



Treasury Issues Regulation for the Requests for Reduction to the Additional Tax on Gross Income

By Felipe Mariani-Franco

On December 31, 2013, the Puerto Rico First Instance Court instructed the Secretary of the Treasury to issue, within a 30-days term, Regulations establishing the specific criteria to be used in order to grant a reduction to the Additional Tax on Gross Income. The Regulations were issued by the Puerto Rico Treasury Department ("Treasury") on January 30, 2014 and they do not bring good tidings to most taxpayers.

What was expected to be a flexible process where Treasury was going to consider all the facts and circumstances of the taxpayer, including the ending effective tax rate and the industry of the taxpayer, has become a very strict mathematical computation boxed within the definition of the law with no recourse for the taxpayer.

Under the new rules, the consideration of the reduction will be limited to a mathematical

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analysis of the effect of the Additional Tax on Gross Income on the gross profit of the entity. With this approach, no consideration is provided to the operating expenses of most businesses, including their general and administrative expenses. This process excludes from the equation some of the highest costs of doing business such as salaries, rental expenses and utilities to mention some of them. This results in an excessive effective income tax rate for taxpayers in the industries with the lower margins.

Determination of the Reduced Tax Rate

Section 1023.10 of the Puerto Rico Internal Revenue Code of 2011, as amended (the "Code") provides that the Secretary may reduce the tax rate applicable to the taxpayer, but never to less than 0.05% when the person shows to the satisfaction of the Secretary of the Treasury (or when the Secretary determines it himself) that the Additional Tax on Gross Income results in a significant amount compared to its gross profit margin. The Regulation uses the limitation provided in the Code to establish as the only criteria to grant a reduction, the amount of the Additional Tax on Gross Income as compared to the gross profit margin of the taxpayer. As a consequence of this rule, only taxpayers with an Additional Tax on Gross Income representing a percentage higher than 7.5% of its gross profit margin will qualify for the reduction. The gross profit margin used in

The Regulation establishes that only taxpayers who have met the gross profit margin criteria may request the reduction. Those taxpayers will be granted a reduced rate in the Additional Tax on Gross Income equal to the higher of: (i) the percentage which will result on an Additional Tax on Gross Income equal to 7.5% of the average gross profit margin of the base period; or (ii) 0.05% of the gross income. The reduced rate will be granted for a two year period.

Pass-through Entities

The reduction on the Additional Tax on Gross Income for pass-through entities will be made at the entity level with the information provided by the entity. If it meets the required criteria, the Secretary of the Treasury will inform the reduced Additional Tax on Gross Income to each owner of the entity but only if the owners provided authorization to the entity to be included in the request.

Administrative Process

The Regulation follows the administrative processes established in the Code regarding the filing due dates, the response periods required to Treasury and the Interruption of such periods. However, it is important to mention that even with the reduced criteria for qualification, the Regulation still requires the taxpayers to submit the information requested in the various Circular Letters and Administrative Determinations issued, including the agreed upon procedure report.

The Regulation also establishes that a

Breakeven Point for Average Gross Profit Margin Percentage		
Gross Income	Tax Rate	Average Gross Profit Margin Percentage
Over \$1MM but not over \$3MM	0.20%	2.66%
Over \$3MM but not over \$300MM	0.50%	6.66%
Over \$300MM but not over \$600MM	0.70%	9.33%
Over \$600MM but not over \$1,500MM	0.80%	10.66%
Over \$1,500MM	0.85%	11.33%

the determination will be the average gross profit margin of the four taxable years prior to the request of partial waiver (base period).

payment of the Additional Tax on Gross Income should be made in its totality even

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Felipe has extensive experience in corporate tax advisory for the oil, manufacturing, distribution and retail industries. Among his areas of expertise, Felipe works with corporate tax incentives, corporate reorganizations, closing agreements with governmental entities and tax accounting work. During 2008, Felipe was a member of the Puerto Rico Treasury Department Team in charge of the drafting of the regulations of the 2008 Act. In 2007, he participated in the preparation of the Sales and Use Tax (SUT) legislation for the Municipality of Dorado. During 2006 he was a member of the team that worked in the preparation of the first Sales Tax Legislation in Puerto Rico, either at the State or Municipal level, for the Autonomous Municipality of Caguas. The engagement included the preparation of the related regulations.

Felipe is member of the Puerto Rico Certified Public Accountants Society and the American Institute of Certified Public Accountants. He has a Master in Professional Accounting degree, major in Taxes, from the University of Texas at Austin and a Bachelor in Business Administration degree, major in Accounting, from the University of Puerto Rico.



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if a request for reduction has been filed and is in the process of consideration. Although not entirely clear, we believe the same should also apply to estimated tax payments required by the Code.

The Regulation concludes by asserting that the automatic reduction to a tax rate of 0.1% in the Additional Tax on Gross Income provided in the Code when Treasury does not respond to the request within the period granted, will only be applicable to those taxpayers that qualify for the reduction under the rules established by the Regulations. Therefore, taxpayers that do not meet the criteria of an Additional Tax on Gross Income higher than 7.5% of its average gross margin, and who requested the reduction, will not benefit from the automatic reduction if Treasury does not answer to their request.

Z&A Comments

With the issuance of this Regulation, Treasury meets the requirements of the Puerto Rico First Instance Court by providing clear and objective criteria for the Secretary of Treasury to follow in the determination of a reduction in the Additional Tax on Gross Income. However, that clear and objective criteria comes at the expense of those subjective ones which are needed for Treasury to evaluate the real economic harm of the Additional Tax on Gross Income upon taxpayers. By not taking into consideration the reality of the taxpayers, the industry they belong to and the economic conditions they

operate in, this Regulation leaves taxpayers with little recourse to try to reduce what will certainly be, to some, an extremely high effective income tax rate.

Although the Regulation is effective immediately pursuant to the emergency procedure established in the Administrative Procedure Act as certified by the Governor of Puerto Rico, taxpayers have 30 days to provide comments to Treasury. Treasury is not required to act upon those comments.

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