



New Economic Incentives Legislation

IN GENERAL

The Governor of Puerto Rico signed House Bill Number 4350 ("House Bill 4350") into Act No. 73 of May 28, 2008 to create the Economic Incentives for the Development of Puerto Rico Act ("Act No.73")* to replace the Tax Incentives Act of 1998 (the A1998 TIA@), effective on July 1st, 2008.

The economic and tax incentives are mainly intended for manufacturers, companies providing services to markets outside of Puerto Rico and key suppliers of exempted business. Additional activities are now eligible for exemption, including strategic projects, construction of social interest housing, recycling activities and production of energy from renewable sources. It seems that the activities of most our clients and potential investors will fit into the definition of a key supplier and that it should be eligible for tax incentives. The employment requirement to enjoy exemption as a key supplier has not been established as of this date and the forms to apply for the exemption are being drafted.

SPECIFIC INCENTIVES

Act No. 73 introduces the following changes to our tax incentives legislation:

A. Exemptions

1) Income – Section 3

a) In general. The proposed law will provide a fixed income tax rate of 4% on industrial development income. The tax will be paid as provided under the Internal Revenue Code of 1994. In the case of businesses that elect to pay a tax of 2% on royalty payments, the tax rate will be 8%.

b) New Pioneer industries. Pioneer industries will be subject to a tax rate of 1% or 0% if the intangible used in the industry was created in Puerto Rico.

c) Low development zone. In the case of exempted business located in low development zones, the income tax rate will be 0.5%. In the case of businesses located in Culebra and Vieques, the income will enjoy full exemption during the first ten years of operations.

d) Royalties. Payment of royalties to foreign corporations or partnerships not engaged in a trade or business in Puerto Rico will be subject to a withholding tax of 12%. Exempted businesses that are subject to the income tax rate of 8% may elect to pay a tax of 2% on royalty payments.

e) Investment income (2(j) income). Retains full exemption.

f) Tax credit for local shareholders. There will be no tax credits for residents in Puerto Rico that are shareholders of an exempted business (30% under current law) of their proportional share of the tax paid by the exempted business on its IDI.

g) Dividends. Dividends from exempted businesses will not be subject to tax (similar to current law).

h) Interest on Loans to Small Businesses. Interest earned by financial institutions in loans of \$250,000 or less to small or medium businesses for their establishment or expansion will be fully exempted from income taxes subject to certain conditions.

2) Property – Section 7

Personal property (including intangible property) used in the development, organization, construction, establishment or operation of an exempted business will enjoy 90% exemption (similar to current law). Real property will enjoy a 90% exemption. Exempted businesses may elect to self-assess real property that has not been appraised by CRIM. Section 7(c)(2). During the construction period and the first year of operations, the real property will enjoy full exemption.

3) Municipal Taxes – Section 8

Exempted business will enjoy a 60% exemption from municipal license taxes, municipal excise tax and other municipal taxes.

a) Special development zone – businesses located in Culebra and Vieques will enjoy a 90% exemption.

b) Small and midsize businesses – will enjoy a 75% exemption

c) Corporate headquarters – will enjoy total exemption during the first five years after the commencement of operations.

4) Commonwealth excise taxes and sales and use taxes – Section 9

Machinery and equipment and raw materials (other than hydraulic cement and oil products) will be exempted from excise taxes and sale and use taxes. Fuel used by the exempted business to generate electric energy for its use, chemical materials used for the treatment of wastewater and energy-efficient equipment is also exempted.

B. Exemption Period – Section 10

1) In general

Exempted business will enjoy exemption for a period of fifteen (15) years.

2) Establishment of operations in other municipalities

Only a notice to OITE is required within thirty (30) days from the commencement of such operations.

C. Industrial Development Income – Section 2(a)

As under current law, the definition of the term “industrial development income” will include the income from currency exchange (Acambio de moneda@) attributable to the sale of exempted products in foreign countries, income from eligible investments (“2(j) income”) and proceeds of business interruption insurance. Income from the sale of intangible property held by the exempted business will also be exempted.

D. Eligible Activities – Section 2(d)

- 1) Industrial units engaged in the production of “manufactured products” in a commercial scale (Section 2(f));

- 2) Industrial units engaged in the production of manufactured products that were not eligible for exemption under prior laws but only with respect to export activities;

- 3) Service units that provide services to markets outside of Puerto Rico (Section 2(h));

- 4) Service rendered in Puerto Rico that are essential for the production process of an exempted manufacturing business that belongs to the clusters classified as high economic impact by the Director of the Office of Industrial Tax Exemption;

- 5) The services rendered for an exempted business as a “key supplier” of said business will also qualify for exemption. The following services may be considered as key supplier services:
 - a. specialized warehousing;
 - b. management of inventory of raw materials, parts, goods in process or finished goods;
 - c. logistics (distribution and sales);
 - d. printed material distribution;
 - e. document digitalization;
 - f. sterilization of instruments, equipment and clothing of clean rooms;
 - g. quality control and validation services;
 - h. calibration and maintenance of equipment;
 - i. repair and remanufacturing of products;
 - j. project engineering;
 - k. programming services;
 - l. specialized technical training;
 - m. development and reproduction of educational programs.The exemption of unit services that were operating in Puerto Rico before the application is filed will be subject to limitations during the first three years of operations. Accounting, tax and legal services are not considered key services.

- 6) Property devoted to industrial development;

- 7) The breeding of animals for experimental uses in research and development facilities;
- 8) Research and development facilities;
- 9) Industrial units engaged in the production of energy from renewable sources;
- 10) Hydroponics and aquaculture;
- 11) Partial or total recycling activities;
- 12) Software development
- 13) Value added activities (such as warehousing, freight forwarding, packaging) related to the operation of Port of the Americas and Roosevelt Roads Port as well as the ports of Mayaguez, Yabucoa, San Juan, Guayama and any other port designated by the Secretary of Economic Development;
- 14) Assembly of equipment for generation of energy from renewable sources;
- 15) Operation of satellites from Puerto Rico;
- 16) Strategic Projects (Section 2(p)) such as landfill recovery, construction of dams, construction of plants for the production of energy using alternate fuels and construction of mass-transportation systems;
- 17) Licensing of intangible property developed or purchased by the exempted business;
- 18) Production of purified water (but limited to the tax credits in Section 5); and
- 19) Construction of social interest housing and planning and development of sustainable communities.

E. Designated Services – Section 2 (h)

The list of designated services is similar to the current law. The following activities were added: strategic planning; software development; training and educational

services; hospital care; strategic planning shared services centers; and international trading companies.

F. Special Deductions – Section 4

1. Investment in buildings, structures and machinery and equipment.

In lieu of capitalization of expenses, the bill will permit exempted business to elect to deduct all expenses incurred in the purchase, acquisition or construction of buildings, structures and machinery and equipment, subject to the following conditions:

- a) That they have not been previously used or depreciated by another person in Puerto Rico; and
- b) That they are used to manufacture the products or render the services covered by the grant.

G. Tax Credits – Section 5

1. Products manufactured in Puerto Rico - Exempted businesses (under this or prior laws) will enjoy a 25% tax credit on purchases of products manufactured (up to 50% of the income tax) in Puerto Rico from unrelated entities (35% in the case of products from recycled materials). The credit is taken against the tax on IDI or any other income tax and may not be transferred.

2. Creation of jobs – Exempted business that commence operations after July 1st, 2008 will be entitled to a tax credit for each job created, as follows:

Location Amount

Vieques and Culebra \$5,000
Low development zone 2,500
Intermediate dev. zone 1,000
High dev. Zone 0

3. Research and development – Exempted businesses (under this or prior laws) will enjoy a 50% credit for special eligible investment in research and development. This credit may be used against the operational costs of the exempted business related to electricity, water and sewer and is transferable (if the transferee is not an exempted business it may be used only against income taxes).

4. Machinery and equipment for generation of energy – Exempted businesses (under this or prior laws) will enjoy a 50% credit (up to 25% of income tax) on the purchase of eligible equipment. The maximum amount of the credit for businesses engaged in the production of energy from renewable sources is \$8 million dollars per exempted business (\$20 million in the aggregate per fiscal year).

5. Credit for payment to PREPA – Any exempted business (under this or prior laws) that is an industrial client of PREPA will enjoy a credit of 3% of the payments to PREPA to be used against income taxes. In addition, exempted business that keep an average employment of 25 employees will be entitled to an additional credit of 3.5% of payments made to PREPA. If the payroll for the year is \$500,000 or more, the exempted business can take an additional credit of 3.5% (that is a maximum credit of 10%). These credits will expire after ten years and are not transferable. The maximum amount to be given per year is \$75 million, up to \$600 million during the

ten-year period. Beginning on taxable year 2013, the maximum credit is reduced by one percentage point as follows:

Taxable Year	Maximum Amount of Credit
2013	9%
2014	8%
2015	7%
2016	6%
2017	5%

The costs associated with this credit will be born by the General Fund and PREPA on the following shares:

Fiscal Year	PREPA	General Fund
2008-2009	---	100%
2009-2010	4%	96%
2010-2011	8%	92%
2011-2012	12%	88%
2012-2013	16%	84%
2013-2014	20%	80%
2014-2015	35%	65%
2015-2016	50%	50%
2016-2017	65%	35%
2017-2018	80%	20%

6. Credit for investment in the transfer of technology- this credit (available to grantees under this law) will be equal to 12% of the payments to nonresident persons for the use in Puerto Rico of intangible property in the exempted operation.

7. Investment in strategic projects – Every exempted business (under this or prior laws) that makes an investment in a “strategic project” will be entitled to a credit of 50% of the investment. For purposes of this credit, the term strategic project means the design, development and construction of dams and reservoirs and the entire infrastructure necessary for its operation. This credit may be sold, assigned or transferred and may also be used against the operational costs (electricity, water and sewer) of the exempted business.

8. Industrial investment – Every investor will be entitled to claim a 50% credit for eligible investments in an exempted business (under this or prior laws) to be taken in two installments. The maximum amount of credit per industrial investment will not exceed \$8 million (up to \$20 million per fiscal year in the aggregate).

9. Limitations- the effective income tax of the exempted business and the tax withheld on royalty payments after the application of the credits will not be lower than the fixed income tax on the net industrial development income (or 1% in the case of small or medium businesses or 3% in the case of locally owned businesses).

H. Sale of Shares or assets– Section 3(d)(3)

Gain from the sale of shares of stock in an exempted business or from the sale of substantially all of the assets of an exempted business will be subject to a 4% tax.

I. Renegotiation – Section 13(b)(1)

As under current law, any exempted business may request a renegotiation of tax exemption grant in effect if it can show that it will increase the average employment of the last five years (three years under current law) by 25% or if it will make a substantial investment in the industrial unit that represents an increase of 25% or more of the existing investment. For purposes of this requirement, the investment will be computed based on the book value of the assets after depreciation under the straight-line method. The Secretary may not impose a fixed income tax rate lower than 4% without the recommendation of the Secretary of Treasury. The fixed rate will only apply on incremental IDI. The IDI of the base period will be subject to tax under the rules of the prior decree.

J. Conversion – Section 13(b)(2)

Conversion of grants is possible during the first 12 months following the approval of the bill. In general, the terms and conditions of the conversion will be those in this bill. The Secretary may establish other conditions and/or impose a fixed income tax rate higher than 4% but not in excess of 7% (10% under current law). The fixed rate will only apply on incremental IDI. IDI for the base period will be taxed as provided under the grant issued under prior law, including the tax on dividends for the remainder of the period under the old grant.

K. Extensions –

There are no provisions to permit the extension of a grant.

L. Office of Industrial Tax Exemption – Section 12

OITE will be under the Department of Economic Development and Commerce (currently under the Department of State).

M. Filing Fees – Section 13(a)

The Secretary will establish the filing fees by Regulations. In the meantime, the fees will be similar to those charged currently by OITE.

N. Nature of the Concessions – Section 14

As under current law, grants shall be deemed in the nature of a contract between the recipient and the Government.

O. Interagency Consideration – Section 13(a)(2)

The bill provides that in all cases the Director will submit the proposed grant to the corresponding municipality and the CRIM for the pertinent economic and fiscal evaluation. If no report is rendered within twenty days, the bill creates a presumption that the report is favorable.

P. Special Fund for Economic Development – Section 17

The bill creates a special fund equal to 5% (7.5% beginning after the fifth year of effectiveness of the law and 10% after the ninth year of effectiveness of the law) of the income taxes paid by exempted businesses under the new law and the Special Surtax under the 1998 TIA, to be used:

- 1) For research and development projects;
- 2) For the development of special programs of self employment and small business;
- 3) For the development of industries of strategic importance to the Commonwealth of Puerto Rico;
- 4) To assist management takeovers of exempted businesses;
- 5) To assist in the establishment of programs to promote investment and training in small businesses;
- 6) To assist community-based organizations;
- 7) For strategic projects;
- 8) For biosciences;
- 9) For the science trust;
- 10) To support initiatives: to establish Internet access to the public; to provide advice and training to small business and unemployed persons in information systems; to establish educational programs in math, languages and sciences; and to establish facilities (incubators) to support new businesses.

Q. Grants Issued Under Prior Laws – Section 20

The tax exemption grants issued under prior law may be amended pursuant to the provisions of the applicable Tax Incentives Act. Applications that have been filed but not approved before the effective date of this law may be processed, at the election of the applicant, under the provisions of this act.

R. Reports – Section 18

Exempted business will be required to file an annual report to show that the operation of the exempted business comply with the provisions of the law and the grant.

S. Energetic Affairs Administration

A new Administration is created under the Department of Economic Development and Commerce. The activities of the Energy Administration of the Department of Natural Resources are transferred to this Administration. A wheeling committee is created (“trasbordo de energía”).

The Electric Power Authority is ordered to implement a system to allow exempted business to sell electric energy to other entities through the wheeling service.

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