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## TAX NEWSLETTER

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### NEW ECONOMIC INCENTIVES ACT APPROVED

The Economic Incentives for the Development of Puerto Rico Act (the "EIA") has been enacted into law as Act No. 73 of May 28, 2008. Effective on July 1<sup>st</sup>, 2008, it will substitute the current Tax Incentives Act of 1998 (the "1998 TIA"), which will expire by operation of law on June 30, 2008.

The EIA is the result of intense discussions between members of private and public sector committees formed to work on the bill. The Technical Committee, headed by Amaya Iraolagoitia-Fernández, a partner at O'Neill & Borges, worked on a proposal for the consideration of the Steering Committee, which made the final policy decisions. Ismael Vincenty-Medina, former Assistant Secretary for Internal Revenue, and also a partner at O'Neill & Borges, was also an active member of the Technical Committee.

The following is a summary of the main provisions of the EIA:

***The EIA expands the list of activities eligible for tax exemption particularly in the service industry***

In general, the EIA offers incentives to industrial units engaged in the production of a manufacturing product on a commercial scale. If the manufacture of a certain product was not eligible under the 1998 TIA, it will be considered eligible under the EIA with respect to exports and only with respect to incremental volume over a base period amount.

The EIA expands the list of activities eligible for economic and tax benefits to include three main service classifications:

1. Services rendered in Puerto Rico that are part of a designated cluster.

These services must be fundamental to the production process of a manufacturing business that is part of a high impact cluster, as determined by the Executive Director of the Puerto Rico Industrial Development Company ("PRIDCO").

2. Services rendered by a key supplier in Puerto Rico for exempt manufacturing businesses.

These services must allow a manufacturing business covered by the EIA to concentrate in its areas of core competency. Some of the services considered eligible under this classification are: specialized warehousing, validation and quality control, project engineering, specialized training, inventory management, and document digitalization, among others.

3. Designated services for export.

The list of services for export that qualify for exemption under the 1998 TIA is expanded to include custom software development, health care and reference laboratory services, and shared services centers.

In order to qualify for exemption, at least 80% of the employees of a service unit must be residents of Puerto Rico.

In addition, the EIA contains a list of other activities that are considered eligible, including:

1. Development of software to be marketed on a commercial scale
2. Research and development, experimental laboratories and clinical trials
3. Recycling activities
4. Value-added activities in the Las Americas Port, and the ports of Yabucoa, San Juan, Mayaguez, Roosevelt Roads and Guayama
5. Research, development, manufacture and operation of satellites
6. Construction of social interest housing and self-sustainable communities
7. Strategic projects, including landfill clean-up, dam construction, energy generation plants construction and mass transportation systems

Property devoted to industrial development continues to qualify for exemption. Therefore, the lessor will qualify for the benefits under the EIA while the property is leased by an exempt business.

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## ❑ Income Tax Scenarios

***The EIA generally provides a 4% flat income tax with a 12% withholding on royalties or the alternative of a higher 8% flat tax with a lower 2% withholding on royalties***

In general, the EIA presents two main income tax rate scenarios:

1. 4% flat income tax on net industrial development income ("IDI"); 12% withholding tax on royalties paid to nonresident foreign entities; or
2. 8% flat income tax on net industrial development income; 2% withholding on royalties paid to nonresident foreign entities.

The scenario to be applied to the exempt business is determined by the Secretary of Economic Development upon the exempt business' request, and must be irrevocably stated in the grant of tax exemption.

Pioneer activities will be subject to a 1% flat income tax rate and a 12% withholding tax on royalties paid to nonresident foreign entities. Products where the intangibles were developed in Puerto Rico will enjoy a 0% income tax rate.

The applicable flat income tax is reduced by 0.5% for activities established in municipalities in low or intermediate development zones. Vieques and Culebra operations will continue to enjoy a 0% flat income tax for 10 years and a 2% flat income tax for the remaining term of the tax exemption grant.

A credit for the transfer of technology, equal to the royalty withholding amount, may be claimed against the income tax on IDI. However, the royalty withholding tax and the income tax on IDI, combined, may not result in a payment to the Puerto Rico Treasury Department lower than the Minimum Tax Amount established by the EIA (even after applying the income tax credits mentioned below). The applicable Minimum Tax amount for a particular exempt business is as follows:

1. 3% of net IDI if the business qualifies as a "local investor business"; that is, if at least 50% of the stock or interests in the business is directly owned by individuals who are residents of Puerto Rico.
2. 1% of net IDI if the business qualifies as a "small or mid-size business"; that is, if the business' gross income for the previous three years does not exceed \$10,000,000.
3. In other cases, the Minimum Tax Amount will be equal to the statutory rate that applies in the particular situation (i.e., 1% for pioneer industry, 4% or 8% depending on the scenario selected by the non-pioneer business)

As an exception, businesses that operate under grants of

tax exemption issued pursuant to the 1998 TIA, with a flat income tax rate ranging between 2% and 4%, may request a grant of tax exemption under the EIA, with the existing flat income tax rate at the date of the application, provided the business maintains at least 80% of its employment level. To approve this request, the Secretary of Economic Development must conclude that this is in Puerto Rico's best interests. A base period minimum tax payment may be imposed as a condition to grant this request. Similarly, the royalty withholding tax rate established in the grant (if lower than 12%) under the 1998 TIA may be granted. In this scenario, the credit for transfer of technology may not be claimed to offset the flat income tax on IDI.

Distributions of IDI, distributions in liquidation, and income from investment of eligible funds in certain investments (commonly known as 2(j) income) continue to be fully exempt. The gain on the sale of stock or substantially all of the assets of the exempt business will be subject to a 4% income tax.

Businesses that were previously ineligible for tax exemption will be subject to a four-year phase-in period. Similarly, existing businesses that obtain a new grant under the EIA will be subject to a minimum base period payment (based on the previous three-year average), which will phase-out in four years.

## ❑ Property Tax

The EIA maintains the 90% exemption from real and personal property taxes during exemption period. Corporate headquarters will continue to enjoy a 100% real property tax exemption for five years.

A 100% exemption will continue to apply during construction period and first year of operations.

Optional self-assessment of real property taxes on property not yet assessed by the Center for the Collection of Municipal Revenue ("CRIM") classified as such by reason of its use (i.e., certain machinery and equipment) at 35% of book value. Minimum assessment ranges between 10% and 25% of cost depending on estimated useful life of property. Businesses that elect to self-assess must pay estimated property tax for year of self-assessment and previous four years (or shorter period applicable). The payment relating to the previous four years may be made in two installments.

Investments of Eligible Funds (commonly known as 2(j) investments) are 100% exempt from property taxes.

## ❑ Municipal License Tax and Other Municipal Taxes

The EIA grants exemption from municipal license taxes and other municipal taxes as follows:

1. In general, 60% exemption
2. 90% exemption for Vieques and Culebra operations
3. 75% exemption for small and mid-size businesses
4. Corporate Headquarters 100% exemption for five years.

Small to medium businesses in operations before

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requesting a grant under the new law would only be 75% exempt with respect to volume of business in excess of base period (average for the three years preceding date of application); 60% exemption on the base period volume of business.

A 100% exemption applies for the first two semesters following semester of commencement of operations.

The taxable portion of volume of business is subject to the rate applicable at the date of signature of grant.

The exempt business, its contractors and sub-contractors will enjoy 100% exemption from municipal excise taxes on construction.

The EIA allows the exempt business to waive the 5% discount for prompt payment of municipal license taxes in exchange for shortening to three years the applicable statute of limitations.

#### **Excise Tax and Sales and Use Tax**

Raw materials and machinery and equipment used in manufacturing process are totally exempt from excise taxes and sales and use taxes. Construction materials and equipment are not exempt.

Energy-efficient machinery and equipment is exempt from sales and use taxes.

#### **Period of Exemption**

General rule is 15 years.

Flexible exemption may be elected and exemption period is extended for years exempt business elects not to be covered by exemption.

#### **Location**

The exempt business may establish operations in a different municipality than the one covered by the grant without requesting a new tax exemption grant. Only a notice to OITE within 30 days of commencement of additional activities would be required.

#### **Special Deduction**

100% expensing of investment in buildings, structures, machinery and equipment is allowed.

Net operating losses from exempt operations may be deducted against income from exempt operations as provided by the Puerto Rico Internal Revenue Code. Upon expiration of the grant, net operating losses may be carried over against taxable income subject to limitation under the Puerto Rico Internal Revenue Code.

#### **Credits**

***The EIA provides various new tax credits that may be used to reduce certain operational costs. Some of these credits may be used by businesses exempt under previous tax incentives laws***

Credit for Purchases of Products Manufactured in Puerto Rico – 25% of purchases of products manufactured in Puerto Rico acquired from unrelated parties, up to 50% of income tax determined for the year. The credit available with respect to purchases of recycled products is 35%. This credit is available to grantees under previous tax incentives acts and may be claimed against income tax on IDI, and carried over until exhausted.

Job Creation Credit – New businesses may enjoy income tax credits equal to \$5,000 per job if the operation is established in Vieques or Culebra; \$2,500 per job, for a Low Development Zone; \$1,000 per job for an Intermediate Development Zone. This credit may be claimed against income tax on IDI, and carried over for four (4) years.

R&D Investment Credit – 50% of special investment, to be claimed against income tax on IDI or against operational costs (electricity, water and sewer). The credit must be used in at least two installments if used against income tax on IDI and may be carried over until exhausted. The R&D investment credit is transferable and available to businesses with grants under previous incentives acts.

Energy Investment Credit – 50% of investment in machinery and equipment for energy generation and efficient use. Equipment may be for individual consumption of exempt business (in which case the maximum amount of credit is 25% of income tax on IDI) or for generation of energy for sale at commercial scale (in which case the maximum is \$8,000,000 per exempt business and up to \$20,000,000 per fiscal year in the aggregate). This credit is available to businesses with grants under previous incentives acts. The EIA does not specifically allow this credit to be carried over.

Energy Cost Credit – Exempt businesses under the EIA or previous incentives acts will be allowed a credit equal to 3% of cost of industrial energy consumption, to be claimed against income tax on IDI. An additional 3.5% credit is available to businesses with an average employment of 25 persons or more, and an additional 3.5% credit is allowed if payroll exceeds \$500,000, for a total maximum credit of 10%. Maximum credit is reduced to 5% (in year 2017) at a rate of 1% per year starting in 2013. This credit may be carried over up to fiscal year 2017-2018 and four (4) years thereafter. The maximum aggregate amount of credits to be allowed under this provision is \$75,000,000 per fiscal year.

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Technology Transfer Credit – Credit for 12% of payments to nonresidents of Puerto Rico for the use of intangible property in the exempt operations in Puerto Rico. If exempt business is under the alternative 2% royalty withholding scenario, the credit is 2%. This credit may be carried over up to eight (8) years.

Strategic Projects Investment Credit – 50% of eligible investment in strategic projects to be claimed against income tax on IDI, up to 50% of tax determined for the year, or operational costs (electricity, water and sewer). This credit is transferable and any unused portion may be carried over until exhausted. Exempt businesses under previous tax incentives acts may generate this credit. Strategic projects include the rehabilitation of landfills, construction of dams, construction of energy plants and mass transportation systems.

Industrial Investment Credit- 50% of cash invested in the purchase of 50% or more of the stock or operating assets of exempt business (under any incentives law) in the process of shutting down operations, to be claimed in at least two installments against the investors' income tax obligation. Also qualifying for this credit is the investment in the stock of an eligible small or mid-size business. The maximum amount of credit allowed is \$8,000,000 per exempted business and \$20,000,000 in the aggregate per fiscal year. This credit may be carried over until exhausted. In the case of investments in exempt business in the process of shutting down operations, the exempt business must maintain operations for at least 10 years or a recapture mechanism will be triggered. This credit is transferable.

**❑ Renegotiations and Conversions**

Renegotiations and conversions of grants of tax exemption are allowed under circumstances similar to those provided under the 1998 TIA. Renegotiations will generally require an increase in average employment or investment. Applications for conversion of a grant issued under the 1998 TIA into the provisions of the EIA must be submitted within 12 months from the date of effectiveness of the EIA. In both scenarios, a minimum base period income tax under the provisions of the 1998 TIA may be applied.

**❑ Tax Grants**

Once a grant is approved, only the Secretary of Economic Development or the Governor may challenge the legality of the Grant. Municipalities may not challenge the legality of the grant.

The statutory term for consideration of application for tax exemption is reduced to 80 days.

**❑ Audits and Annual Reports**

PRIDCO will be required to audit every two years the compliance with the conditions established in the grant. Annual Reports must be filed with the Office of Industrial Tax Exemption 30 days after the due date for the income tax return.

**❑ Wheeling**

The EIA states that it is a matter of public policy to achieve efficiency in the generation of electricity in order to reduce energy costs. The Puerto Rico Electric Power Authority ("PREPA") is ordered to establish on or before January 2, 2010, a system whereby private generators with grants of tax exemption under the EIA or previous tax incentives acts are allowed the transfer of energy to their clients through PREPA's infrastructure ("wheeling"). The EIA creates the Energy Matters Office (the "EMO"), a new division of the Economic and Commerce Development Department, to perform the duties of the existing Energy Matters Administration (currently a division of the Natural Resources Department) and to overlook the implementation of the wheeling system.

**❑ Effective Date**

The effective date of the new law is July 1, 2008. There is no expiration date for the new law.

Grants issued under prior tax incentives laws continue in full force and effect. Such grants may be amended under the provisions of the law under which originally issued.



*Because of the general nature of this newsletter, nothing herein should be considered as legal advice or a legal opinion. For further information about the contents of this newsletter, or should you need further assistance in connection with these matters, please contact the firm's Corporate – Tax Department.*



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