Zaragoza Alvarado
Taxand

# The Tax Advisor

## Quarterly Newsletter

Volume 2, Issue 2 June 2008

**Special points of interest:**

- Act 73 Enacted
- Relevant Provisions of Act 73

**Inside this issue:**



## *Puerto Rico Economic Incentives Act Promises Sour Pineapple No More*

**By Juan Zaragoza**

On May 28, 2008 the Honorable Governor of Puerto Rico, Aníbal Acevedo Vilá signed into law, Act 73, "Tax Incentives Act for the Economic Development of Puerto Rico".

This Act is the result of various months of hard work by a coalition of local tax experts (which included our partner Edgardo "Tuto" Sanabria), business people, industrialists and economists. The Act supersedes the 1998 Tax Incentives Act previously in effect for approximately the last ten years.

This legislation, which is the greatest tool the P.R. Government has for the attraction of foreign capital (and one of the tools for promoting local investment), comes at a crucial time since the local economy has been in a recession for the last year and a half.

As you will see from the article written by Rafael Carazo (see below), in comparison with prior acts, this one is more aggressive in terms of the tax rate structure and the granting of tax credits to promote certain investments or compensate for excessive local cost of energy. In addition, it expands the level of eligible activities.

Attracting and promoting investment through tax incentives is a balancing act. On one side are reduced tax revenues in the short term and on the other side is increased economic growth which will eventually trigger increased tax revenues

in the medium and long term. Hopefully, the sacrifice ends up being commensurate with the benefits. Time will say but meanwhile, let's start working to turn the sour pineapple we have been eating for the last year and a half, into a sweeter Piña Colada.

## *Summary of the Relevant Provisions of the New Puerto Rico Economic Incentives Act*

**By Rafael A. Carazo**

On May 28, 2008, the Governor of Puerto Rico signed the House Bill 4350, which became Act Number 73 of 2008, entitled the **Economic Incentives Act for the Development of Puerto Rico**. In this edition of the newsletter we will summarize those provisions of the Act that we understand will provide a general outlook of it. In subsequent editions we may expand on one or more of the subjects covered herein or discuss specific matters not included in this article.

**I. Entities Eligible for the Incentives**

Act 73 provides incentives for income, property, municipal license, municipal construction, excise, and sales and use taxes. In order to qualify for those incentives the taxpayer must be an **exempt business;** that is, an **eligible business** which has obtained a grant under the Act

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***Relevant Provisions…***
***Continued from Page 1***

(in some instances, however, the incentives are allowed to **exempt businesses** that have obtained a grant under prior Industrial Incentives or Tax Incentives Acts). Thus, to become an **exempt business** the entity must qualify as an **eligible business**. In general, the Act includes the following as **eligible businesses**:

a. an industrial unit engaged in the production of a manufactured product on a commercial scale;

b. an office that provides in Puerto Rico, on a commercial scale, certain services such as:

  1. a **designated service** for export,

  2. rendering **fundamental** services, **as a subcontractor**, to an exempt business that is part of a **high economic impact cluster** (designated as such by the Puerto Rico Industrial Development Company and the Puerto Rico Planning Board), or

  3. services as **key supplier** of an exempt business;

c. a **property devoted to industrial development**;

d. an industrial unit for the **production of energy**;

e. specified **recycling activities;**

f. **value added activities** in connection with the operation of certain ports, including the **ports of Las Americas and Roosevelt Roads**;

g. an industrial unit engaged in the **production of bottled purified water**; and

h. the development of **software** for sale on a commercial scale.

To qualify under the classification of **eligible service provider** (mentioned in b, above), **80% or more** of the employment force of the business must be **residents of Puerto Rico**.

Among the **designated services** that would qualify under b.1., above, are: distribution centers, marketing centers, regional corporate headquarters, air and maritime port facilities, shared services, production of engineering and architectural designs, and trading companies.

On the other hand, the services that can be provided by a **key supplier** include: specialized storage, management inventories, logistics related to the distribution of manufactured products, digitalization of documents, distribution of printed material, and quality control and validation of processes, equipment and systems.

There are special rules in case of a business that intends to carry out an activity that was not an eligible activity under the Puerto Rico Tax Incentives Act of 1998 (the "1998 TIA") or that conducts an eligible activity prior to applying for a tax exemption grant under the Act.

**II. Tax Incentives**

A. Income Taxes

1. General Rule

The Act provides a **uniform/fixed income tax rate of 4%** during all of the exemption period on its industrial development income ("IDI"), except the income derived from the investment of IDI ("2(j) Income") which is totally exempt. However, businesses that are operating under a grant of tax exemption issued pursuant to the 1998 TIA, that enjoy an income tax rate between 2% and 4% (both inclusive) may maintain their existing rate if, among other requirements, maintain an employment level of at least 80% of the average employment for the preceding 3 years.

2. Exceptions

  a. Businesses located in the municipalities of

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***Summary of Relevant… Continued from Page 2***

Vieques or Culebra will be subject to an **income tax rate of 0%** during the **first 10 years** of the 15 years exemption period, and a **2%** rate for the **remaining 5 years** period.

c. Exempted businesses that carry out an "**innovative activity**" (as defined in the Act, "actividad novedosa pionera") are subject to an **income tax rate of 1%** during all the exemption period. If the **intangible property** subject of the novel activity is **produced or developed in Puerto Rico**, the **income tax rate is 0%**.

d. An exempted business **required to withhold** Puerto Rico income taxes **on royalty payments** to non residents of Puerto Rico, can make, prior to the commencement of the exemption period, an irrevocable election to pay Puerto Rico **income taxes** on its IDI at an **8%** rate, and make the required **withholding** at a **2% rate** (in lieu of at the regular rate mentioned below).

e. Exempted **businesses that locate** their **operations** in a designated **low or intermediate** industrial development **zone** can **reduce** their applicable **income tax rate** (4% (mentioned in 1, above), 1% (mentioned in b, above), or 8% (mentioned in c, above)) **by a 0.5%** (resulting in a net rate of 3.5%, 0.5%, or 7.5%, respectively).

B. Income tax withholding on royalty payments

Exempted businesses that make **royalty payments** to non residents of Puerto Rico are **required to withhold** Puerto Rico income taxes thereon at a **12%** rate, subject to the **alternative 2% rate** mentioned in 2.c., above.

However, businesses operating under a grant of tax exemption issued pursuant to the 1998 TIA that are required to withhold at a lower rate may retain their existing rate if, among other requirements, maintain an employment level of at least 80% of the average employment for the preceding 3 years.

C. Taxation of dividends, liquidating distributions and gains on sales of shares of the exempted business

1. Dividends

Dividend distributions from an exempted business out of its current or accumulated IDI are fully exempt from Puerto Rico income taxes.

2. Liquidating distributions

In general, the **liquidation** of an exempted business **prior to the expiration of the** tax exemption **grant** will not be subject to any Puerto Rico income or withholding tax. That rule will also apply to the accumulated IDI of the exempted business when the tax exemption grant has been revoked or has expired before the liquidation takes place, or when the exempted business also carries out taxable operations.

3. Tax on gain from sale of stock of the exempted business

Any **gain** derived from the **sale** or exchange of **stock** of an exempted business **prior to the expiration of the** tax exemption **grant** will be subject to Puerto Rico income tax at a **4% rate**.

D. Special Deduction

The Act provides a special **deduction** (instead of requiring the capitalization of the expense) for the **cost** incurred by the exempted business in **buildings**, **machinery and equipment** that are used in the exempt operations. There are certain requirements that must be met if the property acquired has been used outside Puerto Rico.

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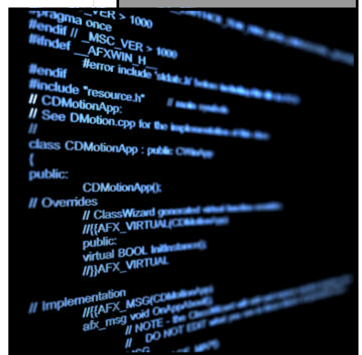


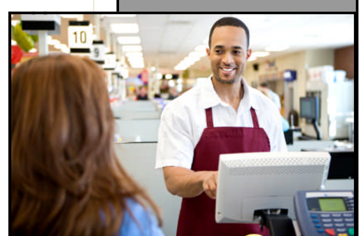

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The amount deducted can **reduce 100% of the IDI**, and any **excess** of the amount invested over the allowable deduction can be **carried over** to subsequent taxable years until fully used.

E. Income Tax Credits

Under the Act, the exempted business has available various credits that are described below:

1. Credit for the **purchase of products manufactured in Puerto Rico**

The exempt business can use as a credit **25% of the cost of the purchases** of products manufactured in Puerto Rico by entities that are not related to the exempted business or **35%** of such cost if the products purchased are **recycled products**. The credit can reduce up to **50% of the income tax liability** for the taxable year in which the credit is used. Any excess of the available credit over the allowable amount can be **carried over** to subsequent taxable years until fully used. This credit, however, is non-transferable.

2. Credit for the **creation of jobs**

An exempt business that commences operations after July 1, 2008, will be granted a credit for each job created (as said term is defined in the Act) during its first year of operations, depending on the industrial zone in which it is established. The maximum amount of the credit is $5,000 for each job created. The credit can reduce up to **100% of the income tax liability** for the taxable year. This credit is non-transferable, but any unused amount can be **carried over**, subject to limitations.

3. Credit for investments in **research and development**

An exempted business is granted a **transferable credit** equal to **50% of** the amount invested in **"special eligible investments"** (as said term is defined in the Act), which term includes **research and development**.
The credit can be applied against its Puerto Rico **income tax liability**, or its **water or energy costs**. If the credit is used to reduce the **income tax liability**, the amount available **must be used in two or more installments**, but the **first installment can not exceed 50% thereof.**

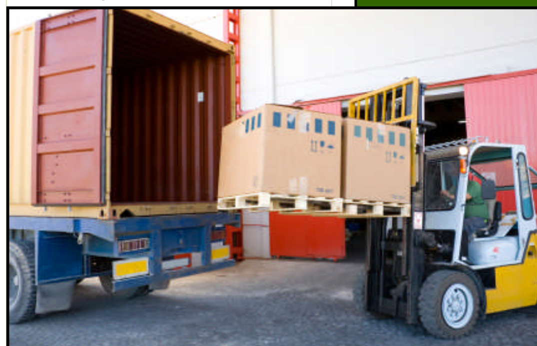
4. Credit for investments in **energy generation equipments**

The Act also grants a **credit** equal to **50% of** the amount placed by the exempted business in **"eligible investments"** (as said term is defined in the Act), which can be used to **reduce up to 25% of the tax liability** of the exempted business.

5. Credit for **industrial investment**

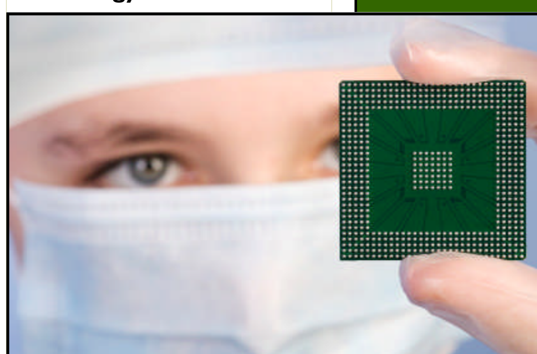
The Act grants a **transferable** income tax credit to any person that makes an **eligible industrial investment** (as said term is defined in section 6 of the Act), which includes the **purchase of 50% or more of the stock of an exempt business**.

The amount of the **credit** is equal to **50% of** the



amount placed by the investor in an **"eligible industrial investment"**, and **must be used in two or more installments**, but the **first installment can not exceed 50% thereof.**

6. Credit for **payments made for the use of energy**



An exempted business that makes payments to the Puerto Rico Electric Power Authority ("PREPA") is granted a **non-transferable income tax credit** of up to **10%** of the **payments made to PREPA** for electricity, as follows:

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***Summary of Relevant… Continued from Page 4***

a. a **regular credit of 3%** of the payments made;

b. an **additional credit of 3.5%** of such payments if the business had an **average employment** during the taxable year of at **least 25 employees**; and

c. another **additional credit of 3.5%** of said payments if, during the taxable year, the business had an **average payroll of $500,000**.

Any unused credits can be **carried over** to subsequent taxable years, subject to certain limitations.

7. **Intellectual Property Credit** (Credit for Puerto Rico income tax withheld on royalties)

   The Act grants a **non-transferable income tax credit** to the exempted business equal to **12% of the amount of royalty payments** made to persons that are non-residents of Puerto Rico for the use of intellectual property. However, **if** the exempted business is **subject to the alternative withholding tax rate** of 2% mentioned in sections I.e. 2.c. and II.B. above, then the **credit is equal to 2% of the royalty payments** made.

   Any unused credit can be carried over until fully used, subject to an 8 taxable year limitation period.

8. Credit for eligible investments in **strategic projects**

   An exempted business is allowed a **transferable** credit equal to **50%** of the **"eligible investment made in a strategic made in a strategic project"** (as said term is defined in the Act). The credit can be used, at the taxpayer's election, to **satisfy in whole** or in part its **electricity or water and sewer operational costs**, or to reduce **up to 50% of its income tax liability**. Any unused credit can be **carried over** until fully used.

9. Limitation on the use of the credits

   The Act establishes a minimum income tax payment on the net IDI of the business, after the application of the available credits, which varies depending on the type of business.

III. **Property Tax Incentives**

An exempted business will enjoy a **90%** exemption on the **property taxes** imposed on its **real and personal property** used in its exempt operations. It will also have a **100%** exemption on its **real property** during the **construction period**.

The Act introduces a **new concept** of **self- assessment of real property taxes**, which is optional, for the **machinery and equipment that is classified as real property**; and the filing of a real property tax return if the business makes such election.

IV. **Municipal License Taxes**

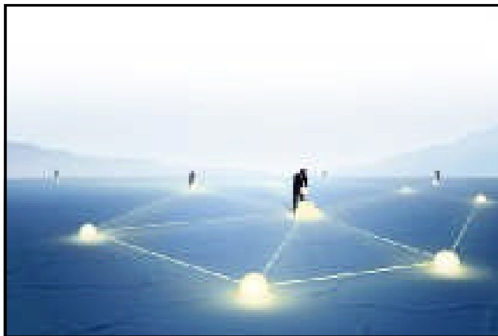
In general, the exempt business will have a **60%** municipal license tax exemption during the period the grant is in effect. The rate increases to **75%** in case of **small businesses**, **subject to** certain **limitations**; **80%** in case of **trading companies**; and **90%** exemption if the operations are carried out in **Vieques or Culebra**. Also, the business will be **fully exempt** for the **first 3 semesters** of operations.

V. **Other Matters**

Every exempt business will have an **exemption period** of **15 years**, and businesses that are presently carrying out exempt operations are allowed to **renegotiate** or **convert** their existing grants under the Act, subject to certain conditions.

The Act is effective on July 1, 2008, and does not have an expiration date.

# TAXAND Achieves Inaugural Cross-Border Award and Receives 4 Best Tax Firm Wins From Leading Tax Publication



**By Taxand Editorial Staff**

TAXAND, the global network of over 2,000 leading tax advisors from independent member firms in more than 40 countries, achieved market recognition for its contribution to tax at this year's International Tax Review's (ITR) European Tax Awards. The "Best Newcomer Award 2008" was presented to TAXAND for delivering best-in-class tax advice across Europe.

The award, which was introduced this year to honor entrants to the market within the last five years, was determined by a panel from the Tax Executives Institute's European Chapter and ITR's editorial team following initial research canvassing the perspectives of tax executives, in-house counsel, tax advisors and private-practice lawyers. Frédéric Donnedieu de Vabres, chairman of TAXAND said: "Five years ago TAXAND was a promising but very theoretical concept. Two years later we launched with eight members. Today we cover 43 countries and continue to expand. This award is major recognition of the work we have done together and I am thrilled our efforts and our brand have been acknowledged in this way".

TAXAND member firms were shortlisted for an impressive 15 awards in total, beating stiff competition in many territories. TAXAND winners on the night were DENMARK, Bech-Bruun, GREECE, Zepos & Yannopoulos, LUXEMBOURG, Atoz and SPAIN, Garrigues. All four firms picked up best national tax firm awards for their track record in delivering innovative international tax transactional work. DENMARK, Bech-Bruun, won the award for the third time, LUXEMBOURG, Atoz, scored a hat-trick, winning for the third consecutive year and SPAIN, Garrigues won for the fourth year in a row.

### *Taxand Countries*

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*Greece, India, Indonesia, Italy*
*Japan, Korea, Luxembourg*
*Malaysia, Malta, Mauritius*
*Mexico, Netherlands, Norway*
*Pakistan, Peru, Philippines, Poland*
*Portugal, Puerto Rico, Romania*
*Russia, Singapore, Spain*
*Sweden, Switzerland, Turkey, UK*
*Ukraine, USA, Venezuela*

# 8th Taxand Conference Held in Maastricht, Netherlands

**By Taxand Editorial Staff**

From June 8 to 10, 2008, TAXAND member firms met in Maastricht for the eighth TAXAND Conference, "Working Together for our Global Future," organized by our Dutch and Belgium firms, Van Mens & Wisselink and AB Taxand.

The conference featured high profile external speakers, with a full day (June 10) dedicated to clients, giving a select group the opportunity to experience our network and attend prearranged bespoke meetings with TAXANDERS.

The event provided an excellent opportunity for members to share technical knowledge that can be translated into advice to address the latest tax issues affecting our clients across the world.

### *How can we be 'passionate' about tax?*

We're passionate because we understand what's at stake—how critical tax is to your business success. We're passionate because we share a sense of purpose—we're proud to belong to a committed, entrepreneurial network of tax advisors. And we're able to fuel that passion because of our focus: our business is tax and tax only.

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## Tax is our business.®

Zaragoza & Alvarado LLP is a Limited Liability Partnership organized under the laws of Puerto Rico and is engaged in providing tax and business advisory services. We are the first truly multidisciplinary tax and business advisory professional services firm in Puerto Rico, unencumbered by the constraints of association with an auditing firm, and the regulatory and disclosure rules of the Securities and Exchange Commission.

Backed up by years of unmatched hands-on experience in public accounting, government and corporate tax, our team of tax consultants is redefining the market by providing professional tax and business advisory services through its "top-heavy" structure, designed specifically to provide high level tax consulting to our clients on a more personalized basis.

Zaragoza & Alvarado LLP is a proud member of Taxand, the leading provider of completely independent tax consulting services.

## Taxand

Taxand is the leading provider of completely independent tax consulting services, with nearly 2,000 tax professionals, including 300 international partners in 43 countries.

Globalization and complexity impose deep expertise, specialization and flexibility. That is the reason why independent and specialized tax firms decided on February 9th 2005 to create Taxand, in order to serve local and international clients.

### The Taxand Advantage

While Taxand is new to the industry, Taxand professionals are not. We bring deep knowledge, proven track records and decades of experience in tax services. One of the major advantages of Taxand is independence. We do not have independence conflicts which might threaten our objectivity or compromise the integrity of a client's operations or decisions.

We optimize clients' businesses by anticipating, measuring and managing tax implications of their day-to-day operations and strategic decisions.

Specialization is key. Business operations and global tax legislation are getting more and more complex. Deep tax expertise is needed to help clients identify, measure, and manage tax implications and risks within their operations. Our model is to specialize our people on Tax only and liaise with any other expertise (Legal, M&A, Finance, Risk Management, Technology…) whenever it is needed by clients.

Different from other international networks such as international law firms or big four firms, our core practice is tax, so every investment we make is in the tax practice rather than in other competencies that may seem more important to other firms.