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Tax Alert: Expenses or charges incurred with related parties outside of Puerto Rico

Do you incur in expenses or charges with related parties outside of Puerto Rico? You may need a waiver to be able to deduct those for Puerto Rico income tax purposes.

Recently approved Act 72-2015 incorporates significant changes to the sales and use tax in Puerto Rico and the adoption of a new chapter to the 2011 Puerto Rico Internal Revenue Code, as amended (PR Code) to transition our current consumption tax into a value added tax (VAT) system.

This could be a preliminary conclusion of the tax reform efforts that began with the filing of Bill 2329 on February 11, 2015, which was supposed to drastically transform our tax system with not only the adoption of a VAT but which would have also brought significant changes to the income tax arena, including the promised tax rates reliefs that never materialized.

In addition to the changes to our consumption tax system, Act 72-2015 also modified certain income tax aspects of the PR code. One of these new changes is an important modification of the treatment of **expenses or charges incurred by taxpayers with related parties that are not engaged in trade or business in Puerto Rico**. As a continuation to the trend initiated with Act 40-2012 and Act 72-2015, it limits the amount of the deduction of these expenses or charges for ordinary tax purposes, as well as it continues to consider them part of the **alternative minimum tax computations** (AMT). Notwithstanding, the law continues to authorize the Secretary of Treasury to approve waivers to reduce the amount of the charges subject to the limitations for ordinary tax purposes, as well as for AMT purposes. We hope and expect this to be the initial development of adopting formal transfer pricing dispositions in Puerto Rico to regulate the transactions with related parties as most countries around the world continue to implement these rules.

In the following paragraphs we discuss the current particular treatment of these expenses for both ordinary tax and AMT purposes.

Ordinary tax

PR Code limits the deduction of the expenses or charges incurred by a taxpayer with a related party that is not engaged in trade or business in Puerto Rico, if such expenses are not subject to Puerto Rico taxes. On this regard, PR Code provides that 51% of these expenses are not allowed as a deduction for ordinary tax computation. However, Act 72-2015 establishes a limit to the amount of expenses that may be covered by the waivers that the Secretary is authorized to issue. The maximum allowed is limited to 60% of the total amount of expenses. The Secretary has not yet issued regulations under these new provisions and there are important details that need to be considered like for example: if a taxpayer obtains this 60% waiver, for how long would it be valid?

Contact us

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June 19, 2015

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Currently, for years commenced before January 1, 2015, the PR Code provides a maximum of 100% total waiver valid for two (2) years. Furthermore, our interpretation of the effectiveness of the waiver provided by this new provision is that a taxpayer that obtains the maximum waiver (i.e. 60%) would be allowed to deduct 79.6% of the expenses or charges incurred by the taxpayers with related parties that are not engaged in trade or business in Puerto Rico. If 60% is excluded, the remaining 40% is subject to the 51% disallowance. Therefore the amount available as a deduction if the total waiver is obtained is 60%, plus 49% (100% less 51% disallowed) of the remaining 40%. This is our interpretation and will be validated when the regulations are issued or by direct consultation with the Secretary of Treasury.

In addition, any expense or charges incurred by a taxpayer with a related party that is not engaged in trade or business in Puerto Rico would not be considered to determine the amount of the net operating loss (NOL) carryover in case the taxpayer incurs in a loss for tax purposes. Notwithstanding, any expenses or charges for which the Secretary of Treasury has issued a waiver would be allowed as a deduction as well for purposes of the NOL deduction carryover computation.

Alternative Minimum Tax

Currently, the AMT to be paid by a corporation depends on the results of two computations. The first of the two computations is the result of multiplying the AMT income by the AMT rate of 30%. The second computation is the sum of two additional calculations.

- purchases of personal property made by a taxpayer with a related party that are not engaged in trade or business in Puerto Rico multiplied by rates that vary from 2.5% to 6.5% depending of the taxpayer's gross revenues, plus
- 20% of the expenses or charges incurred by taxpayers with related parties that are not engaged on trade or business in Puerto Rico (same expenses to which the 51% deduction disallowance)

As in the case for the ordinary tax deduction, the Secretary of Treasury may approve a waiver to exclude up to 60% of these expenses or charges subject to the 20% AMT.

The treatment of expenses (not subject to taxation in Puerto Rico) with related parties that are not engaged in trade or business in Puerto Rico has continue to evolve as a significant area which needs careful evaluation to properly determine its implications in the current tax system. The opportunity of requesting a waiver should definitively need to be considered as part of the ongoing tax planning that our complex tax structure demands.

On this regard, Senate Bill 1433 has been filled. This Bill is proposing technical amendments to Act 72-2015. Among the proposed amendments, the waivers are being limited to three years and in the case of banks they would be allowed to exclude up to 100% of the expenses, not 60% as the rest of the taxpayers.

In addition, if the technical amendments are approved as presented, the waivers should be requested within the first applicable taxable year. Therefore, it is crucial to evaluate this opportunity as soon as possible.

Please contact our Tax Department should you require additional information regarding this or any other tax issue. We will be glad to assist you.