

Puerto Rican government proposes to enact a new value add tax (VAT) regime in 2015

January 19, 2015

Update: Puerto Rico legislators voted against the measure 28 to 22 on April 30, 2015

In brief

The Puerto Rican government is planning a comprehensive tax reform package that is expected to affect most tax types, including consumption, personal income, and business-related taxes. Most notably, it would replace the current sales and use tax system with a value added tax (VAT) system. Additionally, the government is considering lowering rates for both the corporate gross profits tax and the individual income tax. [[Reforma Contributiva: Transformacion Total, Departamento de Hacienda Estado Libre Asociado de Puerto Rico](#); [Commonwealth of Puerto Rico Tax Reform Project, General Observations, Department of the Treasury, Commonwealth of Puerto Rico \(10/27/14\)](#)]

In detail

The Puerto Rican government released presentation documents that highlight a planned comprehensive tax reform package, which includes replacing the current sales and use tax system enacted in 2006. The government stated that, as part of the 'Reform Project', more than 40 meetings have taken place with various interest groups. The government is considering reforming the following taxes:

- sales and use tax
- corporate gross profits tax
- individual income tax
- excise tax

- property tax.

The government has informally indicated it expects to file and approve a tax reform bill between January and March of 2015, stating:

"[C]ertain fine tuning of the proposal is taking place. Results are being presented to the Advisory Committee appointed by the Governor, to the Governor and members of the Legislature. Decisions in regards to the new tax structure will be discussed with interest groups. Drafting of legislation [which has] commenced, will run in various parallel groups in charge of the drafting of legislation related to

consumption tax, individual income tax, corporate tax (domestic and inbound taxes) and property taxes. Transition issues are being considered and included. Tax administration and reorganization of Treasury to achieve the goals of the new system [is] also part of the study."

Consumption tax reform

The current sales tax system does not meet revenue expectations of the Puerto Rican government. Consequently, it has outlined the following consumption tax system alternatives:

- convert to a 'pure sales and use tax,' however with only an estimated 56-65% compliance rate this option presents challenges
- return to a general excise tax, which produced an uneven tax distribution, was difficult to administer, and was unresponsive to revenue needs
- maintain the current sales and use tax system, but with significant reform in order to simplify compliance, educate taxpayers, and reduce evasion
- adopt a value added tax (VAT).

The government noted reforming the current sales and use tax system would require broadening the tax base through the taxation of services, eliminating many exemptions, and reforming business to business (B2B) taxation. Such reforms, according to the presentation documents, would effectively create a VAT. The government noted a better option would be to adopt a formal VAT system based on global best practices.

The government noted the following benefits of a VAT system:

- revenue raising capacity
- neutrality in the production chain and cross border trade
- minimal compliance and administration costs using a broad-based system with a single rate and few exemptions

- earlier tax collections through the supply chain
- leveraging the tax administration experience of over 150 countries.

Specifically, the VAT is a multi-staged, transaction based tax that is levied at each stage of the supply chain. A VAT applies to most goods and services, however, businesses can claim credits for VAT paid on business expenses. For administrative purposes, the VAT is collected when goods are imported. Taxpayers must self-assess VAT from non-resident service providers when a credit cannot be claimed in full.

Modeled after these VAT features, the planned Puerto Rican VAT system would include a broad tax base with few exemptions. Noted exemptions would include: exported goods and services, financial services, and residential housing. The government also stated small businesses would be exempt from registration, and the VAT would include 'regressivity relief' for low income persons.

Corporate and individual tax reform

The presentation documents state the government is considering reducing both the individual income tax and the corporate gross profits tax. Individual income tax rates may be lowered and exemptions for individuals may be materially increased. The individual income tax base may also be broadened by the elimination and adjustment of certain tax expenditures.

The government is also considering repealing the current gross profits tax (Patente Nacional) and reducing overall tax rates. The repeal and/or reduction would be equal "...to the maximum rate paid by individuals to simplify the system. This would rationalize inefficient tax regimes by eliminating the need to create redundant or inefficient flow-through tax regimes and conduit entities as tax planning mechanisms."

Other taxes

The government is also analyzing tax reform alternatives for excise tax and property tax purposes.

The takeaway

If the tax reform bill is filed and approved, taxpayers with Puerto Rico transactions may be subject to different tax collection and remittance rules. Taxpayers, such as manufacturers and service providers, that are currently entitled to exemptions may be subject to a VAT. Taxpayers may, however, be relieved of taxes on corporate gross profits and individual income.

US multinational corporations with Puerto Rican subsidiaries and branches should monitor the tax reform developments and consider how the new VAT regime may affect compliance processes, contract terms, systems, cash flow, and general business operations.

Let's talk

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