

## TAX REFORMS

### New Concepts Introduced by the Tax Reform

By: Juan Zaragoza-Gómez

This is the third of a series of newsletters issued with the objective of assisting our clients and friends in making sense of the changes in the Proposed Tax Reform (House Bill 1544 filed on April 16, 2018, hereinafter the "Proposed Legislation or the Bill").

In the first two newsletters we analyzed the viability of the Proposed Legislation in the context of certain fiscal tests that must be met for the changes to become effective and the fiscal impact at the taxpayers' level (i.e. net increased tax savings or net increased tax burden).

In this newsletter we will discuss various new concepts introduced in the Proposed Legislation that merit a detailed discussion since they represent, either a significant shift from previous tax legislations, or an expansion of concepts which had been previously introduced, but with limited scope.

#### FLAT TAX

For decades, both at the local and Federal levels, tax authorities have considered the possibility of establishing a flat tax. The "flat tax" is an income tax system in which everyone

**Alvarado Tax & Business Advisors LLC** is a Limited Liability Company organized under the laws of Puerto Rico and is engaged in providing tax and business advisory services. We are a multidisciplinary tax and business advisory professional service firm, unencumbered by the constraints of an association with an auditing firm, and the regulatory and disclosure rules of the Security and Exchange Commission.

Backed up by years of unmatched hands-on experience in public accounting, government and corporate tax, our team of tax consultants has redefined the market by providing professional tax and business advisory services through our "top-heavy" structure, designed specifically to provide high level tax consulting to our clients on a more personalized basis.

For information visit us at: [www.alvatax.com](http://www.alvatax.com) or contact one of our Tax Professionals for an appointment:

**Ph. (787) 999-4400**  
**E. [taxadvisors@alvatax.com](mailto:taxadvisors@alvatax.com)**

**Alvarado Tax & Business Advisors is part of Taxand**, the World's largest independent tax consulting organization.

**New Concepts Introduced by...  
Continued from Page 1**

pays the same tax rate regardless of the amount of taxable income. This system eliminates deductions, tax credits and most exemptions, which in theory curbs biases towards certain behaviors and activities.

The Proposed Legislation incorporates a concept similar to a flat tax imposed on gross income for two types of taxpayers engaged in the rendering of services: self-employed individuals and corporations. To qualify, all their income must be entirely derived from the rendering of services, be reported on informative returns, and be subject to the applicable income tax withholding. This flat tax is elective and not mandatory.

The flat tax rate imposed is a single rate depending on the taxpayer's gross income level. In this sense it departs from the traditional concept of progressive rates where the first dollar earned is subject to a lower tax rate than the last one. The rates will be as follows:

<b>GROSS INCOME LEVEL</b>	<b>TAX RATE</b>
Up to \$100,000	5%
More than \$100,000 but not more than \$200,000	10%
More than \$200,000 But no more than \$500,000	15%
More than \$500,000	20%

As already indicated, this flat tax is elective. Therefore, the taxpayer's inclination to select it will depend on the potential benefit as compared to the tax burden imposed under the regular tax system and the revamped minimum tax mechanisms for individuals and corporations. Under these mechanisms, traditional tax deductions will be either limited or subject to informative return requirements.

**EXPANDED USE OF MINIMUM TAX MECHANISMS UNDER THE BILL**

Since the 1987 Tax Reform, our corporate and individual income tax structures have included a mechanism to ensure taxpayers pay a minimum amount of tax.

From the corporate standpoint, the alternative minimum tax ("the AMT") was traditionally designed to capture the benefit of the timing in the recognition of certain income and expense items. Lately, the AMT was expanded to address certain transfer pricing issues. Under the Bill, the corporate AMT is expanded to include a third objective, increase enforcement on the expense side of small and medium size businesses (referred to as the "PYMES" due to its Spanish acronym).

Under the proposed amendments, corporate taxpayers with revenues of less than \$3,000,000 will have their ability to claim trade or business deductions impaired unless they submit with their income tax return audited financial statements or an Agreed Upon Procedure ("AUP") which will be designed to apply certain tests on the expenses of these businesses. Businesses with revenues of \$3 million or more will not be subject to these provisions since they are already required to submit audited financial statements with their income tax returns. Therefore, as discussed in our previous newsletter, most of the incremental corporate taxes of \$286 million per year imposed on corporations once the Bill is approved and enacted will fall on the PYMES.

From the standpoint of individual taxpayers, the alternative basic tax (the "ABT") was originally designed to eliminate the benefit of itemized deductions. Lately, it evolved to reduce the tax benefit of certain types of exempt income items. However, since its inception, it has always been directed toward high income earners (currently applicable to individual taxpayers with net income subject to ABT of at least \$150,000).

Under the Bill, the ABT is first expanded to apply to individual taxpayers with income in excess of just \$25,000, a significant deviation from its original purpose. In addition, its scope is expanded to increase enforcement on self-employed individuals. This is done by significantly limiting the taxpayer's ability to claim expenses unless the income tax return includes an AUP certifying the validity and accuracy of the expenses claimed. Therefore, as discussed in our previous newsletter, most of the incremental individual taxes of \$158 million per year imposed on individuals (related to the ABT), once the Bill is approved and

**ABOUT THE AUTHOR  
Juan Zaragoza Gómez**

Juan is a Member and Co-Founder of Alvarado Tax & Business Advisors LLC (formerly Zaragoza & Alvarado LLP) with over thirty years of experience in the corporate and individual tax advisory areas and as instructor in tax issues.

From November 2014 to December 2016 Juan served as Secretary of the Treasury for the Government of Puerto Rico. During such period he also served as a member in several government boards such as the Government Development Bank, Teachers Retirement System, Puerto Rico Industrial Development Company, among others.

Among other professional experiences Juan adds to his resume being Partner in Charge of Arthur Andersen's San Juan Tax Practice, President of the Puerto Rico Certified Public Accountants Society and Assistant Secretary for Internal Revenue at the Puerto Rico Treasury Department. Over the years he has also participated in several advisory municipal and state committees regarding Tax Reforms, Sales and Use Tax and Municipal Revenue Collection among other tax topics.

Juan has a Master's Degree in Business Administration from Indiana University at Bloomington and a Bachelor Degree in Business Administration from the University of Puerto Rico.

enacted, will fall on the self-employed individuals.

**EXPANDED USE OF CPA'S TO ASSIST IN TREASURY'S ENFORCEMENT**

For decades the P.R. income tax provisions have required the filing of audited financial statements together with the income tax returns of business entities, subject to compliance with certain gross income threshold.

**New Concepts Introduced by...  
Continued from Page 2**

The use of reports issued by Certified Public Accountants participating in Peer Review Programs ("CPAs") in assisting Treasury with its enforcement efforts was significantly extended four years ago by requiring those taxpayers already required to file audited financial statements to submit certain supplementary information in the nature of Agreed-Upon Procedures ("AUP") or a Compliance Attestation Report ("CAR").

The Bill expands dramatically the use of the CPA's in assisting Treasury on its compliance efforts. We have identified 11 provisions where the taxpayer can benefit by subjecting itself or its business to certain attestation procedures by a CPA or where the intervention of a CPA is required. These provisions can be grouped as follows:

- Options to claim the same expenses as those for regular income tax purposes in the case of taxpayers subject to the corporate AMT or the individuals' ABT, provided an AUP or CAR is submitted with the income tax return;
- Option to obtain a waiver on income tax withholding on services for businesses with gross sales of \$1 million or more with the filing of an AUP or CAR instead of audited financial statements;
- Requirement to have a CPA sign the corporate income tax return as preparer or reviewer;
- Option to file together with not-for-profit application an AUP- even though it is not provided in the Bill, we believe it is with the intention to expedite the income tax exemption approval process;
- Option to file a CAR together with a license application to benefit from an expedited approval process;
- Authorization to the Secretary to accept a CAR instead of carrying out a full audit of Large Taxpayers (as such term is defined in the Bill); and
- Requirement for those taxpayers already required to submit audited financial statements to complete a new

addendum to the income tax return disclosing "uncertain tax positions."

**ATBA Comments**

It will be interesting to see how self-employed individuals and service-based corporations react to the option of paying their taxes based on a flat tax system. At the end it will really depend on the expense structure of their businesses and of the "validity" expenses traditionally claimed, since the other option is to be subject to an AUP certifying the quantity and validity of those expenses.

The use of the AMT and ABT as mechanisms to increase compliance among PYMES and individuals that are service providers will certainly impose a significant compliance burden on those taxpayers since they will have to elect to be subject to a new level of attest services by CPAs. In addition, as discussed in our previous newsletters, it is estimated that these two provisions will generate approximately \$450 million in new taxes to this group of taxpayers, which needless to say is an extremely significant amount imposed to a group of taxpayers with traditionally low financial resources.

Finally, in general terms, we agree with the extended use of CPAs to assist Treasury with their compliance efforts. However, the Bill must make a delicate balance between that and the impact of these requirements on other professionals such as accountants, tax experts and CPA's that are not members of a Peer Review program, which, as the Proposed Legislation was submitted, will be excluded from providing such services.

**Continues on Page 4**

**We are Green. Are You?**



Please consider the environment before printing this publication.

**Key Contacts at  
Alvarado Tax &  
Business Advisors LLC**

**Juan A. Alvarado-Zayas, Esq.,  
CPA**

Managing Member  
787-620-7730  
jalvarado@alvatax.com

**Juan Zaragoza-Gómez, CPA**

Member  
787-620-7740  
jzaragoza@alvatax.com

**Felipe Mariani-Franco, CPA**

Member  
787-620-7736  
fmariani@alvatax.com

**Sandra Marie Torres-Martínez,  
CPA**

Member  
787-620-7728  
storres@alvatax.com

**Edgardo Sanabria-Valentín,  
CPA**

Member  
787-999-3015  
esanabria@alvatax.com

**Carlos R. González-Martínez,  
CPA**

Member  
787-620-7739  
cgonzalez@alvatax.com

**César De Jesús-Umpierre, CPA**

Member  
787-620-7734  
cdejesus@alvatax.com

**Alvarado Tax & Business  
Advisors LLC**

104 Acuarela Marginal Street  
Martínez Nadal Expressway  
Guaynabo PR 00969

PO Box 195598  
San Juan PR 00919-5598

T. 787.999.4400  
F. 787.999.4646

E. taxadvisors@alvatax.com  
www.alvatax.com  
www.taxand.com

**Tax Is Our Business®**

This publication supports Alvarado Tax & Business Advisors' marketing of professional services. It is intended for information purposes only and should not be regarded as written advice or recommendation to undertake any position, tax related or otherwise. Readers should not consider the information contained in this publication to be complete, nor act solely on the basis of the material contained herein. Moreover, due to changing laws and associated authoritative literature, that information may not continue to apply to a reader's situation. Therefore, we encourage the readers to contact us or another qualified professional advisor to thoroughly evaluate their specific facts and circumstances; to determine if any information contained in this publication remains valid and; to discuss the potential application of such information to their particular situations.



As provided in Department of Treasury Circular 230, this publication is not intended or written by Alvarado Tax & Business Advisors, to be used, and cannot be used, by a reader or any other person or entity for purposes of avoiding tax penalties that may be imposed on any taxpayer under the Internal Revenue Code.