



ECONOMIC INCENTIVES ACT FOR THE DEVELOPMENT OF PUERTO RICO

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The much-awaited and highly publicized Economics Incentives Act for the Development of Puerto Rico (the “Act”) was enacted on May 28, 2008. The Act will be effective on July 1, 2008 and supersedes the Puerto Rico Tax Incentives Act of 1998, as amended (the “1998 Act”).

Eligible Businesses

A. General. The following businesses are among the businesses eligible for the tax benefits provided by the Act:

- (i) manufacturing of any product on a commercial scale, including products manufactured in Puerto Rico prior to January 1, 1947 that did not qualify for tax benefits under prior tax incentives acts (“Prior Acts”);
- (ii) rendering of certain designated services on a commercial scale for markets outside of Puerto Rico, including among others, distribution centers, corporate headquarters and trading companies (as defined in the Act);
- (iii) rendering of services critical to the production process of an exempt business engaged in manufacturing, that forms part of certain high economic impact clusters;
- (iv) rendering of “key supplier” services to exempt businesses engaged in manufacturing operations (e.g., specialized warehousing, logistics, training, engineering of projects, quality control and validation);
- (v) construction of social interest housing;
- (vi) research and development operations;
- (vii) production of electric power using coal, natural gas or renewable sources;
- (viii) certain recycling activities; and
- (ix) value added activities related to the operations of the Americas Port in Ponce, the port located at the former Roosevelt Roads Base, the Mayagüez, Yabucoa, San Juan and Guayama Ports and any other designated port.

B. Limitations.

1. Manufacturing Businesses. The manufacturing of products that did not qualify for exemption under Prior Acts enjoy the tax benefits of the Act solely with respect to the export of

such products. Additionally, the reduced income tax rates granted by the Act are phased-in during a four year period.

2. Services to Offshore Markets. Exempt businesses rendering designated services that did not qualify for tax benefits under Prior Acts, are also subject to the four year phase-in of the reduced income tax rate.

3. Based Period Limitation. Exempt businesses that at the time of filing their tax exemption application under the Act are engaged in the activities for which the exemption is granted, enjoy the reduced income tax rates solely on their industrial development income (“**IDI**”)¹ in excess of the average net income derived from the qualifying operations during the three taxable years preceding the filing of the tax exemption application (the “**Base Period Income**”). The remaining IDI will be subject to the regular income tax rates of the Puerto Rico Internal Revenue Code of 1994, as amended (the “**PR-IRC**”).

Significantly, the Base Period Income is phased out in 25% annual reductions during a four taxable year period. Thus, at the end of the four year period all of the IDI will be subject to the reduced income tax rate granted by the Act.

Tax Exemption Period

A 15 year tax exemption period is granted by the Act, regardless of the economic development of the zone where the exempt business is located.

Income Tax Benefits

A. Fixed Income Tax Rate and Withholding on Royalties. Generally, exempt businesses under the Act are subject to a 4% income tax rate on their IDI. Additionally, a 12% tax must be withheld from the royalties paid to nonresidents of Puerto Rico for the use of intangibles, such as patents, special formulas or know how, to nonresidents of Puerto Rico. Alternatively, exempt businesses are subject to an 8% income tax rate and a 2% withholding tax rate on royalties, subject to the approval of the Secretary of Economic Development.

B. Pioneer Products. Pioneer products (i.e., products that had not been manufactured in Puerto Rico during the 12 month period preceding the filing of the exemption application and that meet certain other requirements) enjoy a special income tax rate of 1% during the 15 year

¹ Unless otherwise noted, hereinafter the references to IDI exclude the net income derived from the investments set forth in section 2(j) of the Act, which are fully exempt from income tax.

tax exemption period. Under the 1998 Act, full exemption may be enjoyed by the IDI derived from the sale of the pioneer products, but the exemption is limited to 10 years.

Notably, if the intangible property related to the pioneer product was developed in Puerto Rico (including, without limitation, “activities conducent to the commercial viability of the products”), full exemption is applicable to the IDI derived from the sale of the product.

C. Low Industrial Development Zones. In the case of exempt businesses located in low industrial development zones, the foregoing 4%, 8%, and 1% income tax rates are reduced to 3.5%, 7.5% and 0.5%, respectively.

D. Vieques and Culebra. Full income tax exemption on IDI during the first 10 years of exemption and a 2% income tax rate during the remaining tax exemption period, is granted to exempt businesses located in Vieques and Culebra.

E. 2(j) Income. Full income tax exemption is granted to the income derived from the eligible investments listed in section 2(j) of the Act.

F. Dividend Distributions. Distributions of dividends or partnership profits out of ID are exempt from income tax. Likewise, in the case of exempt businesses organized outside of Puerto Rico, distributions of foreign sourced earnings and profits are exempt from income tax.

G. Sale of Shares or Assets. Generally, the gain from the sale of shares of stock or partnership interests of an exempt business, or of substantially all of the assets of an exempt business (i.e., at least 80% of the book value of the assets), is subject to a 4% income tax.

H. Liquidation. Generally, full income tax exemption is granted to the gain from the complete liquidation of an exempt business.

Special Deductions

A. Net Operating Losses. Net operating losses incurred in the eligible operations may be used to offset income derived from the operations that incurred the losses or against income derived under other tax exemption grants under the Act or Prior Acts. The net operating losses may be carried forward indefinitely until exhausted.

B. Special Deduction for Investments in Buildings, Structures, Machinery and Equipment. Generally, exempt businesses may deduct (instead of capitalizing) their investment made after July 1, 2008 in buildings, structures and machinery and equipment.

Tax Credits

A. Purchases of Products Manufactured in Puerto Rico. Exempt businesses under the Act or Prior Acts may credit 25% of their purchases of products manufactured in Puerto Rico by an unrelated entity against the income tax on IDI. The credit may not exceed 50% of the income tax liability of the taxable year, and may be carried forward until exhausted. In the case of products manufactured in Puerto Rico by exempt businesses from recycled materials, the credit is increased to 35%.

B. Employment Credit.

1. General. Exempt businesses that commence operations under the Act after July 1, 2008 will obtain an income tax credit for each permanent full time employee resident of Puerto Rico that is hired during their first year of operations. The credit amounts to \$1,000 per employee in high industrial development zones; \$2,500 per employee in low industrial development zones; and \$5,000 per employee in Vieques or Culebra. The credit may be carried forward for three taxable years.

2. Recapture. The exempt business must maintain an average employment at least equal to the number of employees for which the credits were granted, for each subsequent three years. A breach of this requirement results in the obligation to repay the tax credits, in whole or in part, as set forth in regulations to be promulgated by the Secretary of the Treasury.

C. Research and Development, Clinical Tests and Others.

1. General. Generally, 50% of the investment by an exempt business under the Act or Prior Acts in research and development, including operational expenses, clinical tests, toxicological tests, infrastructure, renewable energy and intangible assets, may be claimed as a credit against the exempt business income tax liability on its IDI or against operational costs of the exempt business related to electric power, water and sewerage. The credit is not subject to any limitation if used against electric power, water and sewerage expenses, but if used against the exempt businesses income tax liability on IDI, only 50% of the credit may be used in the year that the investment is made and any remaining credit may be used during subsequent taxable years.

2. Sale of Credits. The credit may be assigned, sold or transferred, in whole or in part, and the proceeds from any such transfer are exempt from income and municipal license taxes. The transferees of the credit are not subject to income tax on the excess of the credit over its purchase price.

Notably, since tax credits are generally sold at 90 to 92 cents per dollar, the effect of the sale of credits is that for all practical purposes close to 50% of the investment is paid by the government of Puerto Rico.

D. Investment in Machinery and Equipment for the Generation and Efficient Use of Energy. Generally, exempt businesses under the Act or Prior Acts may credit 50% of the cash invested after May 28, 2008 in the acquisition of machinery and equipment for the generation of electric power from fuels, other than petroleum (and after May 28, 2011, only from renewable sources), against their income tax liability on IDI.

E. Credit to Reduce Cost of Electric Power. Generally, exempt businesses under the Act that are “industrial clients” of the Puerto Rico Electric Power Authority (“PREPA”) may credit against their income tax liability on IDI, 3% of the payment made to PREPA during the taxable year for its net consumption of electricity in connection with the operations covered by their tax exemption grants. Additionally, if such exempt businesses maintain an average employment of at least 25 employees, an additional 3.5% credit is granted, and if the exempt businesses have an average annual payroll of at least \$500,000 another 3.5% credit is granted. The maximum 10% credit is reduced by 1% annually commencing on taxable year 2013, until it is reduced to 5% on 2017. The credit will be effective during a 10 year period commencing on July 1, 2008; except that the credit will be revoked if the cost per kilowatt of electric power is reduced to at least 10 cents during two consecutive years.

F. Transfers of Technology. Exempt business under the Act (except those that enjoy a grandfathered royalty withholding rate of less than 12% or that avail themselves of the 8% income tax/2% royalty withholding tax option), are granted a credit against the reduced income tax rate on IDI equal to 12% of the royalties paid to nonresidents from sources within Puerto Rico. In the case of exempt businesses that avail themselves of the 8% income tax/2% royalty withholding tax option, the credit is 2% of such royalties.

The credit may be carried over during a maximum of 8 years, commencing with the taxable year after the close of the taxable year during which the credit is originated.

G. Investments in Strategic Projects.

1. General. Exempt businesses under the Act or Prior Acts are granted a credit against their income tax liability on ID or operational costs related to electric power, water or sewerage, amounting to 50% of certain investments made by the exempt businesses or any of their affiliates in Strategic Projects after May 28, 2008. Strategic Projects include, among others, power plants that generate electricity from fuels, other than petroleum, or renewable sources and construction of water treatment plants.

2. Limitation. The credit may be used against up to 50% of the income tax liability on IDI for the taxable year. No limitation is applicable to the use of the credit against the electric power, water or sewerage costs.

3. Recapture. The exempt business must operate for at least ten (10) years. Otherwise, recapture provisions are applicable, pursuant to which the investors have to repay all or a portion of the credit.

4. Sale of Credits. The credits may be sold, transferred or assigned; thus, close to 50% of the investment is for all practical purposes paid by the government of Puerto Rico. The proceeds derived from the transfer of the credits are exempt from income tax and the transferee is not subject to income tax on the excess of the credit over its purchase price.

H. Investment Credit.

1. General. Investors that make certain investments in exempt businesses are granted a credit against the income taxes imposed by the PR-IRC (including the alternative minimum tax and alternative tax), amounting to 50% of the investment. To qualify for the credit, the cash invested must be (i) used to acquire the equity interests or operational assets of an exempt business under the Act or Prior Acts that is in the process of closing its Puerto Rico operations (or transferred as equity to such exempt business and used by the exempt business for the construction or improvement of facilities or the acquisition of machinery and equipment), or (ii) contributed in exchange for equity of a small or medium exempt business under the Act or Prior Acts, and used by such exempt business for the construction or expansion of facilities on acquisition of machinery and equipment to be used in the establishment or substantial expansion of its exempt operations. Small or medium exempt businesses are defined as exempt businesses under the Act with average gross income of less than \$10 million for the three preceding taxable years. To qualify for the credit the investment

must be made after May 28, 2008 and certain other requirements must be met.

2. Limitation. A maximum of fifty percent (50%) of the credit may be used in the first taxable year; the remaining amount may be used in subsequent years.

3. Sale of Credits. The credits may be sold, transferred or assigned; thus, close to 50% of the investment is for all practical purposes paid by the government of Puerto Rico. The proceeds derived from the transfer of the credits are exempt from income tax and the transferee is not subject to income tax on the excess of the credit over its purchase price.

I. Limitations on Use of Credits. The utilization of the credits described in paragraphs A through H, may not reduce the sum of the income tax payable by the exempt business and the withholding tax on royalties for the taxable year to less than (i) 1% of the IDI of the taxable year, in the case of small or medium businesses (as defined above); (ii) three (3%) of IDI in the case of exempt businesses that are at least fifty (50%) percent owned by residents of Puerto Rico; and (iii) the applicable income tax rate (i.e., 4% or 8%) of IDI, in the case of all other exempt businesses.

Property Taxes

A. 90% Exemption. Generally, the real and personal property of exempt businesses used in the eligible business enjoy 90% exemption from real and personal property taxes during the period of exemption.

B. Self Assessment of Real Property Tax. A new self assessment method may be used by exempt businesses under the Act or Prior Acts to assess their real property tax liability on certain personal property treated as real property tax for property tax purposes.

Municipal Taxes

A. 60% Exemption. Generally, the gross IDI of exempt businesses enjoy 60% exemption from municipal taxes and full exemption on municipal construction taxes.

Sale and Use Taxes

Machinery and equipment used in the eligible businesses, raw materials and fuel used in the cogeneration of electric power are among the products exempt from the sales and use tax.

Renegotiation and Conversion of Tax Exemption Grants under Prior Acts

The Act contains provisions that allow grantees of tax exemption under Prior Acts to renegotiate or convert their grants to the Act. Generally, grantees of tax exemption under Prior Acts may obtain a grant under the Act by filing a petition for renegotiation or conversion (depending on the circumstances of each case) on or before June 30, 2009. Such exempt businesses should generally be able to retain the income and the royalty withholding tax rates applicable under their grant, so long as their income tax rate ranges between 2% and 4% and the exempt business maintains an average employment of at least 80% of the average employment for the three preceding taxable years.

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