Tax experts weigh in on 2011 Tax Reform's first year

Individuals, corporate taxpayers benefited from reduced tax brackets; more education urged on benefits of reform

From left: Pablo Hymovitz Cardona, member of the local law firm López Sánchez Pirillo & Hymovitz LLC; Juan Alvarado, founding partner of local tax & business advisory firm Zaragoza & Alvarado LLP; Juan Bruno, audit & tax director at local CPA & tax advisory firm Horwath Vélez & Co. PSC; and José L. Carmona senior reporter, banking and finance, CARIBBEAN BUSINESS

BY JOSÉ L. CARMONA
josec@caribbeanbusiness.pr

A month after the dust settled following the first tax-filing season under the 2011 Tax Reform, three of Puerto Rico's top tax advisers and consultants passed judgment on how their clients fared with this year's tax returns.

And the verdict was unanimous: In general terms, the vast majority of individuals as well as corporations saw a marked reduction in their income-tax liability under the new tax reform.

Juan Alvarado, founding partner of local tax & business advisory firm Zaragoza & Alvarado LLP; Juan Bruno, audit & tax director at local CPA & tax advisory firm Horwath Vélez & Co. PSC; and Pablo Hymovitz Cardona, member of the local law firm López Sánchez Pirillo & Hymovitz LLC, recently sat with CARIBBEAN BUSINESS to discuss their findings and observations.

Although there were fewer deductions and schedules for both individuals and corporations, a substantial reduction in the income-tax brackets, as well as an increase in the personal exemption and credit for dependents more than made up for the reduction in deductions, according to the tax experts interviewed.

Individual taxpayers now have more spending money

While the deadline to file tax returns for calendar year 2011 was April 17, individual taxpayers started enjoying the benefits of the 2011 Tax Reform in January of last year. At that time, employers reduced the tax amount deducted from each employee's paycheck every month.

"You have to be careful when you ask individual taxpayers if their tax liability was reduced or not because, more often than not, they base their answer on their tax refund. Just because your tax refund was smaller doesn't mean you paid more taxes. That's because you were receiving

Continued on next page

Continued from previous page

part of that tax refund every month, since your employer deducted less taxes from each paycheck," Alvarado commented. "But the general consensus is that individual taxpayers paid a smaller tax liability than the previous year."

For Hymovitz Cardona, the fact individual taxpayers had less taxes withheld from their paychecks had a positive, multiplier effect on the local economy.

"First, taxpayers receive more money in their pockets every month, throughout the entire year. Instead of being in the hands of the government, that money is now in taxpayers' hands. That improves their liquidity and cash flow, while at the same time it benefits the local economy through their purchase of goods and services. That is more money that enters local businesses, which in turn increases sales-tax collections. It's a win-win situation for everyone," Hymovitz Cardona explained.

According to Alvarado, there were many positive reactions among joint filers (both working), who filed their income-tax returns under the new Tax Reform.

"The so-called optional computation really provided tax justice for joint filers, at least in the cases I saw," Alvarado said. "What's more, even in cases where one of the joint filers wasn't working, they were able to benefit as well, since an amendment was passed that allowed them to use the optional computation."

That amendment, Alvarado noted, was particularly useful in cases where the working joint filer had a high level of passive income. In this case, half that income passes on to the nonworking spouse under the optional computation.

"I've had clients who saved up to $10,000 on their income taxes just by using the optional computation," Alvarado added.

But highly paid or compensated individual taxpayers weren't the only ones able to take advantage of the benefits in the recent tax reform. While there was greater focus under the reform to reduce taxes on higher-income earners, Bruno pointed out that the middle-working class also received strong tax relief through a

"I've had clients who saved up to $10,000 on their income taxes just by using the optional computation."

—Juan Alvarado, founding partner of local tax & business advisory firm Zaragoza & Alvarado LLP

dramatic reduction in income-tax brackets.

"We all know that those earning less than $20,000 didn't pay income taxes. That alone benefited a lot of people, who won't have taxes deducted from their paychecks every month," Bruno said. "That's a large group of people whose tax liability was zero."

In addition, and for the first time ever, seniors ages 65 or older received a $400 tax credit under the Tax Reform.

While there are no changes in standard deductions for individuals' next income-tax returns, there will be further, tiered reductions in income-tax rates through 2016—provided the government meets certain tax-collection goals.

"Standard deductions will remain stable, but there will be changes in the income-tax rates. The income bracket, which was raised this year from $50,000 to $60,000, will increase in steps to $70,000. Meanwhile, the gradual adjustment, which is the 5% tax that applies when a taxpayer has more than $100,000 in net taxable income, will be phasing out until it is eliminated," Alvarado explained.

Last year, the gradual adjustment was 5% on more than $75,000 in net taxable income. For next year, the amount subject to the gradual adjustment will increase to $200,000, then to $300,000 and finally to $500,000. Afterward, it will be eliminated.

Dramatic reductions in corporate taxes

For Bruno, the Tax Reform's biggest impact was on corporate taxes, since the highest tax rate was reduced from 39% to 30%, with an effective rate of 20% on taxable income of up to $750,000.

"That reduction plus the 20% effective tax rate had a substantial impact on the corporate level. The reason behind it is to stimulate corporations to create more jobs. By having a smaller tax load, corporations can help lower unemployment and prevent the brain drain the island is experiencing," Bruno said.

Alvarado said the reduction in corporate tax rates was very significant, and the experience of the vast majority of customers paying their estimated taxes in April was also good, he said.

"Previously, the focus was on corporations with tax incentives, whether for manufacturing, tourism, etc., but now the focus is on corporations, especially on small ones, since taxes were reduced on all of them," Alvarado noted. "Now, for a corporation to pay more than 20% in taxes, it has to earn a lot more than $750,000."

As a consultant, Hymovitz Cardona indicated one aspect of the Tax Reform, which clients have commented most about, is the impact of the reduction of corporate tax rates (from 39% to 30%) in the gradual adjustment.

"The highest rate on corporate taxes, which was 39%, is now 30%, and the gradual adjustment, which previously ranged from 31% to 41%, that 41% is now 30%, and that's a substantial difference," Hymovitz Cardona commented. "For 2014, that 30% drops to 25%."

The reduction in corporate tax rates has awakened the curiosity of nonlocal companies, Hymovitz Cardona indicated, saying he has been receiving inquiries from them, especially about treatment of flow-through entities.

"The Puerto Rico tax system is now more aligned with that of the U.S. federal tax system. Concepts that previously were foreign for many investors, I now can refer to as being more like the federal income-tax code," Hymovitz Cardona said. "We can now speak the same language taxwise, and I think that will be very beneficial for Puerto Rico in the long term."

The deduction for expenses incurred in the use of a vehicle for business purposes was changed this year to a standard mileage deduction of 26¢ a mile. To comply with this new deduction method, Treasury is giving taxpayers until July 1 to prepare and comply with the new rules.

"That's one of the most significant changes, in terms of deductions, in the new tax return. While some deductions were eliminated in their entirety, what we have now is more leeway for Treasury to reduce the tax rates even further," Hymovitz Cardona commented.

Reduced tax rates can attract foreign companies

Bruno stated the changes for corporations' in the local tax code can be very attractive to stateside companies, especially those with small operations on the island (such as outlet stores) that wish to expand.

"In the past, when you told them about a maximum tax rate of 39%,

Continues on page 38

Continued from page 37

it scared them away, and that was with earnings of $500,000. Now, they're at an effective tax rate of 20% with earnings of $750,000, and that's a substantial reduction," Bruno explained.

While it can be said few corporations have really been able to take advantage of the benefits of the new Tax Reform, since many have been struggling and others have had losses in recent years, Bruno noted these companies will be able to enjoy the benefits once they recover.

"The bottom line is that these tax benefits will be there when the struggling corporations finally recover. You can't lose perspective, that losses can be carried over," Bruno added.

Considering there was a recessionary economy, the period for which corporations can carry over their losses for tax years was extended from seven years to 10 (from 2005 to 2015, instead of up to 2012), Alvarado noted.

"This extension was included in legislation passed prior to the new Tax Reform, but is part of a package of amendments to the new tax code," Alvarado explained. "Essentially, the government is giving corporations a three-year tax break to make their adjustments and, once again, get back on a profitability track."

Juan Bruno, audit & tax director at local CPA & tax advisory firm Horwath Vélez & Co. PSC

Pablo Hymovitz Cardona, member of the local law firm López Sánchez Pirillo & Hymovitz LLC

Move to simplify local tax code

While there certainly were fewer tax deductions on this year's income-tax returns than in previous years, Hymovitz Cardona pointed out this was all part of a concerted effort by the government to simplify the tax code and filing process.

"Some deductions were eliminated, but that gave way to reducing the income-tax rates. The personal exemption and credit for dependents were also increased," Hymovitz Cardona said. "Essentially, the new Tax Reform eliminated deductions that involved certain degrees of subjectivity, so now that process is more controlled."

Under the new Tax Reform, some deductions were eliminated or phased out, while the reduction in income-tax rates allowed the vast majority of taxpayers to enjoy a smaller tax liability. Nonetheless, taxpayers had the option to file their income-tax returns under the old tax code if they wanted.

"However, the vast majority—more than 99% of taxpayers—opted to file their income-tax returns under the new tax code," Hymovitz Cardona pointed out. "That was a testament that taxpayers obviously filed under the tax code that was more beneficial to them."

Alvarado highlighted the fact he didn't recall having one, single client who filed under the old tax code this year.

"The only ones that could have done it are the so-called special societies, but that commits you to file under the old tax code for five-consecutive years, and there are issues with that," Alvarado said. "The reduction in tax rates was extremely attractive, so enjoying that tax-rate reduction for five years had more benefits than carrying over losses for the same period."

New tax code had its challenges

As with the previous major overhaul of the local tax code in 1994, the new Tax Reform had its glitches.

According to Bruno, many tax issues were cleared up at the last minute through administrative determinations, so taxpayers had to constantly monitor for any changes. Luckily, tax preparers enjoyed resources such as those of the Society of CPAs, which tracked those changes.

"There were many gray areas in the new tax code that needed to be cleared up. Those administrative determinations are good tools because they allow you to tend to those issues so clients can file on time," Bruno indicated. "Administrative determinations can complicate the tax-filing process, but help clear up a lot of the gray areas that surface during the process."

For Alvarado, the fact the Treasury Department tackled the Tax Reform's gray areas through administrative determinations speaks well for the agency's posture and attitude toward the entire process.

"You must bear in mind that legislation for the new Tax Reform was approved, even though it was extremely complicated in terms of its implementation, since it involved technology and new tax forms that had to be modified or amended. Then you have this new tax system that you're implementing and, at the same time, tax preparers are alerting you about things you need to change," Alvarado said.

"I believe that in the months preceding the tax-filing period, the Treasury Department was responding to inquiries through bulletins and determinations, providing clarity. In that sense, Treasury reacted positively, so what we have seen in terms of amendments has been the norm in the past few years," Alvarado added.

Alvarado pointed out that during the 1994 Tax Reform, when he also was in Treasury, a year later a package of legislative measures was approved that contained the technical amendments to the tax code.

"So, additional amendments to the new Tax Reform will come later, as it gets fine-tuned and refined along the way," Alvarado commented.

Bruno pointed to a series of combined returns put out this year by Treasury for foreign branches of limited-liability corporations (LLCs) doing business on the island and how they were going to treat their flow-through income.

"These combined returns, which came out at the last minute (in late March or early April) with little guidance from Treasury, tried to simplify the process, since they provided tax rules about how these LLCs would be taxed," Bruno explained. "Many of these foreign corporations were flow-throughs in the mainland U.S., and these combined returns are taxed locally in one single return."

One thing in which all three tax advisers and consultants agreed on was that Treasury needs to beef up its education efforts about the benefits of the new Tax Reform so more individual and corporate taxpayers can take full advantage of and further reduce their income-tax liabilities. ■