

THE NEW ECONOMIC INCENTIVES ACT: HOW IT CAN BENEFIT YOUR BUSINESS

By Amaya Iraolagoitia

The Economic Incentives for the Development of Puerto Rico Act (the “EIA”) is intended to be one of the main vehicles for the economic development of the Island and an important tool for the promotion of Puerto Rico as an investment alternative for foreign and local businesses.

Now, businesses, new and existing, foreign and local, are evaluating whether the EIA brings potential opportunities for their operations. The main questions in this analysis are: Which business activities qualify? What are the benefits of operating under the EIA? What procedures are required in order to enjoy these benefits? For businesses operating under previous incentives laws, the question of whether to pursue a grant under the provisions of the EIA involves many considerations. The information below is intended facilitate this analysis.

Which business activities qualify under the EIA?

> Manufacture and key suppliers to manufacturers

True to tradition, the EIA maintains the focus of the sixty-year old industrial incentives program on manufacture. Therefore, manufacturing and certain sub-contracted services related to the process of manufacturing are qualifying activities under the EIA.

The concept of manufacture today, no longer limited to the transformation of raw materials into articles of commerce, involves a significant service component, with an increasing trend towards outsourcing and the need to strengthen value chains. For this reason, the EIA includes as an eligible business the concept of the key supplier to an exempt manufacturing business. To qualify, the key supplier must render its services in Puerto Rico, on a continuous basis, to an exempt manufacturer who is the supplier’s usual customer. In addition, the nature of the service offered by the key supplier must constitute a direct cost of the manufacturing business.

Some of the services that may qualify for exemption are: (1) specialized storage; (2) inventory management, including receipt, warehousing and inspection; (3) logistics related to distribution of manufactured products and exportation; (4) logistics related to sales and purchases, including orders and transportation; (5) insertion and distribution of printed material; (6) digitalization of documents; (7) sterilization of instruments and equipment, and clean room apparel; (8) quality control, validation of processes, equipment and systems; (9) calibration of equipment, utilities or facilities; (10) repair and re-manufacture of products; (11) project engineering; (12) technical training; (13) programming and data base system management; and (14) development of education programs.

> Services for non-Puerto Rico markets and other export activities

Certain activities conducted in Puerto Rico for non-Puerto Rico markets also qualify for the benefits of the EIA. These activities, or “designated services”, include: (1) commercial and mercantile distribution; (2) investment banking and other financial services; (3) advertising and public relations; (3) commercial art; (4) assembly, bottling and packaging operations; (5) electronic data centers; (6) activities in port facilities; (7) repair and maintenance of electronic equipment; (8) trading; (9) healthcare services; (10) engineering and architecture services; (11) development of custom software; (12) training; (13) strategic planning and logistics; and (14) operation of shared services centers. Also, certain consulting services to foreign clients qualify as eligible businesses, including advice rendered in the following areas: environmental, economy, technology, science, marketing, human resources, information technology, legal, engineering and accounting.

A service rendered for a Puerto Rico client may still qualify as a designated service if the client, in turn, exports such service.

> *Value-added activities in certain ports*

Value-added activities in the Las Americas Port, and the ports of Yabucoa, San Juan, Mayaguez, Roosevelt Roads and Guayama are covered by the EIA. These activities include warehousing, inventory consolidation and dispatch, re-packing, product finishing and any commercial or service activity related to the administration and handling of goods in such ports. Other ports may be added to the list through regulation issued by the Secretary of Economic Development.

> *Research and development, laboratories and the licensing of intangible property*

The operation of laboratories for research and development for scientific, industrial or medical purposes is an eligible activity under the EIA. Also eligible is the growing of animals for experimental use in laboratories with scientific, medical or other similar purposes. If an intangible is developed or acquired by an exempt business covered by the EIA, such intangible may be licensed to a third party or affiliate. The royalty income derived from such license is also covered by the EIA.

> *Software development, programming and related activities*

As mentioned above, programming services and data systems management for manufacturers are considered key supplier businesses, and information technology consulting and software development services are also eligible if performed for markets outside Puerto Rico. In addition, software development is considered an eligible activity regardless of the market or type of client if the software is reproduced and sold on a commercial scale.

> *Certain agricultural activities*

Hydroponics, aquaculture, pasteurization, and agricultural biotechnology operations are eligible activities under the EIA.

> *Production of Energy from renewable sources*

The EIA represents a potential opportunity for companies engaged in the renewable energy business as well for certain service-related providers in the industry. The production of energy from renewable sources for consumption in Puerto Rico is an eligible activity under the EIA even if the activity is not conducted on a commercial scale. During the first three years of effectiveness of the EIA, businesses producing energy with natural gas or carbon may request a grant of tax exemption under the EIA. Other energy related activities that qualify are the construction of plants for the production of energy with renewable sources, the production of hydroelectric energy, methane recovery from closed landfills, the assembly of equipment for generation of energy from renewable sources, and the design and construction of self-sustainable communities.

Energy produced for consumption in Puerto Rico can be sold to the Puerto Rico Electric Power Authority ("PREPA") or directly to clients once the required regulations are finalized and effective. In the case of sales directly to client, energy could be generated in, or nearby the client's facilities or transmitted through the existing PREPA transmission and distribution lines through a wheeling system. The EIA orders PREPA to make this service available to private generators by January 2, 2010. A new Energy Affairs Administration, under the Department of Economic Development and Commerce, will oversee all aspects of the wheeling system implementation.

> *Recycling*

Partial or total recycling activities are eligible under the EIA. Total recycling consists of the transformation of goods from recyclable materials recovered in Puerto Rico. Partial recycling is defined as an activity involving at least two of the following processes: collection, distribution, reconditioning, compacting and other physical or chemical transformation process.

> *Strategic projects (opportunities for construction and related businesses)*

The infrastructure relating to waste management, water supplies, energy production and transportation is considered of crucial importance for the development of Puerto Rico and the quality of life. For the first time in the history of the industrial incentives program, the following activities are promoted: (1) cleaning, recovery, conversion and restoration of closed landfills, including methane recovery and cleaning of aquifers; (2) construction of dams or reservoirs, including infrastructure necessary for their operation, in order to increase water reserves and protect the Water Authority (“Autoridad de Acueductos y Alcantarillados”) production, including the production of hydroelectric energy and the construction of plants for the treatment of used water; (3) construction of plants for the production of energy from renewable sources (with a three-year window open for natural gas and carbon); and (4) construction of mass transportation systems.

What are the benefits of operating under the EIA?

> Preferential rates for income tax on industrial development income and withholding tax on royalty payments to non-Puerto Rico entities

In general, businesses operating with a grant issued under the EIA are subject to a 4% flat income tax on their net income from the eligible operation, or “net industrial development income” (“IDI”). If royalties are paid to foreign entities for the use of intangibles in Puerto Rico, a 12% tax must be withheld from such payments and remitted to the Puerto Rico Treasury Department. This represents a substantial reduction compared to income taxes up to 39% for regular businesses, and a 29% withholding tax on royalties paid to non-Puerto Rico entities.

The location of the business affects the applicable income tax rate. The income tax rate is reduced by 0.5% for activities established in municipalities classified as low or intermediate development zones. Vieques and Culebra operations are subject to a 0% flat income tax rate for 10 years and a 2% flat income tax for the remaining five years of exemption.

> Special rates for pioneer innovative activities

Pioneer innovative activities covered by the EIA are subject to a 1% income tax on IDI. Products from intangibles developed in Puerto Rico are subject to a 0% income tax rate. Pioneer innovative activities are defined as economic activities that have not been carried out in Puerto Rico during the twelve-month period before the application for exemption is filed and that possess certain characteristics that make them have significant impact on the economic development of Puerto Rico. The Secretary of Economic Development, with the favorable recommendation from the Secretary of the Treasury, PRIDCO’s Executive Director and its Board of Directors, must make the determination that the business will have a significant impact in the economic development of Puerto Rico. Factors to be considered in making this determination are the technology to be used, the integration of R&D activities, capital investment, employee profiles, and uniqueness of the activity in the international market.

> Grandfather option for exempt business under Tax Incentives Act of 1998

Generally, a business operating under a previous incentives statute may wish to consider whether to apply for a new grant under the EIA. One factor to evaluate is whether the income tax rate available under the existing grant is more advantageous than the rates established under the EIA. The Tax Incentives Act of 1998 (the “1998 TIA”), the EIA’s predecessor, allowed for the negotiation of rates ranging between 2% and 7% for non-pioneer industries, and between 0 and 2% for pioneer industries. Business operating under the 1998 TIA that are subject to income taxes at rates ranging between 2% and 4% may opt to request a grant under the EIA, while still enjoying the same income tax rate established in the 1998 TIA grant. This alternative is commonly known as the “Grandfather Scenario”.

Similarly, if an exempt business with a 1998 TIA grant is subject to a withholding obligation on royalty payments at a rate that is lower than 12%, such business may request that said lower rate be maintained under the

EIA, as part of the Grandfather Scenario. It is important to keep in mind that businesses under the Grandfather Scenario are subject to special conditions, as further described below.

> Special deductions and credits

The EIA allows the exempt business to deduct from its IDI the total amount incurred in the purchase, construction or improvement of certain buildings, structures, machinery and equipment, rather than claiming such cost through annual depreciation deductions. In addition, the EIA offers a number of credits to promote certain desired investments or activities, to wit: (1) 25% of purchases of products manufactured in Puerto Rico (35% for purchases of recycled products); (2) job creation credit; (3) 50% of special eligible investment in research & development; (4) energy cost credit; (5) 50% of investment in machinery and equipment for the generation of energy from renewable sources; (6) technology transfer credit; (7) 50% of eligible investment in Strategic Projects; and (8) 50% of industrial investment in businesses in the process of shutting down operations or in small or mid-sized businesses;

Each credit has particular characteristics in connection with the following: who may generate the credit, the type of investment or activity required to qualify, the maximum amount of credit allowed, timing limitations to claim the credit, whether the unused portion of a credit may be carried-over to subsequent taxable years, whether the credit may be sold or otherwise transferred by the investor, whether the credit may be used against certain operating costs in addition to be available to reduce income taxes on IDI, and whether special conditions and procedures are required before the credit is claimed.

Businesses that are operating under previous incentives acts should note that the majority of the credits created under the EIA are available to them, even if they do not request a grant of tax exemption under the EIA. This may be advantageous to businesses that would not be able to benefit from the credits by reason of the minimum tax payment requirement described below. In addition, businesses that decide to apply for a grant under the EIA under the Grandfather Scenario provisions should note that the technology transfer credit will not be available to them.

> The minimum tax payment

The credits mentioned above represent a dollar-per-dollar offset against the income tax obligation of the exempt business. However, the EIA imposes a minimum tax payment obligation to business operating under its provisions. The required minimum payment is equal to the amount resulting from multiplying the business' net IDI by the income tax rate applicable to the business (the statutory income tax rate). Compliance with the minimum payment can be achieved by combining the royalty withholding tax and the income tax on IDI.

As an exception, certain businesses may use the credits allowed under the EIA to reduce their minimum tax requirement to the following rates:

1. 3% in the case of a local investment business, that is, a business operating under the EIA if at least 50% of the stock or interests in the business are owned by individuals who are residents of Puerto Rico.
2. 1% in the case of small or mid-size business, that is, a business operating under the EIA if its average gross income for the previous three years does not exceed \$10,000,000.

Moreover, although not clearly stated in the EIA, the minimum tax requirement is considered not to apply to businesses under the Grandfather Scenario. This will require clarification through regulation or technical amendment.

The above rules are illustrated in the following examples:

EXAMPLE 1: New Business, Inc. operates under a grant of tax exemption issued pursuant to the EIA. During 2009, New Business, Inc. derives net IDI (income from the activities covered by the EIA, net of applicable business deductions) amounting to \$100 and pays royalties to Intangible Owner, Corp., a non-Puerto Rico entity, equal to \$50. New Business, Inc. withheld 12% (\$6) from the royalty payments and deposited this amount with the Puerto Rico Treasury Department. New Business, Inc. made investments that generated credits under the EIA equal to \$10. Assuming it is subject to a 4% income tax rate under the grant,

when New Business, Inc. prepares its Puerto Rico income tax return for 2008, it will determine an income tax obligation equal to \$4 ($\$100 \times .04$). That amount will also become its minimum tax obligation. New Business, Inc. will then apply the credits (technology transfer credit equal to \$6 and other credits equal to \$10) against its income tax obligation and will conclude that its payment obligation for the year is zero ($\$4 - \16). New Business, Inc. will notice that it has unused credits (\$8) that may be carried-over to subsequent years or used in other ways, depending on the credit. It will also conclude that it has complied with the minimum payment required because the royalty withholding tax deposited with the Puerto Rico Treasury Department (\$6) exceeds its minimum tax obligation for the year.

EXAMPLE 2: New Business, Inc. operates under a grant of tax exemption issued pursuant to the EIA. It is owned by individuals who are residents of Puerto Rico. During 2009, New Business, Inc. derives net IDI (income from the activities covered by the EIA, net of applicable business deductions) amounting to \$100 and does not pay royalties. New Business, Inc. made investments that generated credits under the EIA equal to \$10. Assuming it is subject to a 4% income tax rate under the grant, when New Business, Inc. prepares its Puerto Rico income tax return for 2008, it will determine an income tax obligation equal to \$4 ($\$100 \times .04$). New Business, Inc. will then apply the credits (\$10) against its income tax obligation. However, New Business, Inc. will have to make sure it complies with its minimum tax obligation equal to \$3 ($\$100 \times .03$). Therefore, it may use \$1 of its available credits to reduce its income tax obligation from \$4 to \$3. New Business, Inc. may be able to carry-over the unused credits (\$9) to subsequent years or use them in other ways, depending on the credit.

EXAMPLE 3: Assume same facts as in Example 2, but New Business, Inc. qualifies as a small or mid-size business. The minimum payment required under the EIA amounts to \$1 ($\$100 \times .01$), so New Business, Inc. may reduce its income tax payment from \$4 to \$1 with the credits available. The unused portion of the credits (\$7) may be carried-over to subsequent years or used in other ways, depending on the credit.

Other tax benefits

The following benefits also apply to businesses operating under the EIA:

1. 100% income tax exemption for dividend distributions of IDI, distributions of property as part of the liquidation of the business, and income from investment of eligible funds in certain investments (commonly known as “2(j) income”).
2. The gain on the sale of stock or substantially all of the assets (this is new under the EIA) of the exempt business is subject to a 4% income tax.
3. 90% exemption from real and personal property taxes.
4. 60% exemption from municipal license taxes and other municipal taxes during the exemption period.
5. 100% excise tax and sales and use tax exemption for raw materials and machinery and equipment used in manufacturing process. Construction materials and equipment are not exempt.

> Period of Exemption

Grants of tax exemption under the EIA will be effective for 15 years.

What procedures must be followed to operate under the EIA?

> Application for a Grant of Tax Exemption under the EIA

Any new or existing eligible business in Puerto Rico that wishes to operate under the EIA must file an application for a grant of tax exemption with the Office of Industrial Tax Exemption (“OITE”), now a division of the Department of Economic Development. The application must be accompanied with certain documents such as audited financial statements and negative debt certificates issued by the Puerto Rico Treasury Department and CRIM. The application and the instructions for its preparation are posted in PRIDCO’s web site: <http://www.pridco.com>.

OITE is required to remit copies of the application to PRIDCO's Executive Director and to the Secretary of the Treasury. PRIDCO is responsible for the determination of eligibility of the business. Once OITE has received the reports from PRIDCO and the Puerto Rico Treasury Department, a draft of the grant of tax exemption is remitted to CRIM and to the municipality where the business is located.

The final result of this process is the issuance of a grant of tax exemption, signed by the Secretary of Economic Development and unconditionally accepted, under oath, by the exempt business. The grant is a contract between the exempt business and the government of Puerto Rico, and its legality or content can only be challenged by the Secretary of Economic Development or the Governor.

> Businesses operating under previous incentives laws

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. However, a business operating under previous tax incentives statutes may wish to request a new grant of tax exemption under the EIA. This may be accomplished under three scenarios: renegotiation, conversion, or application for a new grant with a waiver from certain successor business provisions. The circumstances under which these scenarios are available and the conditions that could be imposed on the business vary and should be carefully considered before a decision is made.

In addition, an exempt business considering its opportunities under the EIA should evaluate the tax rates scenarios that could potentially apply to its operations. In this context, one consideration would be the applicability of special income tax scenarios (for example, pioneer innovative industry or reduction of rates by reason of the business' location) or the convenience of requesting the Grandfather Scenario (if currently subject to income tax rates ranging between 2 and 4%), as such rates compare with the tax rates applicable under the existing grant. In the determination of whether the Grandfather Scenario will be selected, the business will also have to consider the relevance of the disallowance of the technology transfer credit and the applicability of the minimum tax payment in that situation.

Additional factors that should weight in the decision of whether to request a new grant under the EIA include: (1) comparative analysis of the Puerto Rico tax cost considering the applicable income tax and royalty withholding tax rates; (2) the impact of special deductions and credits no longer available under the EIA (for example, special payroll and training expenses deductions available under the 1998 TIA); (3) the impact of credits under the EIA, most of which are available to an exempt business even if the business continues to operate under previous tax incentives laws; (4) the impact of credits that are available only to businesses operating under the EIA (i.e. the technology transfer credit), and the application of the minimum tax payment; (5) the business' current corporate structure and operations and its potential for expansions; (6) the opportunity for reduction of overall tax cost through foreign tax credits; and (7) other operational considerations, particularly if additional investment and employment requirements are contemplated.

The determination of what is the best course of action for a particular business depends on that business' particular characteristics and situation. Like the fingerprints in a human being, no two businesses are identical. Whether the EIA presents opportunities to the business will require careful consideration of the above (and many other) factors.