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the LEGAL UPDATE

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Tax Update

Value Added Tax under the Proposed Puerto Rico Internal Revenue Code of 2015

Governor Alejandro García Padilla's administration has filed House Bill No. 2329 ("HB 2329") with the Puerto Rico House of Representatives which is expected to drive the efforts for the Puerto Rico 2015 Tax Reform. HB 2329 proposes a new Puerto Rico Internal Revenue Code ("2015 Code") which, among other changes, intends to substitute the current Sales and Use Tax ("SUT") for a Value Added Tax ("VAT").

Background

On August 17, 2013, the Governor issued an Executive Order creating a Tax Reform Advisory Group to analyze the current Puerto Rico tax system, its rules and administration and to report its conclusions and recommendations to build an effective and fair tax system. On March 13, 2014, the firm of KPMG was engaged to make a full assessment of the Puerto Rican tax structure and to develop a full report and set of alternative scenarios for a simplified tax system.

On October 31, 2014, KPMG rendered its report. Thereafter, on December 29, 2014, the Tax Advisory Group issued its recommendations for a new tax system: to shift the Puerto Rican burden of taxation from taxes on income to taxes on consumption. This would require a broad based VAT at a high enough rate to cover other reductions in tax collections and to provide credits for progressivity relief.

This is the first of a series of Legal Updates on HB 2329. This Legal Update contains a summary of the most important VAT provisions that have been proposed for the 2015 Code.

Transition Rules

Assuming enactment of HB 2329 as filed, for the period from April 1, 2015 through December 31, 2015, the VAT will apply in much the same way that the SUT currently applies. The SUT provisions of the Puerto Rico Internal Revenue Code of 2011, as amended ("2011 Code"), related to collection, payment, reporting, etc., will continue to apply until December 31, 2015 but references to the SUT will be substituted for VAT.

A major change will be that transactions occurring after March 31, 2015 but before January 1, 2016 that consist of the **sale or use of a taxable item**, as such term is defined under the 2011 Code, will be subject to a 16% VAT on the sales price of such taxable items instead of the current 7%.

HB 2329 further proposes to amend the **2011 Code** to:

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1. Require retail merchants to bundle and **not** separately state the VAT on receipts, invoices, tickets or any other retail sale evidence reflecting the applicable tax. The VAT will have to be shown together with the sales price of the good or service sold (effective 30 days after the approval of HB 2329).
2. Allow merchants with a valid Reseller Certificate to claim a credit for taxes paid on inventory for resale of up to 100% of the tax liability reflected in the Monthly SUT Return, in lieu of the prior 75% limit (effective the first day of the second month after the approval of HB 2329).
3. Eliminate the following exemptions: funeral services, solar electric equipment, uniforms, materials and text books (effective the first day of the second month after the approval of HB 2329).

In addition, HB 2329 provides that:

1. Manufacturer's Exemption Certificates, Eligible Reseller Certificates, Reseller Certificates and Merchant's Registration Certificates ("MRC") issued under the 2011 Code will be effective until December 31, 2015, regardless of their prior expiration dates. As of the effective date of the 2015 Code, requests for renewal of any of such certificates will not be accepted.
2. Bonds approved under the 2011 Code that are in effect on April 1, 2015, will continue to be effective until their expiration dates.

What the transitory provisions of HB 2329 seem to lack is a mechanism to avoid the taxation of business inputs as recommended by the KPMG report and international best practices.

As drafted, business purchases of tangible personal property not for resale and services currently taxed in a business-to-business context, such as security services, telecommunications services, bank charges, etc., would be subject to an increase from 7% to 16%. Crediting provisions that will apply after December 31, 2015 to reduce the tax burden on merchants would, as currently drafted, not cover these inputs during the transition period.

<u>VAT after December 31, 2015</u>

Effective **January 1, 2016**, sales or transfers of taxable goods and services ("Taxable Transactions") will be subject to either a 16% or 0% VAT.

A 0% VAT ("Zero-rated") will apply to the following Taxable Transactions occurred after December 31, 2015:

- The sale of goods for export
- The rendering of export services
- The import of manufacturing articles by a Manufacturer with an Eligible Manufacturer Imports Exemption Certificate.

<u>VAT Exemptions</u>

The following taxable transfers will not be subject to the VAT:

1. Financial services, except those in which bank charges apply;
2. The sale and import of prescription medicines and items for the treatment of health conditions;
3. The sale of items and equipment for physical or physiological deficiencies when the purchaser can acquire them at zero-rate;
4. The sale of any good or the rendering of any service paid or reimbursed by Medicare, Medicaid or the Puerto Rico Government's health insurance;

5. Sale of goods and services to agencies or instrumentalities of the United States Government, District of Columbia or the Puerto Rico Government;
6. Sale and import of gas, aviation fuel, gas oil, diesel oil, crude oil, partially elaborated and finished products derived from oil and other hydrocarbon mixtures (excluding natural gas and derived products);
7. Lease of property subject to the room tax;
8. Sale and import of food and food ingredients;
9. Sale of goods purchased with funds received by the Federal Nutritional Assistance Program (PAN, for its Spanish acronym) or the Special Supplemental Nutrition Program for Women, Infants and Children (WIC);
10. Sale of real property;
11. Lease of real property that constitutes the principal residence of the lessor;
12. The cost-free transfer of goods and the services rendered by not-for-profit entities that have received tax exemption from the PR Treasury Department;
13. Sale of machinery, medical/surgical materials, items, equipment and technology to, and the import of such goods by, any hospital unit with an Exempt Purchases Certificate;
14. Sale and import of agriculture items to bona fide farmers;
15. Occasional sales by churches and religious organizations;
16. Sale and import of goods by a merchant dedicated to a tourist business with an Exempt Purchases Certificate; and
17. The sale and import of vehicles subject to excise taxes.

<u>VAT Payment and Reporting</u>

Imported Goods

Similar as under the current SUT regime, merchants will generally pay the applicable VAT prior to taking possession of imported items. Bonded importers may, however, remit their VAT payment along with the Tax on Imports Monthly Return, described below, on or before the 10th day of the month followings the introduction of the goods. VAT payments on goods imported by air carriers or electronic means will be remitted with the Tax on Imports Monthly Return as well.

Acquired Goods or Services

The person that purchases a good or receives a service from a merchant in Puerto Rico, except in cases of retail sales, will be responsible for the payment of the VAT. Also, the person that receives a service rendered by a non-PR resident will be responsible for the payment of the VAT. However, in cases where the merchant has the obligation to act as a withholding agent, such merchant will be responsible for the payment.

Merchants that sell goods or services subject to the VAT will be withholding agents. However, Small Merchants (those with annual gross sales of less than $75,000) with a valid Small Merchant Registration Certificate will not have withholding obligations.

Reporting

The following declarations and returns will be filed with Treasury:

1. *Imports Declaration* – to be filed by all importers of goods;
2. *Tax on Imports Monthly Return* – to be filed by all importers of goods on or before the 10th day of the month following the introduction of goods to Puerto Rico. Such return shall contain detailed information of all goods imported to Puerto Rico by any means during the prior month;

3. *VAT Monthly Return* – to be filed on or before the 20th day of the month following the collection of VAT. Such return shall include the amount of VAT to be remitted and the amount of credit to be claimed. Small Merchants will not be required to file this return.
4. *Annual Declaration for Small Merchants* – to be filed within 60 days of the Small Merchant's income tax return due date including any extension of time to file. The declaration shall contain the total value of the goods and services sold during the preceding tax year.

<u>Fiscal Vouchers</u>

In general, purchasing merchants will be able to request a Fiscal Voucher from the selling merchant that withheld VAT. The Fiscal Voucher shall be requested within 30 days of receipt of the goods or services and shall be issued by the selling merchant within 30 days from the request. The Fiscal Voucher shall include the following information: name, address and merchant number of the seller and purchaser, date, description of the goods, sales value and VAT amount.

Debit Notes and Credit Notes will be issued by the selling merchant in cases where the sales value of the goods described in a Fiscal Voucher is downward or upward adjusted, respectively.

<u>VAT Credit and Refund of Overpayments</u>

Merchants, except Small Merchants, may claim a credit in the VAT Monthly Return for the VAT paid during a particular month.

The following amounts may be credited:

1. VAT paid upon import of goods to Puerto Rico as reported in the Tax on Imports Monthly Return that are directly or indirectly related to the sale of taxable goods or services, whether subject to the 16% tax rate or zero-rated;
2. VAT paid on purchases of goods and services as reflected in the Fiscal Vouchers, that are directly or indirectly related to the sale of taxable goods or services;
3. VAT paid by a merchant for receiving services from a non-PR resident as reflected in a VAT Monthly Return.

An overpayment of up to $10,000 generated due to the excess of adjustments or credits may be applied in the VAT Monthly Return of the month following the month in which the overpayment arises. A refund may be requested by merchants that accumulate an overpayment in excess of $10,000 provided that such merchant is an Eligible Merchant, described below, or the merchant has generated overpayments for three consecutive months.

The Secretary of Treasury must issue its determination denying or approving such refund no later than 30 days after the request is filed. Should the request be approved, it shall be refunded to the merchant no later than 5 business days after its approval date.

<u>Merchant's Registry, Exemption Certificates and Eligible Merchants Certificates</u>

A merchant registration certificate ("MRC") similar to the one under the SUT regime will be required for any person conducting a business in Puerto Rico. Small Merchants may, however, request a Small Merchant Registration Certificate in lieu of the MRC.

The proposed 2015 Code provides the following two exemption certificates that will relieve a merchant from paying the VAT:

1. Exempt Purchases Certificate (“EPC”) – will allow a person to purchase or import goods and services exempt from the VAT. The EPC will be available to the United States Government and any of its states, the District of Columbia, the Puerto Rico Government, hospital units, merchants dedicated to a tourism business and bona fide farmers.

2. Eligible Manufacturer Imports Exemption Certificate – will allow Manufacturers to import zero-rated manufacturing items and purchase zero-rated goods and services.

An Eligible Merchant Certificate will be available to merchants whose annual sales volume during the 3 years preceding its determination exceeds $500,000 and 80% of its total sales are zero-rated. Such certificate will allow the Eligible Merchant to claim a refund for excess VAT payments.

Municipal VAT

Under the 2011 Code municipalities are required to impose a SUT of 1% according to the same base, exemptions and limitations provided therein. The 2015 Code proposes to eliminate such municipal SUT imposition and, instead, Treasury would be required to allocate 1% of the 16% VAT (or of the 16% SUT for the period from April 1, 2015 through December 31, 2015) to municipalities. The 2015 Code would require that the 1% tax be deposited with the Municipal Finance Corporation (COFIM) Redemption Fund and administered by the Act of the Municipal Finance Corporation.

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