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Special points of interest:

- Supreme Court Opinion on Taxation of Separation Payments Under Act No. 80
- IRS to Require Reporting of Uncertain Tax Positions

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Puerto Rico Supreme Court Issues Opinion Regarding Taxation of Separation Payments Under Act No. 80

By Rafael Carazo

In 2009, the Puerto Rico Supreme Court (the "Court") issued an opinion in connection with an issue which had been present for a long time: what is the income tax treatment of payments received prior to 2006, by an employee under Act No. 80 ("Act 80")[1] upon his/hers separation from employment. In this article, we will discuss that decision.

I. Applicable Law

A. Labor Law

Act 80 provides, among other things, that a compensation must be paid to employees who are dismissed without just cause.[2] Said compensation cannot be subject to any payroll deductions[3] and must be delivered in full to the employee.[4] Among the payroll deductions applicable in Puerto Rico are: (1) Puerto Rico income taxes, and (2) U.S. Social Security ("FICA") taxes.5 In 2008, Act 80 was amended6 to provide that amounts received by an employee upon a justified dismissal7 (not a dismissal without just cause) will be considered a special compensation8 and will be exempt from Puerto Rico income tax withholding and the payment of Puerto Rico income taxes.9

B. Tax Law

The Puerto Rico Internal Revenue Code (the "PRIRC")10, as originally enacted, provided, among other things, that amounts received as compensation for personal injuries or sickness, and any damages received as a result of such injuries, were excluded from gross income and, thus, were not subject to Puerto Rico income taxes, including income tax withholding.11 It also provided that compensation paid under Act 80 was not wages and, therefore, was not subject to income tax withholding at source.12 In 2006, PRIRC Section 1022(b)(5) was amended to provide that only the compensation for personal physical injuries or physical sickness is excluded from gross income.13

II. Background History

Many taxpayers who received compensation under Act 80 (as a result of a court action or a release/settlement agreement) excluded the amount received from gross income and did not pay income taxes thereon. They argued that the compensation received under Act 80: (1) was not subject to income tax withholding (as provided by both Act 80 and the PRIRC), and (2) was not subject to Puerto Rico income tax (because it was not subject to income tax withholding at source and was compensation received for personal damages resulting from the unjustified dismissal).

The Puerto Rico Secretary of the Treasury (the "Secretary"),

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however, had a different position regarding said matter. In the Administrative Determination 98-01 (the "AD 98-01"), she indicated that compensation received pursuant to Act 80 is not considered compensation for personal injury or sickness (as required by PRIRC Section 1022(b)(5)), and, accordingly, is gross income subject to Puerto Rico income taxes.

Some taxpayers, however, did not agree with the AD 98-01 and continued to exclude from gross income the compensation received upon termination of employment from a claim under Act 80 or pursuant to a release/ settlement agreement including, among others, a possible action under Act 80. The controversy reached the Puerto Rico Circuit Court of Appeals (the "Circuit Court") which considered the income tax treatment of certain payments that an employee received as compensation, upon entering into a release agreement (the "Agreement") with his employer in connection with the termination of his employment covering, among others, a possible claim under Act 80.14 In that case, the Circuit Court rendered a judgment in which it stated that the purpose of the Agreement was to prevent a possible court action under Act 80 and any other applicable acts, and determined that the amount received was not wages, and that it provided compensation for a harm done or a loss sustained as a result of the termination of employment. Based on that, and on the provision of the PRIRC that exempts compensation for personal injuries from income taxes,15 it concluded that the amount received by the employee was exempt from the payment of income taxes. Said judgment was not appealed by the Secretary to the Court.

The Secretary, however, did not agree with that judgment, and in 2007 issued the Administrative Determination 07-01 (the "AD 07-01") which, among other things, reaffirmed that compensation received under Act 80, although not subject to income tax withholding, is gross income subject to Puerto Rico income taxes.

Various taxpayers, based on the Circuit Court decision, continued to exclude from gross income amounts received upon termination of employment, which resulted in income tax deficiencies issued by the Secretary and court actions by the taxpayer contesting them. One of those actions reached the Court and is the subject of the opinion that is analyzed herein.

III. Orsini vs. Secretario de Hacienda16

A. Relevant Facts

In the Orsini case, the Supreme Court considered the following facts.

Mr. Francisco Orsini (the "Employee") worked for a pharmaceutical corporation (the "Employer") and after 10 years of service, he was dismissed in 2003. As part of the dismissal process, the Employer offered him certain amount of money if he signed a document entitled Release Agreement (the "Agreement"). Pursuant to the Agreement, the Employee would release the Employer from any responsibility that it may have in connection with his employment and its termination. On the same date that the Employee signed the Agreement, the Employer gave him the agreed amount (approximately $163,000, the "Compensation") upon which it withheld approximately $32,000 of Puerto Rico income taxes.

In the income tax return for taxable year 2003 (the taxable year in which the Employee received the Compensation), the Employee reported the Compensation as income and paid Puerto Rico income taxes thereon. Subsequently, he filed an amended income tax return for said taxable year in which he excluded the Compensation and requested a refund of approximately $32,000 (the amount of income taxes that was withheld by the Employer). As basis for his claim for refund, the Employee argued that the Compensation was not wages, thus, was not taxable and, therefore, that the Employer improperly withheld income taxes from it. The Secretary denied the refund that the Employee claimed in his amended income tax return, and, instead, issued a final notice of deficiency in connection therewith.

The Employee, on his part, filed a complaint in trial court contesting the deficiency, in which he raised the same arguments presented to the Secretary in support of the refund claim. The Secretary opposed the complaint arguing that the amount received was neither compensation in connection with a personal injury or sickness (as required by PRIRC Section 1022(b)(5)) nor compensation for damages under to the Civil Code. Therefore, he concluded, the Compensation was taxable.

The trial court decided in favor of the Secretary. The Employee, however, appealed to the Circuit Court, which revoked the trial court's judgment and ordered the Secretary to reimburse the income taxes the Employee paid in connection with the Compensation. The Secretary did not

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Food for Thought...

Ever wonder why the IRS calls it Form 1040? Because for every $50 that you earn, you get 10 and they get 40.
Author Unknown

Did you ever notice that when you put the words "The" and "IRS" together, it spells "THEIRS?"
Author Unknown

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agree with said decision and filed a petition for review with the Court, which was granted.

In a unanimous decision, the Court held, among other things, that the Compensation was not taxable for Puerto Rico Income tax purposes.

B. Criteria for Interpretation to be Applied

Initially, the Court discussed the criteria to be used while interpreting the issue presented in the case, which involved a tax (the PRIRC) and labor legislation (Act 80). According to the Court, the labor legislation should be interpreted liberally, while the tax statutes regarding exclusion from gross income (such as PRIRC Section 1022(b)(5)) must be interpreted restrictively. The Court found that it is not clear if under the PRIRC, the compensation received under Act 80 is excluded from gross income or not. Therefore, the Court indicated that it will interpret those two acts so that the legislative intent of the PRIRC provision can be achieved.

The Court stated that all types of compensation paid upon a dismissal have the same objective: to respond for the damages caused from the loss of employment. It further indicated that payments under Act 80 (the "mesada") result from the legal obligation that the employer has to compensate an employee for an unjustified dismissal. The Court then concluded that the compensation received by the Employee under the Agreement was a payment under Act 80.

C. Income Tax Treatment

Finally, the Court discussed the income tax treatment of the compensation paid under Act 80. It accepted that the definition of gross income under the PRIRC is broad, and that for an item to be considered gross income it must be a gain, a benefit or income produced by or resulting from work or capital or income derived from any source. The Court affirmed that wages are subject to income tax withholding, but that payments under Act 80 are not wages and that no payroll withholding shall be made therefrom. In this respect, the Court cited the case of Alvira Cintrón vs. SK&F[17] in support of the conclusion that payments under Act 80 are not subject to FICA tax withholding.

The Court then considered whether the compensation paid under Act 80 is income derived from any source and, thus, gross income upon which the taxpayer must pay income taxes. In this respect, it indicated that compensation received for personal injuries is not gain and is not subject to income taxes. Under that frame of mind, the Court analyzed the DA 98-01 and concluded that the interpretation made by the Secretary therein is extremely unjustified and restrictive.

The Court, then, entered into a discussion of PRIRC section 1022(d)(5). In this respect, it analyzed the term "damages" and concluded that the concept is applicable to a dismissal because it has adverse effects in the life of an employee who is dismissed. Based on that, the Court concluded that the dismissal payments under Act 80 resulting from a judicial claim or out of court settlement are exempt from income taxes since they qualify for the exclusion from gross income applicable to the compensation which pretends to make whole for a personal injury or sickness.

IV. Consequences of the Decision

After the Court's decision in Orsini it is clear that amounts received by an employee under Act 80, resulting from a court action by the employee or from a release/settlement agreement between an employee and his/her employer, prior to the effective date of Act 117 (see note 13), is not gross income and is not subject to Puerto Rico income tax withholding nor the payment of income taxes. In view of that, taxpayers who received Separation Payments and paid income taxes thereon should consider whether to file a claim for refund, if the statute of limitations for filing such claim has not expired.

Since the case involved a payment that was received before Act 117 amended Section 1022(b)(5), it is not clear what is the tax treatment if such type of payment is received after the effective date of the amendment. It is not clear either if dismissal payments that are not related at all to Act 80 will have the same tax treatment as that given to the Employee in the case. Finally, since the Court cited with approval the Alvira case (notwithstanding the federal law and the expressions of the Puerto Rico Federal District Court to the contrary (see note 17)), it is not clear if for Act 80 purposes, payments made thereunder can be subject to FICA tax withholding, nor the possible consequences if the employer makes such withholding.

Footnotes

1 Enacted on May 30, 1976.
2 Article 1 of Act 80.
3 Article 10 of Act 80, added by Act 16 of May 21, 1982.
4 *Idem.*

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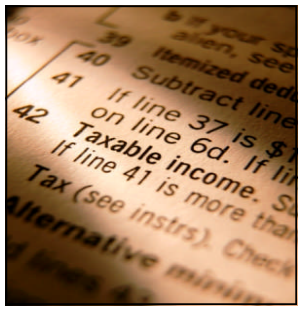

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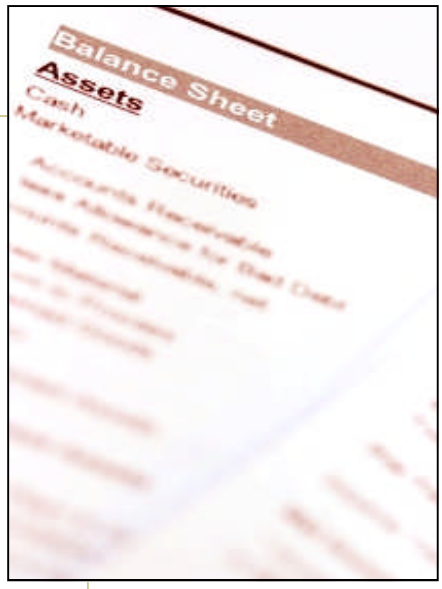
5 The deductibility of FICA taxes on payments made under Act 80 has been discussed in cases considered by the Puerto Rico Supreme Court and the U.S. District Court for the District of Puerto Rico, which are mentioned later herein.
6 Act No. 278 of August 15, 2008 ("Act 278").
7 Among the dismissals considered justified are those resulting from a partial or total termination of operations, and from employment reductions due to a decrease in production output.
8 See Article 7 of Act 80, as amended by Act 278.
9 See Article 10 of Act 80, as amended by Act 278.
10 Act No. 120 of October 31, 1994.
11 PRIRC Section 1022(b)(5).
12 PRIRC Section 1141(a)(1)(G).
13 Act No. 117 of July 4, 2006.
14 Edwin García Pérez vs. Secretario de Hacienda, Case No. KLAN 200100885, October 31, 2001.
15 PRIRC Section 1022(b)(5).
16 Francisco J. Orsini García vs. Secretario de Hacienda, December 18, 2009.
17 In Juan Alvira Cintrón vs. SK&F Laboratories Co., 97 JTS 40, April 4, 1997, the Court held that the compensation paid under Act 80 is not subject to FICA tax withholding. However, the U.S. District Court for the District of Puerto Rico has stated that said conclusion is contrary to Federal law, and that the issue of FICA tax withholding is a Federal law issue; Juan Cancio de Jesús, Civil No. 98-1147, January 18, 1999, page 18, footnote 7, and Rivera vs. Baxter, Civil No. 02-228.

What the…? A Compilation? Are you Crazy?

By Felipe Mariani

On December 16, 2009, the Governor of Puerto Rico signed into law the General Corporation Law. The law requires all corporations to include with their corporate annual report an audited balance sheet signed by a CPA licensed in Puerto Rico. Nevertheless, non-for-profit corporations, corporations without capital stock and for profit corporations with revenues that does not exceed $3,000,000 do not have to file their corporate annual reports with audited balance sheets. However, those corporations which revenue does not exceed $3,000,000 will be required to file with their corporate annual reports a compiled balance sheets signed by CPA licensed in Puerto Rico. No wonder that the client reacted as it did (see title of this article) when we informed him that he had to include a compiled balance sheet signed by a CPA licensed in Puerto Rico with the corporate annual report for his almost inactive corporation.

The compiled balance sheet requirement is certainly the most controversial change of the General Corporation Law because it requires companies which before did not had to engage a CPA (mainly domestic corporations with revenues which did not exceed $1,000,000 and non-for-profit corporations) to incur the additional costs. The law is also not clear in what it means by compiled balance sheet. There is a controversy whether the compiled balance sheet includes or does not includes notes. The Puerto Rico Certified Public Accountant Society has informed its membership that the compiled balance sheet does require that the notes be presented with it. The inclusion of notes to the compiled balance sheet most probably will impact the cost of the compiled balance sheet increasing the dissatisfaction of the small business community with requirement.



This dissatisfaction with the compilation requirement by the small business community has prompted the Puerto Rico House of Representative and the Senate to present two different bills trying to eliminate the requirement. House Bill 2470 provides for an increase of the audited balance sheet requirement from $3,000,000 to $5,000,000 and, ironically, establishes a voluntary compilation requirement for corporations with revenues under $5,000,000. On the other hand, Senate Bill 1422 leaves

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intact the $3,000,000 audited balance sheet requirement but eliminates the requirement to provide compiled balance sheet when the revenues is lower than $1,000,000.

Another area of controversy with the General Corporation Law is the determination of the Puerto Rico Department of State to reduce the time granted with the extension of time to file the corporate annual report from 90 days, the maximum allowed, to 60 days. This reduction of time granted for the extension is significant when it is taken into consideration that the General Corporation Law is a recent law with some new requirements. Also, the 30 days reduction to the extension reduces the time for the Puerto Rico Legislature to consider and approve a bill amending or eliminating the compilation requirement.

Fortunately, the Department of State issued a notice informing that they will grant an additional extension of time to file the annual report of 30 days with the payment of the filing fee for those corporations that do not have compilation or audited balance sheet before the date of expiration (June 14, 2010) of the first extension of time to file the annual report.

Companies will need to decide whether to request an extension and wait for an amendment to the compilation requirement or go ahead with the preparation of the compiled balance sheet. However, companies which choose the extension route run the risk of not having enough time to complete the compiled balance sheet if one of the bills amending the General Corporation Law is not approved.

What? Wow! IRS to Require Reporting of Uncertain Tax Positions

By James Eberle and José Lamela
Alvarez & Marsal—Taxand

The IRS dropped Announcement 2010-9 on American businesses, and what an announcement it is. It alerts us that the IRS intends to require "certain business taxpayers" to report uncertain tax positions in future tax returns, and that it intends to "publish the new schedule quickly" and to "mandate the new schedule for uncertain tax positions be filed with returns after release of the schedule."

Background

The ability of the Internal Revenue Service to obtain taxpayer information about income tax reserves reflected on financial statements has long been subject to a policy of restraint in which the IRS would not request tax accrual workpapers as part of a standard examination unless there were unusual circumstances. In fact, even after the Supreme Court case of *United States v. Arthur Young & Co.* , 104 S.Ct. 1495 (1984) confirmed that tax accrual workpapers were subject to IRS summons power under Internal Revenue Code Section 7602 and were not subject to a work-product privilege or a work-product immunity, the IRS reaffirmed in Announcement 84-46, 1984-18 I.R.B. 18 that it would continue its policy of restraint with respect to requesting tax accrual workpapers. Under this policy of restraint, an examiner may only ask a taxpayer about "the existence and the total amount of a reserve for all contingent tax liabilities" as a matter of routine examination procedure, without a showing of unusual circumstances and without seeking executive approval for the requests.

However, this longstanding policy of restraint began to be curtailed for listed transactions in Announcement 2002-63, 2002-2 C.B. 72. In that Announcement, the IRS stated that it may request tax accrual workpapers in the course of examining any return filed on or after July 1, 2002, that claims any tax benefit arising out of a transaction that the IRS has determined to be a listed transaction. Only when listed transactions were not disclosed would the IRS routinely request all tax accrual workpapers. In addition, when multiple investments in listed transactions were claimed on a return, regardless of whether the listed transactions were disclosed, the IRS, as a discretionary matter, would request all the tax accrual workpapers.

When FIN 48 — Financial Accounting Standards Board Interpretation No. 48 — was enacted, the IRS concluded that Fin 48 workpapers were tax accrual workpapers and were, therefore, subject to its longstanding policy of restraint.

The Announcement

The IRS tells us in the Announcement's opening paragraph that it is "considering changes to reporting requirements regarding certain business taxpayers' uncertain tax positions in order to improve tax compliance and administration." In the concluding sections of the Announcement, it solicits comments but doesn't indicate that it intends to hold any public hearings. Perhaps that is

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because it realizes that it would have to rent out RFK Stadium to accommodate all of the likely interested taxpayers who would no doubt want to attend and protest this unprecedented move.

The Announcement is not a paradigm of clarity, so many questions and issues need to be surfaced and addressed. The stated targets of this announcement are "business taxpayers" with more than $10 million in total assets, yet it isn't indicated when this measurement threshold is to be taken, nor if it is measured by value or basis. The Announcement asserts that certain "taxpayers must identify and quantify for financial accounting purposes a tax position relating to a specific federal tax return for which a taxpayer is required to reserve an amount under FIN 48."

In a nutshell, the IRS wants taxpayers to attach a schedule that:

1. Lists all of these uncertain tax positions;
2. Provides a concise description of "each uncertain tax position"; and
3. Discloses the "maximum amount[1] of potential federal tax liability attributable to each uncertain tax position (determined without regard to the taxpayer's risk analysis regarding its likelihood of prevailing on the merits)."

Perhaps the authors of this Announcement should have consulted the definition of the word "concise." My Merriam-Webster online dictionary informs me that this word means "marked by brevity of expression or statement; free from all elaboration and superfluous detail." Yet as envisioned by these authors, the "concise description" required to be supplied by the taxpayer is composed of at least two parts, perhaps three. The **first** "concise" description must contain information that provides "a rationale for the position." The **second** "concise" description is a "general statement of the reasons for determining that the position is an uncertain tax position." To be sufficient, this second concise description (hence the "perhaps three" statement mentioned above) must contain:

1. The Code sections potentially implicated by the position;
2. A description of the taxable years to which the position relates;
3. A statement that the position involves an item of income, gain, loss, deduction or credit;
4. A statement that the position involves an item that is either permanent or temporary, or both;
5. A statement of whether the position involves a determination of the value of any property or right; and finally
6. A statement of whether the position involves a computation of basis.

The descriptions provided by the taxpayer do not need to disclose the taxpayer's risk assessment or tax reserve amounts.

Finally, it appears that items requiring disclosure are only those where a tax reserve is recorded in the financial statements of a taxpayer. And while the Announcement specifically mentions FIN 48, it appears to envision the possibility that other accounting standards that require tax reserves will satisfy this requirement.

Preliminary Thoughts and Issues

Over the coming weeks and months, we will all discover issues in this Announcement, but here a few things to start thinking about.

1. Applicability to "business taxpayers" appears broad enough to include farmers and sole proprietors that produce GAAP financial statements, so long as the farm or business has "total assets in excess of $10 million.
2. A sub-Chapter S company, even though it may exceed the $10 million threshold, may be effectively exempt from this disclosure because these "business taxpayers" generally do not record tax reserves at the entity level and, normally, neither do their individual shareholders.
3. Is there a difference between the "maximum amount" and an "entire amount" for each uncertain tax return position? Could the "maximum amount" relate to just the uncertain position, whereas the "entire amount" encompass all correlative adjustments that may result for the potential disallowance of the uncertain tax position? So, for example, if a disallowance of a repair expense would result in the creation of a depreciable asset, could the benefit of the depreciation deduction be a component of the "entire amount" but not a component of the "maximum amount."
4. Can the disallowance of one item on a list of uncertain amounts result in the theoretical increase of another item on the same list? For example, a tax payer may have two items on its disclosure schedule, one being an abandonment

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loss, which is uncertain, and the other being the deduction of an expense as a research cost, which is also uncertain. If the disallowance of the research deduction serves to increase the amount of the abandonment loss, which itself is an uncertain tax position, should the taxpayer report that the "entire amount" is a zero dollar impact?

5. How does the disallowance of temporary items affect the calculation reporting of permanent items such as percentage depletion and the domestic production deduction?
6. Will states require similar disclosures?
7. Will the filing of this schedule necessitate a reassessment of the reserve amount that might be required under FIN 48 or FAS 5 (Financial Accounting Standard No. 5)?
8. Does a taxpayer need to disclose an uncertain tax position if it has no reserve established for it? For example, the taxpayer may be 95 percent certain that its position is correct and therefore decides that no reserve is needed.
9. If an uncertain tax position involves a deduction related to an amount that was determined by valuation, must all lost positions presume a zero valuation?
10. Will taxpayers need to perform a "with and without" tax calculation for each individual uncertain tax position, or can grouping be used to reduce calculation burdens?
11. Are taxpayers bound by the "unit of account" determinations in their formulation of uncertain tax positions, and how will the IRS be able to audit the veracity of these new schedules without compelling production of the audit accrual workpapers?
12. Does a taxpayer need to identify or explain any and all legal authorizes that weigh against a position that it has taken as part of its "general statement of the reasons for determining that the position is an uncertain tax position"?
13. Will taxpayers in Compliance Audit Program (CAP) audits be exempt from these rules?

Alvarez & Marsal Taxand Says:

These and many other issues, observations and questions will no doubt surface as taxpayers and preparers respond to the request for comments. No doubt this Announcement will create a lot of "beltway buzz."

The IRS will no doubt encounter significant headwinds. But we are certainly entering a period of heavy-handed regulation, and this is yet another example that will hit businesses.

We won't predict how this might eventually end up, but hang on. This will be a rough ride.

Footnotes

1 The "Schedule" section of the Announcement contains the terms "maximum amount of potential federal tax liability" and "entire amount of United States federal income tax." We believe that these refer to the same calculation, but clearer drafting would surely help reduce possible confusion.

Act No. 194 Brings More Amendments to the Puerto Rico Internal Revenue Code

By Sandra Marie Torres

Act No. 194 of December 22, 2009, was enacted to, among other things, amend certain sections of the Code due to the results of previous amendments provided by Acts No. 7 and 37 of March 9, and July 10, 2009, respectively. Some of these amendments are effective immediately, others for taxable years commenced after December 31, 2008, others for taxable years commenced after December 31, 2009, and even one amendment was enacted with no effective date stated. Therefore, we will cover them by effective date rather than by the related tax affected as from a tax planning standpoint, amendments affecting a taxable year that just ended should be addressed immediately.

Amendments effective for taxable years commencing after December 31, 2008

1. Alternative minimum tax ("AMT") for individuals — The last bracket of the AMT rates was amended and now it is clear that net income subject to AMT in excess of $175,000 is subject to a fixed tax rate of 20%. (Before it had a phrase that read "20% of the excess over $125,000" which was incorrectly stated as such bracket is taxed at a fixed rate of 15% since AMT rates are fixed and not progressive).

   Act No. 194 also reinstates the following adjustments to arrive at the net income subject to AMT[1]: a) a partner's distributable share on a special partnership's income/loss calculated under the percentage of completion contract method (instead of the completed contract method) for special partnerships engaged in building, installation and construction of jobs covering a period in excess of one year[2]; and b) the excess of 30% of the mortgage interest deduction over the taxpayer's adjusted gross income (as determined under the new AMT rules for individuals) must be added back to determine the net income subject to AMT.

2. Extension of time to file the income tax return – corporations, partnerships, estates and trusts — The automatic extension of time to file the income tax returns for individuals as well as for trusts will now grant a 3- month period instead of a 30 day period (before individuals and trust had an automatic 30 day extension period and an additional 60 day period, which for individuals outside of PR maybe had been an additional 150 day period). This 3-month period will be applicable also to corporations and partnerships (before these entities had an automatic 90 day period extension period).
   Also, an additional extension for up to 3 months may now be granted to individuals outside of Puerto Rico subject to any further requirement established by the Secretary of the Treasury (the "Secretary") instead of the 150 day period mentioned above.
3. The Annual Sales and Use tax ("SUT") is eliminated (as well as certain references made to the annual SUT made on the Code)— Note that this applies to taxable years beginning after December 31, 2008. Therefore for a taxpayer with a taxable year ending on October 31st, for example, it last Annual SUT return would be the one for the taxable year ended October 31, 2009 which was due on January 15, 2010.
   Due dates that fall on holiday, Saturday or Sunday— Now the Code includes the language provided by Article 1053-3 of the Regulations issued under the Code where when the filing date of a

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return falls on a Saturday, Sunday or a holiday, the return will be due the following working day.

Amendments effective immediately (i.e. December 22, 2009)

1. Licenses issued by the Treasury Department—The specific requirements provided within various sections of the Code were eliminated to include a language that empowers the Secretary to establish the specific requirements per license by regulations or by "any other public determination." As we understand that statements made by the Secretary at a press conference or at a radio show may be viewed as "a public determination", we understand that the phrase "any other public determination" should have been specified in this amendment.
2. Certain penalties for failure to file reduced to a fixed $100 penalty—The Code provided for filing penalties that run from $500 for each failure to 10% of the amount unreported (and in some cases whichever amount was **higher**) for failure to file various informative returns or declarations required to employers and withholding agents. Now this penalty has been reduced to a fixed $100 per occurrence. Among the declarations and informative returns that will now have the reduced $100 fixed fine are the payroll related quarterly returns (499 R-1 Forms), withholding statements (499 R-2/W-2 Forms) , annual reconciling statement (499 R-3 Forms), informative returns for certain payments made to non residents (Forms 480.6C), informative returns for interest payments and to report mortgage interest.

Amendments effective for taxable years commencing after December 31, 2009

1. Married filing separately status prohibited to spouses that made estimated tax payments jointly— **Act No. 194** also amended Section 1051 of the Code to provide that for spouses to be able to file under the "married filing separately" status, they cannot have done joint payments of estimated taxes. And if that was not clear enough, this Act also amended Section 1059 of the Code to provide, in case of estimated payments that: "In the case of husband and wife living together, they shall make joint payments of estimated tax, unless they elect to file separate returns ….for such taxable year, in which case they shall make separate payments. If they make a joint payment, the estimated tax shall be determined on the aggregate income. If a joint payment is made with respect to a taxable year, the spouses may not opt to file separate returns for such taxable year. Nevertheless, if the spouses are separated during the taxable year under a divorce or separation decree, they may file separate returns following those rules and requirements established by the Secretary of the Treasury by regulations or any determination of public nature he may issue." Besides having again to worry about the phrase "any determination of public nature", married couples must really plan in advance for calendars years 2010 and thereon. In some instance, it may be advisable to married couples to start making estimated payments separately just to have the "married filing separately" option available if needed.
2. Estimated Tax Declaration form is eliminated but the threshold to determine if an individual is subject to estimated tax payments is lowered. In addition now also estates and trusts may be required to make estimated tax payments—This year the Treasury Department did not include the instructions for filing within the printed booklet but made them available at Treasury's website (www.hacienda.gobierno.pr). When one take a look at the instructions for the 2009 individual income tax return (long form) under the caption "Requirement to Pay Estimated Tax" it notifies the elimination of Form 480-E (estimated tax declaration) but emphasizes that the estimated tax payments are still required. But the interesting part of this portion of the instructions is where it is stated (in terms of the estimated taxes applicable for the calendar year 2010) that "every person whose estimated total gross income derived totally or partially from whatever source, that is not salaries and pensions subject to withholding, and whose estimated tax for any taxable year exceeds $1,000 is required to make estimated tax payments."

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The above is interesting because Act No. 194 amended-Section 1059 of the Code to provide the following:

a. Requirement to pay estimated tax.—Every individual whose estimated tax for any taxable year, as determined under subsection (b) of this section, exceeds one thousand (1,000) dollars shall, … pay an estimated tax for the taxable year.

As you can see, the above does not excludes salaries and pensions subject to withholding but it appears that that would be the Secretary's intention. In addition, note that the above mentioned subsection (b) provides the following:

b. Computation of the estimated tax and information required by the Secretary—The estimated tax required under subsection (a) shall be the excess of:

(1) the amount which the individual estimates shall be the amount of tax under this subtitle for the taxable year, including the alternative minimum tax and the gradual adjustment, among other taxes, over

(2) the amount which the individual estimates as credits provided under this Code or special laws for the taxable year, including the non refunded income tax paid in excess from the prior taxable year. At the time to make the estimated tax, the taxpayer shall include with such payment such other information for the purposes of carrying out the provisions of this subtitle as the Secretary, may prescribe by regulations or any determination of public nature.[3]

In other words, the above mentioned provisions mean that the minimum income earned not subject to withholding threshold no longer exists. In addition, when calculating the estimated tax, all income taxes including the special 5% surtax applicable to certain individuals, must enter into the equation to avoid penalties for underpayment of estimated taxes.

c. The penalty for failure to pay estimated tax payments is changed to a fixed 10% - Having in mind that the general rules in terms of safe harbor and dates when an estimated tax apply stayed the same, **Act No. 194** amended certain Sections of the Code to provide that in the case of a failure to pay an installment of the estimated tax within the time prescribed or of making an incomplete payment of an installment of the estimated tax, a fixed 10% penalty computed upon the unpaid amount of such installment must be added. Note that the above applies to corporations, partnerships, individuals, estates and trusts.

d. Certain services rendered by a "tax return specialist" are now excluded from the "taxable services" definition for SUT purposes—Section 2301(pp)(2)(I) was added to the Code to provide that "services rendered by a "specialist in tax returns, statements or refund claims"…[are an exception to the term "taxable services"]. For these purposes, the excluded services are only those services related with the preparation or review of the returns, statements or refund claims related to the taxes imposed under this Code or the U.S. Internal Revenue Code."

Therefore, based on the above services rendered by "tax returns specialists" in connection with the preparation or review of any form or declaration required by the Code or the US IRC are not subject to SUT.[5]

Amendment without an effective date – it seems that it was intended to be effective immediately (i.e. December 22, 2009)

The Duty Free Stores no longer will need an authorization from the PR tourism Company before starting operations (even though these stores must continue complying with the rules established by the PR Tourism Company for their operation).

Other Amendments brought by Act No. 194

Act No. 194 also amended Act No. 255 of October 28 of 2002, as amended, known as the "Savings and Loans Cooperatives Act of 2002" to change the "net taxable income as determined under the Code" to the "net economies" concept to be in accordance with the accounting method used within this specific industry. The special 5% tax will apply to the net economies in excess of $250,000.[6] The Treasury Department has issued Form 485 ("Return for the 5% Special Tax under the Provisions of Act No. 7 of March 9, 2009, as amended") which will be due the 15th day of the fourth month following the close of the cooperative's taxable year (bearing in mind that this special tax is applicable to taxable years beginning after December 31, 2008 and before January 1, 2012). A 3 month extension of

Continues on Page 11

Act No,.194…
Continued from Page 10

time to file (i.e. not to pay the applicable special tax) this return is available.

Footnotes

1. These adjustments were originally incorporated to the Code by Act 7 but inadvertently eliminated by Act 37. Therefore, Act No. 194 reincorporated them.

2. On February 11, 2010, the Secretary issued Circular Letter 10-04 which provides further details and requirements on this subject matter. Please contact us if this AMT adjustment may be applicable to you as the special partnership may need to file certain amended informative returns with the Treasury Department by March 31, 2010.

3. Refer to our comments regarding the phrase "any determination of public nature" made on Section II(a) of this article.

4. Act No. 7 amended the Code to include a special 5% surtax (fortunately for a specific time only) under Section 1020A to provide the following clause (the following language includes the amendments provided by Act No. 37):

   "For each taxable year beginning after December 31, 2008 and before January 1, 2012, in the case of corporations or partnerships, whose gross income exceeds one-hundred thousand dollars ($100,000) or estates, trusts, as well as single individuals, heads of household, married individuals not living with spouse or married individuals living with spouse and filing separate returns, whose adjusted gross income exceed one-hundred thousand dollars ($100,000), or married individuals living with spouse and filing a joint return whose adjusted gross income exceeds one-hundred fifty thousand dollars ($150,000), there shall be levied, collected and paid a special surtax of five percent (5%) over the total tax determined under sections 1011, 1012, 1012B (relative to the special tax on variable annuities in separate accounts), 1013, 1013A, 1014, 1015, 1016, 1017, 1018A, 1121(c), 1201, 1204, 1207 and, in the case of Puerto Rico resident individuals, sections 1012A and 1012B of this subtitle. Notwithstanding any other provision of law, including the provisions of Subchapter C of this subtitle, the special surtax shall constitute a separate tax against which only the credits provided in sections 1030, 1031, 1032, 1033, 1035, 1037, 1038, 1039, 1040 and 1040B of this subtitle and estimated tax payments for the particular taxable year, shall be allowed to be claimed."

5. This in turn means that fees incurred by a tax return specialist for the preparation or review of other payroll related forms like the ones required by the PR Department of Labor and Human Resources and the Workmen's Compensation Act will be subject to SUT. In addition, please note that even though the fees for the preparation or review of other tax returns such as the volume of business preparation and the personal property tax return will not fall under this "tax return specialists' services" exclusion. Nevertheless, these fees may be excluded from SUT under the "business to business" SUT exclusion.

6. On February 2, 2010, the Secretary issued Circular Letter 10-03 to, among other things, state that the tax credits program for the purchase of newly constructed housing provided by Section 1040K of the Code to financial institutions, cannot be used against the 5% special tax. If your business falls within the "cooperative industry", you may contact us regarding this and other tax issues that may apply within such industry as we have the expertise to address them.

Contact us

Our clients tax issues have different levels of complexity. But, no matter how difficult the situation may be, they always count on the sound personalized advice of Zaragoza & Alvarado. In fact, our commitment to them starts with the direct involvement of each of our partners in every engagement. So don't wait more. Contact us to arrange a meeting and discuss how we can help your organization in solving its tax conundrums.

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Taxand 2010 Global Conference 2010: A New Era in Tax Planning

By Taxand Editorial Staff

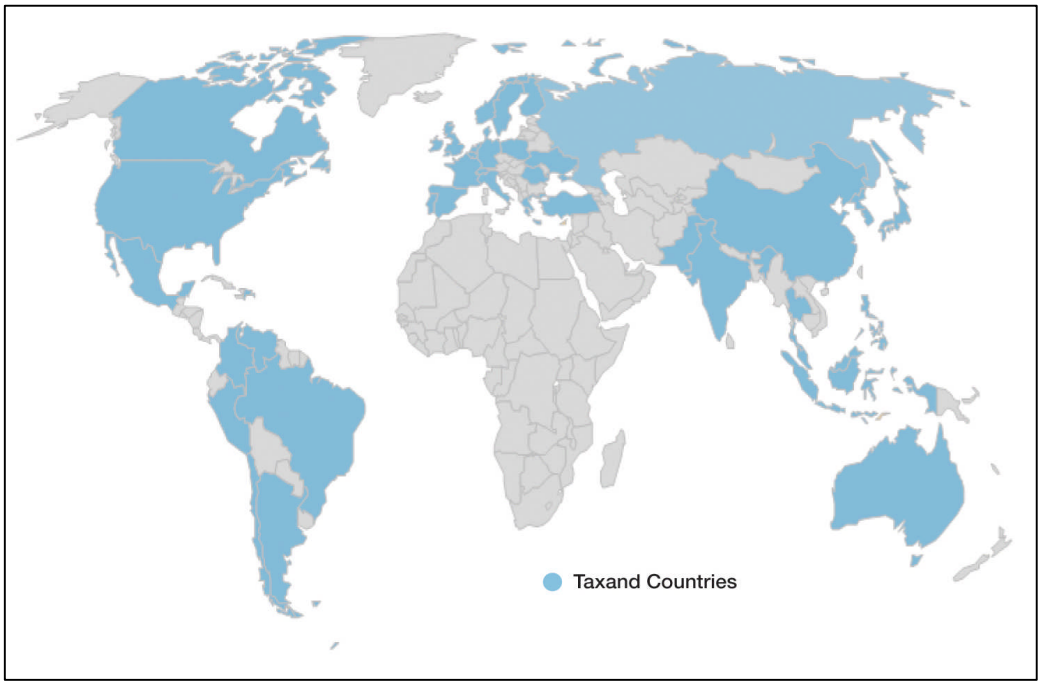
The opening plenary session of Taxand's Global Conference 2010 outlined Taxand's firm belief that the industry is facing a new era in tax planning. Good tax governance is a must as governments worldwide look to tax to claw-back monumental deficits. The rise in scrutiny and its implications for multinationals was a recurring theme as Taxanders from around the world presented a global view of the key tax issues facing clients today and in the future.

Hosted by Luther, Taxand Germany, this year's Taxand Global Conference took place at the Grand Hyatt in Berlin, from the 12th to the 14th April. Over 125 global Taxand clients attended alongside 250 Taxanders, to present and participate in a range of sessions focused on how to handle complex tax issues as we move into a new age of cooperation and transparency.

Key pointers from the conference included:

- follow 2 test levels for your tax planning: economic substance and business purpose
- tax mitigation is a duty
- avoid more than ever black listed countries
- take a regional / jurisdictional approach as one-size fits all cannot work
- make sure your internal tax governance procedures are robust
- focus on enhancing your relationships with the tax authorities
- always think long term when undertaking tax planning
- understand how to manage indirect tax risk and maximise opportunity
- seek to identify the operational and technological root causes of VAT compliance problems and fix them
- define the business case and direction to take vis-a-vis indirect taxes
- transfer pricing planning is essential to enhance the bottom line
- transfer pricing delivers short and long term benefits as long as there is business motive
- don't worry about transfer pricing disputes as provided there is adequate documentation, technical and legal grounds, they can be defended
- how to strengthen the balance sheet through the waiver of debts; debt for equity swaps and debt acquisition
- how to maximise the deductibility of financing costs
- how to optimise NOLs in an M&A context

Anecdotes and case studies were also shared to help clients picture how to apply Taxand's experience to their businesses. Dr. Ralph Solveen delivered a stirring keynote speech assessing the soaring public debt and questioning whether or not inflation is around the corner.



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The Power of Asking the Right Person the Right Question

Don't underestimate the power of asking the right person the right question. The right answer might be worth much more than you ever suspected. Recently our Polish Taxand member identified an opportunity for one of our US clients to obtain a grant valued at US$8 million. In another situation, our Puerto Rican Taxand member identified an opportunity for a client to save over US$3 million. In both of these situations, it was simply a matter of our clients speaking with the local Taxand member to gain an understanding of the incentives available in these jurisdictions.

Your local contact in Puerto Rico is Juan Zaragoza **(jzaragoza@zatax.com)** For all our other jurisdictions visit us at **www.taxand.com** for a full list of contacts.

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