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PUERTO RICO BUSINESS LAW NOTES

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Alternative Minimum Tax and Additional Property Tax: Recent Puerto Rico Tax Developments

Act No. 37 of July 10, 2009 ("**Act No. 37**") has introduced major changes to the additional real property tax, and the corporate and individual alternative minimum tax ("**AMT**") provisions, that were included in the "Special Law for the Declaration of a Fiscal Emergency and Establishment of an Integrated Plan for Fiscal Stabilization to Save the Credit of Puerto Rico" – Act No. 7 of March 9, 2009 ("**Act No. 7**"). The following summarizes the changes to these taxes resulting from Act No. 37.

I. Corporate AMT

The new and temporary corporate[1] AMT adjustment for services rendered outside Puerto Rico ("**PR**"), which was added by Act No. 7 to the PR Internal Revenue Code of 1994, as amended (the "**PR-IRC**"), was modified so that the disallowance of deductions for expenses paid or incurred with respect to services rendered outside Puerto Rico (for corporate AMT computation purposes) will be limited to those services rendered by "related persons"[2]. For these purposes, "related persons" are defined in PR-IRC Sections 1221(a)(3) or 1231 (a) (3).

Under Act No. 7, all such expenses would have been disallowed, regardless of whether the payments are made to related or unrelated persons.

See our Newsletter Article "Puerto Rico Changes Corporate AMT Rules: Services Rendered Outside Puerto Rico Not Deductible" – 2009-TAX05 of June 26, 2009, for a detailed analysis of this new Corporate AMT rule.

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[1] Partnerships, Limited Partnerships and Limited Liability Companies are taxed as corporations under the PR-IRC, absent an election to be treated as a special partnership ("**SP**") or a corporation of individuals ("**CI**"). Unless otherwise indicated, all references to corporations in this article also refer to any of these entities provided that they have not made an SP or CI election.

[2] As a result of this adjustment, when determining the net income of corporations subject to AMT, no deduction will be allowed for expenses paid or incurred with respect to services rendered outside PR by related persons, that are not otherwise subject to PR income taxation. The corporate AMT will be assessed when the "Tentative AMT" exceeds the Regular Income Tax. The Tentative AMT is 22% (increased to 23.10% when the 5% Temporary Surcharge of Act No. 7 is also applicable) of the amount by which the net alternative minimum income ("**Net AMT Income**") exceeds the exempt amount (i.e., $50,000), reduced by the alternative minimum credit for foreign taxes. Net AMT Income is determined by (i) excluding from a corporation's "net taxable income" net long term capital gains subject to the preferential 15% income tax rate and net operating losses ("**NOLs**") from prior years, and (ii) then adjusting such net taxable income by various adjustments, including the "**Non-PR Services AMT Adjustment**".

II. Individual's AMT

The new AMT rules applicable to individuals, trusts and estates (i.e., Act No. 7) were amended by Act No. 37 to exclude obligations issued by the Puerto Rico Conservation Trust[3] from the types of income that are added to the taxpayer's net taxable income ("**AMT Income Items**") in order to compute the AMT. Such taxpayers will have to compute the AMT when their **AMT Income**[4] exceeds $75,000[5], and will have to pay the AMT (i.e., in lieu of the regular income tax) when their AMT is higher than their regular income tax.

Income derived from operations covered under the Puerto Rico Agricultural Tax Incentives Act of 1995 (Act No. 225 of December 1, 1995, as amended) was also excluded by Act No. 37 from the broad list of AMT Income Items.

Act No. 37 imposed an additional annual reporting requirement, for taxable years commenced after December 31, 2008, on those persons that pay or credit to any individual interest, rents, dividends, pensions, annuities or any other AMT Income Item.

Finally, the individual AMT tax rate schedule was modified so that AMT Income in excess of $175,000 will pay the 20% AMT tax rate on AMT Income in excess of $125,000. No similar changes were made to the AMT tax computation when AMT Income is $175,000 or less, and subject to the 10% and 15% AMT rates.

See our Newsletter Article "New PR Alternative Minimum Tax Rules for Individuals" – 2009-TAX02 of April 6, 2009, for a detailed analysis of the new AMT rules applicable to individuals, trusts and estates.

III. Temporary Additional Real Property Tax Assessment Substantially Shifted from Residential Properties of Individuals to Commercial Real Estate

The temporary additional real property tax assessment ("**Additional Property Tax**"), that pursuant to Act No. 7 was to be only applicable to residential properties owned by individuals, was modified by Act No. 37 to among other aspects:

(i) extend this tax to commercial properties owned by individuals and corporations (including SPs and CIs);
(ii) reduce the tax rate; and
(iii) exclude families with less than $20,000 of income, and certain unemployed individuals, from this tax.

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[3]Act No. 37 also provides that debt issued by the Puerto Rico Conservation Trust from July 1, 2009 through June 30, 2011 will not be entitled to income tax exemption under Section 1022(b)(4)(N) of the PR-IRC.

[4]For married individuals living together but filing separately, AMT will have to be computed when their AMT Income levels exceed $37,500.

[5]"**AMT Income**" of individuals, trusts and estates is determined by adjusting the taxpayer's "net taxable income", and adding to it the AMT Income Items. The most relevant of the adjustments to "net taxable income" is that the deduction for interest paid on mortgage loans secured by the taxpayer's principal residence (plus one additional second home residence in PR) will be limited to 30% of the taxpayer's adjusted gross income. Thus, for AMT purposes, the PR-IRC has limited the amount of home mortgage interest that can be deducted.

The Additional Property Tax is payable to the Government of Puerto Rico / PR Treasury Department ("**PR Treasury**"), in contrast with the regular real property tax which is payable to the municipalities through the Municipal Revenue Collection Center ("**CRIM**"). This tax is in addition to the regular real property tax.

The Additional Property Tax will only be applicable during the PR Government's 2009-10, 2010-11 and 2011-12 fiscal years, but it will terminate earlier, once the PR Treasury's aggregate collections from this tax reach $690 million.

The yearly Additional Property Tax is due in two equal installments, on September 1 and March 1, with the first installment for the 2009-10 year due on September 1, 2009. If the tax is paid within 30 days, there is a 10% discount, and if within 60 days a 5% discount; however, for the installment due on September 1, 2009 the 10% discount will be applicable if paid within 90 days.

The Additional Property Tax, as amended by Act No. 37, consists of a yearly tax of .591% on the "CRIM Assessed Value" of real property used for "residential" and "commercial" purposes. The "**CRIM Assessed Value**" will be the longstanding 1957-58 historical CRIM assessed values multiplied by ten (10). Likewise, the $15,000 of CRIM Assessed Value of an individual's primary residential property, which has traditionally enjoyed real property tax exemption (exoneration) and will enjoy exemption from the Additional Property Tax, has also been multiplied by ten (10) to $150,000. Thus, to the extent that the CRIM Assessed Value of the principal residence of its individual owner exceeds $150,000[6], only such excess is subject to the .591% Additional Property Tax rate. If the assessed value of such residence does not exceed $150,000, no Additional Property Tax will be due.

Other residential properties (i.e., second homes and rental residential property), and all commercial and mixed use properties held by any person (i.e., individuals, corporations, SPs, CIs, trusts, etc.), will be subject to the Additional Property Tax. Presumably, raw land that is not being used for commercial purposes will not be subject to this tax.

A tax break for a substantial number of individuals that was adopted by Act No. 37 is that real property used solely for residential purposes, and whose owner's "family unit" earns less than $20,000 of income per year, will be exempt from the Additional Property Tax regardless of its CRIM Assessed Value. This provision of Act No. 37 needs to be clarified, or the PR Treasury may decide to clarify it, with respect to the following issues: (i) whether this $20,000 "family unit" cap applies to the combined income of the owners of the property, or if it also includes the income of other family members who reside within the household; (ii) whether it refers to income derived during the current year or the prior year; and (iii) whether it refers to gross revenues, gross income, or net income as defined in the PR-IRC. Act No. 37 mentions income from annuities and pensions when it describes the $20,000 "family unit" income cap, but this needs to be clarified as the language is garbled and it is not clear whether annuities and pensions are excluded or included within such income cap amount. Furthermore, if the owner of a residence has his employment with the PR Government terminated due to Act No. 7, such residence will not be subject to the Additional Property Tax for as long as said person remains unemployed.

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[6] The $150,000 exempt amount is increased by $50,000 (i.e. $200,000 total) for veterans and their surviving spouses, and by $500,000 for veterans that receive compensation from the Veterans Administration based on a 50% or more disability related to service (i.e., $650,000 total).

New housing units that had not been sold and delivered to the buyer (presumably as of March 9, 2009, but this may also have to be clarified in the future), will not be subject to the Additional Property Tax. Once said unit is sold and delivered, the new owner will be exempt from the Additional Property Tax until the next assessment date, but for not more than 12 months.

For purposes of the Additional Property Tax, commercial real estate includes all types of properties that are considered real estate for purposes of the Municipality Property Tax Act (Act No. 83 of August 30, 1991 – "**Act No. 83**").

The Additional Property Tax will apply to the CRIM Assessed Value after considering those exemptions granted pursuant to (i) Article 2.03 of Act No. 83 of August 30, 1991 (i.e., subsidized rental housing for low and moderate income families); (ii) Article 34.180(1) of Act No. 77 of June 19, 1957 (i.e., $1,000,000 exemption under the PR Insurance Code); and (iii) other special laws (e.g., tourism, agricultural, manufacturing and historical zones tax exemptions). However, real properties that enjoy tax exemptions that are granted by municipalities will not be exempt from the Additional Property Tax.

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