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## **Tax Reform General Information**

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Act No. 257 ("Act 257-2018"), enacted on December 10, 2018, introduced various changes to the Puerto Rico Internal Revenue Code of 2011, as amended, in the areas of individuals, corporations, partnerships, and sales and use taxes. It also changed certain administrative provisions.

The following are the most salient aspects established by Act 257-2018, per topic. Some of these matters require immediate action by taxpayers and merchants doing business in Puerto Rico. Please note that most changes will apply to taxable year 2019, unless otherwise specified below.

### **INCOME TAXES: INDIVIDUALS**

**NORMAL TAX:** The current tax rates applicable to individuals with respect to the normal tax did not change. However, Act 257-2018 introduced a **five percent (5%) credit** from the amount determined for regular tax and gradual adjustment. Thus, the tax liability of the individual will be ninety five percent (95%) of the tax determined using the tax rates applicable for taxable year 2018 and prior years.

**GRADUAL ADJUSTMENT:** The five percent (5%) gradual adjustment would apply on net income in excess of \$200,000, up to a maximum gradual adjustment amount of \$13,273.

**ALTERNATIVE BASIC TAX ("ABT"):** Act 257-2018 introduced significant changes to the computation of the ABT, including the applicable tax rates and the method to calculate the alternative net income. The new tax brackets for ABT range from 1% to 24% depending on the alternative net income of the taxpayers. Also, Act 257-2018 established **new requirements** for the determination of the alternative net income. In summary, significant limitations will apply to taxpayers that claim trade or business expenses. The purpose of these changes is to promote compliance from taxpayers by requiring that most of the expenses to be deducted be reported and informed in the applicable informative return duly filed with the Puerto Rico Treasury Department ("PRTD"). However, an individual that would like to claim as deduction all the ordinary and necessary expenses should be able to do so if he/she includes an Agreed Upon Procedure ("AUP") or a Compliance Report ("CR") with his/her tax return.

**NEW – OPTIONAL TAX FOR SELF-EMPLOYED INDIVIDUALS:** Act 257-2018 introduced a **new optional tax applicable** to individuals who are self-employed. The individuals will be allowed to pay a fixed tax rate on their gross

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income as long as all the income generated by the individual was subject to income tax withholding at source and duly informed on an informative return and/or was subject to estimated tax payments. It should be noted that individuals that avail to this election will not be able to claim any deduction against their income. The optional tax rates are as follows:

<b>Gross Income</b>	<b>Tax Rate</b>
Not in excess of \$100,000	6%
In excess of \$100,000 but not in excess of \$200,000	10%
In excess of \$200,000 but not in excess of \$300,000	13%
In excess of \$300,000 but not in excess of \$400,000	15%
In excess of \$400,000 but not in excess of \$500,000	17%
In excess of \$500,000	20%

**EARNED INCOME CREDIT:** Act 257-2018 reestablished an earned income tax credit for resident individuals with earned income. The credit ranges from \$300 through \$2,000, depending on the taxpayer's facts and subject to phase-out rules based on the amount of income generated.

### **INCOME TAXES: CORPORATIONS**

**NORMAL TAX:** Act 257-2018 reduced the normal tax rate for entities taxed as a corporation from 20% to 18.5%. The surtax brackets remain the same as in prior years. With the amendments introduced by Act 257-2018, the highest tax rate for entities taxed as corporations will be reduced to 37.5% from 39% starting with taxable year 2019.

**ALTERATIVE MINIMUM TAX ("AMT"):** Act 257-2018 modified the AMT rates and the determination of alternative net income. The AMT will be the greater of \$500 or 18.5% of the alternative net income subject to AMT (23% for Corporations with volume of business in excess of \$3,000,000). Please note that there are **new requirements** for the determination of the alternative net income such as limitations to claim certain expenses. In this regard, Act 257-2018 requires more compliance from taxpayers with respect to the reporting of the expenses that will be taken into account in the computation of the alternative net income. Nonetheless, a corporation may claim as deductions all the ordinary and necessary expenses, provided it accompanies with the Puerto Rico tax return an Agreed Upon Procedure or a Compliance Report.

**NEW** – OPTIONAL TAX FOR CORPORATIONS ENGAGED IN RENDERING SERVICES: Act 257-2018 introduced a **new** optional tax computation for corporations who are engaged in the services industry. The corporations that elect this option will be allowed to pay a fixed tax rate on their gross income as long as all the income generated by the corporation is subject to income tax withholding at source and/or estimated tax payments and all the income is duly reported on the applicable informative return. It should be noted that corporations that avail to this election will not be able to claim any deduction against their income. The optional tax rates are as follows:

<b>Gross Income</b>	<b>Tax Rate</b>
Not in excess of \$100,000	6%
In excess of \$100,000 but not in excess of \$200,000	10%
In excess of \$200,000 but not in excess of \$300,000	13%
In excess of \$300,000 but not in excess of \$400,000	15%
In excess of \$400,000 but not in excess of \$500,000	17%
In excess of \$500,000	20%

### **INCOME TAXES: IN GENERAL**

**NET OPERATING LOSS DEDUCTION:** The NOL deduction increased from 80% to 90% of the net income subject to normal tax.

**PAYMENTS TO AFFILIATES OUTSIDE OF PUERTO RICO CURRENTLY SUBJECT TO 51% DISALLOWANCE:** Act 257-2018 established that, if a taxpayer includes with the Puerto Rico tax return a transfer pricing study prepared in accordance with Section 482 of the US Tax Code, the 51% disallowance should not be applicable.

**AUDITED FINANCIAL STATEMENTS:** Act 257-2018 expanded the group of taxpayers required to include audited financial statements. The term “related entities” was amended to include entities that are treated as pass-through entities. As a result of this amendment, the requirement to submit audited financial statements with the Puerto Rico tax return may apply to certain groups of entities that were not considered in the group before.

**SERVICES RECEIVED FROM ABROAD:** Act 257-2018 clarifies that services received from foreign persons are subject to the special tax of 4%, if applicable, in order for the expense to be allowed as a deduction.

**MEALS AND ENTERTAINMENT:** The meals and entertainment deduction is reduced from 50% to 25% of the total expense.

**TRAVEL EXPENSES:** The travel expense will be limited to 50% of the total expense.

**SPECIAL DEDUCTION FOR EMPLOYERS:** Act 257-2018 introduced a new deduction for employers who hire university students of 150% of the salaries paid to said persons, subject to certain requirements.

ACCELERATED DEPRECIATION FOR SMALL BUSINESSES: Entities with a volume of business of \$3,000,000 or less, will be allowed to depreciate machinery, equipment and furniture and fixtures using a useful life of two (2) years.

INCOME TAX RETURN EXTENSION REQUEST: The extension period increase from 3 to 6 months, starting with taxable years commenced after December 31, 2016.

**NEW** – UNCERTAIN TAX POSITIONS: Act 257-2018 introduced a new requirement for taxpayers required to submit audited financial statements with their Puerto Rico tax returns of including a statement with the Puerto Rico tax return disclosing any uncertain tax position in accordance with the auditing standards.

### **ADDITIONAL CHANGES RELATED TO INFORMATIVE RETURNS**

**NEW** – INFORMATIVE RETURN FOR ELECTRONIC TRANSACTIONS: Act 257-2018 introduced a new informative return to be prepared by entities engaged in the business of processing electronic payments, including transactions with debit and credit cards. The informative return will be filed annually starting with calendar year 2019.

INFORMATIVE RETURNS FOR DEDUCTIONS: Act 257-2018 requires in order to claim certain expenses for ABT and AMT purposes that taxpayers prepare an informative return. These **new requirements** apply to the following expenses, among others: telecommunications, internet services, marketing, promotions, advertising and insurance.

### **CHANGES REGARDING WITHHOLDING TAX RULES**

WITHHOLDING TAX ON SERVICES RENDERED: The withholding tax rate on payments for services rendered increased from 7% to 10% starting on January 1, 2019, whereas the exemption amount, which was previously \$1,500, was reduced to \$500. Certain taxpayers are eligible to total or partial (6%) waivers, depending on their facts and circumstances.

WITHHOLDING TAX DEPOSITS: The deposits of tax on services rendered are now due the 15th day of the following month in which the withholding was made (previously the 10th).

QUARTERLY TAX RETURNS: Act 257-2018 introduced a **new** quarterly return for every taxpayer required to deduct and withhold income taxes on services rendered.

## SALES AND USE TAX

“SMALL MERCHANTS” THAT PROVIDES SERVICES: The volume of business threshold to be required to collect sales and use tax increased on business to business services (“B2B”) or designated professional services increased from \$50,000 to \$200,000, starting on March 1, 2019.. Consequently, merchants that provides B2B services or designated professional services with a volume of business of \$200,000 or less will not be required to collect sales tax on their services.

COMMERCIAL RENT EXEMPTION: The exemption will apply only in cases in which the landlord confirms that the tenant complies with the fiscal terminal requirement provided in the Puerto Rico Code.

PREPARED FOOD: The sales tax on prepared food, carbonated drinks and bakery products, among others, will be reduced to 7% starting on October 1, 2019.

SALES TAX EXEMPTION ON BOOKS: Act 257-2018 includes “e-books” as part of the books exempt from sales tax.

Should you have any question please contact Lenda De Jesus at 787-22-8855 or by email [ldejesus@bakertillypr.com](mailto:ldejesus@bakertillypr.com).

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