Zaragoza Alvarado Taxand

The Tax Advisor

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Changes to Administrative Provisions Brought by the Tax Reform

The following article is the third in the series of special bulletins in which Zaragoza & Alvarado discusses the provisions of Act 1 of January 31, 2011, the Internal Revenue New Code for a New Puerto Rico (the "New New Code").

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The approval of Act 1 of January 31, 2011 known as the Internal Revenue Code for a New Puerto Rico (the "New Code") has brought many changes, including renewed efforts against taxpayers who violate the rules and regulations. Let's take a look at some of the changes related to the administrative provisions of this Tax Reform.

NEGLIGENCE AND SUBSTANCIAL UNDERESTIMATION

Section 6042 of the Puerto Rico Internal Revenue Code of 1994, as amended, (the "1994 Code") provided for an addition to the tax of ten percent (10%) in the case of deficiencies which were due to negligence. However, there was no definition or guidelines provided for the determination of negligence, making this penalty a difficult one to sustain. In order to provide more objective rules for the imposition of this penalty, the New Code adopted some of the provisions of the US Internal Revenue Code (USIRC) Section 6662 such as, increasing the addition to the tax in the case of negligence to twenty percent (20%) of the amount of the deficiency, increasing the number of instances in which to apply this penalty, and providing specific rules and thresholds making the penalty automatically applicable if such conditions are met.

The New Code adds four (4) instances very similar to those contained in USIRC Section 6662, in addition to negligence, in which this penalty shall be applicable as follows:

1. **Negligence or Intentional Disregard of the Law and the Regulations**

   Negligence is defined as not doing a reasonable attempt to comply with the dispositions of the New Code. Under the USIRC the application of a negligence penalty would be strongly indicated where a taxpayer fails to: a) include in its tax return income that has been reported on an informative return, b) make a reasonable attempt to ascertain the correctness of deductions and credits which would seem reasonable to a prudent person ("too good to be true test"), or

Continues on Page 2

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Changes to…
Continued from Page 1

c) treat certain items in its tax return in a consistent manner with the items reported by the flow-thru entity (partnership or S corporation) when the taxpayer is a partner or member of a flow-thru entity . This information gives us an idea of where might the Treasury Department ("Treasury") be looking at, although no details are provided in the New Code.

2. Substantial Underestimation of the Income Tax

A substantial underestimation of income tax exists when:

a. In the case of individuals, the underpaid income tax exceeds the higher of ten percent (10%) of the tax required for the taxable year, or five thousand dollars ($5,000).
b. In the case of corporations, the underpaid income tax exceeds the lesser of ten percent (10%) of the tax required for the taxable year, or one million dollars ($1,000,000).

The fact of the inclusion in the New Code of specific thresholds to determine which deficiency is a substantial underestimation clearly reflects Treasury's intention to impose this penalty on applicable cases. The USIRC allows this understatement to be reduced in two ways:

a. by providing substantial authority for the tax treatment of the item being challenged (that is law, regulations, court cases, or other authorities supporting the position); and
b. by providing adequate disclosure of the relevant facts in the tax return. The New Code does not provide anything in this direction.

3. Declaration of a Substantially Incorrect Value of a Property or Adjusted Basis of any Property in an Income Tax Return

The value of a property reported in a tax return is substantially incorrect if it is one hundred fifty percent (150%) or more of the correct value of the property. In these cases the New Code provides a twenty percent (20%) addition to the tax, which may increase to forty percent (40%) if the value of the property reported is two hundred percent (200%) or more of the correct value.

These penalties shall not be imposed if the deficiency related to the difference in valuation of property is less than five thousand dollars ($5,000) in the case of individuals, or ten thousand dollars ($10,000) in the case of corporations.

4. Substantial Overestimation of Obligations to Contribute to an Employer's Plan for Deferring Employees' Compensation

There is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into consideration for purposes of the employer's contribution deduction is two hundred percent (200%) or more of the amount determined to be the correct amount of liabilities, and the tax deficiency related to such deduction for any taxable year exceeds one thousand dollars ($1,000).

This section of the New Code also brings what is called a "gross valuation misstatement", in which case the penalty is increased from twenty percent (20%) to forty percent (40%). This would be applicable in the case of an overstatement in the valuation of property of two hundred (200%) as mentioned in point three (3) above, and would also apply in the case of an overstatement of pension liabilities of four hundred percent (400%) or more of the amount determined to be the correct amount of liabilities.

5. Denial of Tax Benefits for Lack of Economic Substance

Economic substance typically relates to the existence of a business purpose. We believe the Secretary of the Treasury ("Secretary") will need to clarify or provide guidance for application of the penalty under this caption since

Continues on Page 3

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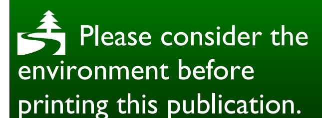
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Changes to…
Continued from Page 2

nothing is said by the New Code as to how will the lack of economic substance be established.

"WHISTLE BLOWER" PROVISION

The New Code also authorizes the Secretary to pay for information that leads to the assessment of tax underestimations and tax deficiencies that may allow them to process violating taxpayers administratively or in the courts. The reward for the person who provides such information may be between fifteen percent (15%) and thirty percent (30%) of the tax assessed and collected, including interest, penalties and surcharges. If the information provided is not substantial for the case, the reward may be of ten percent (10%) or less, even zero, at the discretion of the Secretary. In order to qualify for this "whistle-blower" provision, the information provided must relate to a case where the tax, additions to the tax, penalties, interest and surcharges exceed two million dollars ($2,000,000) In the case of an individual, his/her annual gross income must exceed two hundred thousand dollars ($200,000) for the tax year in question.

In our opinion, the thresholds for the qualification of a case under the "whistle-blower" provision are too high, and we will first see action from the legislators to get them down before any person comes up to volunteer information for any case.

CHANGES BROUGHT BY ACT 171 OF NOVEMBER 15, 2010 ("ACT 171") MAINTAINED BY THE NEW CODE

In the first bulletin of our special series, Juan A. Alvarado discussed several of the changes that Act 171 brought to the 1994 Code. Below we mention some of those that were maintained by the New Code. These changes demonstrate Treasury's renovated emphasis and interest in fiscalization.

One of these changes provide that the voluntary non-compliance with the withholding, reporting and remittance of any tax imposed by the New Code by any person having the responsibility of complying with such duties including the Chief Executive Officer, President, Chief Operating Officer, Chief Financial Officer, Chief Accounting Officer, Controller and any other officer serving a position with such responsibility shall be considered as a third degree felony.

Another one is the new informative return required to all financial businesses approving or extending credit for two hundred fifty thousand dollars ($250,000) or more (five hundred thousand dollars ($500,000) or more in the case of mortgage loans). The return will be known as the Affirmative Declaration of Transactional Amounts and shall include basic information such as the name or names on the credit application, residential or commercial physical address, postal address, account number, amount of the credit approved (adding all credit transactions of the same person within a period of thirty (30) days) and the detail of the supporting information provided to request the credit.

This seems to be Treasury's first step in trying to match the supporting financial data submitted to financial institutions for the approval of credit with the financial information reported in the tax returns, with the purpose of detecting tax evasion.

Act 171 provided that the informative return must be filed not later than the last day of the month following the approval of the credit, for all credit transactions approved after November 30, 2010. However, due to apparent technical complications with the completion and filing of this information in an electronic form, Treasury has issued Internal Revenue Circular Letter 11-02 ("CL 11-02") on January 31, 2011 to extend the time for the submission of the credits approved before December 31, 2010 of all financial institutions, except brokerage houses, for fifteen (15) additional days and thirty (30) days for brokerage houses from the date of the CL 11-02. There is a penalty of one thousand dollars ($1,000) for each form not submitted.

Another provision is the one that requires taxpayers who have failed to comply with the withholding, reporting and remittance of any taxes imposed by the New Code, and who are notified by the Secretary of such violation, to maintain a separate accounting of such withheld taxes and deposit them in a separate bank account designated as a special trust fund for the benefit of the Government of Puerto Rico. This in turn would represent additional administrative work and costs for those taxpayers.

With regards to the Sales and Use Tax, the New Code kept the penalty of up to twenty thousand dollars ($20,000) for refusing to install or use the IVU-Lotto equipment.

Also, the penalty of one hundred dollars ($100) or ten percent (10%) of the tax obligation shown in the tax return, whichever is higher, for failing to file the monthly sales and use tax return was maintained in the New Code. Please keep in mind that this penalty is only applicable for monthly returns filed after December 31, 2010. Also important is the fact that, even if there is no tax liability in the monthly return, the penalty for failing to file of one hundred dollars ($100) may be imposed.

In general, the New Code increased both the compliance requirements and the charges and penalties for failing to comply. Treasury's message is clear; "taxpayers be sure you are in compliance with each and every requirement, or you will have to pay a high cost". We invite you to review your compliance procedures to ensure your business is not exposed. To that end, feel free to call us to discuss how we can assist you in accomplishing this goal.

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