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Tax Alert: The CATIC has issued its report. The verdict is…

As we all know, on May 29, 2015, Act 72 approved an increase to the current Sales and Use Tax to 11.5%, and eliminated the "business to business exemption" with the introduction of a 4% tax on services rendered to other merchants including "designated services". It also added Subtitle DD to the Puerto Rico Internal Revenue Code to introduce a new Value Added Tax system effective on April 1, 2016. Notwithstanding, Act 72 also created the **Commission for Alternatives to Transform the Consumption Tax (Comisión de Alternativas para Transformar el Impuesto al Consumo "CATIC").**

The main purpose of the CATIC was to evaluate the various available consumption tax systems, including the former Excise Tax system, and issue a report no later than sixty (60) days after the approval of Act 72-2015, recommending whether or not Puerto Rico should definitively migrate from the Sales and Use Tax system to a Value Added Tax system or any other consumption tax system that would prove to be more efficient. Act 72-2015 mandated that the CATIC should employ the University of Puerto Rico as its main advisor in this evaluation.

The CATIC's composition was also stated by Act 72-2015:

- The Secretary of Treasury (president of the CATIC);
- The Secretary of Justice;
- The Director of the Office of Management and Budget;
- The Executive Director of the Ports Authority;
- Two (2) member from the House of Representatives and two (2) from the Senate;
- Two (2) representatives from the private sector; and
- One (1) representative from the union sector to be appointed under mutual agreement by the President of the House of Representatives and the President of the Senate.

Before discussing the report issued by the CATIC, let's review the tax reform and political background that have served as prelude.

Act 72-2015 was the result of an intense political debate in Puerto Rico that commenced late in January 2015 when the Secretary of Treasury was obliged to make public the results of a study prepared by KPMG. Prior to that, specifically on August 17, 2013, the Governor of the Commonwealth of Puerto Rico issued an Executive Order creating the Tax Reform Advisory Group to analyze the current tax system, its rules and administration and report its conclusions and recommendations to build an effective and fair tax system. Interestingly enough the members of this Tax Reform Advisory Group were very similar to those of the CATIC:

- The Secretary of Treasury (president of the group);
- The Director of the Office of Management and Budget;

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Please contact our Tax Department should you require additional information regarding this or any other tax issue; we will be glad to assist you.

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August 25, 2015

- The President of the Government Development Bank for Puerto Rico ;
- The Secretary of Economic Development and Commerce;
- an economist;
- a CPA (the one appointed was Juan Zaragoza, the current Secretary of Treasury);
- an attorney;
- The President of the PR Chamber of Commerce;
- a labor union leader;
- The Executive Director of the Treasury Commission of the Senate; and
- The Executive Director of the Treasury Commission of the House of Representatives.

On March 18, 2014, the Department of Treasury (Treasury) hired KPMG to make a full assessment of the Puerto Rico tax structure and to develop a full report and set of alternative scenarios for the Treasury to evaluate. The goal: a simplified tax system that will provide the desired revenues through a more streamlined and effective system that should also result in more effective oversight.

KPMG's report made public by the Secretary of Treasury on January 2015, but dated October 31, 2014, recommended to replace the current tax structure with a broad-based single rate Goods and Services Tax (GST) with regressivity relief accomplished through direct transfer payments. This recommendation was provided after studying the four basic options for consumption taxation: the current system, a pure conversion to a sales and use tax, the return to the general excise tax and the one recommended the adoption of a broad-based GST. Both, the VAT and the GST are the same, it depends on the buyers or the sellers perspective. For the buyer, the GST is a tax on the purchase price. For the seller, the VAT is a tax on the value added to the product, material or service.

The KPMG study represented the cornerstone for the Tax Reform Bill filed by the Governor on February 11, 2015 which was defeated on April 30, 2015, a day later after a substitutive bill was filed.

The recommendations issued by the CATIC come with no surprises. On August 12, 2015, seventy four (74) days after the approval of Act 72-2015, 14 days after the prescribed sixty (60) days, the CATIC issued its report. If the result of that report would have been a recommendation to return to the Excise Tax System, the CATIC would have had a ten (10) days period to file legislation on that regard. Notwithstanding, as anticipated, the CATIC discarded the alternative of returning to the Excise Tax, pointing out among others, that the tax rate to obtain the same projected revenues as under current legislation, would need to be between 19% to 38% (instead of the 11.5% of the VAT).

Unfortunately, the political debate that has accompanied the enactment of this new tax system in Puerto Rico has played a defiant role for the private sector to adequately prepare for this major tax transformation that will directly affect every aspect of how we do business in Puerto Rico.

Based on the above, as of today, Puerto Rico will face a new VAT system, effective April 1, 2016. Businesses need to take all necessary steps to be ready and compliant by the effective date. You must act now, since an average VAT implementation process may take from three to four months.

On this regard, we want to invite you to participate of the Tax Conference we will host on September 23, 2015, addressing the new VAT system and its related implementation issues. For more information http://bit.ly/1I82Yom