Puerto Rico Governor introduces VAT bill to Legislative Assembly

Executive summary

On 11 February 2015, Puerto Rico Governor Alejandro García Padilla introduced a bill to the Legislative Assembly of Puerto Rico that proposes to establish a new Puerto Rico Internal Revenue Code (PRIRC) that includes a value added tax (VAT) (the proposed bill or proposed VAT). If the proposed bill is enacted into law, a 16% VAT would become effective on 1 January 2016. This Alert discusses the provisions of the proposed VAT, key VAT compliance requirements, transition rules, industry-specific considerations and steps to take in preparing for the proposed VAT.

Detailed discussion

Essentials of the proposed VAT

If approved by the Legislative Assembly, the proposed VAT would take effect on 1 January 2016, and it would be imposed at the standard rate of 16%. Transition rules in the proposed bill mandate the phased implementation of the VAT beginning on 1 April 2015, under the rules applicable to the existing sales and use tax (SUT), but at the standard rate of 16%. The proposed VAT would replace the SUT system applied both at the Commonwealth and municipal levels. The proposed bill provides that municipalities may not impose an SUT or VAT unless the imposition is specifically authorized by legislation. Under the current SUT regime, there is a 1% municipal tax and a 6% state tax component. Under the proposed bill, the municipal SUT would be eliminated and the municipalities would be compensated from the proposed VAT revenue instead. Given the current political climate and pressure being exerted by most mayors, it remains to be seen if the proposed prohibition on imposing a municipal VAT or SUT will survive the legislative process.

As a general rule, the party responsible for paying the VAT would be the person that:

- Introduces or imports goods into Puerto Rico
• Purchases goods or receives a service (except in the case of retail sales) in Puerto Rico
• Receives the service in Puerto Rico, in the case of services rendered by a nonresident of Puerto Rico

The proposed VAT would apply to qualifying supplies of goods and services, as well as importations. Certain supplies would be exempt from the VAT, such as the sale of prescription drugs, unprepared food and food ingredients, sales to hospitals, sales to bona fide farmers, financial services, sale of real property, and hotel room charges, among others.

Although the standard proposed VAT rate is 16%, the proposed bill would provide for zero-rated transactions in the case of the supply of goods and services for export, and on the import of articles for manufacturing by a manufacturing plant with a valid exemption certificate.

**Merchant registry and certificates**

Taxpayers would have to register for VAT before commencing a taxable activity.

Merchants with a volume of business of less than $75,000 (Small Merchants) would not be required to collect VAT. Eligible merchants, however, would need to register and request a Small Merchant Registration Certificate in order to be considered as such.

The proposed bill provides for the issuance of an Exempt Purchases Certificate for “eligible persons” that import or acquire goods and services. “Eligible persons” that may qualify for an Exempt Purchases Certificate would include:

• The US Government, its states and the Government of Puerto Rico
• Eligible hospital units
• Eligible merchants engaged in the tourism business
• Bona fide farmers

An Eligible Merchant Certificate also would be available to allow a refund claim of excess VAT paid. Eligible merchants would be defined as those merchants whose volume of business exceeds $500,000 and 80% of whose sales are zero-rated.

**Declarations and returns**

*Imports declaration* – Similar to the current SUT regime, merchants would have to file an imports declaration detailing the VAT to be paid for the goods being introduced. Bonded merchants would be able to postpone the VAT payment on the imported goods until the 10th day of the following month.

*Monthly imports return* – Merchants that are importing goods would have to file a monthly imports return on or before the 10th day of the month following the introduction.

*Monthly VAT return* – To claim the VAT credit, all merchants would have to file the monthly VAT return on or before the 20th day of the month following the taxable transaction.

*Small merchants’ annual informative return* – Small merchants would have to submit an annual informative return 60 days after filing the income tax return. The informative return must detail the small merchant’s total sales of goods and services for the year.

**Remittance obligation**

The following person would be responsible for the remittance of the VAT:

• When importing goods, the person importing the goods
• In the event of sales of goods and services, the withholding agent
• In the event of services being rendered from outside of Puerto Rico, the person receiving the service

**Credits, overpayments and refunds**

As a general rule, merchants would be able to claim a credit on their monthly VAT return for the VAT paid upon the introduction of the goods, on the purchase of goods and services, and for VAT accounted for on services purchased from a non-Puerto Rico resident provider. Merchants only would be able to claim the credit amount to the extent that it was reported on their monthly imports return or evidenced on a fiscal invoice, and as far as the acquisitions can be attributed to their taxable business activity.

Overpayments of less than $10,000 would be carried forward until exhausted. In the event a merchant generates an overpayment of more than $10,000, the merchant would be able to request a refund if considered eligible or other certain circumstances are present. The refund request would have to be submitted in writing by the merchant (in the monthly VAT return or other form specified by the Secretary).
For individuals, the proposed bill would provide a mechanism for nonresidents who pay VAT to be able to claim a refund. Certain low-income individuals and families who are residents of Puerto Rico and meet certain eligibility criteria would receive regressivity relief payments for the VAT paid. A request would have to be filed with the Secretary to be considered an eligible consumer.

**Transition rules and special effectiveness rules**
The proposed bill includes transition rules for the nine-month period beginning on 1 April 2015, and ends on 31 December 2015 (Transition Period). During the Transition Period, the proposed VAT would co-exist with SUT provisions under the 2011 PRIRC, subject to certain exceptions such as the applicable rate. Below is a table summarizing highlights of the provisions for the transition period.

**Industry-specific considerations**
Below are specific considerations for taxpayers in the financial services, tourism and manufacturing sectors. Also highlighted are provisions related to sales delivered by mail.

**Financial and insurance services**
VAT rules for the financial and insurance services industry encompass:

- VAT exemption (without credit) for insurance services
- VAT exemption (without credit) for financial businesses, except those that result in the imposition of bank charges
- VAT liability for financial services that impose bank charges

**Tourism industry**
Existing businesses devoted to a tourism activity with a valid tax grant under the Puerto Rico Tourism Development Act of 2010 would be eligible to request a Certificate of Exempt Purchases. This exemption certificate would grant the right to acquire or import goods and services exempt from the VAT. In order to request this exemption certificate, the business must to be in good standing and provide evidence of its tax-exempt status, among others.

**Manufacturing**
The proposed bill provides for manufacturing plants to obtain a Certificate of Exemption on imports. The certificate would allow them to introduce the articles to be used in their manufacturing business with a zero tax rate. Similar to the exemption certificate that certain export manufacturers currently hold for SUT purposes, the business must be in good standing, have a valid manufacturer ID number, provide a sworn statement identifying the clients to which it expects to sell its products and their location, among other requirements.

Manufacturing plants also would be able to request an Eligible Merchant Certificate, which could potentially entitle them to request a refund.

**Sales by mail (internet sales)**
The proposed bill would define a sale delivered by mail as the sale of goods, ordered by mail, internet or other communication method, to a merchant that receives the order outside of Puerto Rico and then ships the goods from any place within or outside Puerto Rico to a person in Puerto Rico. Under the proposed bill, merchants making sales delivered by mail would be subject to VAT provisions, such as merchant registration and collection of the tax on goods and services.

**VAT readiness and implications**
In preparation for the enactment of the proposed bill, taxpayers should consider:

- Reviewing and mapping their Puerto Rico-related supply chain activities (i.e., purchases and sales) and understanding the liability and compliance implications of the VAT mandate
- Quantifying the financial effects of the VAT mandate (e.g., effects of cash flow, above-the-line costs, effects on pricing, and current supplier and customer agreements, compliance expenses)
- Evaluating their supply chain-related transaction and financial systems to identify the changes that will be required to comply with the VAT mandate by the statutory implementation date

Modifications and changes to the proposed bill are very likely to take place before it is enacted into law. As the proposed bill continues to evolve, other readiness imperatives may arise. EY will issue additional Alerts as warranted.

In addition, EY will host a live webcast to discuss the new legislation in more detail on 24 February.
### Highlights of SUT/VAT transition rules

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Effectiveness</strong></td>
<td>Sale and use of taxable items will continue to apply during the period from 1 April 2015 through 31 December 2015. Any taxable transaction taking place after 31 December 2015, will be subject to taxation under the proposed VAT regime.</td>
</tr>
<tr>
<td><strong>Tax rate</strong></td>
<td>16%</td>
</tr>
<tr>
<td><strong>Taxable basis, reporting and deposit requirements</strong></td>
<td>Same as under the 2011 PRIRC.</td>
</tr>
<tr>
<td><strong>Preexisting contracts and auctions</strong></td>
<td>Retail sales for goods and services under contracts and auctions executed or granted before 1 April 2015 would be excluded from the proposed VAT.</td>
</tr>
<tr>
<td><strong>Sale of taxable services</strong></td>
<td>SUT applicable rule under 2011 PRIRC, except for tax rate. Sales subject to the proposed VAT regardless if the contract or auction was executed or entered prior to the effective date of the proposed VAT.</td>
</tr>
<tr>
<td><strong>Regressivity relief payments to eligible consumers</strong></td>
<td>Eligible consumers include pensioners, married and single individuals with income levels below a certain amount established by the PRTD.</td>
</tr>
<tr>
<td><strong>Exemption and Eligible Reseller exemption certificates</strong></td>
<td>Certificates issued under the 2011 PRIRC continue in full force and effect until 31 December 2015, regardless if they may expire earlier.</td>
</tr>
<tr>
<td><strong>Bonds approved under the 2011 PRIRC</strong></td>
<td>Continue in effect until expiration.</td>
</tr>
<tr>
<td><strong>Credits or overpayments available as of the end of the transition period</strong></td>
<td>Carried over to subsequent monthly returns to be used until fully exhausted. The proposed Bill limits, however, the ability to claim a refund at any point thereafter for credits available at the end of the transition period.</td>
</tr>
<tr>
<td><strong>Sales receipts, invoices, tickets or any other evidence of sale</strong></td>
<td>Requirement to show SUT and Proposed VAT jointly with the sales price. Merchants must comply with this requirement by no later than 30 days after the approval of the proposed Bill.</td>
</tr>
<tr>
<td><strong>Credit for taxes paid by a reseller merchant</strong></td>
<td>Merchants will be allowed to claim taxes paid up to 100% of sales tax obligation, subject to compliance with certain requirements to be established by the Secretary. The effective date for the increased creditability benefit seems to be starting on 1 April 2015.</td>
</tr>
<tr>
<td><strong>Certain exemptions eliminated for transactions after 31 March 2015</strong></td>
<td>Funeral services, solar electric equipment used to produce electric power, including its accessories and parts, and back to school two-day periods in July and January of every year to purchase tax-free uniforms and materials. Exemption on text books would continue being available through 31 December 2015.</td>
</tr>
</tbody>
</table>
For additional information with respect to this Alert, please contact the following:

**Ernst & Young Puerto Rico LLC, State and Local Taxation Group, San Juan**
- Teresita Fuentes +1 787 772 7066 teresita.fuentes@ey.com
- Rosa M. Rodriguez +1 787 772 7062 rosa.rodriguez@ey.com
- Pablo Hymovitz +1 787 772 7119 pablo.hymovitz@ey.com

**Ernst & Young LLP, State and Local Taxation Group, New York**
- Gino Dossche +1 212 773 6027 gino.dossche@ey.com

**Ernst & Young LLP, State and Local Taxation Group, Atlanta**
- Peter Molnar +1 347 651 6081 peter.molnar@ey.com
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Indirect Tax

© 2015 EYGM Limited.
All Rights Reserved.

EYG No. CMS232

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com