



PUERTO RICO'S SALES AND USE TAX

Act No. 117 of July 4, 2006 (“**Act 117**”) establishes for the first time a broad-based sales and use tax in Puerto Rico (the “**Sales Tax**”). Additionally, Act 117 repeals, as of November 15, 2006, the 5% general excise tax (i.e., a 6.6% effective tax rate) currently assessed at the importer or manufacturer level, without providing for a transition period to clear up inventories and avoid double taxation on products that were subjected to the 5% general excise tax. Most of the other specific excise taxes imposed by the Puerto Rico Internal Revenue Code (“**PR-IRC**”), including the taxes on alcoholic beverages, will remain in effect even though they apply to products that are also subject to the Sales Tax. However, the current excise tax on carbonated beverages, rights of admission and retail jewelry sales, and some of the current excise tax exemptions, including the “bona fide farmers” exemption, will be eliminated as of November 15, 2006.

The Sales Tax has two components: (i) a 5.5% tax rate that will become effective on November 15, 2006 (the “**5.5% Portion**”); and (ii) a 1.5% tax rate (generally referred to as the “**1.5% Municipal Portion**”), that will become effective on or after July 1, 2006 at the option of each municipality. Act 117 provides that the two portions of the Sales Tax will be separately administered and collected, and that each municipality will collect its Municipal Portion, while the Puerto Rico Secretary of the Treasury (the “**Secretary**”) will collect the 5.5% Portion. The administration/collection provisions of Act 117 have major flaws, which leads us to expect that these aspects of the Sales Tax are likely to be amended in the near future.

Commencing on November 15, 2006, the total Sales Tax rate will be 7% (except for transactions in those municipalities, if any, that do not impose the 1.5% Municipal Portion). However, the 5.5% Portion may increase next year, as a law pending the Governor’s approval grants him the discretion of imposing, through an executive order and for a three year period, up to an additional 1% if certain tax revenue targets are not met. In such event, the total Sales Tax may be as high as 8%, instead of 7%.

Both portions of the Sales Tax will apply to the sale, use, storage or consumption of “**Taxable Items.**” Taxable Items includes: (i) “tangible personal property;” (ii) “taxable services;” (iii) “rights of admission;” and (iv) “combined transactions,” as each is defined in Act 117, and subject to certain product or buyer exemptions set forth therein (the “**Tax Base**”).

“**Taxable services**” is very broadly defined and includes: (i) all services that are not otherwise exempted; (ii) leasing of real and personal property; (iii) certain telecommunications services (i.e., electronic transmissions of voice, video, audio or other information from a fixed location or between two fixed locations; wireless services; beepers; coin operated telephone services; among others); (iv) programming of computers; (v) installation or repair of tangible personal property; and (vi) warehousing of tangible personal property (excluding warehousing of motor vehicles and all types of food).

The term “**rights of admission**” includes payments, membership fees and other charges for entry or access to: (i) entertainment, sports and recreational events; (ii) recreational facilities; (iii) movies; (iv) theaters; (v) exhibitions; (vi) private clubs (i.e., yacht, tennis, golf, exercise, etc.); and (vii) gyms (other than gyms that operate as non-profit institutions or by hospitals).

When Taxable Items are acquired outside Puerto Rico (i.e., mail, telephone, internet and direct purchases outside Puerto Rico) for use, storage (other than storage for resale in the ordinary course of business) or consumption in Puerto Rico, the person that uses, stores or consumes those items in Puerto Rico will be primarily liable for payment of the Sales Tax.

EXEMPTIONS. In order to understand the scope and reach of the Sales Tax, it is essential to understand which products, buyers and services are exempt from the tax. The following is a summary of the principal exemptions from the Sales Tax, as prescribed by Act 117.

1. **Exempt Products.** The items of tangible personal property that will be exempt from the Sales Tax are limited to the following:

- Unprepared food ingredients (but these are not exempt from the 1.5% Municipal Portion);
- Automobiles, truck tractors, buses and trucks;
- Gasoline, diesel, aviation fuel, crude oil and products derived from oil and other hydrocarbons;
- Medicines for human use that can only be acquired with a medical prescription;

- Insulin, oxygen, prosthetic devices, needles, and other chemical compounds used for the treatment of human sickness, ailments or lesions that are generally sold for internal or external use in the cure, mitigation, treatment or prevention of sickness or illness (however, cosmetics or personal care products that also include medicines and such compounds will not be exempted);
- Machinery and equipment acquired by a **'Manufacturing Plant'** for use in a manufacturing process, and raw materials (excluding hydraulic cement) acquired by a Manufacturing Plant for transformation or integration into different finished products, or used in the manufacturing process, provided such Manufacturing Plant requests and obtains a **'Manufacturing Plant Exemption Certificate'** from the Secretary;
- Money and securities (i.e., stock, bonds and other obligations);
- Water supplied by the Puerto Rico Aqueducts and Sewers Authority; and
- Electricity supplied by the Puerto Rico Electric Power Authority and other electricity generators.

2. **Exempt Buyers of Products.** The following purchasers of personal property items will be exempt from the Sales Tax:

- Wholesalers and retailers engaged in the business of selling Taxable Items (**'Merchants'**) that acquire Taxable Items with the intent of reselling them, and that request and obtain from the Secretary a **'Merchant Certificate of Exemption.'** This certificate will be valid for three years and will be presented to a seller of Taxable Items to evidence that sales to such Merchant are not taxable;
- Purchasers that acquire products for use or consumption outside Puerto Rico; and
- Items purchased by the Puerto Rico and US Governments, their agencies and instrumentalities for official use.

Merchants and Manufacturing Plants should request the above described exemption certificates as soon as possible, and long before the November 15, 2006 effective date of the 5.5% Portion, as they may be currently exposed to 1.5% Municipal Portion for purchases in some municipalities.

3. **Exempt Services.** Act 117 provides that Purchasers or users of the following services, and the transactions described in paragraph 4 below, will not be subject to the Sales Tax:

- Designated professional services, which are limited to legal services and services provided by the following Board Regulated professionals: certified public accountants, real estate brokers, real estate appraisers, surveyors, engineers, architects, delineators, geologists and agronomists;
- Health and medical services;
- Educational services (e.g., school tuition);
- Charges and fees for the use of money, and all other charges by financial institutions;
- Insurance services, including insurance commissions;
- Services provided by the Puerto Rico Government; and
- Services provided by persons, who on a consolidated and controlled group basis, and considering all the sources of income of the provider, have an annual volume of business of less than \$50,000 (the “**\$50,000 Service Provider Exclusion**”).

It should be noted that the \$50,000 Service Provider Exclusion is only applicable to service providers, and not to sellers of personal property items or rights of admission. In order to determine if an individual qualifies for this exclusion, the volume of business of the service provider will include the volume business of all his or her business activities, and all other income generating activities or investments. In addition, if the service provider is a member of a controlled group (as defined in PR-IRC §1028) the volume of business of said person will include the volume of business of all members of the controlled group.

4. **Exempt Buyers of Services.** Transactions involving the following purchasers or users of services are not subject to the Sales Tax:

- Services that are rendered or provided to a person that is engaged in a trade or business (“**Business-To-Business Services**”), presumably services related to such trade or business; and
- Purchases by the Puerto Rico and US Governments, their agencies and instrumentalities for official use.

Note that the exemption for Business-To-Business Services is only applicable to services, and not to the purchase of personal property items or to payments for rights of admission by any businesses.

5. **Real Estate Transactions.** The Sales Tax is not applicable to **purchases of real estate**, as such transactions do not involve the purchase of personal property. A person that pays a contractor to build a house not related to a business, or to make improvements to such house (i.e., expansion, swimming pool, etc.), is not purchasing of real estate, but a service that will be subject to the Sales Tax. Furthermore, if the contractor provides all the materials, the Sales Tax will be paid by the contractor upon purchasing the materials and then again on the payment to the contractor, thereby resulting in double taxation upon the same materials. However, if such person buys and pays for all the materials directly, double taxation will be avoided. Although, the intent of including services within the items subject to the Sales Tax is principally directed towards taxing consumer services, the imposition of sales taxes on services frequently leads to double or multiple taxation on the same articles as illustrated by this example.

As to the **rental of real estate**, which is considered a service for Sales Tax purposes, the following are some of the rules that will apply:

- The rental of real property, for commercial purposes, to a tenant that is a Merchant is not subject to the Sales Tax.
- The rental of real property to a non Merchant will be subject to the Sales Tax, except when (i) the tenant uses the real property as his or her primary residence, (ii) the “tenant” is a student boarder, or (iii) the landlord qualifies for the \$50,000 Service Provider Exclusion.

Thus, when a taxpayer (i.e., the landlord) rents real estate that will not be used as the tenant’s primary residence (i.e., used as a second home, vacation home, or monthly, weekly and weekend rentals), or for commercial purposes by a Merchant, the landlord will have to charge and collect the Sales Tax from the tenant; unless the \$50,000 Service Provider Exclusion applies.

REGISTRATION OF MERCHANTS. Pursuant to Act 117 (PR-IRC §2801), and effective as of November 15, 2006, any person engaged in business in Puerto Rico as a “Merchant,” must request to the Secretary a Certificate of Registration of Merchants for every location where it operates. This certificate is in addition to the Merchant Certificate Exemption and the Manufacturing Plant Certificate of Exemption that were previously described. Failure to so register carries a \$10,000 penalty, presumably per location.

OTHER MUNICIPAL SALES TAXES. Act 117 prohibits, effective as of July 4, 2006, the imposition or assessment of a sales and use tax by any municipality, other than the 1.5% Municipal Portion prescribed by Act 117. Furthermore, it also appears that if a particular municipality has not implemented the 1.5% Municipal Portion by July 1, 2006 (or maybe July 4, 2006 due to the fact that Act 117 was enacted on July 4, 2006), such municipality will not be able to impose or assess any sales and use tax, including the 1.5% Municipal Portion, until November 15, 2006. Thus, the pre-November 15, 2006 non-Act 117 sales and use taxes imposed and assessed by various municipalities may not be imposed after July 4, 2006.

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