CLIENT ALERT

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The past few months have seen a number of legislative measures and laws that significantly change the tax landscape in Puerto Rico. These measures include changes to the Puerto Rico Internal Revenue Code for the 2010 taxable year as well as a completely new tax code for the 2011 taxable year onwards. Additionally, these new measures also include significant changes aimed at giving the Puerto Rico Treasury additional tools to fight tax evasion and increase tax collections. We have enclosed a brief summary of the major changes but in no way should this update be considered exhaustive due to the nature and scope of such changes.

2010 Tax Reform

Act No. 171 of 2010, also known as the 2010 Tax Reform, introduced and amended sections of the Puerto Rico Internal Revenue Code of 1994, which will have certain implications for the 2010 taxable year.

- **2010 Additional Credit**

A new tax credit solely for the 2010 taxable year is available for individuals that derive gross income from wages, services rendered, pensions, annuities or any other similar type of income. The percentage of the credit depends on the taxpayer’s adjusted gross income. The credit will consist of total tax liability multiplied by the corresponding percentage, as listed below:

Adjusted Gross Income	*Tax Credit*
$0 – $40,000	15%
$40,001 $100,000 ($150,000 in case certain cases)	10%
Excess of $100,000 ($150,000 in case certain cases)	7%

In cases of married taxpayers that opt for the optional tax computation for joint filers, the credit's amount will be determined individually for each. This tax credit ***cannot*** be claimed against income subject to preferential tax rates or the alternate minimum tax.

- **Detailed deductions**

The mortgage interest deductions are limited to 30% of the taxpayer's adjusted gross income with certain modifications.

- **Net Operating Losses**

For the 2005 through 2011 taxable years, net operating losses can be carried forward for a period of 10 years, as opposed to the normal 7-year period for operating losses incurred in previous years.

- **Sales and Use Tax**

The 2010 Tax Reform introduced numerous changes to the Sales and Use Tax ("SUT") aimed at improving enforcement. First, any prizes received as part of the Puerto Rico Treasury's IVU LOTO system are exempt from all taxes, including excise taxes. The IVU LOTO is a new receipt system imposed by the Puerto Rico Treasury that includes a special lottery number that is eligible for prizes on a periodic basis. The main goal of the IVU LOTO is to increase the percentage of the SUT's collection—especially for cash sales—which has proven difficult for the Puerto Rico Treasury to collect. As part of this new measure, any person found not using or tampering with the IVU LOTO system will be subject to a $20,000 fine.

In addition to the IVU LOTO, the 2010 Tax Reform lowers the threshold requiring electronic filing and payment of the collected SUT from $500,000 in annual sales to $200,000, thereby increasing the number of merchants that will be required to file SUT returns electronically. Finally, failure to file the monthly SUT return will result in a $100 penalty or 10% of the SUT reflected therein, whichever is greater. These changes are effective for SUT returns corresponding to the 2011 taxable year and thereafter.

- **Informative Return Regarding Credit Applications**

Another enforcement measure approved for the 2010 Tax Reform is the requirement that *financial businesses must file an informative return with the Puerto Rico Treasury for credit requests by taxpayers. This new informative return will be required for any credit request of $250,000 or more. In the case of mortgage applications, the informative return will be required for requests of $500,000 or more. If a taxpayer makes multiple credit requests within a period of 30 days, all credit request will be added up to determine whether the information return will be required. Said informative return is due on or before the last day of the month following the credit request filed by the taxpayer. These new provisions apply to credit requests after November 30, 2010.*

2011 Tax Reform

Act No. 1 of January 31, 2011, enacted a new Puerto Rico internal revenue code for taxable years beginning after December 31, 2010. Along with reduced tax rates for both individual and corporate taxpayers, the new code also introduces significant changes to the taxation of partnerships, special partnerships and limited liability companies in Puerto Rico.

- **Major Tax Changes for Corporate Taxpayers**

The first major change to corporate taxpayers is a change in the income tax rates. Previously, corporate taxpayers—who under the previous code included partnerships, limited liability companies ("LLCs"), and limited liability partnerships ("LLPs")—, were taxed at progressive tax rates between 20% and 41% (including the special 5% temporary surtax of net income). Under the new code, all corporate taxpayers will be subject to a 20% income tax rate on their net income. Additionally, corporate taxpayers with net taxable income in excess of $750,000 will also be subject to an additional surtax as follows, resulting in a maximum tax rate of 30%:

Net Taxable Income	*Tax*
Up to $1,750,000	5%
In excess of $1,750,000	$87,500 + 10% of the excess above $1,750,000

Moreover, for tax years commencing after December 31, 2013, this additional surtax is reduced to 5%, resulting in a maximum tax rate of 25% for all corporate taxpayers regardless of their net taxable income. Please note that in the case of controlled corporate groups or related entities the applicable additional surtax is determined taking into consideration the net taxable income of all such entities.

The second major change under the new code is a change to the alternate minimum tax ("AMT"). Under the new code, if a corporate taxpayer is subject to the AMT, it will pay the greater of the following:

≈ The tax determined under the regular corporate tax rates;

≈ 20% of the income subject to the AMT; or

≈ 1% of the value of personal property purchased from "related persons" but only for corporate taxpayers with gross income in excess of $50 million per year.

The third major change under the new code for corporate taxpayers is a change in the tax treatment of partnerships. Under the new code, partnerships will no longer be taxed as entities separate from their partners. As such, their partners will now be subject to taxation upon their distributive share of the partnerships' income at the individual level. Furthermore, while LLCs will continue to be treated as corporations under the new code, they will be eligible to elect to be treated as a partnership for tax purposes. However, this partnership tax treatment will be mandatory in cases in which such LLCs are taxed as a partnership for United States or foreign tax purposes. The new code establishes certain transition rules for partnerships and LLCs that were in existence prior to the approval of the new code.

The following additional changes have also been introduced under the new code:

≈ Elimination of the special 5% surcharge for certain corporate taxpayers;

≈ No new special partnerships election will be permitted as of January 1, 2011;

≈ "Spin-offs" are now allowed as a tax-free corporate reorganization method;

≈ Source of income rules for personal property imposed under the United States internal revenue code are incorporated into the new Puerto Rico code;

≈ Income from air or maritime transportation that starts and ends in Puerto Rico will now be deemed 100% Puerto Rico source income, regardless of whether they occur over or through international waters;

≈ Income from trips between a point within Puerto Rico and a point without Puerto Rico will now be deemed 50% Puerto Rico source income;

≈ Audited financial statements will only be required for entities with a volume of business in excess of $3,000,000, although entities with volumes of business between $1,000,000 and

$3,000,000 can opt to file audited statements in order to be eligible for a total waiver on withholding of service income;

≈ The "Trust Fund Recovery Penalty" of the United States internal revenue code is now incorporated into the new Puerto Rico code;

≈ New rules for "related persons" and "controlled corporate groups" are adopted;

≈ Changes to the computation and the method to claim a tax credit for the purchase of products manufactured in Puerto Rico;

≈ Corporate taxpayers, including partnerships and LLCs, have the irrevocable option to compute their tax liability under the previous code for a period of five years, starting in 2011.

- **Major Tax Changes for Individual Taxpayers**

The new code introduces new income tax rates that increase the threshold at which a taxpayer is subject to the maximum tax rate of 33%. For the 2011 taxable year, taxpayers with taxable net income of $60,000 are subject to the 33%, up from $50,000 under the previous tax code. This top level is increased every year until the top rate reaches $121,501 by year 2016. Furthermore, individuals with taxable net income of less than $5,000 for the 2011 taxable year will be exempted from taxation, increasing to $16,500 by the year 2016. Please note, however, that the tax rates and brackets for the 2014 through 2016 taxable years are only triggered if the government reaches certain tax collection threshold for their corresponding fiscal years.

The second major change was the reduction of the permitted deductions:

≈ Mortgage interest, up to 30% of the taxpayers adjusted gross income of the current tax year or any of the previous three taxable years;

≈ Charitable donations, up to 50% of the taxpayer's adjusted gross income;

≈ Medical expenses and orthopedic equipment in excess of 6% of the taxpayers adjusted gross income;

≈ Student loan interest;

≈ Contribution to certain governmental retirement plans; and

≈ Contribution to Individual Retirement Accounts ("IRAs"), Educational IRAs and Health Savings Accounts.

In the case of retirement accounts, under the previous code total contributions to IRAs and deferred compensations plans, generally known as 401(k) plans or 1165(e) plans, were limited to a combined total for both. Under the new code, contributions to such plans are not subject to this combined total taxpayers can now contribute the maximum amount allowed under the new code to both IRAs (maximum of $5,000 in 2011, $10,000 for married taxpayers that file joint returns) and employer-sponsored retirement savings plans (maximum of $10,000 in 2011, $13,000 in 2012 and $15,000 in 2013).

Finally, the following additional changes have also been introduced under the new code:

≈ Elimination of the special 5% surcharge for certain individual taxpayers;

≈ Elimination of the special real property tax for the 2011-2012 fiscal year;

≈ Gradual elimination of the gradual adjustment tax for certain taxpayers;

≈ Elimination of the "marriage penalty" for married taxpayers filing separate returns or electing the optional computation;

≈ Increase of the personal exemption to $3,500 for all taxpayers ($7,000 for married taxpayers that file joint returns);

≈ Special partnership losses can no longer be used to offset income derived from wages or from taxpayer's principal industry or business; and

≈ Individual taxpayers have the irrevocable option to compute their tax liability under the previous code for a period of five years, starting in 2011.

"While certain provisions of the new code have different effective dates, most of its provisions will be effective for taxable years commencing after December 31, 2010."

We at Goldman remain committed in assisting you and your business to adjust to changes in the law. For further information you may contact Angel D. Marrero at 787.759.4153 (amarrero@ gaclaw.com); Roberto Montalvo at 787.759.4123 (rmontalvo@gaclaw.com); or José E. Villamarzo at 787.759.4120 (jvillamarzo@ gaclaw.com).