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Puerto Rico Changes Corporate AMT Rules: Services Rendered Outside Puerto Rico Not Deductible

A new and temporary feature has been added to the Puerto Rico ("**PR**") corporate alternative minimum tax regime ("**Corporate AMT**") of the PR Internal Revenue Code of 1994, as amended (the "**PR-IRC**"). The change was made by Act Number 7 of March 9, 2009 ("**Act No. 7**"), which also added an additional 5% temporary income tax surcharge for all taxpayers (the "**5% Surcharge**").

The change to the PR Corporate AMT regime is a temporary provision. It will only be applicable to taxable years commenced after December 31, 2008 and prior to January 1, 2012 (the "**Temporary Period**").

As a result of this new rule, and solely for purposes of determining the Corporate AMT, no deduction will be allowed for expenses paid or incurred for services rendered outside PR that are not otherwise subject to PR income taxation.

I. Corporate AMT

Generally, corporations are subject to PR income tax on their net taxable income at a maximum income tax rate of 39% (the "**Regular Income Tax**").

The Corporate AMT equals the excess, if any, of the "Tentative AMT" over the Regular Income Tax.

The Tentative AMT is 22% of the amount by which the net alternative minimum income ("**Net AMT Income**") exceeds the exempt amount (i.e., $50,000), reduced for the alternative minimum credit for foreign taxes.

[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**"). All references to corporations in this article also refer to any of these entities that have not made an SP or CI election.

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 adding to it the following adjustments:

(1) expenses related to exempt interest;
(2) installment sales;
(3) long term contracts;
(4) accelerated and flexible depreciation;
(5) 50% of the excess of book income over Net AMT Income (the "**Book Income Adjustment**"); and
(6) **expenses paid or incurred with respect to services rendered outside Puerto Rico, that are otherwise subject to income taxation (the "Non-PR Services AMT Adjustment" – applicable only during the Temporary Period).**

Corporations are **only** subject to the Corporate AMT, instead of the Regular Income Tax, when the AMT exceeds the Regular Income Tax. Thus, if the Regular Income Tax is higher than the Corporate AMT, the Corporate AMT is not applicable and the Corporation is subject to the Regular Income Tax. Whichever of these taxes is applicable, it will be further subject to the 5% Surcharge.

The PR-IRC provides that industrial development income ("**IDI**") and exempt tourism development income ("**ETDI**") are not subject to the Corporate AMT Book Income Adjustment. No similar exemption exists for the Non-PR Services AMT Adjustment. At the present time, the PR Treasury Department has not determined whether the Non PR Services AMT Adjustment will be applied to IDI and/or ETDI, or whether IDI and ETDI dividends are AMT Items for purposes of the AMT payable by individuals. A determination that these adjustments, and items of income, are subject to the Corporate AMT, or Individual's AMT, respectfully, may be legally challenged by beneficiaries of tax exemption grants.

The Non-PR Services AMT Adjustment may represent additional PR income taxation for corporations organized in PR, and foreign corporations engaged in a trade or business in PR, that in determining their regular PR income tax deduct expenses for services that were rendered outside PR by such corporations' head office, parent company, affiliates, or even by unrelated entities (i.e., allocations of head office or affiliate's expenses, or other service costs specifically billed, charged to or allocated to the PR operation); and service providers (related or unrelated) that directly or indirectly render services to the PR operation from outside PR, including among these call centers, customer service centers, programmers, advertising agencies, lawyers and auditors who render their services outside PR. Those corporations operating in PR as a branch of a non PR corporation would also appear to be more likely to be exposed to the Corporate AMT as amended by Act No. 7. It should also be noted that a possible future amendment to the new Corporate AMT rules of Act No. 7 may involve limiting the applicability of the Non-PR Services AMT Adjustment to services rendered by related persons.

The particular exposure of any corporation to the Corporate AMT depends on the particular circumstances of each corporation, and these should be reviewed as soon as possible to determine what actions, if any, can be undertaken to minimize the exposure.

II. The 5% Surcharge

The 5% Surcharge will be imposed for a temporary 3 year period commencing on taxable years commenced after December 31, 2008 and prior to January 1, 2012.

Since the 5% Surcharge is imposed on the tax liability instead of the income subject to tax, the effect of the 5% Surcharge will be that during the temporary period the 39% maximum income tax rate of individuals will be increased to 40.95%, while the 15% corporate long term capital gains tax rate will be increased to 15.75%. Furthermore, if the AMT is applicable, the 22% Corporate AMT rate will be increased to 23.10%.

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The above summary of the PR-IRC's Corporate AMT changes and 5% Surcharge provisions applicable to corporations is intended for information purposes only. It cannot to be considered a legal opinion, and it does not intend to consider all the tax and legal considerations that could be relevant to any particular corporation. It should also be noted, that this provision was recently enacted, and that the PR Treasury has not yet issued regulations, tax forms or interpretative announcements on this change to the corporate AMT tax.

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