

## MEMORANDUM TO CLIENTS AND FRIENDS

January 30, 2006

### Fiscal Reform

This is the first of a series of memoranda discussing the proposals for fiscal reform that have been presented by the Legislative and executive branches in Puerto Rico. Both proposals introduce significant changes to the Puerto Rico Internal Revenue Code of 1994 (the “Code”), including the imposition of a 7% tax on consumption. This memorandum summarizes the proposals relative to the consumption tax and related changes to current excise tax provisions.

On November 15, 2005, the House of Representatives filed H.B. 2193, to provide for a new tax on consumption, following the model of the State of Florida. The Governor of Puerto Rico submitted his office’s proposal for a new Code on January 16, 2006. The Executive Proposal follows the sales and use tax concepts contained in H.B. 2193, with very important differences.

### Tax Basis and Rate

Under H.B. 2193, a 7% sales and use tax would be imposed on the following transactions: (1) retail sales in Puerto Rico, including mail orders and unitary transactions;<sup>1</sup> (2) admissions to public shows; (3) taxable services; and (4) the use, consumption or storage for use or consumption in Puerto Rico of tangible personal property. Said tax will apply only once.

The Executive Proposal also contemplates a 7% tax on any sales involving a “taxable item,” as well as on the use, consumption and storage of taxable items in Puerto Rico. The term “taxable item” includes tangible personal property, combined transactions, taxable services and admissions to public shows.

Both proposals present similar definitions in this context.<sup>2</sup> In general, the term “sale” includes:

1. Any transfer of title or possession of tangible personal property;
2. The manufacture, processing or printing of said property for consideration when the customer provides the materials (contract manufacturing);

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1. Means any personal property and services that are provided as part of one order or agreement, for which only one charge or price is computed.

2. We will point out any significant differences when applicable.

3. Mail orders;
4. Furnishing, preparing or serving, for consideration, tangible personal property, such as food served by the employer to its employees.
5. Financing leases are subject to sales taxes under both proposals. However, H.B. 2193 exempts such financing leases if the property object of the lease has already been subject to sales tax.

Not subject to sales taxes are non-taxable exchanges and reorganizations under Code Section 1112.

The term “retail sale” includes the sale, rental, licensing or leasing of tangible personal property (taxable items, in the case of the Executive Proposal) or taxable services, to a consumer or any person for any purpose except when made for resale or sub-lease. It includes the cost of any tangible personal property that is included in the performance of a contract, if the cost of said property is charged to the client under the contract.

The term “tangible personal property” is very broad and includes specifically boats, motor vehicles food, and all the articles that will remain subject to excise taxes. It excludes cash, cash equivalents, stock, bonds, notes, mortgages, insurance, securities, obligations, intangibles, electricity and water. The Executive Proposal limits this last exemption to electricity provided by the Puerto Rico Electric Power Authority and the Water Authority.

The 7% sales tax will be imposed on certain articles that will remain subject to excise taxes, such as: cigarettes, gasoline, aviation fuel, gas oil, diesel oil, crude oil, products derived from oil, hydrocarbon mixtures, motor vehicles, and alcoholic beverages. The term “purchase price” in this context includes the cost of the article as well as any excise taxes paid in connection therewith.

### **Taxable Services**

H.B. 2193 defines the term “taxable services” as any service **not** covered by Section 1143 of the Code. Also excluded from the 7% sales and use tax are education services, financial services, professional services, health or hospital services, and housing services.

The Executive Proposal includes within this concept professional services, entertainment, and commercial leasing of real property. Although H.B. 2193 excludes all financial services, the Executive Proposal only excludes interest and other charges for the use of money and insurance.

### **Responsibility for payment**

The dealer, seller, or lessor is required to collect the sales tax and the user is required to pay the use tax, and both have to remit such tax to the Puerto Rico Treasury Department. The dealer,

seller or lessor cannot announce that it will absorb the tax and not collect from its customers. Any person that purchases articles or services subject to this tax who does not have evidence of payment, will also be responsible for such taxes.

The Executive Proposal specifically provides that for these purposes, the term dealer or seller includes a wholesaler. This proposal exempts from this collection requirement dealers with volume of business not exceeding \$50,000, as reported in the Sellers Registry Application or in the Annual Sales Tax Report. This benefit will not be available to certain dealers who are subject to license requirements.<sup>3</sup>

### **Municipal Taxes**

Both proposals expressly prohibit the imposition of similar taxes by municipalities.

### **Government Agencies**

Both proposals provide that Government agencies are subject to the payment of the sales or use taxes, with the exceptions mentioned below.

### **Exemptions**

Both proposals specifically exempt from sales taxes the acquisition of goods for resale. H.B. 2193 **also provides that services acquired as part of the business** “input” will not be subject to sales taxes, an exclusion that is not incorporated in the Executive Proposal. Note that under both proposals, an authorized seller must be making the sale and an exemption certificate must be submitted to the seller by the customer. However, the Executive Proposal seems to limit the authorized seller certification to wholesalers, while the H.B. 2193 provisions seem to allow for any seller who obtains authorization from the Department of the Treasury to receive exemption certificates from clients.

In order to implement the exemption with respect to purchases for resale, the Secretary of the Treasury will issue exemption certificates to persons who comply with certain requirements and conditions. A list of persons with exemption certificates will be published in the Department’s web site. Any person with an exemption certificate who acquires property or services that do not qualify for the exemption will be responsible for the payment of the sales and use tax.

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3. Proposals relating to licencing requirements under the Code will be covered in a separate memorandum to clients.

Other exemptions are:

1. Raw materials to be used by a manufacturing plant in Puerto Rico in the manufacturing process.<sup>4</sup> Raw materials include any product derived from agriculture or extractive industries, and sub-product, residual product or product partially elaborated, bulk sugar (or 50-pound or more units), extracts or syrups used for the production of carbonated beverages, except for fountain syrups. Hydraulic cement is specifically excluded from the definition of raw materials for these purposes and, thus, will be subject to a 7% tax.<sup>5</sup>

2. Machinery, equipment and accessories used exclusively in the manufacturing process or in the construction or repair of vessels within or outside the premises of a manufacturing plant. This includes machinery, trucks, and lifters used exclusively and permanently in the transportation of raw materials within the premises of the manufacturing plant. Also included are machinery and equipment and accessories used in the manufacturing process and/or that are required by State or federal law for the operation of a manufacturing plant.

Machinery and equipment used in administrative activities will not qualify for exemption, except if used more than 90% in the manufacturing process. Also, certain articles are expressly disqualified for this exemption: construction materials, pre-fabricated buildings, electric materials, water pipelines in buildings, lubricants, paints, oils not related to the manufacturing process, light posts and lights installed in parking areas, treatment plants and power plants.

An exemption certificate must be obtained to enjoy the benefit of this exemption.

3. Articles in transit or for export, that is, tangible personal property sold for use or consumption outside Puerto Rico, provided the property is exported within 60 days from such sale without having been object of internal commerce. Also, articles related to film industry that are introduced into Puerto Rico and re-exported within 90 days, as well as accessories introduced into Puerto Rico to be installed or used permanently in cruise ships or vessels.

4. Luggage introduced by tourists and visitors will be generally exempt. Puerto Rico residents will be able to introduce into Puerto Rico, free from the use tax, articles with a value not exceeding \$600 every 31 days. The Executive Proposal allows only \$500 to be introduced by Puerto Rico residents and does not establish any time limit.

5. Articles sold by duty free shops in airports or ports will be exempt from the sales tax.

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4. The Executive Proposal's definition requires that the raw material be necessary or essential for the manufacturing process, and does not make specific reference to bulk sugars, extracts or syrups.

5. Excise taxes on cement are six cents per quintal. Such excise taxes would be eliminated, but the 7% sales and use tax would be imposed on the sales price of this product.

6. Articles acquired by, for official use by, the U.S. Government, art objects sold to or used by certain museums and public agencies, articles acquired in Post Exchange (except for vehicles) stores located in military facilities, and educational materials acquired by the University of Puerto Rico will be exempt from the tax on consumption. Vehicles sold by the U.S. government in public auctions will not be exempt.

7. Certain personal belongings introduced into Puerto Rico by employees of the Government of the U.S. or Puerto Rico when they are moved to Puerto Rico for official reasons.

8. Motor vehicles specially prepared for persons with certain physical disabilities. The exemption is limited to one vehicle per person, per 4-year period (except for special circumstances). The Executive Proposal limits this to the equipment and accessories that are incorporated into the vehicle to adapt it to the owner's needs.

9. Food and beverages for human consumption when purchased with coupons from the WIC or PAN programs, food and beverages for human consumption for patients and inmates, or served by public schools or educational not-for-profit entities, and complimentary meals.

10. Medicines or medical products acquired with a prescription. The Health Department will issue a list of products, which will be certified by the Secretary of Treasury, which will enumerate the hygiene and cosmetic products that will not qualify for the exemption even if their content include medical ingredients.<sup>6</sup>

### **Procedures and Filing Requirements**

#### **Point of sale**

The seller will collect the tax from the customer at the moment of sale. The consumer will be liable for the use tax at the moment of consumption.

The seller will add the sales tax to the sales price, and such sales tax will be separately disclosed on the invoice or other evidence of sale. The tax, together with the sales price, will become a debt from the customer to the seller, and will be collected as any other debt.

#### **Sales for resale**

An authorized seller (wholesaler in the case of the Executive Proposal) must document the exempt status of a sale for resale by retaining a copy of the buyer's exemption certificate. The seller

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6. Certain exemptions relating to cigarettes and contaminated gasoline and diesel oil are included in H.B. 2193 but not in the Executive Proposal.

may rely on the exemption certificate without having to verify its effectiveness every year, if the customer buys from that seller regularly and in the ordinary course of business.

A business person who does not have an exemption certificate, or who buys from an unauthorized seller, will be obliged to pay the sales tax. When the taxed article is resold, the seller will collect the tax on the sale and will claim a credit against the tax so collected in the amount of tax paid on the original purchase.

#### Registration Certificate

In order to be authorized to make retail sales in Puerto Rico, and thus, to be authorized to accept exemption certificates from customers, a dealer must submit a Registration Certificate Application with the Secretary of the Treasury. This certificate is required for each store or commercial establishment that the seller operates in Puerto Rico.

Note that under the Executive Proposal only wholesalers who obtain this Registration Certificate will be exempt from the obligation to collect sales taxes when buyers present their Exemption Certificates at the point of sale. On the other hand, H.B. 2193 allows any seller or dealer with the Certificate of Registration the same treatment.

#### To obtain the Exemption Certificate

A person engaged in the purchase of tangible personal property for resale may request an exemption certificate from the Secretary.

#### Deposit of collected amounts

Collected amounts will constitute funds of the Government of Puerto Rico and must be deposited with the Department of the Treasury on or before the 10th day of the month following the month in which the taxable event occurred. The Executive Proposal requires the deposit to be made on the 20<sup>th</sup> day of the month following the taxable event.

#### Credit and Refund Procedures

Certain procedures and conditions are established to provide for the reimbursement of sales taxes paid on returned merchandise. Credits will generally be allowed in connection with sales taxes paid with respect to repossessed articles, bad debts, transactions where the tax was not required but paid, and resold articles. The Executive Proposal limits to 50% the amount of credit that may be claimed in one month, and establishes carry-over provisions. Refunds will require special procedures and authorization from the Secretary of the Treasury.

### Importers Registry

Pursuant to H.B. 2193, any person who continuously imports tangible personal property into Puerto Rico, unless importations are casual or occasional, must request from the Secretary a certificate of registration and importers license. This requirement does not apply to carriers, but to the owners of the imported property. The Secretary may require the posting of a bond as a condition to issue this certificate. The person who imports goods without the certificate may be considered as illegally importing such goods into Puerto Rico, and the goods may be confiscated as contraband. Certain procedures must be followed before the Secretary becomes authorized to sell the property in public auction.

The Executive Proposal does not incorporate this requirement.

### Certificate of Registry

Any person who wishes to engage in a business in Puerto Rico must request from the Secretary a certificate of registry for each of its places of business in Puerto Rico. This certificate is not required to make sales by mail. The Secretary shall request a deposit, bond or any other security.

The certificate must be displayed in an accessible place in the business, and no license will be issued if the person does not have the certificate.

With the registry certificate, the Secretary will automatically issue an initial sellers certificate, which will be renewed annually.

Certain procedures must be followed before the registry certificate is revoked.

Certain requirements apply in connection with conventions or specialized trade shows.

### Filings

#### **Annual and Periodic Statements**

Both proposals require the filing of an annual Internal Revenue Statement. Under H.B. 2193, this statement is due on or before the fifteenth day of the fourth month after the close of the taxable year. Under the Executive Proposal, it is due on the fifteenth day of the third month after the close of the taxable year.

Also, the dealer must file a return on the 20<sup>th</sup> day of the month. Such return must report the sales, purchases, if applicable, admissions, rentals, and other taxable transactions, that

occurred during the previous calendar month. The corresponding tax must be remitted with the return.<sup>7</sup>

H.B. 2193 provides that the Secretary may require the filing of quarterly, biannual or annual statements and payment depending on the amount deposited during the previous four calendar quarters. A taxpayer may request the Secretary to continue with the same frequency of filing and payment even if the amounts change, provided such change is not recurrent and the taxpayer makes the request in writing.

A taxpayer with several places of business will be authorized to submit one consolidated return, but the amounts corresponding to each place of business must be separately disclosed.

### **Estimated Return**

H.B. 2193 requires any seller who has deposited \$200,000 or more during the previous fiscal year to determine the estimated tax to be paid in a particular month. The amount so determined is payable on the 20<sup>th</sup> of the month. The difference between the estimated amount paid and the actual amount owed for the month is payable on the first day of the following month and must be paid before the 20<sup>th</sup> day of the same month. This requirement has not been incorporated into the Executive Proposal.

### **1% Deduction**

Under H.B. 2193, the dealer is allowed “a deduction” from the amounts to be remitted to the Treasury Department equal to 1%. This is allowed to compensate businesses for the cost of compliance of the Subtitle G provisions. A discount may be negotiated with distributors that service mail orders. This deduction is not allowed under the Executive Proposal.

### **Contracts Executed Prior to July 1, 2006**

The Executive Proposal exempts from sales taxes any transaction pursuant to a contract entered into before July 1, 2006.

### **Excise Taxes**

In general, both proposals contemplate the elimination of the general excise tax imposed by Code Section 2015. Certain articles formerly excluded from payment of the general excise tax will not be excluded from sales taxes. Such articles include: food, medicines, children clothing, articles

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7. Note that the deposit is required to be made on the tenth day of the month following the taxable event. This seems to be an error.

used for religious purposes, certain food products (chocolates, sweets, sugar cane, pop corn, ice cream, food in general), books and publications, art objects, detergents, and working shoes, among others.

Special excise taxes formerly imposed on certain products are also eliminated. These include excise taxes on sugar, carbonated beverages, and locally produced or imported cement.

Therefore, only the following articles remain subject to excise taxes: cigarettes, gasoline, aviation fuel, gas oil or diesel oil, crude oil, products derived from petroleum (finished or partially elaborated), hydrocarbon mixtures, and motor vehicles.

The Code currently requires any carrier to receive a certification from the Secretary prior to the delivery of the taxable articles introduced into Puerto Rico. This requirement will remain the same under the Executive Proposal, but will be applicable to any article, taxable or exempt, under H.B. 2193.<sup>8</sup>

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If you have any questions or comments, or wish additional information, please contact any of the attorneys listed below, members of our Tax Department:

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8. Certain changes to the excise tax provisions and licensing requirements will be covered in a separate memorandum.