



# State & Local Tax **Alert**

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## **Puerto Rico Provides Withholding Guidance Concerning Government Contracts, Waivers for New Businesses**

Puerto Rico's reconstruction in the wake of Hurricane Maria's devastation has created a series of logistical and fiscal challenges, which require the government to respond in an efficient and agile manner. To facilitate the recovery, the Puerto Rico government has entered (and will enter) into various contracts with service providers within and outside Puerto Rico. These government contracts are subject to provisions in the 2011 Puerto Rico Internal Revenue Code (PRIRC) relating to dispositions on withholding at source and filing requirements. On November 10, 2017, the Puerto Rico Treasury Department (PRTD) issued Administrative Determination No. 17-28 (AD 17-28) to provide guidance on withholding requirements related to government contracts. In addition, the PRTD issued separate withholding guidance in Administrative Determination No. 17-30 (AD 17-30) on November 15, 2017 to clarify what constitutes a new business for purposes of requesting a waiver from withholding on payments made for services performed in Puerto Rico.

### **Government Contracts**

Sections 1091.01 and 1092.01 of the PRIRC establish that nonresident alien individuals and foreign corporations have a fiscal responsibility with the Puerto Rico government for their Puerto Rico-source income. Specifically, any person who is engaged in a trade or business in Puerto Rico must withhold at the source 29 percent of any payment made to nonresident alien individuals and foreign corporations that are **not** engaged in trade or business in Puerto Rico for services performed in Puerto Rico. If the nonresident individual is a U.S. citizen, the withholding rate at source is 20 percent.

AD 17-28 covers service contracts that are formalized after September 19, 2017 but before January 1, 2018, between the Government of Puerto Rico, and either a Foreign Service Provider or Local Service Provider.

#### *Foreign Service Providers*

A Foreign Service Provider (FSP) is defined as a foreign contractor that has entered into a service contract with the government and is **not** engaged in trade or business in Puerto Rico. Under regular circumstances, this contractor would be subject to 29 percent withholding at source.

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Under AD 17-28, the FSP must first determine if, given the nature of the service contract with the government, it will be deemed to be engaged in trade or business in Puerto Rico and required to notify the Puerto Rico government during the contract negotiation process. The FSP may *opt* to be treated as being engaged in a trade or business in Puerto Rico for tax purposes by including the corresponding option in the contract. A copy of the contract, along with the corresponding option and explanatory letter, must be filed with the PRTD within 30 days of its execution.

By being deemed “engaged in trade or business in Puerto Rico,” the FSP will be subject to a 7 percent withholding rate at source instead of the 29 percent withholding rate for services rendered, though it will need to file a Puerto Rico income tax return. Moreover, the FSP cannot request any of the available withholding at source waivers under Sections 1062.03(b)(8) and 1062.03(g).

*Compensation Paid to Nonresident by Local or Foreign Service Provider*

As a general rule, a nonresident employee rendering services in Puerto Rico is subject to either a 20 percent (U.S. citizen) or 29 percent (nonresident alien) withholding rate at source.

AD 17-28 establishes that the withholding rate at source for payments made to a **nonresident U.S. citizen** is 10 percent. Moreover, this amount represents all of the individual’s fiscal responsibility to the government of Puerto Rico, and he or she will be exempt from filing a Puerto Rico income tax return. However, for nonresident aliens, the general 29 percent withholding rate at source remains in place.

*Foreign Subcontractors*

Similar to an FSP, a Foreign Subcontractor (defined as any juridical entity organized under the laws of the U.S. or any other foreign jurisdiction that is not considered to be engaged in trade or business in Puerto Rico) is subject to a 29 percent withholding rate at source.

The Foreign Subcontractor may *opt* to be treated as engaged in a trade or business in Puerto Rico by including the option discussed above on the service contract, and filing a copy of it (along with the explanatory letter) within 30 days after the execution of the contract. The payments from either the Foreign Service Provider or Local Service Provider to the Foreign Subcontractors are subject to the 7 percent withholding rate at source. As with the Foreign Service Provider, the Foreign Subcontractor cannot request any waiver from withholding at source.

*Compensation Paid to Nonresident Employees by Foreign Subcontractor*

Foreign Subcontractors follow the same treatment as Local and Foreign Service Providers. U.S. citizens are subject to a preferential 10 percent withholding rate at source, while nonresident aliens are subject to the customary 29 percent withholding rate.

*Puerto Rico Registration*

It is imperative that Foreign Service Providers, Foreign Subcontractors and Subcontracting Nonresident Individuals complete Puerto Rico's Merchants Registration through the PRTD's SURI system, within 30 days after executing the service contract.

Also, pursuant to the PRTD's Internal Revenue Bulletin No. 17-26, entities or individuals must review the particular facts and circumstances of their operations in Puerto Rico to determine if they are engaged in trade or business in Puerto Rico, and perform the corresponding registration with the PRTD for income and payroll tax compliance as well as other pertinent agencies (e.g. the Puerto Rico Department of State, the Municipal Revenue Collection Center, Municipality, etc.)

*Exemption for Tangible Personal Property*

Services performed for the government by the Local or Foreign Service Providers will not be subject to sales and use tax (SUT). Moreover, goods introduced in Puerto Rico by the Local or Foreign Service Providers, as well as by Foreign Subcontractors, which are to be used in the contracted services with the government, are exempt from the excise taxes imposed by the PRIRC's Subtitle C for a six-month period. Also, every importer that temporarily introduces otherwise taxable goods that will be used for contracted services with the government, and which will be later re-exported within six months, will not be subject to SUT. The importer can request that this initial six-month period be extended for an additional six months. Nonetheless, payments between Local or Foreign Service Providers, and Foreign Subcontractor or Individuals, are subject to the special 4 percent SUT imposed by Sections 4210.01(c) and 4210.02(c) of the PRIRC.

**New Business Eligible for Withholding Waiver**

The PRIRC provides certain exceptions to the general obligation to withhold 7 percent on payments made to another person for services performed in Puerto Rico. One of the exceptions – the “first three year” exception of Section 1063.08(b)(8) – has been subject to scrutiny concerning what constitutes a new business for its application.

Pursuant to Section 1062.03(a), as a general rule, the Puerto Rico government, as well as every individual and entity, must withhold 7 percent on payments made to another person for services performed in Puerto Rico and remit the withholding to the PRTD. Section 1062.03(b) allows for various exceptions to this general rule. For example, Section 1063.08(b)(8) provides an exception for “[p]ayments for services to individuals, corporations and partnership during the first three (3) years of their commencement of a rendering of services activity.” The statute expressly provides that “[t]his exemption may be enjoyed by the taxpayer only once.”

To receive the exemption, the taxpayer who begins a “new business” may request the waiver from the PRTD by submitting either Form AS 2678.1 (Individuals) or AS 2680.1 (Corporations, Limited Liability Companies and Partnerships). AD 17-30 clarifies who or what is considered a new business for purposes of the exception.

*New Business*

AD 17-30 explains that entities or individuals that begin to perform services, within or outside Puerto Rico, during the year for which they are requesting the waiver, and these services are being performed within the first three years of operation, are considered a new business regardless of where the services were rendered for the first time. For example, if a business is currently performing consulting services in a location outside Puerto Rico, the mere fact that it registers in Puerto Rico for the first time to perform services in Puerto Rico does not mean that it will be considered an eligible new business for its first three years of operation in Puerto Rico.

*Waiver Requirements – Companies*

To request the waiver, entities must comply with the following:

- Register with the Puerto Rico State Department, and obtain the necessary authorization to conduct business in Puerto Rico;
- Register with the PRTD for income tax and SUT purposes;
- Neither the requesting company, nor any related party, has offered any services within or outside Puerto Rico at the time of requesting the waiver, **or** is within its first three years of operation at the time of the request;
- If the requesting company was organized outside Puerto Rico, copies of the three previous income tax returns must be provided with the waiver request; and
- The person in charge of the company has not provided the services in question on behalf of the company, through a sole proprietorship or related entity.

*Waiver Requirements – Individuals*

Individuals must comply with the following:

- Register to conduct business in Puerto Rico;
- Register with the PRTD for income tax and SUT purposes;
- The individual has not offered any services within or outside Puerto Rico prior to beginning the services in Puerto Rico – if services have been previously performed, they must be within the first three years of operation;
- The service has not been performed by a related person during any of the prior three calendar years prior to the beginning date for performing the services; and
- Both the individual and any related person must file copies of the three previous income tax returns.

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