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TAX ALERT

The Act to Transform the Tax System of the Commonwealth of Puerto Rico

On February 11, 2015, House Bill 2329, known as "The Act to Transform the Tax System of the Commonwealth of Puerto Rico," was introduced in the Puerto Rico Legislature. The much awaited bill will introduce a new tax code to be known as the Puerto Rico Internal Revenue Code of 2015 (the "Code"). Due to the magnitude and importance of the proposed new Code, we have decided to issue several Tax Alerts to separately discuss changes to individual and corporate income taxes, conduit entities, and the value added tax (the "VAT").

Below is a summary of the most significant provisions of the VAT, which are included in Subtitle D to the Code. Please note that the sales and use tax (the "SUT") provisions in Subtitle D of the Puerto Rico Internal Revenue Code of 2011, as amended (the "2011 Code") will continue to apply during calendar year 2015, but it appears that the applicable tax rate will increase to 16% effective on April 1, 2015. Starting on January 1, 2016, the VAT will replace the SUT. This new tax structure contains many definitions and details that must be analyzed carefully as they relate to each particular transaction. We hereby provide a summary of the most significant aspects of the VAT as proposed, although we anticipate that these provisions will suffer changes in the process of becoming law.

VALUE ADDED TAX

A. Introduction

Every supply of goods and services generally will be subject to the VAT, unless the transaction falls outside the scope of the VAT system. The VAT is collected at every stage of the supply chain, with the tax paid on purchases ("Input VAT") and the tax charged on sales ("Output VAT"). Generally, the VAT system allows registered merchants to deduct the tax charged on their inputs from the tax they collected on sales, which is why the tax should be transparent to most merchants. The actual VAT burden therefore will be borne by the final consumer.

B. Tax on Goods and Services

The tax is imposed on the following "taxable transactions" after December 31, 2015, and is computed applying the applicable rate to the "sales price" of the "good" or "service":

- The import of goods into Puerto Rico (“PR”);
- The sale or transfer of goods (including certain leases) and the rendering of services in PR by a “merchant” in exchange for consideration;
- The rendering of services by a nonresident person to a person in PR; and
- A “combined transaction”.

“Goods” generally includes real and personal property, including admission rights, computer programs and prepaid calling cards.

“Services” includes designated professional services, the warehousing of goods, certain leases, computer programming, installations and repairs of goods.

“Sales price” is the total consideration paid, including the cost of goods sold, transportation costs and service charges, among others, and excluding discounts, warranties, delivery and installation charges (which are considered taxable services), among others.

“Merchant” includes any person engaged in any business in PR (which is broadly defined under nexus rules), with certain exceptions, including independent distributors in a multilevel business.

“Combined Transactions,” with certain exclusions, is the sale of two or more goods or services that are different and identifiable and are sold at a total price.

The following are excluded from the definitions of “goods,” “services,” “sales,” or “imports,” so that they are not considered taxable transactions and fall **outside the scope** of the VAT (“Out of Scope”):

- Money, stocks, bonds, notes, life insurance, and other securities and obligations;
- Intangibles (except computer programs);
- Electricity;
- Water supplied by the PR Aqueduct and Sewer Authority;
- Any property of the Commonwealth of PR or of the U.S. Government;
- Certain entertainment machines;
- Sales by non-merchants;
- Exempt transfers under Subtitle A of the Code;
- The delivery of donated goods;
- Goods introduced into foreign trade zones;
- Alcoholic beverages deposited in a bonded warehouse under certain conditions;
- Certain promotional materials introduced into PR;
- Certain vessels acquired by non-residents of PR;
- Services rendered between affiliated entities;
- Services rendered by the PR Government and by the U.S. Government; and
- Services rendered as an employee.

The following taxable transactions are within the scope of the VAT, but they are **exempt** from the tax:

- Certain financial services (other than bank charges, which are taxable);
- Import and sale of prescription medicines and articles for the treatment of health conditions;
- Certain sales of articles for physical deficiencies;
- Sales and services that qualify for Medicare, Medicaid and the PR Government's Health Insurance Plan;
- Sale of goods and services to the U.S. Government and PR Government;
- Import and sale of petroleum derivatives, except propane gas;
- Certain hotel room charges;
- Import and sale of certain foods that have not been prepared and food ingredients;
- Sales of goods acquired with PAN or WIC funds;
- Sale of real property;
- Certain real property leases by individuals;
- Transfers of goods and services by non-profit entities without consideration;
- Certain imports by and sales to hospitals;
- Certain imports by and sales of agriculture products to bona fide farmers;
- Certain imports by and sales to hotels;
- Import and sale of vehicles;

Taxable transactions that are not exempt from the VAT generally will be subject to a 16% tax, except that the following transactions are subject to a **0% tax rate**:

- Sale of goods for export;
- Services for export; and
- Import of articles for manufacturing (raw materials, certain machinery and equipment, among others) by Manufacturing Plants that hold an Exempt Certificate on Imports by a Manufacturing Plant (see H. below).

C. <u>Person Responsible for the Payment of the Tax</u>

Generally, the person responsible for the payment of the VAT will be:

- Imports – the person that imports the goods to PR;
- Transfers of goods in PR (non-retail) – the seller as withholding agent for the buyer is primarily responsible, but the person that buys the goods or services is also responsible;
- Retail sales – the seller as withholding agent for the buyer.
- Services rendered by a non-resident to a PR resident – the person in PR that receives the service.

D. Collection of the Tax

Merchants that sell goods or render services are obligated to collect the VAT as withholding agent.

1. Sales to Merchants

   a. Fiscal Statement – Merchants that purchase goods or services may request the merchant seller that withheld the tax to provide a Fiscal Statement. The merchant seller, however, will not have the obligation to supply the statement if the goods or services were exempt, were subject to a 0% tax rate, were sold to a “small merchant” (gross sales under $75,000), or were sold at retail. The statement of account must contain certain specific information.

   b. Debit and Credit Notes – At the request of a merchant-purchaser, merchant-sellers that issue a Fiscal Statement are required to issue to the merchant-purchaser a Credit Note when there has been an increase in the value of the sale. If there has been a decrease in the value of the sale, the merchant seller is obligated to issue to the merchant purchaser a Debit Note. Debit and Credit Notes must contain certain specific information.

2. Retail Sales

A merchant seller is obligated to give to the buyer in a retail sale a receipt or other evidence that does not separately show the price of the good or service sold and the applicable tax. The Secretary of the Treasury, however, is authorized to issue an official document establishing that the VAT may be separately shown in any receipt or evidence of sale.

3. Release from Collection of the Tax

A merchant seller will be released from the requirement of charging, withholding and depositing the VAT in a taxable transaction if the merchant-purchaser possesses an Exempt Purchases Certificate or an Exempt Certificate for Imports by a Manufacturing Plant (see H. below). These certificates are presumed to be valid, and the merchant seller does not have to request additional documentation from the merchant purchaser.

4. Collection of the Tax on Sales by Mail

All merchants in the business of mail sales must register as merchants and collect the VAT. This includes the sale of goods ordered through the mail, via Internet or other means of communication, to a merchant who receives the order outside of PR and that transports the good from any place within or without PR, to a person in PR

E. Time and Form of Payment

1. Time of Payment

In the case of merchants that use the accrual method of accounting, the obligation to pay the VAT arises upon one of the following events, whichever happens first:

- Issuance of an invoice;
- Receipt of payment from the customer; or
- 30 days after the delivery of the goods or finalizing the rendering of the service.

When importing goods, the obligation to pay the VAT arises at the time the product is imported into PR.

As with the SUT, there will be an Imports Declaration upon the introduction of goods into PR as a pre-requirement to obtain the release of the imported goods. No later than the 10th day following the closing of each month, a Monthly Imports Return will be required. In addition, a VAT Monthly Return will be required no later than the 20th day following the closing of each month.

Payment must be made before taking possession of the goods, except in the case of bonded Importers who will make the payment with the Monthly Imports Return.

Merchants with a Small Business Registration Certificate will only be required to file a Small Business Annual Informative Return no later than 60 days counted from the filing of the small merchant's income tax return, including any applicable extension.

The Secretary is expressly authorized to establish the method and requirements for filing, including electronic filing and payment, through the issuance of a regulation, circular letter or administrative determination.

2. Payment Amount or Overpayment

The amount of VAT to pay in the Imports Declaration or the Monthly Imports Return will be the value of imported goods, as reflected in the commercial invoice, multiplied by the VAT 16% rate.

In the VAT Monthly Return, the VAT to pay will be the sales price of the goods and services sold times the VAT 16% rate. This amount will be increased or reduced by the applicable adjustments and credits and available overpayments discussed below. For purposes of this return, the sales price of the goods and services sold will not be reduced by any returns.

3. Form of Payment

The VAT can be paid by money order, credit card, debit card, electronic transfer or any other means established by the Secretary. Upon the issuance of a returned check, the Secretary can require subsequent payments to be made by certified or manager's check. Payments required by electronic means must be made by the 10th or 20th day, even if it falls on a holiday or weekend day.

F. <u>Adjustments, Credits and Reimbursements</u>

The VAT Monthly Return will show the merchant's VAT liability for a month computed as follows:

- VAT (0% or 16%) on goods and services sold during a month
- Plus: VAT on adjustments that increase the sales price of goods sold
- Minus: VAT on adjustments that decrease the sales price of goods sold
- Minus: Credit for VAT paid on goods or services purchased (imported)
- Equals: VAT Liability or Overpayment

The following provides a description of the various items in the computation of the VAT liability (or overpayment) of a merchant for any given month.

1. <u>Sales Price Adjustments that Increase/Decrease VAT</u>

The merchant will determine its VAT monthly liability (or overpayment) by increasing or decreasing the VAT computed on the sales of goods and services made during a month by the VAT calculated over the adjustments made, due to corrections, discounts, returns or uncollectible accounts, on the sales price of goods sold ("Adjustments").

The following items will increase the VAT to be remitted to Treasury:

- any Adjustment on the VAT disclosed in a Fiscal Statement sustained by a Credit Note received by a merchant;
- any Adjustment on the VAT disclosed in a Fiscal Statement sustained by a Debit Note issued by a merchant; and
- any Adjustment in the VAT collected or withheld due to an increase in the sales price, including any correction, made after a sale to purchasers that did not receive a Fiscal Statement ("Sales without Fiscal Statements").

The following items will decrease the VAT to be remitted to Treasury:

- any Adjustment in the VAT disclosed in a Fiscal Statement sustained by a Credit Note issued by a merchant;
- any Adjustment in the VAT disclosed in a Fiscal Statement sustained by a Debit Note received by a merchant; and
- any Adjustment in the VAT collected or withheld in a Sale without Fiscal Statement due to (i) a reduction in the sales price, or (ii) a reduction in whole or in part of an account receivable that was classified as uncollectable by a merchant under the accrual method of accounting.

2. Credit for VAT Paid

All merchants that have not received a Small Merchant Certificate can claim in their VAT Monthly Returns a credit against their VAT liability, computed as stated above, for an amount equal to the VAT paid during the month (the "Credit").

The Credit is computed by adding the following items:

a. the VAT paid on the introduction of goods as reported on the Monthly Imports Return,
b. the VAT paid on the purchase of goods and services as disclosed in the Fiscal Statement, and
c. the VAT paid by a Merchant for services rendered by a non-resident person, as disclosed in the VAT Monthly Return.

Only the VAT paid under a. and b. above that is directly or indirectly related to the sale of taxable goods or to the performance of taxable services (i.e., subject to the 0% or 16% tax rate) can be claimed as a Credit.

If the VAT is indirectly related to the sale of taxable goods or services, an allocation should be made to determine which portion of the VAT indirectly related to the sale of goods and services will be attributed to the taxable sales. In general, such allocation will be made based on the proportion of taxable sales against all sales applied to the total taxable sales of goods and services.

3. VAT Overpayment

A VAT Overpayment will be the excess of the Adjustments and Credit over the VAT computed on the sales of goods and services made during a month ("Overpayment").

- If the Overpayment does not exceed $10,000, it must be applied against any VAT liability of the merchant, as computed in the VAT Monthly Return, in the following month and the months thereafter, until exhausted.

- If the Overpayment exceeds $10,000, the merchant may request a reimbursement if it holds an Eligible Merchant Certificate (see H. below), or is the third consecutive month in which an Overpayment is reflected in the Merchant's VAT Monthly Return ("Reimbursement").

The Reimbursement must be requested in writing using the VAT Monthly Return or any other form or return required by the Secretary. The Secretary must issue a determination granting or denying, in whole or in part, the Reimbursement within 30 business days following the date that the request was filed by the merchant. Once approved, Treasury must pay the Reimbursement within 5 business days following the date of the Secretary's approval.

G. Regressivity Relief

The Secretary s granted the authority to reimburse eligible consumers an amount of money, to be determined based on certain criteria, to compensate in whole or in part for the VAT paid. The individuals can avail to this benefit by filing with the Secretary the required information that would document the relief requested. The amounts determined by the Secretary to be reimbursed to the consumers must be sent, deposited or made available no later than the last day of the months of November, March and July, beginning in November 2015.

H. Registry, Certificates and Permits

1. Merchants and Small Business Registry

Any person who wants to do business in PR will be required to register with Treasury before commencing operations. There will be a Merchant's Registry and a Small Business Registry. A Small Business Registry Certificate can be requested by all those who qualify as such.

As with the SUT, the Registry Certificate must be visible to the public. Any person doing business in PR without the Registry Certificate will be subject to certain penalties.

2. Manufacturing Plant Certificate

An Exempt Certificate on Imports by a Manufacturing Plant may be issued subject to certain requirements. Such Certificate will allow the Manufacturing Plant the right to import goods for manufacturing at a 0% rate without paying the VAT. It will be effective for 3 years.

3. Exempt Purchases Certificate

This Certificate will be issued to: (i) the U.S. Government, the States, and the PR Government; (ii) a hospital unit; (iii) merchants engaged in the tourism business; and (iv) bonafide farmers, subject to certain requirements. It will allow merchants to acquire or import goods and services exempt from the VAT. It will be effective for 3 years and a bond may be required.

4. Eligible Merchant Certificate

This Certificate will be issued to those merchants with an annual volume of business in excess of $500,000 for a 3-year period, whose total sales in excess of 80% are subject to a 0% rate. Such merchants should comply with certain requirements, including evidence of no debts and filing of returns, and the posting of a bond. It will allow the merchant to claim the refund of an Overpayment of the VAT.

5. Multilevel Business

As with the SUT, a multilevel business can request through the filing of a closing agreement, that its independent distributors not be considered merchants for purposes of collecting and remitting the VAT.

6. Permit for Direct Payment of the VAT

The merchant that is granted this permit will pay the VAT directly to Treasury and will have a full exemption when purchasing goods and services. The merchant must purchase goods and services annually with a value of $800,000 or more, excluding goods and services for which an Exemption Certificate would have been issued under the provisions of the VAT.

I. Other Administrative Provisions

1. Merchants will be required to keep evidence of all goods and services acquired or sold, such as commercial bills and Credit and Debit Notes, among others, for a period of no less than 6 years.

2. A merchant may be required by the Secretary to deposit cash, post a bond, letter of credit or any other instrument to obtain or retain any of the Certificates issued by the Secretary.

3. Special Funds, including various Municipal Funds, are created with their corresponding allocation of VAT funds.

J. Transitory Provisions

1. The VAT provisions will not be applicable to the sales and use of taxable items before January 1, 2016. It appears that the SUT provisions under the 2011 Code will continue to be in effect for sale and use transactions of taxable items realized after March 31, 2015, and before January 1, 2016, but subject to a 16% tax rate applicable to the sales prices of the taxable item.

2. Retails sales covered by contracts or auctions issued or granted before April 1, 2015, will not be subject to VAT. Such contracts and auctions will be subject to the SUT provisions to the extent applicable. In the case of taxable services, they will be subject to VAT if they were rendered after March 31, 2015, regardless of whether they are related to contracts or auctions issued or granted before the effective date of this Subtitle. However, such services will be subject to the SUT provisions to the extent applicable.

3. The Certificates issued under the 2011 Code will continue to be in effect until December 31, 2015, regardless of whether they have a previous expiration date. Request for the renewal of such Certificates will not be accepted after the effective date of the Code.

4. The bonds approved under the 2011 Code in force as of April 1, 2015 will continue to be in effect until their expiration date.

5. Any credit or overpayment generated under the SUT provisions, which has not been claimed as a reimbursement and is available as of December 31, 2015, may be taken as a credit in subsequent monthly tax returns in chronological order until fully exhausted. Such credits will not be reimbursed.

K. Municipalities

Municipalities are prohibited from imposing any type of tax on sales and use, goods and services, value added, or any other similar tax, except as provided by law.

If you have any questions, you may contact any of the attorneys of our Tax Practice Group listed below:

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