



Tax newsletter

We want to be part of your success



In our last issue, we reviewed some of the income tax changes applicable to the 2009 Puerto Rico Individual Income Tax Return. We also summarized the changes to the Puerto Rico General Corporate Law. At this moment we find ourselves in the midst of the 2010 Tax Filing Season and are encountering challenges in the application of these new rules.

The Puerto Rico Treasury Department has issued several Informative Bulletins in which they provide guidance as to the application of these changes: estimated tax payments rules and the application of the foreign tax credit in the case of the new alternative minimum tax for individuals.

On the other hand, at least three Bills have been introduced in our Legislature proposing amendments to the recently enacted General Corporation Law.

Finally, the Puerto Rico Supreme Court recently issued its opinion on the income taxation of payments received as part of a termination agreement. In *Orsini-García v. Puerto Rico Treasury*, 2009 TSPR 190 (December 18, 2009), the Court reversed the Puerto Rico Treasury's long held position that these payments were subject to income tax.

As if all of this did not add enough confusion on how to operate a business in Puerto Rico, we find P del S 1355 that proposes a flat 10% tax on all corporations with at least \$10 million in annual revenue, including those that enjoy tax exemption grants.

These initiatives are affecting our tax laws and regulations and we will be on the alert as to its repercussions to inform you.

María de los A. Rivera
Tax Partner



The second installment of the special real property tax pursuant to Act 7 was due on March 1, 2010. If payment is made on or before March 30, a 10% discount applies.

The requirement to file Form 2035, Sales and Use Tax Annual Informative Return, has been eliminated.

Remember, April 15 is the due date to file your 2009 PR and US individual income tax returns.

New estimated tax payments rules for Puerto Rico

Act 194 of December 22, 2009, eliminated the requirement of filing an estimated tax declaration for all taxpayers in Puerto Rico. Nevertheless, the requirement to make estimated tax payments remains in place with certain changes .

The amended section 1059 states that in the case of individuals, if the estimated tax for a given year exceeds \$1,000, such taxpayer will be required to pay estimated taxes.

The estimated tax is defined as the excess of:

1. The amount that the individual estimates his income tax liability for the taxable year will be. This amount must also include the alternative minimum tax and the gradual adjustment in the case of taxable income in excess of \$75,000, over
2. The estimated amount of credits allowed by the Code or special laws, including the amount of tax paid in excess for the prior year if the same was credited to estimated tax.

In the case of married taxpayers, they must make estimated tax payments together unless they will be filing separate income tax returns. If the couple is planning to file separate returns, then, they must pay separate estimated taxes

The Code section, as we read it, does not make any distinction on the type of income generated for the year. Therefore, every taxpayer, not withstanding his income nor if such income is subject to withholding at source or not, will be subject to the payment of estimated taxes as long as the estimated tax computed as stated above, exceeds \$1,000.

Based on that premise, an individual that has an under withholding of income tax from his salary in excess of \$1,000 would be subject to the payment of estimated taxes, according to a strict reading of the law.

Nevertheless, the Puerto Rico Treasury Department, on BI No. 10-06 states that estates and trusts and individual tax payers whose income is

exclusively derived from salaries and pensions subject to withholding at source, will not be required to pay estimated taxes.

The dates to make the payments remain the same:

1. 1st installment on the 15th day of the fourth month of the tax year;
2. 2nd installment on the 15th day of the sixth month of the tax year;
3. 3rd installment on the 15th day of the ninth month of the tax year; and
4. 4th installment on the 15th day of the first month of the next tax year.

The penalty for not making these payments for tax years started after December 31, 2009 is 10% of the amount of any installment not made. For these purposes, the estimated tax will be the lower of 90% of the income tax for the year or the income tax reflected in the prior year's return.



If you received an estimated tax booklet from the Puerto Rico Treasury Department, be aware that the instructions contained therein do not reflect the amendments explained herein. You may use the payment coupons included in the booklet to make your estimated tax payments for 2010.

Supreme Court of Puerto Rico held dismissal / severance payments income tax free

In a decision that reverses Puerto Rico Treasury's long held position on taxation of Law 80 related payments, the Supreme Court of Puerto Rico concluded that all payments received by an employee resulting from payments required by Law 80 are exempt from income taxes. **Orsini-García v. Puerto Rico Treasury**, 2009 TSPR 190 (December 18, 2009)

According to AD 08-13, "*the compensation received by an employee due to a dismissal without just cause under Act No. 80, better known as the "mesada", is considered taxable gross income insofar as it is paid in consideration of the years of service rendered to an employer, and it has not been excluded from the definition of gross income by law. However, this severance payment will not be subject to income tax withholding at source.*

Likewise, payments received as economic compensation for damages of any kind or from any source, for reasons other than the exceptions of paragraph (5) of subsection (b) of Section 1022 of the Code (mainly physical injuries), are considered taxable gross income; unless said compensation is specifically excepted by law."

The reasoning provided by the Court in finding these payments to be tax exempt are:

1. The amendments to both Law 80 and the Puerto Rico Internal Revenue Code (the Code) which excluded payments for wrongful discharge from withholdings or deductions implied that such payments are not taxable income, and
2. These payments must be treated as tax exempt payments for a personal injury or illness.

The Court understands that the tax exempt nature of these payments still holds true even though the Code was amended to exclude solely payments received on account of physical (and not mental) injuries.

The Court also confirmed its prior holding in other case, that Law 80 payments do not constitute salaries subject to FICA/Medicare tax. This statement seems to be in direct conflict with the IRS position that all payments made by an employer to an employee on account of the employee's dismissal are taxable wages for FICA/Medicare. Based on the above, should you encounter a situation in which you must decide to withhold and pay FICA/Medicare in a dismissal payment, we strongly recommend you to consult your labor law counsel in order to determine your exposure should you decide to follow the Court's position.



To compile or not compile, a good question!



The 2009 Puerto Rico Corporation Annual Report is due on April 15, 2010. A sixty (60) days extension of time to file is available. The same must be requested via internet.

As previously reported in our January – February edition, the new General Corporation Law changes the requirements applicable to both domestic and foreign corporations in relation to the balance sheet that must accompany the annual corporation report that needs to be filed with the Puerto Rico Department of State by every corporation registered to do business in Puerto Rico.

The new requirement to accompany the Corporate Annual Report with a balance sheet audited by a CPA licensed in Puerto Rico will only apply to domestic and foreign corporations whose volume of business exceeds \$3,000,000. On the other hand, those corporations whose volume of business is \$3,000,000 or less will be required to file their annual report with a balance sheet compiled and certified by a CPA licensed in Puerto Rico.

The new law became effective on January 1, 2010 and the Department of State has ruled that the change in the nature of the balance sheet to be attached to the annual report is effective for the year 2009 filing. This has generated a great deal of concern and discussion, especially in the case of domestic corporations whose volume of business does not exceed \$1MM and were not required by the prior law to attach a compiled balance sheet, certified by a CPA licensed in Puerto Rico.

Making this new requirement effective for the 2009 filing creates in some instances a financial hardship for struggling businesses that now face the fact that in order to maintain their good standing position with the PR Department of State they must incur an additional cost in obtaining a compilation of their balance sheet.

During the last weeks, three different Bills have being filed in the

Legislature. The approval of any of these bills may once again change the current requirement if made effective for the 2009 filing.

Given the fact that the filing due date is approaching, it is our recommendation for those corporations with volume of business of \$3MM or less to file a request for extension of time to file the 2009 annual report (until June 14, 2010), hoping that by the extended due date, this controversy regarding the compilation requirement is finally decided upon.

"Let's balance the budget at any cost" - P del S 1355

That seems to be the objective of the recently introduced P del S 1355. Even though it is expected that the Bill will not make it to the Senate floor for the voting process, since it is the opinion of several industry leaders that it will only continue to damage Island's economy and investment developing programs.

The Bill, which has several clauses that need further explanation or clarification, proposes a flat 10% income tax applicable to all corporations that generate annual revenue of at least \$10MM. It specifically includes corporations that are enjoying tax exemption grants under Act 73, the Economic Incentives Law for the Development of Puerto Rico, and other tax incentives laws.

Act 73 establishes, in general, a flat 4% income tax rate on income generated by the exempt operation.

It has been said that the Bill violates several constitutional provisions:

1. The bill was originated in the Senate, but our Constitution states that all Bills to impose taxes must originate in the House of Representatives.
2. Given the contractual nature of tax grants, the Constitution blocks any law that will hinge contractual relations.

The nature of tax grants is that of a contract between the corporation and the PR Government. Changing the rules after agreeing to such contractual obligation is contradictory to basic legal statutes and only shakes the stability of the system and the credibility that the Government projects to possible new investors.

We will continue to keep you posted on any further developments on this Bill.



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