

July 10, 2015

NEW TAX LAW INTRODUCING VALUE ADDED TAXES AND CERTAIN
TRANSITION CHANGES TO THE SALES AND USE TAX SYSTEM

PART TWO: THE VALUE ADDED TAX

As informed on our June 12, 2015 newsletter, Governor Alejandro García Padilla enacted Act No. 72-2015 that introduces a value added tax (“VAT”) on consumption to replace the current sales and use tax (“SUT”) system of taxation. Other provisions of the Puerto Rico Internal Revenue Code of 2011, as amended (“Code”), were also amended.

The new VAT regime will become effective on April 1, 2016, with temporary changes for the transition into the VAT to become effective during the period of July 1, 2015 through March 31, 2016. The Secretary of the Treasury is authorized to extend the April 1, 2016 effective date of the VAT for a maximum period of 60 days under certain terms and conditions; if the VAT is extended, the SUT will continue to apply during the extended period.

Since its enactment, the Puerto Rico legislature has proposed various bills to amend certain provisions of Act No. 72-2015. House Bill No. 2531 was submitted on June 9, 2015 and subsequently enacted into Act No. 107-2015. Thereafter, on June 16, 2015, Senate Bill No. 1433 was introduced to propose technical amendments to Act No. 72-2015. The bill was approved by the Senate and submitted to the House of Representatives, where it is currently pending further action. We have not addressed the proposed amendments in this newsletter, as the bill is at an early stage of the legislative process and there is no indication of its outcome.

This is the second and last of a series of newsletters describing the changes introduced by Act No. 72-2015. Below are some salient aspects of Act No. 72-2015 with regards to the VAT:

Value Added Taxes

1. Tax Rate:

- a. A VAT of **10.5%** is imposed on the value of “Taxable Articles” that are “introduced” to Puerto Rico and on “Taxable Transactions.” The term “introduced” means the arrival to Puerto Rico of articles through any means, including ports, airports, delivery to commercial or residential premises, through the internet or electronically.
- b. The following items and transactions are, however, subject to a rate of **0%**:
 - i. Sales of Taxable Articles for export;
 - ii. Sales of Taxable Services for export; and
 - iii. Sales of “raw materials” and “articles and equipment for manufacturing” sold to a “manufacturing plant,” as such terms are defined in the statute, if the “manufacturing plant” holds an exemption certificate (see 4.e. below) issued by the Secretary of the Treasury (the “Secretary”).
- c. No VAT will be imposed upon the introduction of Taxable Articles in Puerto Rico if the purchaser/importer can provide evidence that the seller charged the VAT upon sale.

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2. Taxable Articles and Transactions:

a. Articles

Generally, the term “Articles” means all tangible real or personal “property” that can be owned, including admission rights, computer programs and prepaid phone cards, except for the following, which are not treated as “property” for such purposes:

- i. Cash and cash equivalents, stock, participations in partnership profits and limited liability companies, bonds, notes, mortgages, IOUs, securities and other obligations;
- ii. Intangible property;
- iii. Human blood and products derived therefrom, and human tissue and organs;
- iv. Electricity;
- v. Water supplied by the Puerto Rico Aqueduct and Sewer Authority; and
- vi. Any property of the Commonwealth of Puerto Rico or of the agencies or instrumentalities of the United States of America.

b. Exempt Articles

The term “Taxable Articles” means all “Articles,” except the following, which are “Exempt Articles:”

- i. Articles used in manufacturing by a “Manufacturing Plant” that holds an *Manufacturer’s Exemption and Zero Rate Certificate* (see 4.e. below) issued by the Secretary;
- ii. Prescription drugs, including items related to their labeling and packaging;
- iii. Certain health treatment mechanisms and devices;
- iv. Certain articles and equipment to assist certain qualifying individuals with physical or physiological impediments;
- v. Articles reimbursable by Medicare, Medicaid and the Puerto Rico government-sponsored health care plan;
- vi. Articles acquired by agencies and instrumentalities of the Government of Puerto Rico, the United States, any of the states of the United States or the District of Columbia;
- vii. Gasoline, aviation fuel, “gas oil” or “diesel oil,” crude petroleum, petroleum derivatives and other hydrocarbon mixtures;
- viii. Foods and food ingredients;
- ix. Machinery, equipment, surgical materials, and technology acquired by hospital units that possess a *Certificate of Tax Exempt Purchases* (see 4.c. below) exclusively in providing healthcare services to human beings, except inventory, machinery, equipment, construction materials and furniture and fixtures used for administrative or maintenance purposes;
- x. Articles used in agriculture by *bona fide* farmers;
- xi. Articles used in a tourism activity by a merchant that possesses a *Certificate of Tax Exempt Purchases* (see 4.c. below) except inventory, machinery, equipment, construction materials and furniture and fixtures used for administrative or maintenance purposes;
- xii. Printed books; and
- xiii. Vehicles, vessels and heavy equipment subject to excise taxes.

c. Taxable Transactions

The term “Taxable Transactions” means the sale or transfer in Puerto Rico of: (1) “Taxable Articles,” (2) “Taxable Services,” and (3) “Services” rendered by a non-resident person to a person in Puerto Rico, as well as “Combined Transactions.”

The term “Combined Transactions” includes the sale or transfer of two or more

articles or services where the articles or services are different and identifiable from each other, and are sold or transferred for a total price instead of an itemized price.

The following rules apply for determining the situs of Taxable Transactions:

- i. **Sale of Articles.** The situs is in Puerto Rico if the articles are located in Puerto Rico at the time of the transfer, or the articles will be shipped to an address in Puerto Rico.
- ii. **Services Rendered by a “Merchant.”** The general rule is that the situs is in Puerto Rico if the services are rendered by a “Merchant,” that is, a person engaged in business in Puerto Rico. A person is treated as engaged in business in Puerto Rico under principles that are similar to the SUT rules and which provide that this criteria will be met if:
 - A. **Such person:**
 - I. Has an office or place of business in Puerto Rico directly or through an affiliate;
 - II. Has employees, independent contractors, or agents in Puerto Rico that solicit business or engage in business transactions on behalf of the person;
 - III. Is the owner of any Article located in Puerto Rico;
 - IV. Has referral contracts with residents of Puerto Rico;
 - V. Creates a “substantial nexus” with Puerto Rico by entering into contracts in Puerto Rico, marketing in Puerto Rico through mail, radio, catalogues, computers, television, other electronic means, advertising in newspapers and magazines;
 - VI. Voluntarily submits to Puerto Rico’s VAT;
 - VII. Participates in the imports of Articles sold from a state or foreign country through an internet link; or
 - VIII. Otherwise creates a sufficient nexus with Puerto Rico; or
 - B. **A Merchant:**
 - I. Sells a line of products that is similar to the line of products sold by the person under the person’s trade name or similar name;
 - II. Uses its employees or facilities in Puerto Rico to advertise, promote or facilitate the sale by the person to buyers in Puerto Rico;
 - III. Has an office, distribution center, warehouse or similar facility to facilitate the delivery to local buyers of Articles or Services sold or rendered by the person;
 - IV. Uses the person’s trade name or similar names;
 - V. Provides delivery, installation, assembly or maintenance services to Articles sold by the person; or
 - VI. Engages in other activities in Puerto Rico that are significantly associated with the person’s capacity to maintain a market in Puerto Rico.
- iii. **Services Rendered by a non-Puerto Rico resident to a person in Puerto Rico.** The situs is in Puerto Rico if the services are rendered for the benefit of a person in Puerto Rico.

The implications of this rule may come as a surprise to many businesses in Puerto Rico, as it entails the payment of a VAT on any service rendered by a non-Puerto Rico service provider (such as attorneys, bank charges from non-Puerto Rico banks, architects, advertising agencies and others), including services rendered outside Puerto Rico.

Moreover, this rule is also relevant for intercompany service charges that do not fall within the exception described in 2.d.i. below.

- iv. Wireline telecommunication services. The situs is where two of the following three events take place: (a) where the services commence; (b) where the services end; or (c) where the services are invoiced.
- v. Wireless telecommunication services. The situs is at the location of primary use by the customer, which should be the client's residential or commercial address.
- vi. Cable or satellite television services. The situs is at the location of primary use by the customer, which should be the client's residential or commercial address.
- vii. Leasing of personal property. The situs is at the location where the personal property is being used.
- viii. Leasing of real property. The situs is at the location where the real property is located.

d. Services

The term "Taxable Services" means any trade or business conducted by a "Merchant" that is not sale of "Articles," except that it does not include the following ("Exempt Services"):

- i. Services rendered by a person engaged in a trade or business in Puerto Rico to another person that is also engaged in a trade or business, provided both persons are members of the same controlled group or are related persons, as such determination is made for these purposes.

It is important to highlight that this exception does not apply to the extent the amount charged for the services represents a reimbursement of expenses for services by a person that is not a member of the controlled group or a related person and is engaged in a trade or business in Puerto Rico.

- ii. Services rendered by the Commonwealth (including the Puerto Rico Aqueduct and Sewer Authority) and by the agencies or instrumentalities of the United States of America;
- iii. Services rendered by an employee; and
- iv. Maritime and air cargo transportation.

e. Exempt "Taxable Transactions"

The sale of the following "Taxable Transactions" is exempt from the VAT:

- i. Financial services, except those that may result in the imposition of bank charges;
- ii. Sales of goods and services acquired with funds from the PAN, WIC, or other similar government-sponsored voucher plans;
- ii. Sales of real estate;
- iv. Rental of residential real estate that represents the lessee's principal residence;
- v. Rental of commercial real estate, including office space, warehousing space and parking;
- vi. Sales of Taxable Articles by non-profit organizations;
- vii. Occasional sales of goods by churches or other religious organizations, subject to certain conditions;
- viii. Rendering of educational and childcare services;
- ix. Rendering of healthcare and hospital services to human beings and animals, not including prescription drugs;
- x. Rendering of legal services under a contingency contract regarding the following areas of the law: family, child support, medical malpractice and torts; and
- xi. Services rendered to associations or residents of condominiums, condominium owners' boards or associations, or to the housing cooperatives created under Act

No. 239-2004 for the benefit of the residents of the condominiums or government-subsidized residential projects.

3. Responsible Party:

- a. The persons responsible for payment of the VAT vary depending on the type of transaction, as follows:
 - i. On Taxable Articles introduced to Puerto Rico, the importer is responsible for paying the VAT;
 - ii. On sales or transfers of Taxable Articles and Taxable Services by a Merchant, the person acquiring the articles or receiving the services is responsible for paying the VAT, except in the case of retail sales;
 - iii. On Taxable Services rendered by a non-Puerto Rico resident, the person receiving the service in Puerto Rico is responsible for paying the VAT; and
 - iv. On certain transactions where the Merchant is required to act as a withholding agent (see following Section 3.b.), the merchant is responsible for paying the VAT.
- b. *Merchants acting as withholding agents.* In general, all Merchants are required to charge and collect VAT on sales of taxable items and services, except if they have a *Certificate of Registry of Small Merchant* (“Small Merchants,” see 4.b. below).
- c. *Retail sales.* The VAT system includes provisions identical to those related to retail sales under the SUT system as to the following: disclosure of the value of the transaction and the tax on the sales receipt; advertisement of admission fees; duty to withhold the tax on all taxable transactions; prohibition to advertise or publicly express in any manner that the Merchant will absorb the tax or relieve the buyers from payment of the tax; and submittal of event tickets for prior approval by the Secretary.
- d. *Multilevel Businesses.* Qualifying independent distributors of multilevel businesses may be exempted from the obligation to withhold and deposit the VAT on their sales of taxable items and/or services.
- e. *VAT on mail orders.* All Merchants (including Puerto Rico and non-Puerto Rico Merchants) sending over the mail retail sales of Taxable Articles that are ordered through the internet, phone, mail or other means of communication are responsible to register as a Merchant and for the withholding and depositing the VAT.

4. Registration, Certificates and Fiscal Vouchers:

- a. *Merchant registration requirement.* All Merchants engaged in selling taxable items and/or services in Puerto Rico are required to be registered in the VAT Merchants Registry. However, it is not clear if this is the same registry enacted for the SUT system, a new registry, or a converted registry.
- b. *Certificate of Registration as Small Merchant.* A Merchant with sales for the immediately preceding taxable year of less than \$125,000 may request to be registered as a Small Merchant. A Small Merchant is not required to charge and collect VAT on its sales of taxable goods and services, nor is it entitled to claim a credit for VAT paid on its inputs.
- c. *Certificate of Tax Exempt Purchases.* Qualifying merchants can request this certificate in order to be able to introduce or purchase taxable items free of VAT. The certificate is effective for three years. Qualifying merchants include:
 - i. The Government of the United States and any of its states, territories and District of Columbia;
 - ii. The Government of Puerto Rico;
 - iii. Hospital units;
 - iv. Merchants in the tourism industry; and
 - v. *Bona fide* farmers.
- d. *Eligible Merchant Certificate.* Merchants whose sales volume exceeds \$500,000 per year for the preceding three years (or such shorter period as they have been operating)

and 80% or more of whose sales consist of items and/or services subject to VAT at a 0% rate may request an *Eligible Merchant Certificate*. This certificate will entitle the Merchant to an expedited VAT refund process.

- e. *Manufacturer's Exemption and Zero Rate Certificate*. A manufacturing plant may request this certificate in order to be able to introduce or purchase taxable items free of VAT. The certificate is effective for three years.
- f. *Business to business sales*. The selling Merchant must issue to the purchasing Merchant, within 30 days of the sale, a Fiscal Voucher evidencing payment of the VAT, including credit notes or debit notes, as applicable, showing any adjustments made to the Fiscal Voucher.

5. Returns and Payment:

a. *Due date for VAT Returns:*

- i. Monthly Return of Tax on Imports. Due no later than the 10th day of the month following the date of the taxable transaction. Filing of this return will not be a prior requirement for receiving the items on the docks.
- ii. Monthly VAT Return. Due no later than the 20th day of the month following the date of the taxable transaction.
- iii. Annual Informative Return of Small Merchants. Due within 60 days of the due date of the merchant's income tax return (including extensions).
- iv. The Secretary may require, via regulation, circular letter or administrative determination of a general nature, that certain Merchants file all or some VAT returns electronically.

b. *Due date for payment:*

i. When VAT liability arises:

A. Merchants using the accrual method of accounting will become liable for the VAT when the first of the following events occurs:

- I. Issuance of invoice;
- II. Receipt of payment from a customer; or
- III. Within 30 days from delivery of the taxable items or completion of the taxable services.

B. Imports – Tax liability attaches upon introduction to Puerto Rico.

C. Designated professional services – Merchants that render “designated professional services” may use the cash basis of accounting for VAT purposes.

ii. When to pay VAT:

A. Imports

- I. General rule: The tax must be paid prior to taking possession of the article.
- II. The VAT must be paid together with the Monthly Return of Tax on Imports, no later than the 10th day of the month following the date of the taxable transaction, when:
 - (1) The Secretary has authorized an extension of time to pay to a bonded Merchant, and the bond posted covers the VAT on the imported articles;
 - (2) When the payment relates to an adjustment to the tax determined on an article whose tax was paid prior to taking possession;
 - (3) The article was introduced through the mail or by air carrier; or
 - (4) The article was purchased over the internet.

- B. Sale or transfer of goods, rendering of services and combined transactions – together with the Monthly VAT Return, no later than the 20th day of the month following the date of the taxable transaction, or such other date and manner as the Secretary may establish.

6. Credits Against VAT:

a. *Credit for VAT payments.*

- i. All Merchants, except Small Merchants, may claim a credit for the direct and indirect VAT they have paid or accrued on taxable items and services.
- ii. Merchants that are members of a controlled group or related persons may determine the credit for VAT payments as a single Merchant.

iii. Amount of the credit.

A. The amount of the VAT credit will be the sum of:

- I. The VAT paid on imports, as reported in the Monthly Return of Tax on Imports, that is related, directly or indirectly, with the sale of Taxable Articles or Taxable Services;
- II. The VAT paid on the purchase of goods or services, as evidenced in Fiscal Vouchers (see 4.f. above), that is directly or indirectly related to the sale of taxable goods or services; and
- III. The VAT paid on Taxable Services rendered by a nonresident of Puerto Rico, as shown in the Monthly VAT Return.

B. VAT paid or incurred that is not directly related to Taxable Articles sold by the Merchant or Taxable Services rendered by the Merchant must be allocated on a proportionate basis between the amount of sales of Taxable Transactions and Tax Exempt Transactions (sales of Exempt Articles and Exempt Services).

C. Exception: Merchants 70% or more of whose sales for the preceding three year period stem from the sale of (1) unprepared foods and necessities (other than small appliances, toys, beauty products, school and office supplies, hardware, shoes, clothing and alcoholic beverages); (2) prescription drugs and products used in treating ailments; or (3) automobiles (both retail and wholesale), may claim a VAT credit for the full amount of VAT payments made during the month.

b. *Credit for Foreign VAT paid.* Merchants, other than Small Merchants, that have paid VAT to a foreign jurisdiction with respect to services rendered to it by an affiliate that is not engaged in trade or business in Puerto Rico may claim a credit for such foreign VAT. The amount of this credit:

- i. Is limited to the amount, if any, of the Puerto Rico VAT on such services that cannot be claimed as a credit pursuant to a. above; and
- ii. Cannot result in a refund or overpayment of the Puerto Rico VAT.

A Merchant that claims this credit for foreign VAT paid may not claim a deduction for income tax purposes with respect to such foreign VAT paid.

7. Transition Rules

Sales of Taxable Articles that relate to contracts or bids executed prior to April 1, 2016 will not be subject to the VAT during the shortest of a 12-month period or the duration of the contract, provided that the sales were exempt from the SUT.

8. Municipal Taxes

Except for the 1.0% municipal SUT, no municipality or agency in Puerto Rico is authorized to impose a value added tax, or a tax of similar nature, on goods and services

sold in Puerto Rico that are subject to or exempted from the VAT. It is not clear from the statute whether the 1.0% municipal SUT shall continue after the effectiveness of the VAT system.

9. Administrative Pronouncements

Since the enactment of Act No. 72-2015, the Department of Treasury of Puerto Rico has issued administrative pronouncements interpreting the provisions of Act No. 72-2015, as follows:

- a. Circular Letter of Tax Policy No. 15-09, published on June 24, 2015, regarding the SUT rate applicable to contracts executed prior to July 1, 2015 for sales of tangible personal property and taxable services.
- b. Circular Letter of Tax Policy No. 15-10, published on June 24, 2015, regarding the SUT rate and other requirements applicable to eligible construction contracts executed prior to July 1, 2015.
- c. Circular Letter of Tax Policy No. 15-11, published on June 24, 2015, regarding the SUT rate applicable to contracts executed prior to July 1, 2015 covering business-to-business transactions for taxable services and designated professional services.
- d. Administrative Determination No. 15-10, published on June 24, 2015, regarding the SUT rate applicable to contracts executed prior to July 1, 2015 for sales of tangible personal property and taxable services.
- e. Administrative Determination No. 15-12, published on July 10, 2015, regarding the SUT rate and the ticket endorsement procedure applicable to tickets sold prior to June 30, 2015 for events scheduled after July 1, 2015.



If you have any questions or comments, or would like additional information about this matter, please call any of our tax attorneys:

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