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Tax Alert: Insight on 50-50 rule for transportation services in Puerto Rico

On May 8, 2017, the Puerto Rico Treasury Department issued Administrative Determination No. 17-02 ("AD 17-02") to express its position in regards to the computation of net taxable income for taxpayers' involved in the maritime and air transportation industry.

Allocation of income and expenses – Transportation business
Pursuant to Section 1035.07(a) of the 2011 Puerto Rico Internal Revenue Code, as amended (the "Code"), all income from transportation that begins and ends in Puerto Rico will be sourced entirely to Puerto Rico. Nonetheless, according to Section 1035.07(b) of the Code, if the transportation service begins or ends in Puerto Rico, only fifty percent (50%) of the income attributable to said transportation service will be sourced to Puerto Rico (the "50/50 allocation rule").

While the Code is quite clear on how transportation income will be allocated in transportation services between Puerto Rico and a foreign destination, there is no analogous section detailing how expenses will be treated. The Code's silence in this regard raises a series of questions:

- since income is subject to the 50/50 allocation rule, should expenses be apportioned in the same manner?

- if not, should the taxpayer freely determine the amount of expenses to be attributed to the transportation service?

Moreover, uncertainty turns into outright confusion when we consider Section 1033.17(a)(17) of the Code. In determining net taxable income, this Section imposes a fifty-one (51%) disallowance of 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. Is the transportation industry subject to this 51% disallowance?

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AD 17-02 states that the 51% disallowance limitation under Section 1033.17(a)(17) of the Code will not be applicable in those cases where the *50/50 allocation rule* is in effect.

Administrative Determination 17-02 ("AD 17-02")

To address the above referenced inquiries, and bring much needed clarity and consistency in the determination of net taxable income for transportation purposes in Puerto Rico, the Puerto Rico Treasury Department has resolved that the *50/50 allocation rule* should also apply to expenses incurred in the transportation service that generated the corresponding transportation income.

Moreover, AD 17-02 states that the 51% disallowance limitation under Section 1033.17(a)(17) of the Code will not be applicable in those cases where the *50/50 allocation rule* is in effect.

AD 17-02 is effective immediately and applicable to taxable years beginning after December 31, 2015. In addition, those taxpayers that, at the date of issuance of AD 17-02, have already filed their Income Tax Return for taxable year 2016, may petition the Puerto Rico Treasury Department for Closing Agreement or a Private Letter Ruling to address any issue that may arise from the application of AD 17-02 and the amounts reported in the corresponding Income Tax Return.

Note: As highlighted in our July 1, 2016 Tax Alert, PROMESA seeks to provide Puerto Rico with fiscal and economic discipline through the creation of a control board, among other things. Virtually every fiscal decision by the Government of Puerto Rico will be made or approved by the Oversight Board created by PROMESA. On this regard, the board has authority to prevent the execution or enforcement of a contract, rule, executive order or regulation to the extent that it is inconsistent with the approved fiscal plan.

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

María de los Angeles Rivera
Partner Head of Tax and
IBC Director
Kevane Grant Thornton
E maria.rivera@pr.gt.com

Lina Morales
Tax Partner
Kevane Grant Thornton
E lina.morales@pr.gt.com

Francisco Luis
Tax Partner
Kevane Grant Thornton
E francisco.luis@pr.gt.com

Isabel Hernández
Tax Partner
Kevane Grant Thornton
E isabel.hernandez@pr.gt.com

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