, if an entity is now subject to the requirement to file AFS, it will also be required to file the Supplementary Information Report. Also, Act 257-2018 established that if the entity is required to file AFS, its income tax return should also be reviewed by a CPA with a license in Puerto Rico.

B. New filing requirement of AUP or CA report for entities below the \$3 million volume of business threshold.

Entities not required to file AFS under the rules previously discussed, may nonetheless be required to file a AUP

or CA report to deduct certain expenses for AMT, in the case of corporations, or ABT, in the case of self-employed individuals. Also, if the entity wants to request a waiver from the 10% withholding tax on services provided (the "10% Waiver"), which we addressed in our February 2019 newsletter, the entity will now be required to file the AUP or CA report.

Act 257-2018, also modified Sections 1021.02 and 1022.03 of the Code, to limit the deduction on certain expenses for ABT and AMT purposes, unless the taxpayer includes with the return an AUP or CA report prepared by a CPA with license in Puerto Rico. In the case of individuals, to claim the disallowed expenses, the CPA should certify that the expenses incurred are ordinary and necessary expenses related to the self-employment income. Examples of disallowed expenses are: vehicle expenses, travel expenses, and the deductible portion of meal and entertainment expenses, among others. The PRTD, together with the Puerto Rico Society of CPA's, are working on the guidelines to be followed by CPA's to complete the required report. Such guidelines should address the content of the AUP or CA report, clarify if the CPA can certify in the AUP or CA report only a portion of an expense, and if the voluntary filing of AFS will waive the requirement to file the AUP or CA reports.²

Entities required to file AFS with the return are not required to file the AUP or CA report and may claim the same expenses for AMT and ABT, as applicable, as for regular tax purposes. Therefore, the requirement to file the AUP or CA report will apply to entities (and to each member of a *group of related entities*) with a volume of business of less than \$3 million, and to entities with a volume of business of less than \$1 million that are members of a *group of related entities* with an aggregate volume of business that exceeds \$3 million. For instance, in example #2 above, if the partnership had a volume of business of less than \$1 million, then the partnership would be subject to the AUP or CA requirement.

ATBA Comments:

The PRTD has still yet to issue official guidelines with regards to the application of the changes in the definition of the term *group of related entities* to the requirement to file AFS together with the income tax return. For example, the changes are effective on the date Act 257-2018 was signed into law, which was December 10, 2018. Will this change be applicable to the returns for the taxable year 2018 or would it apply to the taxable year 2019 like many other provisions of Act 257-2018?³ In the case of foreign corporations, will the volume of business include gross income not from Puerto Rico sources to determine if the \$3 million volume of business threshold is met? Does the volume of business include the distributable share of a pass-through entity's net income to determine if the \$1 or \$3 million volume of business threshold is met? We expect future PRTD's guidance to address these and other issues.

Note that the requirement to file the AUP or CA report is different from the requirement to file AFS with the income tax return. If the entity is required to file AFS, but does not file them when filing the income tax return, the return may be considered as filed incomplete until such statements are filed with the PRTD, and penalties for not filing, or for filing the return incomplete, may be applicable. Therefore, the AFS are an integral part and a required attachment of the filed income tax return. On the other hand, if an entity not required to file AFS does not file the AUP or the CA, the "penalties" will be that the taxpayer cannot claim certain expenses for AMT or ABT purposes, and that the taxpayer will not be eligible for the 10% waiver. Not filing the AUP or the CA will not deem the return as filed incomplete.

Since the non-deductibility of the expenses for AMT or ABT purposes may not result in a higher tax responsibility, the taxpayer must determine if the filing of the AUP or CA report is cost-effective. Such analysis should also consider the desire to obtain a 10% Waiver.

Other returns applicable to entities doing business in Puerto Rico, such as the personal property tax return, the volume of business declaration, and the corporate annual report (applicable to corporate

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taxpayers), also require to include AFS when the volume of business of such entity exceeds \$3 million. However, it should be noted that for these other returns the \$3 million of volume of business threshold is calculated on a stand-alone basis, and the rules previously discussed, with regards to the determination of the volume of business in the case of a *group of related entities*, are not applicable. Similarly, the AUP or CA report is not required to be filed with these other returns.

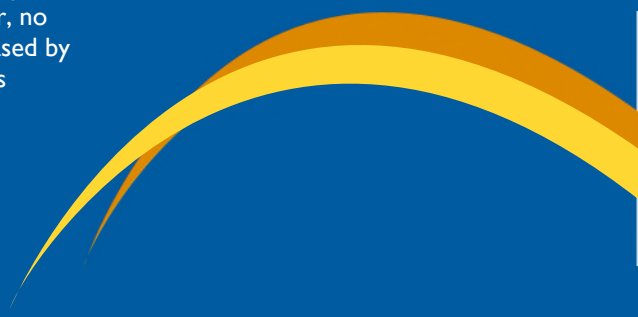
At ATBA, we have experienced tax specialists who may assist you in determining if you or your company are required to file AFS, AUP or CA with the applicable tax returns. Contact us to seek further guidance with regards to these and other tax and business topics.

Notes:

¹ Please refer to our ATBA comments section for our thoughts on the effective date of this requirement.

² High-end officials of the PRTD has unofficially stated that the voluntary filing of AFS will waive such requirement. However, no formal communication has been issued by the PRTD to this regard.

³ High-end officials of the PRTD have unofficially commented that these changes will be made applicable administratively for the taxable year 2019 and thereafter. However, no official guidance has been released by the PRTD as of the date of this newsletter.



Effects of Act 257-2018 - Summary

Entities with:	Before Act 257-2018	After Act 257-2018	Comments
Volume of Business of Less than \$1 million.	Not required to submit AFS.	Not required to submit AFS. Required to submit AUP or AC report to claim certain expenses for AMT or ABT and to request a partial waiver from the 10% withholding over rendered services.	Entity should evaluate if AUP or AC report is cost-effective.
Volume of Business between \$1 million and \$3 million.	Required to submit AFS only if a member of a group of related entities with an aggregate volume of business of \$3 million. If a pass-through entity, it was not required to submit AFS. AFS were required to request the waiver from the income tax withholding on services rendered.	Required to submit AFS only if a member of a group of related entities with an aggregate volume of business of \$3 million. Pass-through entities are subject to this rule also. If AFS are not applicable, then it will be required to submit AUP or AC report to claim certain expenses for AMT or ABT. AFS, AUP or CA are required to request the waiver from the income tax withholding on services rendered.	Pass-through entities and entities members of a group of related entities that include a foreign entity that were previously not required to submit AFS should re-evaluate if they are now required under the revised rules to file AFS. If they are still not required, the entity should also evaluate if filing an AUP or AC report is cost-effective.
Volume of Business of \$3 million or more.	Required to submit AFS.	Required to submit AFS. Not required to submit AUP or AC.	At a minimum, the income tax return will be required to be revised by a CPA.

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