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H.B. 1073: Act for the redistribution and adjustment of the tax burden.

On Monday, April 29, 2013, House Bill 1073 (the "Bill") was filed. The Bill creates the Act for the Redistribution and Adjustment of the Tax Burden to provide additional funds to the Government of Puerto Rico.

The Bill includes amendments affecting individual and corporate taxpayers from both an income tax and a sales and use tax perspective. The proposed measures are summarized below.

Proposed Amendments Related to Corporate Income Taxes
Effective for taxable years beginning after December 31, 2012, the tax burden of corporations is impacted in several ways by the proposed amendments:

1. The reduction of the surtax deduction from the current amount of $750,000 to lower amounts depending on the entity's taxable income as follows:
In essence, by reducing the surtax deduction to the above referred levels, corporate taxpayers will see their effective tax rate increase since such deduction is deducted from net taxable income before subjecting it to the surtax rates of 5% and 10%.

Net Income Subject to Normal Tax	Surtax Deduction
Not more than $500,000	$250,000
More than $500,000 but not to exceed $1,000,000	$150,000
More than $1,000,000 but not to exceed $2,000,000	$50,000
In excess of $2,000,000	$25,000

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2. The Bill limits the use of Net Operating Losses ("NOLs") to 90% of the entity's net income for the current year. This proposal seems to be intended to impose a minimum tax on corporate taxpayers with current profits, but with accumulated losses.
In an effort to mitigate the impact of the proposed limitation on the existing NOLs, the Bill proposes an increase in the carryforward period of NOLs. For NOLs corresponding to taxable years beginning after December 31, 2004 and ending before January 1, 2013, the carryforward period is extended from 10 to 12 years. For NOLs generated after such date, the carryforward period will be 10 years instead of the current 7-year period.
Consistent with this limitation, the Bill also reduces to 90% the use of NOLs resulting from a change in control.
3. The Bill makes two significant changes to the Alternative Minimum Tax ("AMT") computation. On one hand, the adjustment related to the excess of book income over the alternative minimum taxable income from 50% to 60%. In addition, the use of the NOLs for AMT purposes is reduced from 90% to 80%.

Proposed Amendments Related to Transfer Pricing
As previously discussed in one of the February 2011 issue of the "Special Bulletin – The Tax Advisors" entitled *A Different Approach of the Old Problem of Transfer Pricing*, during the last few years, the Puerto Rico Treasury Department ("Treasury") has

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been addressing the issues related to intercompany charges (which are deductible locally and not subject to any withholding due to the sourcing rules) and transfer pricing in indirect ways. The Puerto Rico Internal Revenue Code of 2011, as amended (the "Code") currently provides an AMT preference item related to intercompany charges. In addition, the Code currently provides a second, or Intercompany Purchases Based AMT computation based on 1% of intercompany purchases.

In an apparent effort to strengthen these two measures, effective for taxable years beginning after December 31, 2012, the Bill eliminates the AMT preference item related to intercompany charges and substitutes it with a new tax equal to 20% of the intercompany allocations. The mechanism chosen by Treasury is not through the AMT calculation, thus, any tax paid will not be creditable in the future. The proposal does not disallow the deduction for intercompany charges for regular income tax purposes nor for AMT purposes.

However, in the case of entities operating as flow through entities, such as partnerships, the deduction related to these charges is disallowed instead of imposing the 20% tax on the total amount of the charges.

On the other hand, the existing 1% Intercompany Purchases Based AMT computation is amended as follows:

- The AMT tax rate is increased from 1% to 2%.
- Articles or products currently exempted from the 1% Intercompany Purchases Based AMT will be subject to the tax at reduced rates. Importers of oil related products, including gasoline, will be subject to the tax based on a 1% tax rate, while liquor importers will be subject to a .5% tax. Finally, the rate applicable to importers of motor vehicles, which were previously subject to the standard 1% rate, will be subject to a 1.5% tax.
- The proposal provides that entities operating as a branch will also be subject to the tax.
- The sales level threshold for the application of this AMT is reduced from $50 million to $10 million.

Proposed Amendments Affecting Individual Taxpayers

Effective for taxable years beginning after December 31, 2012, the Bill impacts individual taxpayers in two ways. First, the home mortgage interest deduction, which is currently limited to 30% of the taxpayer's adjusted gross income (adjusted for certain exempt income items), is further limited to $35,000 per year.

In addition, the Bill introduces a new tax applicable to individuals engaged in a trade or business, including the rendering of services, of 2% of the gross income, as defined under the Code. The tax is applicable to sole proprietor businesses generating gross income, as defined under the Code, in excess of $200,000. This tax is in addition to the regular income tax and is not subject to the payment of estimated taxes.

Moratorium of Certain Tax Credits

The Bill places again in moratorium the concession of certain tax credits for a 3-year period, commencing with the taxable year beginning after December 31, 2012. The tax credits subject to the moratorium are the following:

- Clause (a) of Article 4 of Act 159-2011, known as the Tax Incentives Act for Investment in Facilities for the Reduction, Disposition and Treatment of Solid Waste (formerly clause (b) of Article 21 of Act No. 70 of June 23, 1978, as amended, known as the "Puerto Rico Solid Waste Authority Act");
- Clause (a) of Article 14 of Act No. 46 of January 28, 2000, as amended, known as "The Puerto Rico Capital Investment Fund Act of 1999";
- Clause (a) of Article 11 of Act No. 178 of August 12 [18], 2000, as amended, known as the "Special Act for the Creation of the Santurce Theater District" [23 L.P.R.A. § 591h(a)], covering from Bolivar Street to Ernesto Cerra Street in Santurce;
- Clause (a) of Article 17 of Act No. 183 of December 27, 2001, as amended, known as the "Puerto Rico Conservation Easement Act";
- Paragraphs (E) and (F) of Article 4.03 of Act No. 212 of August 29, 2002, as amended, known as the "Urban Centers Revitalization Act";
- Clause (A) of Article 3 of Act No. 140 of October 4, 2001, as amended, known as the "Tax Credits for Investment in New Construction and Rehabilitation of Rental Housing for Low or Moderate Income Families Act";
- Clauses (a) and (b) of Article 4 of Act No. 98 of August 10, 2001, as amended, known as the "Tax Credits for Investments in Housing Infrastructure Act"; and
- Section 1051.09 of the Code.

Subject to certain limitations credits under paragraphs (E) and (F) of Article 4.03 of Act 212 may still be issued.

The Bill provides that the credits issued or purchased prior to April 26, 2013 may still be used by the taxpayers subject to the limitations imposed by the act under which the credits were issued, provided that the credit used may not reduce the taxpayer liability by more than 50%.

Proposed Amendment Affecting Insurance Companies

The Bill introduces a new tax of 1% on insurance premiums subscribed after June 30, 2013. The tax will be payable on an annual basis, on or before March 31 of each year, through the Office of the Commissioner of Insurance.

Proposed Amendments Related to the Sales and Use Tax ("SUT" or "IVU")

The proposed amendments impact the current SUT provisions in four ways: it reduces the tax rate, eliminates or limits existing exemptions, imposes the SUT on entities previously exempted from this tax and substitutes the reseller exemption with a credit system. Except for the rate reduction, the effective date of the proposed changes is July 1, 2013.

Reduction of the tax rate

Effective on December 1, 2013 the combined state

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and municipal SUT rate is reduced from 7% to 6.5%. Currently, the components of the 7% SUT rate is composed of 5.5% for the Central Government and 1.5% for the Municipality. Of the 1.5% Municipal SUT, .5% is paid directly to Treasury together with the 5.5 % Central Government portion. The remaining 1% Municipal SUT is paid to either the Municipality, through a separate tax return (in the case of Non Participating Municipalities), or directly to Treasury (in the case of Participating Municipalities), depending on whether or not the Municipality has decided to outsource the collection process with Treasury.

Under the Bill, the .5% reduction in the rate will come from the elimination of the .5% of the Municipal SUT which is currently paid to Treasury.

Therefore, once the amendments become effective, merchants will collect 6.5% on taxable sales and will remit 5.5% to Treasury and 1.0% to the corresponding Municipality, in the case of Non-Participating Municipalities. On the other hand, merchants operating in Participating Municipalities will collect 6.5% on their taxable sales and will remit the entire amount to Treasury.

Exemptions affected

Under the proposed amendments, the following exempt items (goods or services) will become fully taxable:

- B2B services or services rendered business to business
- Designated professional services (except those rendered to persons not engaged in business). These services are limited to services provided by licensed professions such as Lawyers, CPAs, Engineers, Architects, etc.
- Bank charges, excluding interests, but limited to charges made to businesses
- Motor vehicle leasing
- Services rendered by a tax specialist
- Commercial real estate leasing
- Equipment and medical supplies purchased by Hospitals

In addition, the following SUT exemptions were amended:

- The Back to School Tax Holiday was amended to provide:
  - o Two (2) days periods; one in July and another in January of each year in which taxpayers will be allowed to buy uniforms and school supplies free of the SUT
  - o Complete exemption throughout the year of textbooks and notebooks
- The exemption granted to Child Care Centers was amended to clarify that the exemption is limited to the care services and not to the goods or services purchased by the Center.

Finally, the amendments impact the following entities which were previously exempt from the SUT:

- o Higher education institutions, regardless if they are for profit or not-for-profit entities
- o Savings and Loan Cooperatives
- o General Cooperatives

Changes to the tax treatment applicable to resellers

Under the existing provisions, resellers are entitled to receive an Exemption Certificate from Treasury, which allows them to purchase goods for resale free of the SUT. The proposed amendments eliminate the Exemption Certificates and subject resellers to the SUT on their purchases of goods for resale.

However, in order to allow resellers to recuperate the tax paid on their purchases, the proposal allows resellers to claim a tax credit for the amount of taxable purchases of goods for resale made during the month. As a general rule, the credit is limited to 50% of the tax due on the monthly return (i.e., the tax due on taxable sales); however, the Secretary is granted authority to increase or decrease the allowable percentage based on the economics of a particular industry.

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