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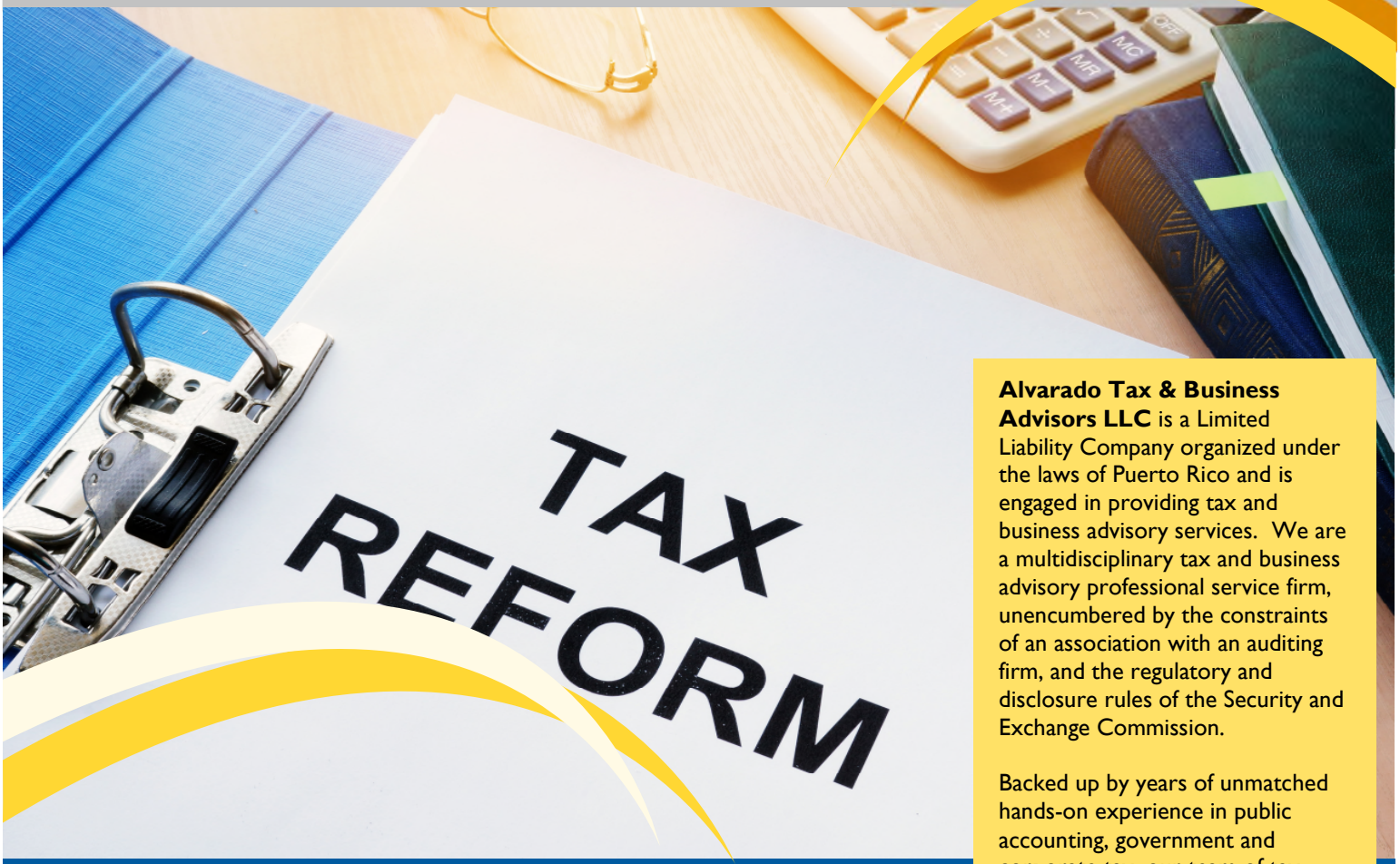

Viability of the Tax Reform

By: Juan Zaragoza Gómez

On April 16, 2018 House Bill 1544 ("in Spanish P. de la C. 1544", hereinafter referred to as the "Proposed Legislation or the Bill") was filed at the House of Representatives of Puerto Rico, to simplify the tax system and promote economic development. The Bill includes provisions affecting individual and corporate income, excise, as well as, and sales and use taxes among other areas.

This is the first of a series of newsletters directed to assist you in making sense of the proposed amendments and be able to quantify the final effect on your personal tax burden or the one of your business. Therefore, we will not be providing just a laundry list of the proposed changes but, instead, will analyze them to identify risks and opportunities for our clients.

VIABILITY OF THE PROPOSED LEGISLATION

Considering the existing fiscal and economic crisis in Puerto Rico, the first issue we will be addressing is the conditions imposed by the Proposed Legislation and the New Fiscal Plan for Puerto Rico, as certified by the Financial Oversight and Management Board for Puerto Rico ("the Board") on April 19, 2018 (the "Fiscal Plan") for the Proposed Legislation to

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become effective. The interplay of the provisions included on both documents provides a framework of fiscal responsibility tests that will be necessary to be met for the tax relief measures to become effective.

Fiscal Responsibility Tests under the Proposed Legislation

The proposed changes to the tax system will be effective, as a general rule, for taxable years beginning on or after January 1, 2019. This is, at the mid point of the Government's Fiscal year ending June 30, 2019.

For the income tax rate reductions applicable to corporations and individuals to become effective the following tests must be met (collectively referred to as the "First Test"):

- General Fund Revenues for Fiscal Year 2017-18 must exceed the budget by 2%.
- General Fund Revenues for the first four months of Fiscal Year 2018-19 must exceed by 3% the budgeted amount.
- Any excess of revenues over the budget for the above periods must be deposited in a special fund to subsidize tax reductions.
- If requirements #1 and #2 are not met, the Bill authorizes the Puerto Rico Secretary of the Treasury ("Secretary") to adjust the tax reductions to the amounts accumulated in the special fund.

In addition, the proposed rate reductions in the sales and use taxes area are subject to their own fiscal responsibility test as follows:

- The proposed rate reductions must be financed by a reduction in tax credits and incentives provided in special acts (i.e. not by the P.R. Internal Revenue Code of 2011, as amended), based on the amounts accounted for such items in the Government's Budget for Fiscal Year 2017-18.

Finally, the Bill authorizes the Secretary to reduce the budgeted amount of tax credits and incentives as considered necessary to finance the proposed tax reductions. Furthermore, the Secretary is also authorized to impose new non tax revenue measures if a revenue shortfall is expected upon the effectiveness of the tax reduction measures.

Fiscal Responsibility Tests under the Fiscal Plan

From a broad perspective, the Fiscal Plan requires that the tax reduction initiatives be financed by a series of measures, including:

- The creation of a minimum flat tax withholding at source regime for self-employed individual service providers and service based companies;
- Expanded use of corporate and individual alternative minimum tax mechanisms; and
- Reduction of deductions, credits and cash grants.

Furthermore, the Fiscal Plan requires the Fiscal Responsibility Tests in the Proposed Legislation to follow the guidelines below:

1. Implementation of the changes must be made sequentially, with the Government ensuring the reductions are paid for before rates are reduced;
2. The Government must submit quarterly reports to the Board measuring the performance of the tax initiatives and the offsetting revenue generation or cost reduction measures;
3. The Proposed Legislation must include specific measures to restore revenue neutrality which must be structured so that no further legislation will be required;
4. Revenue neutrality can only be reached on categories and legislation related to the Bill's proposed tax initiatives and cannot be reached by outperforming the baseline, improving compliance or including the general expense categories; and
5. Reduction in taxes will be reversed in cases of non-compliance and failure to meet revenue neutrality.

ATBA Comments

Contrary to fiscal revenue tests included in previous tax legislations, these ones are pursuant to a Fiscal Plan as approved and monitored by the Board. The Board is a non governmental entity imposed by Federal Legislation in 2016. Therefore, strict compliance with the tests will be required by the Board until fiscal year 2025-26 as provided under the Fiscal Plan.

The P.R. Government has a long history of revenue shortfalls on its Fiscal Year Revenue Budgets. Based on

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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.

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P.R. Treasury's press release of April 20, 2018, there is a cumulative shortfall of revenues versus the budget for the first nine months of the fiscal year (FY 17-18) of $380.9 million or 5.8% of the budgeted amount. This shortfall imposes a challenge with respect to a possible compliance with the First Test under the Proposed Legislation.

It is pertinent to point out that the provisions that are subject to suspension or partial implementation due to failure of the above-mentioned tests are those related to tax rate reductions. Other provisions that increase the tax burden of individual or corporate taxpayers will become effective on January 1, 2019 regardless of any revenue shortfall.

With regard to the Fiscal Plan requirement to include specific automatic revenue raising provisions in the case of a shortfall, it is not clear whether it will be considered complied with by the inclusion of the general authority granted to the Secretary to reduce exemptions and credits as well as to impose new non-tax charges in the case of a shortfall.

Finally, this provision granting the Secretary quasi-legislative power by allowing him to amend laws to reduce or eliminate incentives and or credits to more of a dozen industries that currently enjoy those benefits, without going through the Legislature, may be subject to challenge in the legislative process as it may be seen as an intrusion to the legislative branch's prerogatives.

If you need to analyze any specific tax impact the Proposed Legislation may have or your business or individual tax return, please contact us as our tax professionals can run these estimates for you.

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