ALERT
KPMG LLP (U.S.)

SALT Alert! 2015-15: Puerto Rico Comprehensive Tax Reform Enacted

On May 29, 2015, the Governor of Puerto Rico signed Act No. 72 (the "Act") that amends the Internal Revenue Code of 2011 to make significant changes to the income tax, sales and use tax (known in Spanish as *impuesto a las Ventas y Uso* "IVU"), and excise tax schemes in Puerto Rico.

Sales and Use Tax (IVU)

On July 1, 2015, the current IVU rate of 7 percent will increase to 11.5 percent. This amount includes a Commonwealth tax of 10.5 percent and Municipal tax of 1 percent. For periods after June 30, 2015, merchants with a Reseller Certificate may claim credit of 100 percent for IVU paid on inventory against IVU collected on their sales.

The Act further provides that on October 1, 2015, business-to-business services that are currently subject to IVU will be subject to tax at the 11.5 percent rate. Business-to-business services and designated professional services, such as those rendered by accountants, lawyers, and engineers, that are not currently subject to IVU will be subject to a 4 percent IVU. Please note that no municipal IVU will apply to services subject to the 4 percent IVU. The Act specifically enumerates certain services exempt from IVU, including services provided by the Government of Puerto Rico, education, interest, and other charges, insurance, health, and hospital services, and services offered by persons with a volume of business under $50,000. Services rendered by members of the same group of controlled corporations are exempt from IVU only if both the entity rendering the service and the one receiving the service are engaged in trade or business in Puerto Rico.

Contracts entered into prior to July 1, 2015 are exempt from the IVU increase for a period of twelve months, and acquisition of goods and services under construction projects that began prior to May 30, 2015 are also exempt from this increase. The Department of Treasury will issue guidance in the coming weeks regarding how to properly claim the exemption for preexisting contracts and construction projects.

The Act provides that the IVU and related amendments will remain in effect until March 31, 2016, unless the Secretary of Treasury extends the effective date of the IVU for an additional 60-day period as provided in the Act.

Value Added Tax (VAT)

Effective April 1, 2016, or following any extended sunset date of the IVU, the Act provides that Puerto Rico's IVU will expire and be replaced by a new value added tax (VAT) system. A 10.5 percent VAT rate will apply to the introduction into Puerto Rico of taxable articles and to taxable transactions, including a merchant's sale into Puerto Rico of goods and services, a non-resident's rendering of a service to a person in Puerto Rico, and other combined transactions. (The 1 percent Municipal IVU remains in effect.)The Act provides a comprehensive list of exempt articles and transactions including items used in manufacturing, prescription medicine and articles and services relating to providing healthcare, unprepared food and food ingredients, gasoline and other fuels, articles sold by the Puerto Rican or United States governments, articles related to agriculture and tourism, financial services (including insurance), leases subject to the tourism room tax, sale or lease of real property, educational and childcare services, and sales of vehicles, boats, and heavy equipment.

Sales of articles for manufacture to a manufacturing plan, where the manufacturer holds a "Certificate of Exemption and Zero Rate for Manufacturing Plants," are taxable transactions subject to a zero rate. Zero-rated transactions also include the sale of goods or services for export.

The Act provides for a credit for VAT paid on the acquisition of goods and services attributable directly or indirectly to taxable transactions (including zero-rated transactions). A VAT credit is not available on the acquisition of goods and services attributable directly or indirectly to exempt transactions. Note that merchants that are sellers of unprepared food, prescription drugs, medicines, or articles relating to healthcare, or motor vehicles may claim a credit on their monthly VAT return for the VAT paid or accrued on the acquisition of goods and services up to the total amount of VAT paid or accrued during such month. Generally, merchants must credit overpayments of VAT in the month following the month the credits were created. However, a merchant that generates an overpayment for a particular month in excess of $10,000 may request reimbursement thereof in the month in which it was created if there are three consecutive months of overpayments, or the merchant is an "eligible merchant."

The due dates for filing and paying VAT are the same for VAT as they are for IVU: the monthly VAT on imports returns will be due by the 10th day of the month following the imports; VAT on sales must be declared by the 20th day of the month following the sales.

Sales and use tax refunds must be filed prior to March 31, 2016. Following that date, Puerto Rico will grant only credits for overpayments if included on the IVU monthly return to be filed on or before April 20, 2016.

Corporation Income Tax

Alternative Minimum Tax

Under the 2011 Code, corporations (except for certain foreign corporations not engaged in a trade or business in Puerto Rico and not having made certain elections) pay an Alternative Minimum Tax equal to the excess of the tentative minimum tax for the tax year over the regular tax for the tax year. The tentative minimum tax for a tax year is the greater of: (1) 30 percent of alternative minimum taxable income, plus the additional surtax on gross income, or (2) the sum of the following: (i) 20 percent of certain expenses paid to a related person that are related to the operation of a trade or business in Puerto Rico and are not subject to tax or withholding and/or the amount of costs transferred or allocated from a home office outside Puerto Rico to a branch that have not been subject to Puerto Rico tax, and (ii) 2 percent of the value of purchases of tangible personal property from a related person and/or 2 percent of the value of personal property transferred from the home office located outside Puerto Rico to a branch engaged in a trade or business in Puerto Rico, and (iii) the additional surtax on gross income. For tax years beginning after December 31, 2014, the applicable percentage is:

Purchasing entity's gross receipts from a trade or business in Puerto Rico:	**Percentage**
Greater than or equal to $10 million, but less than $500 million	2.5%
Greater than or equal to $500 million, but less than $1,500 million	3%
Greater than or equal to $1,500 million, but less than $2,000 million	3.5%
Greater than or equal to $2,000 million, but less than $2,750 million	4.5%
Greater than or equal to $2,750	6.5%

Under current law, the Secretary can evaluate the nature of expenses and costs paid to a related person or allocated from a home office to see if any of them should be excluded from the 20 percent levy. The Act provides that the total costs excluded from the levy by the Secretary cannot exceed 60 percent of the total expenditure. Furthermore, provisions allowing the Secretary to set a lower rate for measuring the value of purchases from a related person or the value of property transferred from the home office are eliminated for tax years beginning after December 31, 2014.

For purposes of computing Net Alternative Minimum Taxable Income, taxpayers are currently allowed to deduct net operating losses (NOLs) up to 80 percent of alternative minimum net income. The Act reduces the percentage to 70 percent effective for tax years ending after December 31, 2014.

Net Operating Losses

For purposes of computing regular corporation income taxes, prior law allowed NOL carryovers to offset 90 percent of net income. The Act revises the limitation so that for tax years beginning after December 31, 2014, NOL carryovers are limited to 80 percent of net income. In determining NOLS, deductions for payments made to certain related persons are not allowed.

Non-deductible Items

In computing Puerto Rico net income, unless the taxpayer has been granted an exemption, no deduction is allowed for 51 percent of the expenses incurred or paid to a related party not doing business in Puerto Rico if such payments are attributable to the operation of a trade or business in Puerto Rico and are not subject to income tax or withholding tax. Likewise, taxpayers cannot deduct 51 percent of the payments made to a home office located outside of Puerto Rico by a foreign corporation engaged in business in Puerto Rico through a branch. The Act continues the disallowance of the deduction, but limits provisions that allowed the Secretary to evaluate the nature of the expenses to determine if they should be excluded from the disallowance provisions. Specifically, in tax years beginning after December 31, 2014, the Secretary cannot exclude from the disallowance provisions more than 60 percent of the taxpayer's total expenses. In addition, the Act creates two new categories of expense that are non-deductible, including costs incurred to provide services if the taxpayer has failed to pay sales and use tax or VAT on the service, and depreciation costs associated with property upon which sales and use tax or VAT has not been paid.

Excise Tax

The excise tax on SUV-type vehicles is increased from 7 percent to 11.5 percent effective July 1, 2015. Further, those entities with exemptions under the Economic Incentives Act for the Development of Puerto Rico (Act No. 73-2008) are exempt from excise tax.

Next Steps

KPMG professionals can assist with companies with preparing for the sales tax changes effective July 1 and October 1, 2015, and ultimately for the implementation of a VAT in 2016. Note that while the Act contains all of the changes described above, including the creation of a new article of the tax law for VAT, it also creates a Commission to Consider Alternatives to Transform Consumption Taxes, which is charged with examining whether excise taxes should be imposed instead of a VAT. The Commission has 60 days from the effective date of the Act to make its recommendations on the viability of tax reform options in Puerto Rico.

For more information on Act No. 72 (May 29, 2015), please contact Rolando Lopez at (787) 756-6020, Carlos Molina at (787) 622-5311, or Leah Durner at (202) 533-5542.