



## New PR Alternative Minimum Tax Rules for Individuals

In this article we will discuss the amendments made by Act Number 7 of March 9, 2009 (“**Act No. 7**”) to the alternative base tax, commonly known as alternative minimum tax (“**AMT**”), imposed on individuals by the Puerto Rico Internal Revenue Code of 1994, as amended (the “**PR-IRC**”), and the new 5% income tax surcharge enacted by Act No. 7 (the “**5% Surcharge**”).

The amendments, particularly to the AMT, will represent additional taxation on certain types of income that previously enjoyed full or partial tax exemption or preferential tax rates, and thus may impact the investment portfolios of Puerto Rico (“**PR**”) residents.’

### I. ALTERNATIVE BASE TAX/AMT

A. **THE AMT.** Generally, individuals are subject to Puerto Rico income tax on their net taxable income at a maximum income tax rate of 33% (the “**Regular Income Tax**”). Commencing with the taxable year that began on January 1, 2009, certain types of income that are 100% or partially exempt from the Regular Income Tax, and other items of income that are subject to preferential income tax rates of 10% or 17% (collectively, the “**AMT Income Items**”), may be subject to the AMT.

Unlike the 5% Surcharge, these changes to the AMT rules are not temporary measures. They have now become a permanent feature of the PR-IRC.

Only those individuals whose income reach certain AMT Income threshold levels (“**AMT Threshold**” – as described in the next paragraph) will have to pay the AMT, and **ONLY IF** the AMT is higher than the Regular Income Tax.

The AMT rates for married individuals filing jointly, and for single taxpayers, is:

- (i) **10%** if alternative base tax income (the “**AMT Income**”) ranges between \$75,000 and \$125,000;
- (ii) **15%** if AMT Income is more than \$125,000 and up to \$175,000.00; or
- (iii) **20%** if AMT Income exceeds \$175,000.00.

For married individuals living together but filing separately, the above AMT Income levels are reduced by 50%.

An individual’s AMT Income is determined by adjusting the taxpayer’s “net taxable income”, and adding<sup>1</sup> to it the AMT Income Items<sup>2</sup>. 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 (“**AGI**”) <sup>3</sup>. Thus, for AMT purposes, the PR-IRC has limited the amount of home mortgage interest that can be deducted.

**B. Regular Income Tax or AMT.** As previously stated, individuals are subject to the AMT instead of the Regular Income Tax **only if** the AMT is higher than the Regular Income Tax. Thus, if the Regular Income Tax is higher than the AMT, the AMT is not applicable and the individual is subject to the Regular Income Tax, plus the 5% Surcharge described in part II of this Article.

Given that the Regular Income Tax rate on ordinary income (e.g., salaries, compensation, rent, business income, etc.) is generally higher than the AMT rates, individuals who have ordinary income levels that are higher than their AMT Income Items may not be subject to the AMT

Conversely, individuals who have levels of AMT Income Items that are higher than their ordinary income, which when combined exceed the applicable AMT Thresholds, may be subject to the AMT.

**C. AMT Income Items.** For individuals with investment portfolios, the following listing includes the most relevant AMT Income Items that could be subject to the AMT:<sup>4</sup>

- (i) interest derived from GNMA bonds that are exempt from Regular Income Tax;
- (ii) interest derived from bonds, notes and other obligations of the Conservation Trust of Puerto Rico;
- (iii) interest derived from deposits in banks, credit cooperatives and savings associations that are subject to a 10% tax rate, including the first \$2,000 of interest derived from deposits in banks or certain financial institutions;
- (iv) interest derived from bonds, notes and other obligations of Puerto Rico corporations or partnerships and certain foreign corporations or partnerships resident of Puerto Rico, that are subject to the 10% Puerto Rico withholding tax imposed by the PR-IRC;
- (v) interest derived from obligations secured by residential properties located in Puerto Rico, that are subject to the 10% withholding tax imposed by the PR-IRC;
- (vi) interest derived from bonds, notes and other obligations of “Banco Cooperativo de Puerto Rico”;
- (vii) interest derived from bonds, notes and other obligations (including deposits) of Puerto Rico savings and credit cooperatives;
- (viii) interest derived from obligations issued by the Federal Farm Credit Banks Funding Corporation, and Puerto Rico Farm Credit, ACA;
- (ix) net long term capital gains;
- (x) dividends on common or preferred shares, and distributions of partnership profits, from Puerto Rico corporations and partnerships, and from certain resident foreign corporations and partnerships, that are subject to the 10% withholding tax imposed by the PR-IRC;
- (xi) taxable dividends on common or preferred shares of Puerto Rico mutual funds that are subject to the 10% withholding tax rate;
- (xii) the amount of pension income exempt from Regular Income Tax (\$11,000 below age 60, or \$15,000 if the pensioner is 60 years of age or older);
- (xiii) rental income that is exempt from Regular Income Tax derived from real property leased to the Puerto Rico Education and Health Departments for certain eligible uses;
- (xiv) rental income derived from the leasing of real property located in Historical Zones and that otherwise enjoys partial tax exemption grants;

- (xv) the portion of IRA distributions subject to the 17% optional withholding tax rate;
- (xvi) the cost of living allowance (“COLA”) received by federal employees that work in Puerto Rico;
- (xvii) income that enjoys partial exemption under the PR Agricultural Tax Incentives Act, including such Acts’ income that flows-through special partnerships (“SPs”) and corporations of individuals (“CIs”) to individuals; and
- (xviii) probably, dividends paid by businesses that enjoy tax exemption under the various Industrial and Tax Incentives Acts, and the Tourism Incentives Act, and the Tourism Incentives Act income that flows-through SPs and CIs to individuals.

**D. Planning for Long Term Capital Gains and the AMT.** Taxpayers planning to sell appreciated securities that have been held for six months or more should gauge the impact of the AMT on such gains, as gains that would otherwise pay a 10% capital gains rate could be taxed at the AMT’s 15% or 20%.

Furthermore, through proper tax planning, the right circumstances and income mix, some taxpayers may be able to pay only 10% on gains from the sale of real estate and other capital assets wherein the sales price is spread out over various years, through the use of the installment sale provisions of the PR-IRC. Generally, this involves careful tax planning, and it must be done prior to making any commitments, executing an option to sell, or entering into a sales agreement for the property.

**E. Investment Income Not Subject to AMT.** The following types of income are not considered AMT In-

come Items, and will not be subject to the AMT. Thus, this income will continue to enjoy full income tax exemption in PR:

- (i) interest derived from bonds, notes and other obligations of the Commonwealth of Puerto Rico, its instrumentalities or political subdivisions;
- (ii) interest derived from bonds, notes and other obligations of the United States and any of the States or territories or their political subdivisions;
- (iii) interest derived from bonds, notes and other obligations of Puerto Rico mutual funds that are “exempt interest”;
- (iv) exempt dividends from Puerto Rico mutual funds; and
- (v) interest derived from bonds, notes and other obligations of the Federal Home Loan Bank (“FHLB”), the Tennessee Valley Authority (“TVA”), and the Student Loan Marketing Association (“Sallie Mae”)<sup>5</sup>.

## II. THE 5% SURCHARGE

**A. The 5% Surcharge.** The 5% Surcharge will be imposed for a temporary 3 year period commencing on taxable year 2009 and ending on taxable year 2011.

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 33% maximum income tax rate of individuals will be increased to 34.65% and the 10% preferential tax on certain interest, dividends and capital gains will be increased to 10.5%. Furthermore, if the AMT is applicable, the 10%, 15% and 20% AMT rates will be increased to 10.5%, 15.75% and 21%, respectively.

The 5% Surcharge will be imposed upon

- (i) individuals who are either (A) single, head of household or married filing separate returns, whose adjusted gross income for the taxable year exceeds \$100,000; or (B) married filing joint returns, whose adjusted gross income for the taxable year exceeds \$150,000;
- (ii) corporations and partnerships organized under the laws of Puerto Rico; and
- (iii) corporations and partnerships organized outside of Puerto Rico and engaged in trade or business in Puerto Rico.

### III. AMT'S IMPACT ON AN INDIVIDUAL'S INVESTMENT PORTFOLIO INCOME

In summary, the AMT may have an adverse impact on the after tax return of individuals with large investment portfolios, especially those that do not generate a higher level of ordinary income. If the AMT is applicable, the after tax return of exempt or preferential income tax rate investment income will be reduced.

Given the potential adverse impact of the AMT, individual that may be exposed to the AMT should review the composition of their investment portfolio to determine what modifications, if any, can or should be made to reduce or minimize the adverse impact of the AMT on their portfolio's after tax return.

<sup>1</sup> Prior to adding the AMT Income Items, net long term capital gains will have to be deducted (otherwise they would be duplicated), as currently prescribed in the taxable year 2008 tax return's AMT schedule. Additionally, income/losses of special partnerships involved in construction must be reported on the percentage of completion method.

<sup>2</sup> For 2008, and prior taxable years, an individual's AMT was not assessed on taxable income, but on adjusted gross income reduced by: (i) the allowable deductions for ordinary and necessary expenses and installation of solar equipment; and (ii) the amount of net long term capital gains.

<sup>3</sup> AGI is the amount reported on the last line of the first page of the income tax return-long form.

<sup>4</sup> This listing is not exclusive, as there are multiple other miscellaneous types of income, generally of interest to a limited number of taxpayers that are also AMT Income Items. Act No. 7 enumerates the AMT Income Items as those described in PR-IRC Section 1022(b)(4)(C) through (R); Section 1022(b)(8); Section 1022(b)(7), (9), (13), (22), (23), (24), (26) through (29), (33), (34), (36), (40), (43), (46) through (48), (50), (55) and (56); and other income items excluded or exempted by other laws, that are not otherwise also exempted under the PR-IRC.

<sup>5</sup> The interest from these obligations is exempt from the AMT pursuant to United States federal laws that preempt the PR-IRC.

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The above summary of the PR-IRC's AMT and 5% Surcharge provisions applicable to individual is intended for information purposes only. It cannot 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 person. It should also be noted, that these provisions were recently enacted, and that the PR Treasury has not yet issued regulations, tax forms or interpretative announcements on these taxes.

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