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Tax Newsletter

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On August 28, 2007 P de la C 3798 was filed by the President of the House of Representatives. The Bill, commonly referred to as the "Proposed Tax Incentives Act", will replace Act 135, the Tax Incentives Act of 1998, if approved.

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In this edition we provide you a summary of P de la C 3798, the Puerto Rico Socioeconomic Development Incentives Act which was filed last August 28, 2007. If approved by both, the House and the Senate, and then signed into law by the Governor, it will replace Act 135, the Tax Incentives Act of 1998, which expires on December 31, 2007.

A lot of discussion and controversy is expected during the next months as the Governor and many sectors of the private industry are promoting the extension of the current law instead of the approval of a new Act in such a short period of time.

Along with P de la C 3798, the president of the House also filed P de la C 3799, the Proposed Act for the Immediate Jumpstart and Expansion of the Puerto Rico Economy. This Bill proposes the formalization of social contracts between the Government and the private sector to promote the creation of jobs and

preservation of labor force in the municipalities. The provisions of both bills will be in effect until December 31, 2019.

The following pages include a brief summary of the principal provisions of P de la C 3798. By no means, this newsletter will provide all the needed information to evaluate the Bill. Our purpose is to bring to your attention the major provisions for your evaluation and comparison with the current provisions of Act 135.

As always, we will continue monitoring the developments related to the P de la C 3798 and keep you informed as they are announced.

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Changes and additions to eligible activities

New eligible activities

P de la C 3798 adds several activities to the list already included in Act 135. For example:

- Any agricultural unit which main purpose is to grow crops for energy or fuel, such as ethanol and methanol, for local consumption and export.
- The construction of "vivienda de interés social" (Low-income housing) and planning and development of self-sufficient communities.
- Development, manufacture, and wholesale distribution and marketing of any type of portable technology or computer equipment.

- Socioeconomic Development Strategic Projects: cleaning of closed landfills; revitalization of urban centers and designated enterprise zones; construction of dams; planning and development of mass transportation systems; conversion of commercial properties into care centers for the elderly; construction of plants for the production of energy from renewable sources; construction or repair of schools and special education centers; establishment and operation of training centers for teachers and students in science, math and information technology; operation of a sector or activity formerly carried out by the government; and income from the work of former government

employees affected by a lay-off plan.

- Research, development, manufacture and wholesale distribution of any type of product closely related to the robotic and nano-technology industries
- In addition, the Bill also allows for the subcontracting process as long as at least 80% of the subcontractor costs are incurred in Puerto Rico. In this cases, the subcontractor will also qualify as an industrial unit.
- In the case of service units, the employment requisite of residents of Puerto Rico is lowered from 80% to 70%.

Continuing eligible activities

Even though the proposed bill keeps the manufacturing of designated articles (which list has been modified) as an eligible activity, it adds an additional requirement for these industrial units to qualify for exemption: they must export at least 50% of their production.

This is one of the provisions of the proposed legislation that is attracting the attention of those evaluating it, since its application will limit the possibility of exemption to a great number of local businesses that are presently enjoying exemptions pursuant to Act 135.

Tax exemptions

Income Tax

The Bill establishes a flat income tax rate of 8% (vs. the 7% established by Act 135). In addition, only under exceptional circumstances, the rate may be reduced but not to less than 6.5%. The reduced rate will be effective for 10 years with the possibility of a 10 year extension. For those cases where the extension is not approved, then the exempt business will enjoy the 8% flat rate for the remaining of its exemption period. Those businesses located in Vieques, Culebra and the Port of Yabucoa will enjoy

100% exemption for a period of ten years. The flat rate of 8% will apply for the remaining of the exemption period.

Income generated by the investments of the "2j" type continues to be fully exempt.

Property Tax

In general, exempt businesses will enjoy a 40% exemption on qualifying personal and real property.

Other municipal taxes

Exemptions will be determined by municipal ordinances.

Dividend distributions and liquidations

A tax of 5% will apply to the distributions of industrial development income (IDI) except when the income was accumulated during the last 5 years of operation at which time a 10% tax will apply. In addition, further distributions of that income will also be subject to a 5% tax.

In general, no tax is assessed upon distributions of the IDI accumulated during the exemption period in the case of liquidations.



New special deductions and other provisions

Special deductions

The Bill maintains the special deductions provided by Act 135: research and development, training, payroll, etc. Some of them are adjusted or limited to certain types of businesses. In addition, the exempt business may be limited to enjoy the full benefit of these special deductions if their effective tax rate is reduced to less than 5% after the application of these special deductions.

Contrary to Act 135, the Bill does not provide a hierarchy for the application of the deductions. It only states that the business may decide which deductions to take.

Nevertheless, the Bill grants authority to the Secretary of the Treasury to regulate this area.

Some of the new special deductions are: accelerated depreciation for energy efficient equipment, expenses for the establishment of care centers or classrooms for the education of the children of employees, expenses incurred in providing computer equipment training, internet access to employees and their dependents.

Administration

The Bill creates a Board of Regents which will be composed of five members: the Secretaries of Treasury and Economic Development and Commerce, and three representatives from the private sector to be appointed by the Governor with the consent of both the House and the Senate. The Board will have the authority to make determinations as provided in the Bill, request the performance of investigations and studies, among other functions.

Compliance report

All exempt businesses must submit a compliance report issued pursuant to a guide to be prepared by the Comptroller of Puerto Rico. This report will be issued by an independent CPA who will not be allowed to provide other services to the business. The CPA will electronically file the report with the Tax Exemption office. The report will be available for public access.

DISCLAIMER: This Newsletter and its content do not constitute advice. Clients should not act solely on the basis of the material contained in this publication. It is intended for information purposes only and should not be regarded as specific advice. In addition, advice from proper consultant should be obtained prior to taking action on any issue dealt with in this newsletter.