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Tax Newsletter

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In this edition we provide you a summary of the changes suffered by the capital gain tax rates applicable to individuals, estates, trusts, corporations and partnerships over the last two years. We will also include a brief explanation about the new informative returns: forms 480.6D and 480.7C. Finally, we talk about the IRS Voluntary Disclosure Program, which is an important practice currently followed by the IRS.

Over the past several years, the sections of the Puerto Rico Internal Revenue Code of 1994 ("PRIRC") that deal with the taxation of long-term capital gains have undergone various amendments. The capital gain rates have fluctuated from 5% to 25% depending on the type of taxpayer and the type of transaction. In order to incentive the economy of Puerto Rico, the Legislature approved a number of temporary provisions. For example: the tax rates were decreased by 50% for certain particular transactions occurred during a specific period. Another temporary provision established by the government was the prepayment on the increase in accumulated value of specific capital assets using a special tax rate of 5%.

After all these changes, Act No. 181 of December 10, 2007 ("Act 181") was enacted in order to provide uniformity to the different tax rates applicable to long-term capital gains. Act 181 reduces the special tax rate applicable to individuals, estates and trusts to 10%. The special tax rate for corporations and partnerships is 15%.

These tax rates will apply to transactions occurred on July 1, 2007 and after.

In the following pages you will find two tables summarizing the applicable tax rates for individuals and corporations from January 1, 2005. We hope this summary clarify most your doubts and questions in relation to this important matter. Remember that every case is unique and in order to determine which rate applies to your specific transaction you should contact your Tax Advisor.

Important Reminders

- Remember to obtain your 2008 income tax withholding waiver and deliver it to your clients on time to avoid any excess withholdings.
- The maximum earnings subject to Social Security taxes will increase to \$102,000 for 2008. The percentages will remain the same as for 2007.

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Individuals, estates and trusts – long term capital gain rates

CONCEPT	CAPITAL GAIN RATES FROM JANUARY 1, 2005 TO JUNE 30, 2005		CAPITAL GAIN RATES FROM JULY 1, 2005 TO DECEMBER 31, 2005	CAPITAL GAIN RATES FROM JANUARY 1, 2006 TO JUNE 30, 2007**	CAPITAL GAIN RATES FROM JULY 1, 2007 AND AFTER***
	With Reinvestment*	Without Reinvestment			
Other Properties	10%	20%	20%	12.5%	10%
Property Located in Puerto Rico	5%	10%	10%	12.5%	10%
Shares of Eligible Corporation or Partnership	3.50%	7.00%	7%	12.50%	10%

* To be entitled to the benefit of the reduced tax rates during this period, the taxpayer must have complied with certain requirements among which are the reinvestment in Puerto Rico of the gain realized during the temporary period not later than 60 days from the date in which the transaction occurred, and that such reinvestment must be held for a minimum period of one year from the reinvestment date.

** Temporary provision from July 31, 2006 to December 31, 2006 applied to the increase in the value of the stock or the property located in PR. For the purpose of this temporary provision, other properties include only stock of foreign corporations or partnerships. During this period a 5% of capital gain rate applied to property located in Puerto Rico and other properties.

*** In case of nonresident alien individuals the applicable capital gain rate is 25%.

Corporations and partnerships – long term capital gain rates

CONCEPT	CAPITAL GAIN RATES FROM JANUARY 1, 2005 TO JUNE 30, 2005	CAPITAL GAIN RATES FROM JULY 1, 2005 TO DECEMBER 31, 2005	CAPITAL GAIN RATES FROM JANUARY 1, 2006 TO JUNE 30, 2007*	CAPITAL GAIN RATES FROM JULY 1, 2007 AND AFTER
Other Properties	12.50%	25%	20%	15%
Property Located in Puerto Rico	6.25%	12.50%	20%	15%
Shares of Eligible Corporation or Partnership	3.50%	7%	20%	15%

* Temporary provision from July 31, 2006 to December 31, 2006 applied to the increase in the value of the stock or the property located in PR. During this period a capital gain rate of 10% applied only to real property located in Puerto Rico.

Informative Returns:

Exempt Income (Form 480.6D)

Retirement Plans and Annuities (Form 480.7C)

As all of you may remember, Act No. 87 of May 13, 2006, as amended ("Act 87") established that every distribution made by a qualified pension plan solely by reason of separation of service, paid between May 16, 2006 and December 31, 2006 was subject to a special tax rate of 5%. This special tax rate also applied to any amount accumulated and undistributed from such trusts, but for which the taxpayer elected to prepay the tax. The amounts elected to be prepaid by the taxpayer were originally informed in Form 480.6B as taxable income. However, the Regulations to Act 87 specify that once those prepaid accumulated amounts are actually paid,

they will be reported as exempt income in the informative return established by the Secretary of the Treasury ("Secretary"). To those effects, the Secretary issued Informative return 480.7C in order to report the distributions paid during 2007, but for which the applicable special tax of 5% was paid during year 2006.

In addition to these distributions, any distribution made during the year 2007 related to pension plans and annuities should be reported in this form.

This form should be filed on or before February 28, 2008.

During the same year 2006, the Tax Fairness Act established that every eligible distribution made by a corporation or partnership during the period from July 1, 2006 and December 31, 2006 was subject to a special tax rate of 5%. This special tax also applied to deemed eligible distributions. The term "deemed eligible distributions" means distributions declared by the corporation or partnership, for which the corresponding special tax of 5% was paid, however the distribution per se was not paid to the stockholder or partner. In this case the regulations provide that such deemed eligible distributions have to be reported in the year declared as taxable income

and also in the year paid to the stockholder or partner as exempt income.

In order to report the deemed eligible distributions as exempt income, the Secretary issued Form 480.6D.

This form will also be used to report the following transactions:

- The accumulated gain on nonqualified options
- Compensation for injuries or sickness under Section 1022(b)(5)
- Distributions from non-deductible individual retirements accounts

This form should be filed on or before February 28, 2008.

IRS Voluntary Disclosure Practice

It is currently the practice of the IRS that a voluntary disclosure will be considered along with all other factors in the investigation in determining whether criminal prosecution will be recommended. This voluntary disclosure practice has helped people avoid prosecution for possible tax evasion and reduce taxes, penalties and interest. This practice is an internal procedure of the IRS and does not automatically guarantee immunity from prosecution. However, it is the only opportunity that the taxpayers have to avoid a prosecution recommendation.

In order to qualify for the IRS voluntary disclosure program the taxpayer needs to comply with the following requirements:

- the taxpayer's communication with the IRS must be truthful, timely, complete.
- the taxpayer must show a willingness to cooperate with the IRS in determining his or her correct tax liability; and
- good faith arrangements with the IRS must be made to pay in full the tax, interest, and any penalties determined to be applicable.

A voluntary disclosure is considered "timely" if it is received prior to the following events:

- the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation;
- the IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance;
- the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or

- the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).

In some specific situations it is the best practice to voluntarily disclose to the IRS the tax position taken in a particular tax return in order to avoid potential criminal tax prosecution and negotiating abatement of penalties and interest.

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