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## TAX ALERT

### ***Tax Reform House Bill 2482***

During the late hours of May 18, 2015, House Bill 2482 (“the Bill”) was introduced in the Puerto Rico Legislature in an effort to reach a consensus to raise revenues and obtain a balanced budget for the Government’s fiscal year 2015-2016. The Bill replaces the controversial House Bill 2329 (“HB 2329”), known as “The Act to Transform the Tax System of the Commonwealth of Puerto Rico,” which was defeated in the House of Representatives. Unlike House Bill 2329, the Bill does not introduce a new tax code, but rather amends the existing Puerto Rico Internal Revenue Code of 2011 (the “Code”).

As we did with HB 2329, we have decided to issue two Tax Alerts this time to separately discuss the changes to individual and corporate income taxes, and to the sales and use tax (the “SUT”) and the value added tax (the “VAT”). This Tax Alert must be read in conjunction with our [Tax Alert of February 12, 2015](#) discussing the VAT of HB 2329. Since the VAT provisions in the Bill are very similar to those in HB 2329, we are summarizing the most significant changes between both bills. The VAT provisions would be included in a new Subtitle DD to the Code. The SUT provisions in Subtitle D of the Code would continue to apply until March 31, 2016, but with the changes discussed herein. Starting on April 1, 2016, the VAT would replace the SUT.

### **SALES AND USE TAX**

#### **A. Introduction**

Until the implementation of the VAT on April 1, 2016, the Bill provides that the state portion of the SUT rate is increased up to 10.5% (resulting in a combined state and municipal SUT tax of 11.5%) from July 1, 2015 to March 31, 2016.

The Bill also provides that a new special state SUT rate of 4% will be imposed only from October 1, 2015 to March 31, 2016 on: i) certain services rendered to a merchant or to a person engaged in a trade or business or in the production of income (known as “B2B Services”); and ii) designated professional services.

As explained in further detail below, municipalities may continue to impose the municipal SUT rate of 1% on taxable items on or after April 1, 2016.

## **B. Changes to Taxable Services**

From July 1, 2015 to March 31, 2016, the sale or use of taxable items, including services already subject to the 7% SUT, will be subject to a state SUT of 10.5%. In general, goods or services excluded or exempted from the definition of taxable items will continue to be excluded or exempted from the new state SUT rates.

During the period running from July 1, 2015 to March 31, 2016, the following services will continue to be **excluded** from the application of the state SUT (i.e., they are **not** considered taxable services subject to the state SUT of 10.5% **or** services rendered to merchants subject to the state SUT of 4%):

- Services provided by the Government of Puerto Rico, including sewer services;
- Educational services, including registration fees;
- Interest and other charges for the use of money and the service charges established by financial institutions (excluding banking charges considered taxable services, as described below<sup>1</sup>);
- Insurance services and commissions, including the underwriting of any insurance contract, and including, but not limited to, life, health, property, and contingency insurance, warranty and extended warranty service contracts, title deeds, reinsurance and excess limit, disability, credit insurance, annuities and bonds, and service fees for the underwriting of the aforementioned instruments;
- Health or medical-hospital services;
- Services rendered by a person whose annual volume of business does not exceed \$50,000 (amount determined taking into consideration the volume of business of all members of the controlled group, if applicable); and
- Services rendered to a member of a controlled group of corporations or related entities as defined in Sections 1010.04 and 1010.05 of the Code.

Commencing on October 1, 2015 and ending on March 31, 2016,<sup>2</sup> services rendered to merchants and designated professional services (which prior to the Bill were generally excluded from the application of the SUT) are subject to a state SUT rate of 4%.

The term “services rendered to merchants” covers B2B services, except the following taxable services that are subject to the state SUT tax rate of 10.5% from July 1, 2015 to March 31, 2016:

- Banking charges and fees that are imposed by financial institutions to their business clients for the management of their demand deposit accounts and other types of deposit accounts;
- Collection services;
- Security services, including armored services and private investigation services;

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<sup>1</sup> There is an error in the Bill regarding the reference to this exclusion.

<sup>2</sup> The language of the Bill is uncertain as to the rules applicable on September 30, 2015 with respect to taxable services. There are guidelines for taxable events before September 30, 2015 and after September 30, 2015.

- Cleaning services;
- Laundry services;
- Repair and maintenance services;
- Telecommunication services
- Waste disposal services; and
- Daily rental of motor vehicles.

Effective from October 1, 2015 to March 31, 2016, the term “designated professional services” includes services rendered by persons duly registered as “specialists” with the PR Treasury. For these purposes, the services that fall within this term are those related to the preparation or review of tax returns, statements or refund claims in connection with taxes imposed by the Code or the U.S. Internal Revenue Code. Therefore, on and after October 1, 2015, the foregoing services rendered by “specialists” are no longer excluded from the SUT and are subject to the special state SUT rate of 4%.

**C. Person Responsible for the Payment of the SUT**

The Bill provides that the state SUT applicable to the services rendered by a nonresident of Puerto Rico to a person of Puerto Rico shall be paid by the recipient of such services in Puerto Rico.

**D. SUT Tax Credits**

In the case of merchant-resellers, commencing on and after July 1, 2015, the Bill provides that the credit for the period in which the SUT was paid can be up to 100% of the tax obligation shown in the monthly return. The 75% credit limitation and the requirements to claim a full credit will no longer be in effect.

**E. SUT Rate Applicable to Contracts and Bids**

The Bill provides that sales of taxable items covered by executed contracts or approved bids at auction before July 1, 2015, will be subject to the SUT rate in effect as of June 30, 2015. This rate would apply to taxable items acquired under such contract or bid within the earlier of (1) 12 months, or (2) the term of the contract. If the taxable items are taxable services, such services must be paid before July 1, 2015.

**VALUE ADDED TAX**

**A. Introduction**

As with HB 2329, under the Bill 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. The VAT rate will be 10.5%.

## **B. Tax on Goods and Services**

The Bill provides that the VAT will be imposed on certain “Taxable Articles” introduced into Puerto Rico, which is defined as articles that are not “Exempt Articles,” and on the following “Taxable transactions” (as in HB 2329), computed applying the applicable rate to the “sales price” of the “good” or “service”<sup>3</sup>:

- The sale or transfer of goods 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.”

The list of transactions that 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”) remains substantially the same, except for the following changes:

- Blood and products derived from blood, and human tissue and organs are now Out of Scope;
- Shipping services of goods by air or sea, including delivery charges by air or sea are now Out of Scope;
- Services rendered between affiliated entities continue to be Out of Scope, except that they will be taxable if the payment constitutes a reimbursement of expenses for services rendered by persons that are not affiliated; and
- Certain vessels acquired by non-residents of PR are no longer Out of Scope.

The Bill provides separate lists for “Exempt Articles” introduced into PR and for “Taxable transactions” that are within the scope of the VAT, but are **exempt** from the VAT. The list of “Exempt Articles” **introduced or imported** into PR that are exempt from the VAT is as follows:

- Articles for manufacturing (raw materials, certain machinery and equipment, among others) imported by manufacturing plants that hold an Exempt Certificate for Manufacturing Plant are exempt from the VAT (no longer zero rated as under HB 2329);
- Prescription medicines continue to be exempt, but the exemption now extends to certain jars, security lids, labels and bags;
- Articles for the treatment of health conditions continue to be exempt;
- Articles for physical deficiencies continue to be exempt;
- Articles that qualify for Medicare, Medicaid and the PR Government’s Health Insurance Plan are now exempt;

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<sup>3</sup> The Bill contains an error, as it makes reference to the 0% tax rate for both taxable imports and taxable transactions.

- Petroleum derivatives continue to be exempt, but the exemption is extended to propane gas;
- Certain foods that have not been prepared and food ingredients continue to be exempt;
- Machinery and equipment by hospital units that hold an Exempt Purchases Certificate continue to be exempt;
- Agriculture products by bona fide farmers continue to be exempt;
- Certain articles by hotels continue to be exempt;
- Textbooks are now exempt; and
- Vehicles continue to be exempt, but the exemption now extends to boats and heavy equipment that were subject to the excise tax.

The list of “Taxable transactions” that are within the scope of the VAT, but are **exempt** from the VAT is similar to HB 2329 for **sales** of goods and services with the changes noted as follows:

- The definition of the term “Financial Services” now includes certain specific services, as well as insurance services rendered by entities regulated by the Office of the Commissioner of Insurance of PR, as further described below;
- The exemption for the sale of prescription medicines now extends to the sale of certain jars, security lids, labels and bags;
- The sale of articles for the treatment of health conditions continues to be exempt;
- Certain sales of articles for physical deficiencies continue to be exempt;
- Sales and services that qualify for Medicare, Medicaid and the PR Government’s Health Insurance Plan continue to be exempt;
- The sale of goods and services to the US Government and the PR Government continues to be exempt;
- The exemption for the sale of petroleum derivatives now extends to propane gas;
- Certain hotel room charges continue to be exempt;
- The sale of certain foods that have not been prepared and food ingredients continues to be exempt;
- The sale of goods acquired with PAN or WIC funds continues to be exempt;
- The sale of real property continues to be exempt;
- In addition to real property leases by individuals, the exemption now extends to commercial property leases, including office, sales, warehouse and parking spaces, paid by a Merchant;
- The sale of donated goods by non-profit entities continues to be exempt;
- Sales of machinery and equipment to hospital units that hold an Exempt Purchases Certificate continue to be exempt;
- The sale of agriculture products to bona fide farmers continues to be exempt;
- The sale of certain articles to hotels continues to be exempt;
- The exemption for the sale of vehicles was extended to boats and heavy equipment that were subject to the excise tax;
- The exemption now extends to certain education and childcare services;
- The exemption now extends to the sale of articles for manufacturing to a Manufacturing Plant that holds an Exempt Certificate for a Manufacturing Plant;

- The sale of textbooks is now exempt;
- The rendering of certain defined health and medical-hospital services is now exempt.

As mentioned above, the “Financial Services” that are exempt from the VAT are now defined to include services rendered in connection with any type of deposit, loans, credit card services, lines and letters of credit, currency exchange, and other similar financial services provided by financial businesses. The term also includes insurance services rendered by entities regulated by the Commissioner of Insurance of PR, including the issuance of insurance contracts, warranty, and extended warranty contracts.

The sale of goods and/or services for export continues to be subject to a **0% tax rate**. As discussed above, a significant change is that the import of articles for manufacturing by Manufacturing Plants is now exempt from the VAT, as opposed to zero rated. In addition, the definition of goods for export at the 0% tax rate now includes goods sold to cruise ships that benefit from certain special government programs, and the definition of services for export at the 0% tax rate now includes services rendered to cruise ships that enjoy certain benefits under various laws.

#### **C. Person Responsible for the Payment of the Tax**

The persons responsible for the payment of the VAT remain the same as in HB 2329.

#### **D. Collection of the Tax**

Merchants that sell goods or render services are obligated to collect the VAT as withholding agents, except in the case of “small Merchants” that had obtained a Small Merchant Registry Certificate, which are now defined as those Merchants whose gross sales are under \$125,000 (under HB 2329, it was \$75,000).

In the case of sale to Merchants, Fiscal Statements continue to be required with the same exceptions. Merchant-sellers continue to be required to issue Merchant-purchasers Debit and Credit Notes when there is a change on the value of the sale for which a Fiscal Statement was issued. Contrary to HB 2329, a Debit Note must be issued when there has been an increase in the value of the sale, while a Credit Note must be issued when there has been a decrease in the value of the sale.

Contrary to HB 2329, in the case of retail sales, Merchant-sellers are required to issue a receipt showing the VAT separately from the price of the goods or services sold. When due to the nature of the business it would be impractical to show the VAT separately, the Secretary of the Treasury is authorized to waive this requirement at the request of the Merchant or by its own determination.

Merchant-sellers will continue to be released from the requirement of charging, withholding and depositing the VAT when a Merchant-purchaser possesses an Exempt Purchases Certificate or an Exempt Certificate for Manufacturing Plant.

Merchants in the business of mail sales will still be required to register as Merchants and collect the VAT as in HB 2329.

#### **E. Time and Form of Payment**

The provisions related to the time and form of payment remain almost identical as under HB 2329. There are no significant changes in this area.

#### **F. Adjustments, Credits and Reimbursements**

Except as otherwise stated below, the mechanism originally established to determine a Merchant's VAT monthly liability was not modified. Thus, in general, Merchants will be able to claim in their VAT Monthly Returns a credit against their VAT liability for an amount equal to the VAT paid during the month.

##### **1. Merchants Mainly Engaged in the Sale of Non-Prepared Food and Medicines**

In general, under the credit mechanism, if the VAT is indirectly related to the sale of taxable goods or services, an allocation is required to determine which portion of the VAT indirectly related to the sale of goods or services will be attributed to the taxable sales. Nonetheless, Merchant's "mainly" engaged in the sale of non-prepared food or supplies (i.e., "Cash and Carry"), or in the sale of prescription medicines, medicines or articles for the treatment of health conditions, will be able to claim on their VAT Monthly Return a credit in the total amount of the VAT paid or accrued during the month. For these purposes, "mainly" means that during the three taxable years immediately before, an average of 70% or more of the Merchant's retail sales are attributable to the sale of non-prepared food and supplies, or to the sale of prescription medicines, medicines or articles for the treatment of health conditions.

##### **2. Credit for Consumption Tax Paid to Foreign Countries**

A Merchant to which a related entity (not engaged in trade or business in Puerto Rico) has rendered a service may claim a credit, subject to certain limitations, for the amount of consumption taxes paid to foreign countries pertaining to the services rendered.

##### **3. Reimbursements for the VAT Paid on Services Rendered to a Related Entity**

The VAT paid by a Merchant that is directly or indirectly related to services rendered to a related person will not be reimbursed if the person receiving the service is mainly engaged in transactions exempted from the VAT. For these purposes, "mainly" means that the Merchant generates more than 80% of its gross sales from exempt transactions.

#### **G. Regresivity Relief**

The regresivity relief originally granted to certain individuals is eliminated under the Bill.

#### **H. Registry, Certificates and Permits**

In addition to the registrations and certifications originally proposed in HB 2329, every Merchant that qualifies as an exhibitor that is required to collect and remit the VAT must register with the Register of Exhibitors using the form to be provided by the Secretary.

The Merchants that are part of a controlled group, or of a related group of entities, can elect to be treated as one Merchant.

#### **I. Other Administrative Provisions**

Similar administrative provisions to those enacted under HB 2329 are included in the Bill.

#### **J. Transitory Provisions**

- In the case of Merchants whose sales of goods or services for the previous taxable year do not exceed \$1,000,000, the VAT related to the sales of goods and services during the month of **July, 2015** will be paid as follows: (1) 55% of the VAT will be paid no later than August 20, 2015; and (2) 45% of the VAT will be paid in 3 equal installments no later than the 20<sup>th</sup> of September, October and November, 2015.
- The bonds approved under the Code will continue to be in effect until their expiration date.
- Any credit or overpayment generated under the SUT provisions, which has not been claimed as a reimbursement and is available as of March 31, 2016, may be taken as a credit in subsequent monthly tax returns in chronological order until fully exhausted. Such credits will not be reimbursed.
- Letter rulings or closing agreements issued to a Merchant under the 1994 Code, or under the provisions of Subtitle D of the Code, which are similar to the provisions of the VAT and that have an impact on the tax liability of taxable events occurring after April 1, 2016, will be deemed issued under the corresponding provisions of the VAT. The Merchant, however, must obtain from the Secretary an official document confirming that the letter ruling or closing agreement will remain in effect under the VAT regime.
- Sales covered by agreements or auctions related to goods, and to services paid before April 1, 2016, that were granted before April 1, 2016, may not be subject to the VAT if they were excluded from the SUT. Merchants with agreements subject to these provisions must obtain written authorization from the Secretary to sell goods or to render services free from the VAT.
- The SUT provisions under the Code will apply to taxable events taking place on or before March 31, 2016.
- The VAT provisions will apply to taxable events taking place on April 1, 2016 and thereafter.

#### **K. Municipalities**

Municipalities are prohibited from imposing or collecting any excise or tax on sales and use, goods or services, value added, or any other similar tax, except as provided by law, over articles, goods, services or transactions that are subject to or exempt from the VAT.

Notwithstanding, the municipal SUT equivalent to 1% provided under Subtitle D of the Code is excluded from said limitation, as well as construction excise taxes and the municipal license tax which imposition is expressly authorized.

Therefore, municipalities will be allowed to impose and collect the 1% municipal SUT after the VAT is implemented on April 1, 2016.

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

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