

Tax Alert

Goldman Antonetti & Córdova, P.S.C.

Attorneys at Law

Tel. 787.759.8000 • Fax 787.767.9333

www.gaclaw.com

By: Angel D. Marrero-Murga, Esq.
Assisted by Mariangely González-Tobaja
4th year student at the
University of Puerto Rico Law School

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Administrative Determination No. 12-08

The PR Treasury Department (the “PR Treasury”) recently issued the Administrative Determination No. 12-08 (“AD 12-08”) to provide guidance on the alternative minimum tax (“AMT”) calculation under the provisions of the Internal Revenue Code of 2011, as amended (the “Code”).

If a taxpayer has net income subject to AMT of \$150,000 or more, he must pay an additional 10%-20% tax, when it exceeds the regular contribution amount. The Code defines the term “net income subject to AMT” as the taxpayer’s gross income minus certain deductions. Some of these deductions refer to ordinary and necessary expenses paid or incurred during the taxable year in carrying on of a trade or business, including:

- ◆ Salaries and other compensation.
- ◆ Rents or other payments for the possession of property used in trade or business, that is not owned nor the taxpayer has a participation interest.
- ◆ Depreciation, amortization, and depletion of property used in trade or business.

The PR Treasury has determined that the following trade or business expenses, whether paid or incurred by a self-employed individual or by a pass-through entity, may be deducted in determining the net income subject to AMT:

- ◆ Professional services.
- ◆ Employee fringe benefits, including: (a) health plan premiums (b) employer’s contribution to retirement plans and (c) cafeteria plans.

- ◆ Motor vehicle expenses subject to the Code’s limitations.
- ◆ Rent and royalty payments for tangible and intangible property used for trade or business.
- ◆ Direct costs that are indispensable for the provision of services or to conduct the trade or business.

In case of self-employed individuals, these expenses are reported in Schedules K, L, M, or N, as applicable. For pass-through entities (corporations of individuals and special partnerships), these expenses are included in the entity’s tax return and should not be reported as an adjustment to the shareholder’s or partner’s net income subject to AMT.

Some of the expenses allowed against income subject to AMT require further explanation.

Motor Vehicles

The Code distinguishes between two types of vehicles: automobiles and other motor vehicles. The term “automobile” is defined as any motor vehicle manufactured primarily for use on streets and designed for people transportation. The term excludes vehicles used directly in a passenger or freight transportation business, such as: limousines, taxis, funeral cars, and ambulances.

Expenses for depreciation, use and maintenance of vehicles that are not automobiles qualify as deductions against income subject to AMT. In case of automobiles, the allowable expense for AMT purposes is limited by the Code (generally, the deduction is limited to \$6,000 annually per automobile up to \$30,000 total during the automobile’s useful life).

Indispensable Trade or Business Direct Costs

According to the PR Treasury, these expenses include only critical costs to the business, for example:

- ◆ Malpractice premiums, insurance premiums on inventory and on real or personal property used in trade or business.
- ◆ Marketing expenses incurred by businesses that sell consumer goods or provide services.
- ◆ Interest paid on debt incurred to purchase inventory or to acquire real or personal property used in the business.
- ◆ Bad debts write-off; debts should be related to the selling of inventory or the rendering of services;
- ◆ Advertising expenses incurred by an advertising agency.
- ◆ Payments by a travel agency to industry providers.

The PR Treasury has determined that the following will not be considered as indispensable trade or business direct costs:

- ◆ Traveling, meals and entertainment expenses;
- ◆ Representation or public relations expenses; and
- ◆ Lobbying expenses.

Partners or shareholders of pass-through entities

Partners or shareholders of pass-through entities should make the corresponding adjustment to income and expenses earned or incurred by the entity, which for individuals are items subject to AMT. Such adjustment is reported in line 7, Part I of Schedule O of the partner's or shareholder's income tax return.

Option to terminate the pass-through entity election

Even though the Code does not provide for an option to revoke the special partnership ("SP") or corporation of individuals' ("CI") election retroactively, the PR Treasury will allow SP and CI to request the termination of its election, with a retroactive effect, to the first day of taxable year 2011 or 2012.

This request should be filed on or before the latter of: (1) June 30, 2012 or (2) the fifteenth day of the fourth month of the taxable year for which the termination is effective (2011 or 2012). The Code provides that the CI's election may be terminated by submitting a duly notarized sworn statement, if shareholders who own more than 50% of the CI approve the revocation. In case of a SP, a sworn statement signed by the partners or by the partner in charge of the administration is required. Also, a SP's or CI's application to terminate its election should include a schedule of:

- ◆ Estimated tax payments on income attributable to partners or shareholders made by the SP or CI during the taxable year for which the termination is effective.
- ◆ Distributions made to partners or shareholders during the taxable year for which the revocation is effective.

Those SP and CI requesting termination of its pass-through entity treatment for taxable year 2011, must file a regular corporation income tax return along with a copy of the termination's request. These SP and CI could claim amounts paid during taxable year 2011 for estimated tax on income corresponding to the partners' or shareholders' participation, as estimated tax payments of the corporation.

Distributions to partners or shareholders in 2011 will be considered as a return of capital up to the partner's or shareholder's tax base and any excess will be taxed as a long-term capital gain. In case of entities that paid tax on retained earnings at the conversion date, any undistributed balance at the revocation's effective date will be treated as a partner's or shareholder's capital contribution, and thus, his tax base in the entity's equity will increase.

Effectiveness

AD 12-08 has been effective since its approval on March 30, 2012.

Goldman Antonetti & Córdova, P.S.C. remains committed in assisting you and your business to adjust to changes in the law. If you need further assistance in this area, please contact Angel D. Marrero, Esq. at 787.759.4153 (amarrero@gaclaw.com); José E. Villamarzo, Esq. at 787.759.4120 (jvillamarzo@gawlaw.com); or Roberto Montalvo, Esq., 787.759.4123 (rmontalvo@gaclaw.com).



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