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Act 40-2013: Changes to Corporate Taxpayers

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With the signing of Act 40-2013 on June 30, 2013 (Act for the Redistribution and Adjustment of the Tax Burden, herein after "Act 40"), the Governor of Puerto Rico put an end to one of the most active and controversial period in recent tax history. For the last two months businesses and professional associations participated in public hearings in the Legislature and private meetings with members of the legislative and executive branches of the Puerto Rico Government. At the same time, the media gave intensive coverage to the processes and discussions that concluded with the signing of the law.

All these discussions resulted in a law significantly different from the House Bill originally filed (see our May 2013 Tax Advisor, HB 1073: Act for the Redistribution and Adjustment of the Tax Burden). Although some claim that the changes reduced the tax impact when compared to the original bill, this is certainly not true for everyone.

In the following paragraphs we will discuss the changes to corporate income taxation brought upon by Act 40 in order to help you determine the impact in your business. Subsequent bulletins will be issued discussing other changes to the Internal Revenue Code for a New Puerto Rico (the "Code").

Background

Act 40 amended several provisions of the Code and introduced new ones. The purpose of those amendments was to increase the collection of taxes by the Puerto Rico Treasury Department. The amendments that are expected to generate the highest amount of income tax collection may be grouped in three principal areas:

1. Income tax rate increase.
2. Intercompany transactions limitation.
3. modification to the computation of the alternative minimum tax.

The amendments on these three areas will certainly impact every corporation doing business in Puerto Rico, even those with accumulated net operating losses. The significance of the impact will depend on the profit margins of the entities and the extent of their intercompany transactions.

Increase in Corporate Income Tax Rates

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Corporate income tax is made up of a normal income tax and a surtax. The normal tax is computed on the net taxable income of the corporation. On the other hand, the surtax is computed on the surtax net income (net taxable income less the surtax deduction).

Act 40 did not modify the normal income tax rate of 20%. However, it modified the progressive tax table used in the surtax computation and significantly lowered the surtax deduction.

Prior to the amendments of Act 40, a corporate taxpayer could reduce its net taxable income by a surtax deduction of $750,000. The only limitation to that deduction was that it was to be apportioned among the members of a controlled group of corporations. Act 40 reduced the surtax deduction to $25,000 and kept the apportionment requirement among the members of a controlled group. This amendment alone will have an impact of approximately $65,250 for companies in the highest tax rate.

As mentioned before, Act 40 also modified the progressive tax tables used to compute the surtax. Before the amendments to the Code the progressive table had only two tiers. The first was a 5% tax rate when the surtax net income was lower than $1,750,000. The second tier was a 10% tax rate on the surtax net income of $1,750,000 or more. The Code required the apportionment of the benefit of the first tier among the members of a controlled group of corporations.

Act 40 adopted the progressive surtax table of the Puerto Rico Internal Revenue Code of 1994, as amended ("1994 Code") (see Table 1). This tax table not only has higher rates but the amount of surtax net income on each tier is smaller. This results on taxpayers being subject to the top marginal tax rate earlier than before. With Act 40 amendments corporate taxpayers will reach the maximum surtax rate of 19% when the surtax net income is in excess of $275,000. Prior to the amendments, some of the taxpayers subject to the maximum surtax rate would had either not been subject to surtax due to the high surtax deduction or would had been only subject to a 5% surtax. After the amendments of Act 40, the benefit of the lower rates in the progressive tax table does not have to be apportioned among the members of a controlled group of corporations. Table 1 below, depicts the new Surtax Progressive Tax Table.

Table 1 – Surtax Progressive Tax Table

If your Surtax Net Income is		**Your Surtax is:**		
Over	But not Over		Plus	Of the Excess Over
$0	$75,000	5%		
$75,000	$125,000	$3,750	15%	$75,000
$125,000	$175,000	$11,250	16%	$125,000
$175,000	$225,000	$19,250	17%	$175,000
$225,000	$275,000	$27,750	18%	$225,000
$275,000		$36,750	19%	$275,000

Intercompany Transactions Limitation

One of the main targets of Act 40 was the limitation of the benefits of intercompany transactions. Most jurisdictions actively monitor the transactions between related entities because it is a way of transferring revenues from a high tax jurisdiction to a low tax jurisdiction. Usually this is done through transfer pricing rules and audits of these transactions. The Puerto Rico Treasury Department ("Treasury") has never developed an expertise on transfer pricing within the agency to be able to monitor effectively the transactions between related entities. Therefore, they decided to limit the effect of intercompany transactions through legislation instead than through administrative reviews and audits.

Act 40 establishes limits to the two most common intercompany transactions (1) purchases of goods for sale (inventory) and (2) intercompany charges (management fees, service fees, etc.). The limitations to both of these types of transactions were made part of the alternative minimum tax computation which we will discuss later in this bulletin. However, knowing that not all taxpayers will be subject to the alternative minimum tax, the Government decided to limit the deduction of intercompany charges in the computation of the net taxable income.

Effective for taxable years commencing after December 31, 2012, fifty one percent (51%) of the expenses incurred or paid to a related person not engaged in a trade or business in Puerto Rico will be disallowed for purposes of determining the net taxable income of the corporation. However, expenses incurred or paid to a related person subject to Puerto Rico income tax or to income tax withholding at source shall be allowed as a valid deduction.

For purposes of this particular provision of the Code, and the alternative minimum tax provisions subsequently discussed, a related person will include the following structures:

1. Parent-Subsidiary as long as the shareholder owns 50% or more of the shares of stock in the subsidiary.
2. Brother-Sister as long as shareholders with common interests in both corporations own 50% or more of the shares of stock in both entities.
3. Home Office-Branch.

The disallowance of the deduction will not be applicable to corporations with operations covered under an industrial or tourism tax exemption grants, but only with respect to the operation covered by the tax exemption grant.

Act 40 provides the authority to the Secretary of the Treasury ("Secretary") to evaluate (upon request by the taxpayer) the nature of the expenses or costs paid to a related person or home office in order to determine

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if they should be excluded from the disallowance provided in the Code. To that effect, Treasury issued Circular Letter 13-06 ("CL 13-06") providing the procedures to be followed to make such request. CL 13-06 provides that the taxpayer should submit (1) a detailed memorandum supporting the request and (2) a Report of Agreed Upon Procedures prepared by a CPA licensed in Puerto Rico, who is also a member of a peer review program, in order for the Secretary to determine which expenses or charges should be excluded from the disallowance. The Report of Agreed Upon Procedures shall include information for the last four years (or the applicable period if the taxpayer has been in operation for less than four years) such as:

1. Amount of the charges or expenses incurred or paid, their nature and the methodology used to assign those costs to the Puerto Rico operations.
2. Net taxable income of the entity.
3. Amount of income tax paid.
4. Amount of loans to shareholders or, if applicable, with members of a controlled group or related entities group.

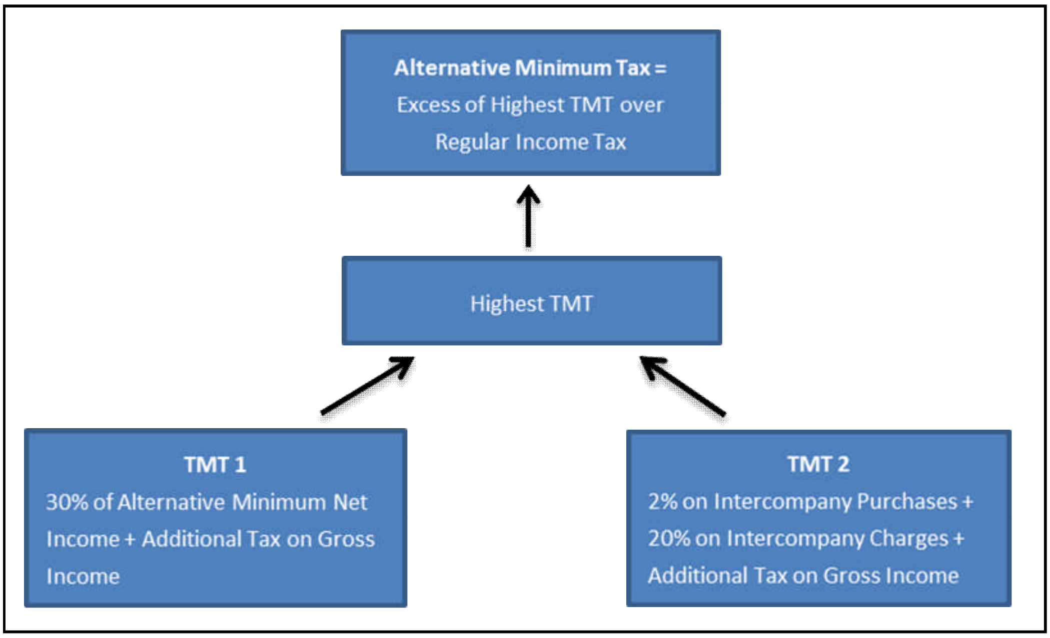
Treasury did not provide guidance of the nature of the information to be included in the detailed memorandum to support the request. However, the information should be of a nature that justifies the exclusion of the expenses by supporting that the expenses charged to the Puerto Rico operation are true and valid expenses of the local operation.

Alternative Minimum Tax

The alternative minimum tax is one of the most complicated and misunderstood areas of our Code. In its origin, the purpose of the alternative minimum tax was to ensure that no taxpayer with substantial economic income could avoid significant tax liability by using exclusions, special deductions and credits provided by the Code. That original purpose was modified upon the enactment of the Code, when a second tentative minimum tax ("TMT") computation was introduced. This second TMT was one percent (1%) of all purchases of personal tangible property from a related person. With this second TMT in the Code, Treasury started targeting the intercompany transactions through the alternative minimum tax instead of through the transfer pricing provisions of the Code and its Regulations.

Act 40 retained the two TMT computations but increased their level of complexity by adding the "additional tax on gross income" to the two TMT computations among other adjustments to each particular tentative minimum tax computation. Table 2 below provides a summary of the components of both TMT computations.

Table 2 – Alternative Minimum Tax Computation Summary



First TMT Computation

The first TMT is the sum of the alternative minimum net income (which is the net taxable income adjusted by certain items provided in the Code) times the applicable tax rate plus the additional tax on gross income. This TMT targets locally owned corporations and corporations with little or no transactions with related entities. Entities with low profit margins will most likely end up with a TMT higher than its regular income tax and, therefore, an alternative minimum tax payment on the income tax return.

The computation of alternative minimum net income under the first TMT was amended by Act 40 as follows:

1. The adjustment for expenses for services rendered outside of Puerto Rico by a related person is no longer an adjustment under the first TMT. A portion of these expenses became a component of the second TMT instead. This component is going to be discussed on the second TMT.
2. Increase on the adjustment for the excess of net income per books over tentative alternative minimum net income from 50% to 60%.
3. The limitation on the use of the accumulated net operating losses deduction to determine the alternative minimum net income is now 80% of the alternative minimum net income before net operating loss instead of 90%.
4. Increase in the applicable alternative minimum tax rate from 20% to 30%.

Second TMT Computation

The second TMT targets corporations which are members of a multinational

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group of corporations, especially those with substantial amounts of intercompany transactions. This TMT is composed on the sum of the dollar value of the following three computations:

1. 20% of the expenses incurred or paid to a related person if such payments were not subject to Puerto Rico income tax or income tax withholding.
2. 2% of the purchases of personal property from a related person. In the case of alcoholic beverage and fuel and crude oil products the percentage applicable is 0.5%. In the case of automobiles the percentage is 1.5%.
3. Additional tax on gross income.

Although the Code had this second TMT, Act 40 changed completely how it is computed.

Act 40 provides the authority to the Secretary of the Treasury to determine, upon the request of the taxpayer, which of the expenses paid to related persons should be included in the pool of expenses subject to the 20% rate. The request to the Secretary should be made following the procedures established by CL 13-06, as any expenses incurred or paid to a related person not subject to Puerto Rico income tax or income tax withholding that would not be disallowed under the rule previously discussed would neither be included in the pool of expenses subject to the 20% rate.

Act 40 also granted the authority to the Secretary to reduce the percentage used in the computation of the purchases of personal property to a rate that may never be lower than 0.2%. However, the Secretary has no limitation in the case of taxpayers in the business of reselling fuel and crude oil product. To that effect, Treasury issued Circular Letter 13-07 ("CL 13-07") to provide the procedures to request the reduction allowed in Act 40. CL 13-07 provides that the taxpayer should submit (1) a detailed memorandum supporting the request; (2) a transfer pricing study and (3) the following information for the last four years (or the applicable period if the taxpayer has been in operation for less than four years):

1. Net taxable income of the entity.
2. Amount of income tax paid.
3. Amount of charges or expenses incurred or paid to a shareholder who owns 50% or more of the interest in the corporation if the charges or expenses were not subject to Puerto Rico income tax or tax withholding.
4. Amount of loans to shareholders or, if applicable, with members of a controlled group or related entity group.

Additional Tax on Gross Income

Probably the most controversial of all amendments to the Code was the inclusion of an additional tax on gross income on both of the TMT computations. Due to the nature of this tax, it severely impacts those corporations with low profit margins (i.e., retail, some distribution).

This additional tax is computed on the gross income, as defined by the amendments of Act 40 to the Code, but adjusted by not allowing the deduction of the cost of the products sold. The tax imposed depends on the amount of gross income of each corporation, and in the case of a controlled group of corporations, the applicable percentage should be determined by aggregating the gross income of all the entities members of the controlled group. Table 3 below, depicts the applicable percentages depending on the gross income bracket of the taxpayer(s).

Table 3 – Additional Tax on Gross Income

If your Gross Income is		Your Rate is:
From	**But not Over**	
$1,000,000	$3,000,000	0.20%
$3,000,000	$300,000,000	0.50%
$300,000,000	$600,000,000	0.70%
$600,000,000	$1,500,000,000	0.80%
$1,500,000,000		0.85%

In the case of financial businesses the rate is a fixed 1% no matter the amount of the gross income. However, financial businesses may reduce their income tax by a credit equal to 0.5% of the gross income (or half of the additional tax on gross income paid).

Corporations with industrial or tourism tax exemption grants will not be subject to the additional tax on gross income. The same will apply to bona-fide agricultural businesses. Insurance premiums received from Medicare Advantage, Medicaid, Mi Salud (Puerto Rico Government health program) and annuities are also exempted from the additional tax.

Act 40 authorizes the Secretary of the Treasury to reduce the additional tax rate to a rate which shall never be lower than 0.2% to those taxpayers who can prove that the additional tax will cause an undue economic harm to their business. Treasury issued Circular Letter 13-05 ("CL 13-05") on July 12, 2013 providing the procedures to request the tax rate reduction provided in Act 40. CL 13-05 provides that the taxpayer should submit: (1) a detailed memorandum supporting the request and (2) a Report of Agreed Upon Procedures prepared by a CPA licensed in Puerto Rico, who is also a member of a peer review program, in order for the Secretary to determine if the additional tax will cause an undue economic harm. The Report of Agreed Upon Procedures will be prepared for the last four years (or the applicable period if the taxpayer has been in operation for less than four years) and shall include the following information:

1. Components of the gross margin (sales and cost of sales).
2. Net taxable income of the entity.
3. Amount of income tax paid.
4. Amount of salaries paid to shareholders.

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5. Amount of charges or expenses incurred or paid to a shareholder who owns 50% or more of the interest in the corporation if the charges or expenses were not subject to Puerto Rico income tax or tax withholding.
6. Amount of loans to shareholders or, if applicable, with members of a controlled group or related entity group.

Other Changes to the Code

Although we have discussed the changes that will have the biggest impact to corporations there are still some other changes that may be important to some taxpayers. The following is a summary of them:

Net Operating Losses

Act 40 amended the provisions of net operating losses to limit the amount a corporate taxpayer is able to use to reduce its net taxable income. In exchange for that limitation, Act 40 extended the carryover period of net operating losses.

Effective on years commenced after December 31, 2012 the net operating loss deduction that may be claimed is the lower of the net operating loss being carried over or 90% of the net taxable income before the net operating loss deduction. Prior to Act 40, the net operating loss deduction could offset completely the net taxable income of the year. This means that all entities with a net taxable income before net operating losses will be subject to an income tax on 10% of the current year net taxable income before net operating losses.

At the same time, Act 40 extended the carryover period of a net operating loss. The new carryover rules for net operation losses are the following:

1. Taxable years stated before January 1, 2005 – 7 years.
2. Taxable years started after December 31, 2004 and before January 1, 2013 – 12 years.
3. Taxable year started after December 31, 2012 – 10 years.

Act 40 establishes similar limitations and rules for the net operating losses acquired due to a change in control.

Estimated Taxes

Due to the fact that the additional tax on gross income was enacted on June 30 of the current calendar year, but became effective for taxable years beginning after December 31, 2012, a relief from the underpayment penalties of estimated tax was enacted. Act 40 provides that taxpayers may adjust their estimated tax payment to reflect the additional tax on gross income through the remaining installments without being subject to the estimated tax penalty. Taxpayers should review their estimated tax calculations to determine if an adjustment is required since the safe-harbor rules in the Code remain unchanged.

Moratorium of Tax Credits

Act 40 established a partial moratorium on the use and issuance of certain tax credits. It establishes that those persons who have acquired or have been granted a tax credit before June 30, 2013 will be able to use them but limited to 50% of the income tax for the particular year. The moratorium of the use of the credit is effective for three years and ends in the taxable year commencing after January 1, 2016.

Act 40 also imposes a three year moratorium on the issuance of certain tax credits. However, it allows, subject to certain monetary limitations, the issuance of tax credit for (1) conservation easement; (2) urban centers development project; and (3) extraordinary housing infrastructure projects. Table 4 below shows a list of the tax credits under moratorium.

Table 4 – Credits under Moratorium

1. Act 159-2011 – Solid Waste
2. Act 46-2000 – Capital Investment Funds
3. Act 178-2000 – Santurce Theater District
4. Act 183-2001 – Conservation Easement (exceptions)
5. Act 212-2002 – Urban Center (exceptions)
6. Act 140-2001 – Low or Moderate Income Housing
7. Act 98-2001 –Extraordinary Housing Infrastructure (exceptions)
8. Section 1051.09 – Products Manufactured in PR

Corporations with Election to be Taxed under the 1994 Code

Corporations that elected to be taxed under the 1994 Code did not escape to certain amendments introduced by Act 40. These corporations will be subject to the additional tax on gross income. Although not completely clear, it seems that these corporations will need to include the additional tax on gross income as a separate tax and not as part of the alternative minimum tax. However, such additional tax should be part of the estimated tax computation.

Act 40 allows those corporations that elected to be taxed under the 1994 Code to revoke such election and be taxed under the Code for the first taxable year commenced after December 31, 2012.

Z&A Comments

With the changes to the alternative minimum tax system, including the introduction of the additional tax on gross income, Act 40-2013 increased the complexity of the Code, which in itself was already complex. Corporations should take a careful look at all the changes brought by Act 40-2013 and determine their impact. A special evaluation should be made of the reliefs allowed by this act, which are addressed in the Circular Letters issued by Treasury. If granted by Treasury, those reliefs may result in substantial tax savings.

The amendments of Act 40 may have a significant impact to certain businesses and industries. Our tax consultants are available to help you determine the impact of Act 40 and to answer any question you may have.

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