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Puerto Rico Moving from a Sales & Use Tax to a Value Added Tax

By Denisse Galarza-Mora[1]

On February 11, 2015, the House of Representatives filed House Bill 2329 (the "Bill") with the purpose of establishing a new Puerto Rico Internal Revenue Code ("2015 Code"). The Bill proposes changes to the income tax and consumption tax systems in Puerto Rico with the main objective of moving the weight of tax revenue collections from those imposed on production (income tax) to those imposed on consumption. To achieve this objective the government is betting on a change from sales and use taxes ("SUT") to a value added tax ("VAT") system.

For those following the changes to the SUT in Puerto Rico during the past few years, this change may have been expected. The current SUT in Puerto Rico includes many of the characteristics of a VAT, including the collection of the tax and the use of credits to compensate for the tax paid on certain purchases throughout the distribution or supply chain. It, however, does not have the broad base of taxation that VAT systems usually have and the tax rate is way smaller than those seen in countries with VAT.

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Therefore, the Bill proposes a significant increase in the consumption tax rate from the 7% rate in the current SUT to a 16%. It also proposes a broader tax base in which the VAT will be imposed. This is achieved by eliminating many of the exemptions in the current SUT system, probably the most important being the "business to business exemption" which provides that most services provided between merchants are not subject to SUT.

The government expects that with these changes coupled with reduction in the corporate and individual tax rates, they will be able to change the composition of their tax collections from one based more on the income tax to one which will give a greater weight to the consumption tax. It is expected that the proposed changes will create a much balanced tax system. Currently, the Puerto Rico Treasury Department collects 72% of all tax revenues from the tax on income and the consumption tax (mainly, SUT and excise tax) accounts for only 28% of the total collections. They estimate that if the Bill becomes law, that composition will change so that consumption tax (primarily, VAT and excise taxes) will make up 55% of all collections and the income tax will be reduced to 45%.

The Bill proposes a two phase movement from the SUT to the VAT. The first phase should be implemented very quickly after the approval of the Bill and will just bring minor changes to the current SUT system. The second phase, to be implemented on January 1, 2016, is the one that brings the VAT truly in place.

First Phase – Minor changes to SUT

The Bill provides for the first phase to commence on April 1, 2015 and end on December 31, 2015. This phase will be based on the SUT system in the Puerto Rico Internal Revenue Code of 2011, as amended (the "2011 Code"), with some minor changes. Although the changes in this phase are minor, the impact may be significant.

The most important change and the one that will have the bigger impact is that the tax rate is increased to 16%. With this change, there is also a change in the name of the tax to VAT, even though it still imposed on the same tax base as the current SUT, and, contrary to the current practice, retailers will be required to provide an invoice or a bill in which the VAT is built-in the sales price of the merchandise. Therefore, the customer will be blind to the VAT being included on the retail or selling price.

On the other hand, the limitation that the resellers had on the credit they may claim for the tax paid on the purchases for goods for resale is eliminated. Currently, merchants may only use as a credit the amounts of SUT paid on the purchase for goods for resale up to 75% of the SUT collected. The Bill proposes to repeal such limitation and allow a credit of the VAT paid of 100% of the VAT collected during the period.

The Bill also includes the elimination of the 1% of the Municipal SUT. This amendment will apply for both the first phase and second phase. However, it is expected that the Legislature will look carefully into this amendment because it has the opposition of the mayors of the main municipalities in the Island.

Finally, in this phase some of the SUT exemptions currently in the 2011 Code will be eliminated. These exemptions are the ones provided for (1) funeral services, (2) solar electric equipment and (3) uniforms and materials (also known as "Back to School"). The exemption on books and notebooks remains during the first phase period.

Second Phase – Implementation of VAT

The Bill provides for a second phase to start on January 1, 2016 where the VAT will be fully implemented. Although some of the definitions included in the SUT provisions under the 2011 Code remain, there are important changes in what is taxed, who is taxed and how is taxed. There is also a more complex credit system than before. In the following paragraph, we summarize the most important VAT provisions.

Registration

The Bill provides that any person engaged in business or that wants to be engaged in

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Denisse is a Manager at Alvarado Tax & Business Advisors and has over eight years of experience in the corporate and individual tax advisory areas with various international and local clients. She provides corporate and individual tax services for clients in the retail, manufacturing, and service industries, among other.

With regards to the areas of technical experience and consulting, Denisse has provided sales and use tax consulting services to various municipalities, governmental agencies and private industry clients. She has assisted multiple corporate clients with the implementation of the recent changes to the Sales and Use Tax provisions, which provide for the collection and remittance of this tax. She has also assisted manufacturers and wholesalers in obtaining sales tax waivers from the Puerto Rico Treasury Department to allow them to continue buying and selling their goods without sales and use tax. Denisse represents clients before the Puerto Rico Treasury Department on income and sales and use tax investigations and has participated in the preparation of closing agreements and ruling requests.

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business within Puerto Rico shall file before the Secretary of the Treasury a Request for a Merchant Registration Certificate. These certificates may not be sold, assigned or transferred to another merchant unless the Secretary of the Treasury provides authorization to do so. The certificate will provide whether the merchant is required or not to act as a withholding agent for purposes of the VAT.

Those merchants that qualify as a small merchant (gross sales under $75,000) may request a Small Merchant Registration Certificate. This certificate provides that the small merchant is not required to collect VAT on its sales. However, the small merchant may not claim a credit for VAT paid on the purchases they make. Therefore, they may only obtain relief from the VAT they pay on goods and services by including those costs on the sale price of the goods or services they provide.

The Merchant Registration Certificate or the Small Merchant Registration Certificate shall be displayed in a location that is visible to the general public in each place of business for which it was issued.

Tax Basis and Exclusions

Under a VAT system, a tax is imposed on the value that a merchant adds to his/her raw materials or purchases before selling the new or improved product or service. The Bill proposed by Treasury establishes the mandatory collection of a VAT on all "taxable transactions" and defines this term as one that includes the following:

- introduction or import of goods (including admission rights, computer programs and prepaid calling cards) to Puerto Rico;
- the sale or transfer of assets and services rendered in Puerto Rico;
- the rendering of services by a non-resident person to a resident of Puerto Rico; or
- a combined transaction.

By establishing a VAT on taxable transactions, each merchant pays the tax

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for the purchases he/she makes as part of his/her operations to sell products or services. The Bill, however, also provides for several excluded and exempted transactions from the VAT (see Tables I and 2). The excluded or exempted transactions are very important in the VAT because they have a direct impact on the credit that the merchant selling the good or service may claim.

by a manufacturing plant that holds an Exemption Certificate on Imports for an Eligible Manufacturing Plant should be taxed at a 0% tax rate ("zero rate"). Pursuant to the Bill, transactions subject to a 16% and 0% tax will be considered taxable transactions although in the latter, no tax is collected in the transaction.

VAT Input Credits

Under a VAT system, merchants are entitled to claim a credit for the amount of VAT paid on their purchases of goods and services ("inputs"). This is how they recover the VAT paid on their inputs. The Bill establishes that all merchants, with the exception of those that hold a Small Merchant Registration Certificate, will have a right to claim a credit for the VAT paid on their inputs. This credit is to be taken against the tax determined on their monthly VAT return.

The total amount of credit available for the merchant will be the sum of the:

- VAT paid on imports directly related to taxable transactions,
- VAT paid on local purchases of goods or services directly related to taxable transactions and,
- VAT paid on services rendered by a nonresident person.

Table I – Exempted Transactions			
Financial services, except for bank charges	Sale and introduction of gas, diesel and other petroleum products, except propane gas and related products	Rental of Principal Residence	Goods acquired or imported by tourism businesses
Import and Sale of Prescription Drugs	Rental of properties subject to a room tax	Transfer of goods and services rendered by nonprofit entities	Sale and Import of Motor Vehicles
Sale of medical equipment for disabled persons (when zero rated)	Sale and introduction of food and foodstuff	Equipment acquired or imported by Hospital Units	
Sale of goods or services reimbursed by Medicare/ Medicaid and the PR government health plan	Goods acquired under PAN & WIC Programs	Goods acquired or imported by bona fide farmers	
Goods and services acquired by Government (PR and US)	Sale of Real Estate	Occasional sale of goods by churches or other religious institutions	

Table II – Excluded Goods and Services			
Money	In transit goods (less than 60 days)	Goods imported into a Foreign Trade Zone	Goods imported to PR as part of a move of a nonresident individual
Intangibles (except computer programs)	Home Owner Association's dues and fees	Alcoholic beverages imported into a bonded warehouse	Services rendered as an employee
Electricity	Goods sold by graduating classes	Certified promotional materials	Various Telecommunication services or charges
Aqueduct and Sewer Authority Service	Traditional lottery tickets	Vessels registered abroad owned by nonresident persons	Donations to nonprofit entities
Property owned by Government (PR and US)	Public Transportation	Services rendered by a related entity	

Tax Rate

The Bill establishes a VAT of 16% to be imposed on all taxable transactions. Nonetheless, it specifies that the sale of goods for export, the rendering of exported services and the import of goods

In regards to the VAT paid on local purchases, merchants will be required to obtain a fiscal invoice from their vendors. This fiscal invoice must be requested by the merchant to the vendor within 30 days of the receipt of the goods or services acquired. The vendor must

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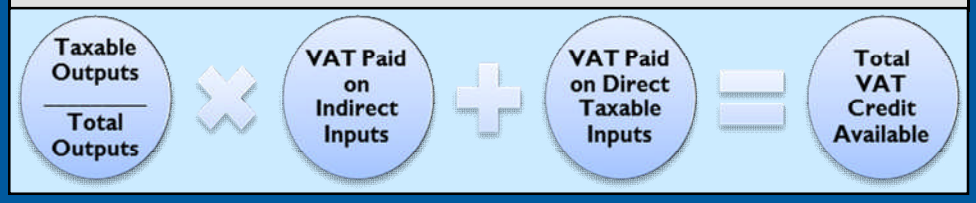
issue this fiscal invoice and provide it to its client within 30 days of receiving the request. The fiscal invoices issued by merchants must include the description and value of the goods and services provided and must also include the total amount of VAT billed, among other details regarding the parties involved in the transaction. No details as to how the fiscal invoice will be monitored by Treasury are included in the Bill but will most likely be specified later upon issuance of regulations.

A fiscal invoice is not to be issued for transactions where all goods and services provided are exempt, excluded or zero rated from VAT. Also, fiscal invoices should not be issued to small merchants (that hold Small Merchant Registration Certificates) nor to persons that are not registered merchants. In the case of merchants that use the cash basis method of accounting, the fiscal invoice should be issued to them after they have paid the VAT that corresponds to the purchase transaction. The Bill also establishes the requirement to issue debit and credit notes to reflect any changes to invoices that have been modified after the issuance of the fiscal invoice due to additional discounts, corrections or bad debts.

The total amount of VAT credits available for merchants as proposed by the Bill depends on the taxability of the goods and services each merchant sells ("outputs"). The Bill establishes a methodology to determine the amount of VAT credits a merchant may claim in the case he sells taxable and non-taxable outputs. Pursuant to this methodology, each merchant must begin by determining the percentage of **taxable** outputs. Then, the merchant must evaluate its inputs in order to determine if they are **directly related** to the sale of **taxable** outputs and must limit the VAT paid on **indirect inputs** to the percentage of **taxable** output (see Table 3).

Please note that the VAT paid on **directly related** inputs, such as the purchase of taxable goods for resale, may be completely claimed as VAT credit by the merchant. Nonetheless, a merchant that sells both taxable and non-taxable outputs, will not be able to recover all of the VAT paid on indirect inputs since its VAT credits will be reduced by the portion of its non-taxable outputs, both direct and indirect.

Table III – Formula to Determine VAT Credit Available



Overpayments and Refunds

The Bill provides that an overpayment will be the excess of the adjustments to the VAT and the credits over the amount of the VAT within a month. If the overpayment in the monthly VAT return does not exceed $10,000, the merchant should carry such overpayment to the next monthly VAT return until such overpayment exceeds $10,000. Once the overpayment reaches $10,000, the merchant may request a refund of such overpayment if it meets one of the following:

- the merchant is considered an Eligible Merchant; or
- the month in which the overpayment exceeds $10,000 is the third consecutive month with an overpayment in the monthly VAT return.

The merchant is not required to request the refund once the overpayment exceeds $10,000. He may continue to carry such overpayment to the next monthly VAT return.

The Secretary of the Treasury should evaluate and issue a decision regarding the acceptance or denial of the refund claim within a period of 30 working days after the date the refund was requested. If the refund is approved, it should be issued within 5 working days after the date of the approval.

Every merchant who believes that it will have substantial overpayments on a continuous basis should consider requesting a Certificate of Eligible Merchant in order to avoid the three months waiting period.

Declarations, Returns and Payments

Similar to the current SUT system, the Bill proposes that the merchants who will import goods into Puerto Rico will need to complete a declaration to be able to obtain the release of the imported goods and a monthly import tax return to report those imports. All merchants, be them importers or not, also need to file a monthly VAT return.

The declarations are due upon the introduction of the goods into Puerto Rico and, as previously mentioned, are a requirement for the release of the merchandise if the goods arrived through the docks. If the goods arrived through the United States Postal System or using an air carrier, the declaration is required but the release of the merchandise is not subject to the filing of the declaration. All taxpayers are required to pay the VAT with the declaration unless they are bonded importers. Bonded importers are allowed to pay the VAT with the monthly import tax return.

The monthly import tax return is due on the 10th day following the month of the imports. In such a return all the imports are declared and the VAT for those that entered Puerto Rico through the United States Postal Service or air carrier is paid. Also, bonded importers will pay all the VAT on imports on such return.

The monthly VAT return is due on the 20th day following the month of the collection of the VAT. In such a return the VAT collected from sales is reported together with the credit allowed for the VAT paid by the merchant. The merchant should pay with such return the VAT collected reduced by the credit allowed.

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The Bill also provides for a new return for small merchants. Those merchants that have a Small Merchant Registration Certificate are required to file an annual return. The return is due 60 days after the filing date of the income tax return of such taxpayers. That return is merely informative and no payment is required with it.

Certificates and Permits

Besides the Merchant Registration Certificate and the Small Merchant Registration Certificate, the Bill provides three additional certificates and one permit where each one provides a particular benefit to the holder of the certificate:

1. Exemption Certificate on the Imports by an Eligible Manufacturer – This certificate allows the eligible manufacturer to import manufacturing items with a "zero rate". However, the Bill does not provide a definition of what is an eligible manufacturer to determine if all manufacturers do qualify for the certificate or only those that meet a particular requirement. Only raw material, machinery and equipment used in the manufacturing process and certain articles exempt from excise taxes under tax incentives acts qualify for the "zero rate".

2. Exempt Purchases Certificates – This certificate allows the eligible person to purchase or import goods of services exempt from VAT (note that it is not "zero rate"). However, the merchant selling the goods or services should be prudent and shall exercise due care to avoid selling goods or services to a merchant exempt of VAT when it is unreasonable to think such merchant could acquire those goods or services exempt from the payment of VAT. This certificate will be valid for a three year period. The eligible persons to request this certificate are: (1) the Government of Puerto Rico, the United States, any of its States and the District of Columbia; (2) an hospital unit; (3) merchants engaged on a tourism related business; and (4) bona fide farmers.

3. Eligible Merchant Certificate– Any merchant which annual volume of business exceeds $500,000 for the three prior years and at least 80% of its sales are subject to a zero rate will qualify for a Eligible Merchant Certificate. These merchants may claim a refund of their VAT credits without waiting the three month period if the excess credits surpass $10,000.

4. Permit to Pay the VAT directly to the Secretary – The Secretary is authorized to issue a permit allowing a merchant to pay the VAT directly to the Secretary and therefore not pay it when importing or purchasing goods and services. These permits do not provide an exemption on the goods or services but rather authorizes the merchants that sell the goods or services not to collect the VAT on those transactions with the holder of the permit.

Transitional Provisions

The Bill includes certain transitional provisions to address the change from the SUT to the VAT. One of such provisions is the one discussed as the first phase of the conversion to the VAT system as related to the imposition of the VAT of 16% to the items previously subject to SUT.

The transitional provisions also provide an exclusion for preexisting contracts and bids. The Bill provides that all retail sales covered by contracts related to good granted prior to April 1, 2015, will not be subject to VAT. Nevertheless, taxable services rendered after March 31, 2015 will be subject to the VAT, without taking into consideration that the contracts were granted prior to the effectiveness of the 2015 Code.

Finally, while in this transition period the certificates (exemption certificate, the eligible reseller certificate, the reseller certificate and the merchant's registration certificate) granted to merchants under the 2011 Code will be valid until December 31, 2015, independently from their expiration date. All bonds approved by the Secretary under the 2011 Code that are active by April 1, 2015 will still be valid until their expiration date. The credits that have not been claimed as refund and are available to the merchant by December 31, 2015 will be available as a credit for subsequent returns, provided that the use of this credit will not result in a refund.

ATBA Comments

The purpose of a VAT is to collect a consumption tax on the final consumer (individual) of the products or services in order not to increase the costs of the businesses and therefore, of the products or services they sell. That purpose is usually achieved by allowing a credit equal to the VAT paid on goods and services purchased by merchants. However, merchants which sell goods or services that are exempted or excluded or sell goods or services to persons that are not subject to VAT will not be able to credit the totality of the VAT paid on the goods or services they buy. Therefore, it is important that those merchants evaluate the impact that the VAT will have on their business. Even those merchants that are able to credit all the VAT that they pay shall consider the impact, if any, on their cash flow.

Currently, there is opposition to the Bill from some industries and interests group. The opposition range from those requesting exemption for certain goods or services to those completely opposed to the VAT. It is important to follow the legislative process to be aware of possible amendments to the Bill. The inclusion of an exemption in the Bill may be a very favorable outcome to the consumer but it may be costly to the merchants in that particular industry.

Our advisors may assist you in the determination of the impact of the Bill in your operations and help you understand the ins and outs of a VAT system. We will keep you informed of the changes in the Bill and its final outcome.

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[1] Federico Aguirre (Manager) and Felipe Mariani Franco (Member) assisted in the preparation of this bulletin.

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