



Tax newsletter

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In times where almost every country and specially most of the states in the United States are looking into ways to increase revenue collections, Puerto Rico is not the exception.

In the United States for example, several states are starting to impose sales tax on services that were previously exempt. New York may tax haircuts, manicures and pedicures. In 2009, Maine started taxing dry cleaning and car repairs services. In Nebraska, a bill introduced proposes to tax 60 services. In Puerto Rico, services, with certain exceptions, have been subject to sales and use tax since the inception of Law 117. Nevertheless, the collections from the sales and use tax are far less than expected. Given the deficient collections and the fiscal and economic crisis that, by now, we are all aware, the

Governor appointed a Tax Reform committee last February.

The committee must produce a viable tax reform in order to accomplish two main purposes: protect the most fragile levels of our society while promoting economic development and produce the necessary revenues to achieve that goal.

In this issue we provide some comments on how the Tax Reform Committee is approaching this huge task. In addition, we summarize some recent developments in the area of the Sales and use tax in Puerto Rico and changes brought by the recent Health reform in the United States that affect employers in Puerto Rico.

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Tax Partner



The second installment of the special real property tax pursuant to Act 7 was due on March 1, 2010. You have **90 days** to make the payment without interest or surcharges.

Remember, **June 15** is the due date to make the second individual estimated tax payment for 2010 for both PR and US.

The basics for the Puerto Rico tax reform

The Tax Reform Committee appointed by the Governor of Puerto Rico last February is currently working on the research phase of the reform. They are meeting two or three times per week and have requested economic studies of the impact the different recommendations will have.

The Tax Reform will not concentrate only in income tax legislation but should also include both property and "patente" taxes. In connection with the Sales and use tax, the Committee does not foresee an increase in the rate. The Committee will consider not only the needs and concerns of businesses but those of the general population:

- protect the most fragile levels of our society and
- promote economic development.

One of the biggest concern of the Committee is the amount of tax credits that are available to be claimed by taxpayers. According to data provided, there are around \$1,000 millions of these credits. Among these:

- Law 212 - \$270 millions
- residential purchases - \$220 millions
- purchase of local manufactured products - \$62 million

The Committee will be evaluating these credits.

One of the major objectives is to simplify processes: a shorter tax return with less deductions. In addition, they are looking into ways to increase the cost of non compliance as well as the chances of being caught in no compliance. The Committee will propose ways to make it easier to identify those taxpayers that are not complying with all their responsibilities in order to impose stronger penalties.

In the income tax area for businesses, the Committee is looking into the following:

- direct expensing of fixed assets;
- tax free reorganizations to temper them to changes in the US rules;
- taxation of transportation businesses;
- taxation of businesses that did not

exist when the Code was enacted (i.e. internet).

In terms of the municipal taxes (property and patente) the Committee is aware of the need to extend the tax reform to cover these too. They also understand that it is a very sensitive topic due to the many jurisdictions involved (78 different municipalities and mayors) and the commitments that these taxes are currently guarantying. They do not foresee the total elimination of the personal property tax on inventories and equipment, but they agree that the property tax system must be carefully revaluated. In specific the assessment of all the residential properties that are not currently included in CRIM's records and a re assessment of those already included.

We will keep you posted of all developments in the area of the Tax Reform as soon as they become available.



Fact: According to the Puerto Rico Electric Power Authority, there are 1,200,000 registered households in Puerto Rico. CRIM has only 800,000 registered and assessed for real property tax.

New social security tax exemption applicable to Puerto Rico employers

The President of the United States signed The Hiring Incentives to Restore Employment Act (HIRE) on March 18, 2010. Under the new law, businesses can receive two new benefits:

1. an exemption of the 6.2% employer share of Social Security taxes on new hires that were previously unemployed and
2. an additional credit of up to \$1,000 if the new employees are retained for 52 weeks that will be claimed on the 2011 income tax return.

The new employees must be hired after February 3, 2010 and before January 1, 2011. Employers still need to withhold the employee's share of Social Security taxes and income taxes. In addition, the new hires must certify under penalties of perjury that they have not been employed for more than 40 hours during the 60 day period ending the day the new employment

begins and they are not replacing a previous employee unless that employee left voluntarily or for a cause that according to the IRS includes layoffs or downsizing.

According to the law, any credit due in the first calendar quarter of 2010 must be claimed in the second quarter. That is, the exemption of Social Security taxes on salaries or wages paid from March 19 to March 31 will be claimed in the quarter ending June 30, 2010.

A new form, Form W-11, is already posted in the IRS web page. The form, Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit, must be prepared by the newly hired employee and kept by the employer. There is no need to send the Form to the IRS. The exemption will be claimed on Form 941 by the employers.

Employers in the US possessions, i.e. Puerto Rico, that are subject to federal social security tax also

qualify for the payroll tax exemption. This exemption does not apply to household employees. In addition to the new form, the IRS has also published a list of frequently asked questions (FAQ) in its web page.

According to the AICPA, the FAQs and the responses would seem to indicate that the IRS is taking a liberal position with regards to implementing these rules and is in effect using an honor system approach to employees and employers certifying eligibility for the payroll exemption.

Please contact our Tax Department for more information or guidance.



The latest on the sales and use tax



The monthly sales and use tax return is due on the 10th of each month. If you or your business have at least \$500,000 of gross sales, you are required to file and pay electronically.

Earlier this year, the Secretary of the Treasury of Puerto Rico had announced that those merchants that fail to comply with the law requirements as to payment and filling of the sales and use tax returns would have their certificates of exemptions revoked. Accordingly, 4,533 certificates were revoked.

Nevertheless, and due to numerous reconsideration requests, the Secretary re activated the certificates and issued Informative Bulletin 10-09 on April 5, 2010.

The new bulletin establishes the new parameters under which the certificates of exemption will be revoked due to non compliance with the law requirements.

The following merchants, upon evaluation, will have their certificates revoked:

1. those that in the twelve months period before the evaluation have not filed the monthly

return for three consecutive months, or

- those that in the twelve months period before the evaluation have deposited the sales and use tax collected late in three or more occasions.

In addition, the certificate will also be revoked in those cases where deficiencies of more than 25% of the reported sales and use tax are found or where the certificate is used incorrectly.

Any merchant that has his certificate revoked will have to pay the sales and use tax on purchases for resale or use in a manufacturing process and claim a credit on the monthly tax return. After a year from the revocation, the merchant will be able to re apply for a new certificate of exemption.

We asked the Secretary regarding the responsibility of those merchants that sell

inventory to a merchant that has his certificate of exemption revoked and follow an alternate method to document their exempt sales. According to the Secretary, it will be the responsibility of the client merchant to pay the use tax on purchases made where the sales and use tax was not collected by the seller.

The Secretary has announced that the IVU-Loto may be up and operational by November 2010. It is expected to increase the sales and use tax collections by 20% in two years. Every 1% increase equals \$20 millions more of collections. Therefore, they expect to increase sales and use tax collections by \$400 millions in two years. All merchants will be required to register.

More recent developments that affect employers

In our last issue we summarized de Puerto Rico Supreme Court decision in **Orsini-García v. Puerto Rico Treasury**, 2009 TSPR 190 (December 18, 2009) related to the taxability for income tax purposes of severance payments required by Law 80.

In a recent decision, **U.S. vs. Quality Stores, Inc.**, a U.S. District Court ruled that certain severance payments issued to former employees were not subject to FICA (Social Security) withholdings. It is expected that the IRS will appeal the case to the U.S. Circuit Court of Appeals.

In other employment related area, the IRS has launched the Employment Tax Compliance Program. Under the program, 6,000 employers will be audited over a three year period. The first 2,000 audits were to commenced in early 2010 and they will

include all industries and employers' sizes.

The primary focus of the program is the employee-independent contractor classification. Other areas include taxable fringe benefits and certain executive compensation. The following types of workers are likely to be scrutinized by the IRS:

- household workers
- consulting
- former employees hired back as consultants
- leased employees.

The following are example of audit triggers:

- claims by employees
- late filings of employment tax return
- 1099 and W-2 issued to the same worker in the same year
- 1099's issued to the same worker continuously over

- several years
- issuance by a company of a disproportionately large number of 1099's compared to W-2's.

The impact of a reclassification of a worker from independent contractor to employee signifies penalties and criminal exposure.

Should you need further information on this area, please contact our Tax Department for assistance.



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