

Tax Alert: The Tax Reform Impact Assessment Report

On February 4, 2015 the Puerto Rico Treasury Department made public the Tax Reform Impact Assessment Report to be considered in the analysis for the development of a new tax system in Puerto Rico.

In summary, the report recommends to replace the existing consumption tax structure by a broad-based single rate value-added tax (VAT) with regressivity relief through direct transfer payments. It also recommends the simplification of the income tax by eliminating or modifying virtually all existing tax deductions and credits. A significantly higher exemption level is also proposed which should result in a drastic reduction of the number of taxpayers subject to income tax.

In regards to businesses, they are divided in two sectors. The first group includes corporations, unincorporated businesses, sole proprietorships and other entities taxed as pass-through entities. The recommendation for this group is to eliminate the multiple rates, repeal of the alternative minimum tax, repeal of the Patente Nacional, among others. The second group is referred to as the “inbound investors”. Basically these are the exempt business under Act 73-2008 and Act 20-2012. No major changes are elaborated for the inbound investors except that it is expressly identified the need that the conditions to grant decrees under Act 20-2012, be reviewed to require conditions that allow specific levels of economic activity for Puerto Rico in lieu of the exemptions.

Lastly, the area of property tax is also covered. It is recommended to increase the percentage of revenue that is raised from property taxes considering that the property tax revenues in Puerto Rico constitute a smaller percentage of GDP than in comparable jurisdictions.

Following are the main highlights of the recommendations by area of tax:

Consumption Tax

Proposed changes in this area focus on a broad-based consumption tax. The proposed VAT rate is a sixteen percent (16%) single rate across the board which includes all goods and services, except::

- exported goods and services;
- financial services;
- residential housing;
- electricity;
- water;
- fuel; and
- hotel services

In addition, it proposes for:

- all small businesses to be exempt from registration,
- the identification and elimination of the double taxation of items still subject to excise tax,
- cash payments to low income households, as a regressivity relief measure to eliminate the tax burden on the purchase of food, medical expenses, education and clothing.



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Individual Income Tax

The proposed changes for this area are focused on the repeal and/or modification of most of the existing tax expenditures, as follows:

- repeal preferences for capital gains
- repeal of Act 22-2012
- include eighty percent (80%) of social security payments in income
- repeal “step up” in basis for property held at death and treat certain gifts of appreciated property as income tax realization events
- limit charitable contributions deduction
- change the home mortgage interest deduction into a tax credit that phases out as income increases
- repeal basic alternative tax
- increase income tax exemption
- creation of a new rate schedule under the proposed parameters listed below:
 - i. 15% tax rate on income between: \$35,000 and \$125,000 for singles, \$70,000 and \$125,000 for married couples.
 - ii. 20% tax rate on income between: \$125,000 and \$200,000 for singles and married couples
 - iii. 30% tax rate for income above those amounts.

Domestic Business Income Taxation

Proposed changes for this area include the following:

- repeal of tax preferences for capital gains
- repeal of the Patente Nacional
- repeal of the alternative minimum tax
- imposition of a flat 30% tax rate (or the rate that is equal to the highest individual rate) on corporate income
- provide generous transition relief to encourage existing corporations to become to pass-through entities
- rationalize pass-through taxation to create a simple regime for small businesses with PR individual owners.

Inbound Business Taxation

In the area of exempt businesses the proposed changes are:

- examine and rationalize existing incentives by subjecting grants to rigorous cost benefit review
- amend Act 20-2012 to require specific PR economic activity as a condition for awarding the grants
- consider short term (e.g. five years) extension of Act 154-2010 on excise tax, necessary for revenue collection purposes and which provides improved planning certainty for affected taxpayers
- consider a reduction of the excise tax rate if specified economic and revenue goals are reached

Property Tax

Options to improve the system proposed for this area focus on:

- repeal personal property tax
- updating and maintaining real property values at current fair market value
- creating systems to capture new construction and improvements
- consideration of differential rates for different property uses
- consideration of a real property transfer tax

To access the full report as released by the Puerto Rico Treasury Department, please follow this link:

<http://www.hacienda.gobierno.pr/informe-de-kpmg-sobre-la-reforma-contributiva>

Please bear in mind that the above proposed changes are only included in the referenced report.

Still a bill legislation has not been filed and not necessarily such bill, when presented, will include all the proposed changes as well as it may also include other changes.

We will continue to alert you as the Tax Reform develops.