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Taxand

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Corporate Income Tax under the Internal Revenue Code for a New Puerto Rico

The following article is the second 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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On January 31, 2011, the Governor of Puerto Rico signed into law the Internal Revenue Code for a New Puerto Rico (the "New Code"). This law replaces the Puerto Rico Internal Revenue Code of 1994, as amended ("1994 Code"), and as the latter one it covers the Puerto Rico income tax, gift and estate tax, sales and use tax, excise tax, liquor tax and their administrative provisions. Most of the New Code provisions are similar to those of the 1994 Code with different section numbers. However, there are also significant changes. In the following paragraphs we will cover some of those changes applicable to corporations.

REDUCED INCOME TAX RATES

The New Code retains the twenty percent (20%) regular income tax rate but establishes significant lower surtax rates. The 1994 Code provided a surtax rate from five percent (5%) to nineteen percent (19%) while the New Code provides a surtax rate from five percent (5%) to ten percent (10%) for years starting after December 31, 2010 but before January 1, 2014. That surtax rate may reduce to five percent (5%) after December 31, 2013 if certain economic tests are met by the Government of Puerto Rico. If such economic tests are not met, the reduction of the surtax rate will start when such economic tests are met. In the case of a controlled group of corporations the determination of which surtax rate applies will be made by adding the net taxable income of all the entities part of the group.

The New Code also provides a significantly higher surtax deduction, the 1994 Code provided for a twenty five thousand dollars ($25,000) surtax deduction which the New Code increased it to $750,000. In the case of controlled group of corporations, the surtax deduction should be distributed among the members of the controlled group.

Apart from the reduced rates provided by the New Code, it also eliminates the five percent (5%) additional surtax which was established by Act 7 of March 9, 2009 ("Act 7") and the five percent (5%) recapture of the benefit of the income tax tables.

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ALTERNATIVE MINIMUM TAX

The New Code provisions regarding alternative minimum tax include some changes that may have a significant tax impact on corporations doing business in Puerto Rico. The first change is the reduction of the alternative minimum tax rate from twenty two percent (22%) to twenty percent (20%). Although a positive change for corporations, the reduction in the alternative minimum tax rate is not proportional to the reductions in the regular income tax rates. This difference in the tax rate reductions will increase the probability of corporations paying alternative minimum tax.

The New Code also establishes the permanent nature of the adjustment to arrive to the alternative minimum income regarding the payments to related parties for services rendered outside Puerto Rico not subject to Puerto Rico income taxes. Such adjustment was incorporated into the 1994 Code by Act 7. However, Act 7 provided that such adjustment would only apply for a period of three years. The temporary nature of the adjustment allowed companies to recoup any alternative minimum tax paid once the effectiveness of the adjustment ended. The possibility of using the alternative minimum tax paid as a credit is significantly reduced on the New Code since the adjustment is permanent. Companies with significant intercompany services charges may end continuously paying alternative minimum tax and never being able to use the amount as a credit in their income tax return.

The New Code also added a second computation for the tentative alternative tax comprising of one percent (1%) of the purchases made to a related party. Please refer to the second bulletin of our special series, "A Different Approach to the Old Problem of Transfer Pricing" by Juan Zaragoza, for additional explanations regarding this computation.

ELECTION TO BE SUBJECT TO INCOME TAX UNDER THE 1994 CODE

Probably, the strangest of the provisions of the New Code is the one which allows corporate taxpayers to elect to be taxed under the provisions of the 1994 Code instead of the provisions of the New Code for a five (5) year period. This election is made with the income tax return of the year that starts after December 31, 2010 but before January 1, 2012 and is irrevocable. Even when electing to be taxed under the 1994 Code entails losing the reduced income tax rates, it may be advantageous to some taxpayers because it prevents the imposition of several taxes applicable under the New Code. Therefore, a forecast of the income tax to be paid under the New Code and the 1994 Code should be made to determine if this election is favorable for the corporation. Additional comments regarding this election are also found in "A Different Approach to the Old Problem of Transfer Pricing" article.

DEPRECIATION AND AMORTIZATION

The last amendments to the New Code reestablished the depreciation portion of the benefits granted to the small and medium businesses under Act 147 of August 1, 2008 and which were not originally included as part of the New Code Bill. Those benefits allow businesses with revenues under three million dollars ($3,000,000) to:

1. depreciate in the year of acquisition the cost of computer equipment and its related installation cost; and
2. reduce the useful life for depreciation purposes to two years of all transportation equipment, excluding vehicles, and environmental conservation equipment.

The New Code also provides for an increase in the limitation of the depreciable basis of automobiles from twenty five thousand dollars ($25,000) under the 1994 Code to thirty thousand dollars ($30,000). The vehicle useful life remains the same, using a five years life, except sellers which may use a three year useful life. A similar limitation has been established for vehicles under operating leases whereby the annual lease deduction for a vehicle may not exceed six thousand dollars ($6,000) or ten thousand dollars ($10,000) if the taxpayer is a seller. Under the 1994 Code operating leases had no limitation on the amount of lease expense to be deducted as long as they were not related to personal use of the automobile.

The allowance for depreciation for automobiles is an important change when compared with the original version of the Bill which provided for the use of a mileage method to compute the depreciation, lease expenses and auto expenses. The New Code retained the

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mileage method but now it only applies to gas, insurance, repairs, maintenance and related expenses. The Secretary of the Treasury will determine the standard mileage rate to be used under this method. The introduction of the mileage method for automobile expense will require companies to establish a methodology and policies to compute the mileage incurred in a business related activity.

CORPORATE DIVISIONS

The New Code incorporates provisions that allow corporate divisions to be completed with fewer steps. Under the 1994 Code, spin-offs, split-offs and split-ups could be completed under its reorganization provisions but required to structure a transaction to comply with rules not particularly established for these types of transactions and, therefore, required certain additional steps in order for the transaction to qualify for a tax free reorganization. The provisions of the New Code are specifically made for these types of transactions which allow for a simpler structuring of the transactions.

STATUTORY FINANCIAL STATEMENT REQUIREMENTS

The New Code provides a new set of rules regarding the statutory financial statements to be included with the Puerto Rico income tax return. As in the 1994 Code, no audited financial statements will be required for corporations with volume of business of less than three million dollars ($3,000,000) during the taxable year. However, corporations with a volume of business no lower than one million dollars ($1,000,000) but not higher than three million dollars ($3,000,000) may elect to file audited financial statements signed by a Certified Public Accountant authorized to practice in Puerto Rico. Those corporations will receive a waiver for the income tax withholding on services rendered in Puerto Rico as long as they are up to date with their tax responsibilities. The possibility of a full waiver may entice some taxpayers to file financial statements in order to receive the totality of their fees rather than having to claim the related withholding tax as a credit on its annual income tax return.

Corporations with a volume of business equal to or in excess of three million dollars ($3,000,000) will be required to submit audited financial statements signed by a Certified Public Accountant authorized to practice in Puerto Rico. However, if the corporation is part of a group of related entities which perform business within Puerto Rico, then consolidated financial statements will be required where the financial position of the parent company and its subsidiaries are presented together. The New Code requires that such consolidated statements include a statement with the financial information of the parent company and its subsidiary, including columns with the elimination entries and the consolidated totals. Such statement also has to be audited. In the case of foreign corporations that operate in Puerto Rico through a branch, the consolidated financial statement requirement will not be applicable and, therefore, audited financial statements which include the Puerto Rico operation will be valid. If the corporation decides to present consolidated financial statements, a statement with separate columns for the home office and the branch information will be required and should also be audited.

Z&A COMMENTS

The New Code provides a significant reduction on the income tax rate which should benefit most corporations doing business in Puerto Rico. However, corporations with significant transactions with related parties may end up with a high alternative minimum tax which reduces or completely eliminate the benefits of the reduced rates for regular income tax. Such companies need to quantify their possible exposure and analyze the options available under the New Code before pursuing drastic solutions.