

October 12, 2015

**CHANGES TO THE INCOME TAX, SALES AND USE TAX AND VALUE  
ADDED TAX RULES**

On September 30, 2015 Governor Alejandro García Padilla signed into law Act 159-2015 (“Act 159”) to amend various provisions of the Puerto Rico Internal Revenue Code of 2011, as amended (“Code”); Act 159 became effective immediately.

As noted herein, the most significant amendments are in connection with the rules concerning the type of “merchant to merchant services” that are subject to the new 4% sales and use tax (“SUT”) and the 10.5% value added tax (“VAT”) introduced by Act No. 72-2015.

The following is a brief summary of the amendments introduced by Act 159:

**Income Taxes**

**1. Corporations**

*a. Alternative Minimum Tax.*

One of the items that is taken into account in determining a corporation’s “tentative minimum tax” is an amount equal to 20% of the total expenses paid or accrued to certain related persons and, in the case of branch operations, expenses allocated from a home office that is not located in Puerto Rico. The Code provides that the Secretary may recognize exceptions and exclude from the base for this computation those expenses that the Secretary determines to be eligible to be excluded (the “Exception”); however, the amount of expenses excludible under the Exception may not exceed 60% of the total expenses otherwise subject to the 20% computation.

Act 159 amended these rules to provide that:

- i. In order to be entitled to the Exception for a taxable year or years, the taxpayer must file a request (the “Request”) with the Secretary of the Treasury during the first taxable year for which it is being filed.
- ii. If approved, the Exception will be valid for a maximum of three taxable years. The taxpayer may file for a new Request for subsequent taxable years after the expiration of the period covered by the preceding Exception.
- iii. Banks organized under the Puerto Rico Bank Act, as well as those that are organized under the National Bank Act that are doing business in Puerto Rico, are not subject to the 60% limitation, and may therefore be allowed by the Secretary to exclude up to 100% of payments to related persons or allocated home office expenses from the calculation of their tentative minimum tax.

*b. Disallowance of Deductions*

The Secretary’s authority to waive the 51% disallowance of deductions for expenses paid or accrued to related persons or non-resident home office is limited to three taxable years, after which taxpayers may file a request for a waiver for subsequent taxable years under procedures that are similar to the filing of a Request, as described in 1.a., above.

As in the case of the alternative minimum tax, after Act 159, banks organized under the Puerto Rico Bank Act, as well as those that are organized under the

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National Bank Act that are doing business in Puerto Rico, may be allowed by the Secretary to claim up to 100% of payments to related persons or allocated home office expenses.

Further, the disallowance of expenses incurred or paid for services rendered by a nonresident person, and for the cost or depreciation of property, if no SUT or VAT has been paid with respect thereto, will not apply if such services and taxable items are excluded or exempted from payment of the SUT or VAT.

*c. Supplementary Information*

The supplementary information to be submitted with the income tax returns of merchants that report transactions exempted from the SUT must establish that the exemptions have been properly claimed.

The supplementary information to be submitted with the income tax returns of merchants that consume inventory, must establish that the consumption has been properly declared for SUT purposes and that the corresponding SUT has been paid.

**2. Corporations of Individuals**

*Election after Termination*

A corporation of individuals that terminated its election cannot elect anew until after five full taxable years have elapsed since the termination. However, this limitation will not apply to corporations of individuals that requested voluntary termination for taxable years that commenced after December 31, 2010 in order to take advantage of the 8% special tax on deemed dividends in Section 1023.25(b) of the Code.

**3. Non-Profit Organizations**

*a. Organizations exempt under the Puerto Rico Internal Revenue Code of 1994*

Act 159 clarifies that exempt organizations or entities engaged exclusively in the fostering and development of sports and for recreational purposes that requested tax exemption prior to January 1, 2011 shall continue to be exempt despite a change in ownership of the sports league franchise, provided the organization does not change its purpose or mission.

*b. Presumption of Private Interest*

Non-profit organizations will not qualify for income tax exemption unless it serves a “public interest”. Act 159 further provides that an organization is presumed to serve a “private interest” and the organization must show, to the satisfaction of the Secretary of the Treasury, that it is not organized for the private interest of the creator of the entity, its family, shareholders, or related entities.

*c. New Cause for Revoking Exempt Status*

The Secretary of Treasury may revoke the exempt status of a non-profit organization if such organization incurs in:

- i. Lavish, extravagant, or excessive expenditures,
- ii. Expenditures that are not clearly related to the exempt purposes of the organization,
- iii. Expenditures that indicate a profit motive on the part of its directors, officials or employees, or
- iv. Personal or family expenditures of the organization’s directors, officials or employees.

*d. Services to residents of Puerto Rico*

In order to qualify for income tax exemption, the organization must show that it provides services to residents of Puerto Rico.

**4. Amendments that Apply to All Taxpayers**

*a. Special Tax on Dividend Distributions and Designated Deemed Dividend Distributions.*

Act No. 44-2015 introduced a special tax of 8% on dividend distributions made between May 1 and June 30, 2015. Act 159 introduces a new window for paying the special 8% tax on dividend distributions paid, or designated deemed distributions, that are distributed or designated between October 1 and December 31, 2015, provided the 8% tax is paid no

later than December 31, 2015. A distribution subject to the 8% tax need not be included in the shareholder's income tax return, so long as the tax has been paid with the forms established by the Secretary for such purposes.

The 8% tax on dividend distributions or designated deemed distributions will not be available to "taxpayers that are subject to the provisions of Section 1022.03(b)(2)(B)" of the Code. Technically, therefore, taxpayers that purchase personal property from affiliates that are not subject to Puerto Rico income tax on the income derived from the sale of the property, or that receive transfers of personal property from a home office located outside Puerto Rico, would not be able to take advantage of the reduced tax on dividends of 8%.

*b. Long Term Contracts*

Entities engaged in the development of land or buildings may no longer use the completed contract method of accounting to recognize their income.

*c. Use of Tax Credits*

Before the amendments of Act 159, the Code provided that tax credits purchased before June 30, 2013 that are subject to a moratorium may be used during the moratorium period in accordance with the laws under which the credit was granted, but may only reduce "taxes imposed by this Subtitle" (i.e., the income tax portions of the Code) by up to 50%.

Act 159 maintains the 50% limitation and states that the credit may be claimed "income taxes imposed by this Subtitle or by any special law".

*d. New Income Tax Credit for the Acquisition or Broadcasting of Television Shows Developed in Puerto Rico*

Act 159 introduces a new income tax credit for the purchase or broadcasting of certain movies, documentaries, or series produced in Puerto Rico by independent producers if 90% or more of the artists employed in the production are residents of Puerto Rico. This credit is not applicable to programming qualifying under the Film Industry Economic Incentives Act, as amended, or a similar prior or subsequent statute.

The credit amount is 15% of the eligible expenses incurred by the television channel, in the taxable year for which the credit is claimed, for the acquisition or broadcasting of new programming produced in Puerto Rico.

The maximum amount of credit that may be claimed in a taxable year is limited to 15% of the income tax imposed for the year and any unused credit may be carried forward to subsequent taxable years.

The credit may not be transferred.

### Excise Taxes

#### **1. Tax on Oil Products (*Crudita*)**

The exemption from additional excise taxes of \$9.25 and \$6.25 per barrel (or fraction thereof) available to grantees of tax exemption under Act No. 73-2008 with respect to fuel used for: (a) the cogeneration of electric power for their own use (or for use by their affiliates); and (b) energy efficient equipment properly certified by the Energy Affairs Administration is extended to grantees covered by prior or subsequent industrial tax incentives acts.

#### **2. Excise Tax on Automobiles Acquired by Non-Profit Organizations**

Current law provides for a maximum \$5,000 exemption for the excise tax imposed on non-luxury automobiles acquired by non-profit organizations. Act 159 amends this rule to limit the exemption to two automobiles per year; however, the annual limitation will not apply to "vans" and "minivans".

### Sales and Use Taxes

#### **1. Machinery and Equipment Used in Manufacturing**

The definition of "machinery and equipment used in manufacturing" was expanded to include machinery, equipment, tools, parts and components used by a grantee under Act 73-2008 (or

analogous prior or subsequent law) to repair, maintain and condition air vessels. The definition of “manufacturing plant” was likewise expanded to include any factory or business engaged in the repair, maintenance and conditioning of air vessels, if covered by an industrial tax incentives act.

## 2. Services Related to Commercial, Industrial or Residential Construction Projects

The “sales price” of services rendered **to another merchant** in connection with and directly related to **commercial, industrial or residential construction projects** will be 35% of the invoiced amount.

## 3. Services

In general, Act No. 72-2015 added two categories of taxable services that, effective October 1, 2015, are subject to a 4% SUT. These two categories are referred to as “professional designated services” and “services rendered by a merchant to another merchant”. All services that are not “professional designated services” or do not consist of “services rendered by a merchant to another merchant” continue to be subject to the general 11.5% SUT.

Act No. 72-2015 also included a number of exemptions from the 4% and 11.5% SUT; Act 159 expanded the number of exemptions to the different categories of transactions. A unified list of the exemptions that exist after the Act 159 under all of the categories of transactions is as follows:

- a. Repair, maintenance and conditioning services with respect to air vessels, if rendered by a grantee under Act 73-2008 (or analogous prior or subsequent law);
- b. Services rendered to any entity engaged in the repair, maintenance and conditioning of air vessels, if covered by a grant under Act 73-2008 (or analogous prior or subsequent law);
- c. Toll manufacturing or contract manufacturing services, if the service provider obtains a Collection Waiver Certificate;
- d. Services related to the transportation of goods by sea, air and land, including delivery fees;
- e. Fees paid to duly licensed lawyers for legal representation before the courts or administrative agencies, legal advice or notarial services (financial advice, lobbying and other services that may be rendered by other professionals, even if rendered by licensed lawyers, are not considered “legal services” for such purposes);
- f. Services rendered by a non-resident provider to a grantee of tax exemption under Act 73-2008, Act 83-2010, Act 20-2012, or any analogous prior or subsequent law, or to a bank organized under the Puerto Rico Bank Act or the National Bank Act, provided both the service provider and the local customer are “related persons” within the meaning of Section 1010.05 of the Code (including, for such purposes, partnerships and excluded members);

**It is important to note that on October 5, 2015, the Puerto Rico Treasury Department issued Administrative Determination No. 15-21 (“AD-15-21”) which states that this exemption does not apply to amounts charged by the service provider that consist of reimbursement of expenses incurred by service provider in connection with services rendered by third parties.**

- g. Services provided to residents associations, condominium boards, owners’ associations and residential cooperatives, provided at least 85% of the units served by the association, board or cooperative are residential units;
- h. Services rendered to low-income housing projects subsidized by the Puerto Rico or Federal government, if the residents pay maintenance fees and have obtained an exemption certificate from the Secretary of the Treasury;
- i. Services rendered to a person engaged **solely** in the warehousing or processing, within a Foreign Trade Zone or subzone, of fuels, petroleum products and other hydrocarbon mixtures subject to excise tax (the exception does not apply to a person engaged in distribution or transportation of such products);
- j. Services rendered to bona fide farmers certified by the Department of Agriculture;
- k. **Designated professional services** rendered to unions or syndicates organized under the Labor Relations Act of Puerto Rico of 1945 and the Public Service Labor Relations Act of Puerto Rico (Act 45-1998);

- l. Services rendered to a public or private entity whose Organic Act provides that it shall be exempt from all taxes and tariffs;
- m. Services rendered by the government of Puerto Rico;
- n. Educational services, including costs of tuition;
- o. Interest and other charges for the use money and charges for services provided by financial institutions (other than bank charges on commercial accounts that are subject to the 11.5% SUT);
- p. Insurance commissions and services;
- q. Health or hospital medical or veterinary services;
- r. Services rendered by persons whose annual volume of business does not exceed \$50,000 (determined on an aggregate basis in the case of controlled groups of related entities, for which purposes partnerships, special partnerships and corporations of individuals shall be considered “corporations”);
- s. Services rendered by a person that is engaged in a trade or business in Puerto Rico to another person that is engaged in a trade or business in Puerto Rico, provided both persons are members of the same controlled group (including, for such purposes, partnerships and excluded members);
- t. Rights for the use of intangibles;
- u. Production services rendered by producers of television and radio programming, or advertisements, produced in Puerto Rico;

**It is important to note that AD-15-21 states that this exemption does not apply to public relations services covered by Act No. 204-2008, known as the “Act for the Creation of the Relations Regulatory Board of Puerto Rico”.**

- v. Advertising and promotion services provided in any media –including electronic, print, digital, interior or exterior– including advertising agency commissions and fees; the exemption also includes production of content for electronic and digital media in Puerto Rico;
- w. Subcontracted services hired by a contractor in connection with commercial, industrial or residential construction projects; the exemption also applies to telecommunication services subcontracted by a merchant engaged in providing telecommunications services;
- x. Services rendered to a merchant by employees of a temporary employment agency that correspond to the gross salaries paid to employees, if duly identified in the invoice issued to the merchant.

#### **4. Transition to VAT**

The statutory language was amended to make clear that the SUT will remain in effect, at the current rates, until such time as the Value Added Tax (“VAT”) becomes effective.

#### **5. Person Responsible for the Tax**

From October 1, 2015, the responsible person required to pay the tax, if any, on taxable services, designated professional services and business to business services rendered by a nonresident provider to a resident of Puerto Rico, regardless of where the services are rendered, will be the service recipient, provided the service is directly or indirectly related to the recipient’s operations or activities in Puerto Rico. Note, however, that services rendered by nonresidents are **not** subject to the 1% municipal SUT, and are therefore taxed at 4% or 10.5%, as applicable.

#### **6. Exemption for Books**

The exemption for textbooks has been extended to all printed books of a scientific, literary or artistic nature, but excluding periodicals, magazines and electronic publications.

#### **7. Other Developments**

- a. *Informative Bulletin No. 15-14 (“I.B. 15-14”).* The Department issued I.B. 15-14 to notify that the IVU Loto draws will cease after the draw of September 29, 2015.

- b. *Circular Letter of Tax Policy No. 15-13 (“C.L.T.P. 15-13”)*. Notwithstanding I.B. 15-14, C.L.T.P. 15-13 clarifies that merchants must continue to display in the receipts all of the information required in Section 6.4 of the Processor Guidelines and Specifications, except that Merchants:
- i. Must eliminate reference to the IVULoto draw number and date; and
  - ii. Must substitute the word “IVULOTO” with the word “CONTROL.”
- c. *Administrative Determination No. 15-20 (“A.D. 15-20”)*. The Department of Treasury of Puerto Rico (“Department”) issued A.D. 15-20 to notify certain changes regarding the use of fiscal terminals for the SUT transactions, as follows:
- i. Merchants with aggregate annual sales volume of \$125,000 or less will no longer be required to install, have and maintain a fiscal terminal to record SUT transactions.
  - ii. Merchants with aggregate annual sales volume in excess of \$1,000,000 may choose to have a fiscal terminal integrated in each of its points of sales of its commercial establishment, or have cash registers that are able to transmit electronic data to the Department.
  - iii. In addition to the merchants listed in §2501(a)-2(a) of the SUT Regulations, merchants dedicated exclusively to leasing real estate for residential or commercial purposes, those registered as temporary businesses, and independent contractors rendering services only to “multilevel businesses” are not required to use fiscal terminals in their SUT transactions.
  - iv. On **October 29, 2015**, the fiscal terminals that were provided by the Department will cease to operate.
  - v. Beginning on **October 30, 2015**, merchants will be required to bear all costs associated with the acquisition, installation and maintenance of the fiscal terminals, and those associated with the transmission of information to the Department.
  - vi. Failure to comply with the obligation to install, have and maintain the fiscal terminals and to process and register sales transactions using a fiscal terminal may be subject to the imposition of penalties up to \$20,000 per occurrence.
- d. *Administrative Determination 15-21 (“A.D. 15-21”)*. The Department issued A.D. 15-21 to further clarify the technical amendments of Act 159 and provide examples for the implementation of such amendments.

### Value Added Taxes

#### **1. Articles Used in Manufacturing and Manufacturing Plant**

The definition of “articles used in manufacturing” was expanded to include machinery, equipment, tools, parts and components used by a grantee under Act No. 73-2008 (or analogous prior or subsequent law) to repair, maintain and condition air vessels. The definition of “manufacturing plant” was likewise expanded to include any factory or business engaged in the repair, maintenance and conditioning of air vessels, if covered by an industrial tax incentives act.

#### **2. Services**

The definition of “services” was amended to **exclude**:

- a. The right to use intangibles;
- b. Services rendered by a non-resident provider to a grantee of tax exemption under Act 73-2008, Act 83-2010, Act 20-2012, or any analogous prior or subsequent law, or to a bank organized under the Puerto Rico Bank Act or the National Bank Act, provided both the service provider and the local customer are “related persons” within the meaning of Section 1010.05 of the Code (including, for such purposes, partnerships and excluded members);
- c. Services related to the transportation of goods by sea, air and land, including delivery fees; and
- d. Services rendered to a public or private entity whose Organic Act provides that it is exempt from all taxes and tariffs.

### 3. Export Services

The definition of “export services” is modified to provide that services covered by a tax exemption grant under Act 73-2008 or 20-2012 (or analogous prior or subsequent act) will constitute “export services”, so long as they do not have a nexus with Puerto Rico **within the meaning of Act 20-2012.**

### 4. Exempt Transactions

Act 159 added the following transactions as exempt from VAT:

- a. Services rendered to bona fide farmers certified by the Department of Agriculture;
- b. Fees paid to duly licensed lawyers for legal representation before the courts or administrative agencies, legal advice or notarial services (financial advice, lobbying and other services that may be rendered by other professionals, even if rendered by licensed lawyers, are not considered “legal services” for such purposes);
- c. Services provided to residents associations, condominium boards, owners’ associations and residential cooperatives, provided at least 85% of the units served by the association, board or cooperative are residential units;
- d. Services rendered to low-income housing projects subsidized by the Puerto Rico or Federal government, if the residents pay maintenance fees;
- e. Retail sales of solar electric equipment;
- f. Repair, maintenance and conditioning services with respect to air vessels, if rendered by a grantee under Act 73-2008 (or analogous prior or subsequent law);
- g. Toll manufacturing or contract manufacturing services, if the service provider obtains a Collection Waiver Certificate;
- h. Maintenance fees paid under a Time Sharing or Vacation Club Plan pursuant to Act 252-1995, or analogous prior or subsequent law;
- i. Services rendered to a person engaged **solely** in the warehousing or processing, within a Foreign Trade Zone or subzone, of fuels, petroleum products and other hydrocarbon mixtures subject to excise tax (the exception does not apply to a person engaged in distribution or transportation of such products);
- j. Services rendered to a merchant engaged in the generation and sale of electricity on a commercial scale;
- k. Services rendered to any entity engaged in the repair, maintenance and conditioning of air vessels, if covered by a grant under Act 73-2008 (or analogous prior or subsequent law); and
- l. Services rendered to a public or private entity whose Organic Act provides that it shall be exempt from all taxes and tariffs.

### 5. Credits

- a. Although the sale of goods paid with funds from the Nutritional Assistance or Women with Infant Children programs continues to be exempt from VAT, the VAT paid by merchants on the purchase of these goods will be treated as a VAT that is directly related to the sale of taxable articles. The effect of this amendment is that merchants will be allowed a full credit with respect to VAT paid on said goods.
- b. While VAT paid or incurred that is not directly related to taxable sales of goods or services must be allocated on a proportionate basis between the taxable and tax exempt transactions, merchants 70% or more of whose sales for the preceding three year period stem from the sale of (1) unprepared foods and necessities (other than small appliances, toys, beauty products, school and office supplies, hardware, shoes, clothing and alcoholic beverages); (2) prescription drugs, medicines and products used in treating ailments; or (3) retail or wholesale sales of oil products or fuels (that is, goods subject to excise tax under Sections 3020.06, 3020.07 and 3020.07A) or automobiles, may claim a VAT credit for the full amount of VAT payments made during the month.

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**Administrative Matters**

**1. Fines and Penalties Related to the VAT**

Act 159 added to the Code provisions relating to the fines and penalties that will apply for failure to comply with the VAT, which provisions are very similar to those applicable for purposes of the SUT.

**2. Closing Agreements**

Act 159 substantially curtails the Secretary's authority when entering into closing agreements by establishing a number of limitations. Thus, the Code now provides that the Secretary may not, in a closing agreement:

- a. Accept, after June 30, 2016, the prepayment of taxes not due at the time the agreement is entered into;
- b. Allow or apply tax rates that are lower than those established under the Code or applicable special statute;
- c. Allow or apply deductions or tax credits that are not allowed under the Code or special applicable statute;
- d. Classify or apply as an overpayment amounts that do not consist of previously paid taxes;
- e. Extend the statute of limitations, except as allowed in the Code;
- f. Waive the imposition of interest or surcharges, except as allowed by the Code;
- g. Modify the basis or the amount of gain upon the sale of assets other than as provided in the Code;
- h. Exempt from the requirement to file a return, unless the return is included with and is part of the closing agreement; or
- i. Execute closing agreements on issues or matters with respect to which the Secretary is not expressly authorized to exercise his discretion.

**3. Cooperatives**

Act 159 amends Act 255-2002 (relating to savings and loans cooperatives) and Act 239-2004 (the General Cooperatives Act) to provide that, notwithstanding the general exemption from taxation provided by said Acts, cooperatives are not exempt from SUT, VAT or excise taxes.



If you have any questions or comments, or would like additional information about this matter, please call any of our tax attorneys:

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