

TAX PERSPECTIVES

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Special Edition

Economic Incentives for the Development of Puerto Rico Act

ON THE ROAD TO ECONOMIC DEVELOPMENT

by: Ariadna Alvarez, Special Counsel, McConnell Valdés Tax Practice Group, Editor-In-Chief, Tax Perspectives

Welcome to this special Tax Perspectives edition focused on the recently enacted Economic Incentives for the Development of Puerto Rico Act of 2008.

This statute was designed to foster growth by providing a tax incentives structure geared towards promoting local and attracting foreign investment in Puerto Rico. It is intended that such investment will, in turn, boost Puerto Rico's social and economic

development. This new legislation (which was drafted with significant input from members of the private sector) builds upon decades of experience with incentives programs, while introducing new concepts in tune with the challenges of the 21st century.

Our goal in bringing you this issue is to provide an overview of this broad and complex legislation, and at the same time, spotlight those provisions that are central to the statute's objective

of promoting Puerto Rico's economic development. The articles in this special edition (some of which were written by members of the Steering Committee or the Technical Committee charged with drafting the statute) are designed to merge the technical and legal exposition of the law with practical hints and insights that will prove helpful to the potential and current grantee. We are confident you will find this issue both enjoyable and useful. **MV**

In this Issue...

On the Road to Economic Development1
by: Ariadna Álvarez

The Economic Incentives for the Development of Puerto Rico Act: Most Recent Incentives Legislation... Most Likely, the Last Incentives Legislation2-4
by: Carlos E. Serrano

"Pioneer Industries" vs. "Pioneer Activities" a Pioneer Challenge5
by: Esteban R. Bengoa

New Income Tax Credits Provided by EIDA: An Opportunity to Reduce Operational Costs6-7
by: Rubén Muñiz

Power Boost: Energy Initiatives Under the Economic Incentives for the Development of Puerto Rico Act 8-10
by: Xenia Vélez Silva

Renegotiations Under EIDA11
by: Esteban R. Bengoa

In the Nature of a Contract12-13
by: Rafael Fernández Suárez

Should I Be Tempted Into Swapping with EIDA.....14
by: Esteban R. Bengoa

Thumbs Up to Construction Companies: Construction of Self-Sustainable Communities and Affordable Interest Housing Included as Eligible Business.....15
by: Janelle Reyes & Carlos Serrano



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THE ECONOMIC INCENTIVES FOR THE DEVELOPMENT OF PUERTO RICO ACT: MOST RECENT INCENTIVES LEGISLATION... MOST LIKELY, THE LAST INCENTIVES LEGISLATION

by: *Carlos E. Serrano, Chair, McConnell Valdés Tax Practice Group, Member, Technical Committee*

Puerto Rico is no stranger to the use of tax and other economic incentives to enhance the Island's position as a business destination. For decades, starting in the late 1940's and early 1950's, the manufacturing sector has played a central role in Puerto Rico's economy. It quickly became one of the main economic growth engines of the Island and the largest sector of the Puerto Rican economy. Puerto Rico became known as a manufacturing powerhouse, and that activity helped transform the Island's economy from one based on agricultural activity to an economy based on industrial production.

As with preceding industrial or industrial related legislation, the Puerto Rico Tax Incentives Act of 1998¹ ("TIA"), effective on January 1, 1998, had a limited life span of 10 years, scheduled to expire on December 31, 2007. The continuation of the cornerstone of the Island's economic development program required action on this subject just when Puerto Rico was going through one of its most contentious periods for the enactment of any economic development related legislation.

By June 2007, a proposal for the extension of TIA for an additional two-year term had been filed.² Nonetheless, public discussion on the subject took flight in August 2007, with the filing of H.B. 3798 (Incentives for the Socioeconomic Development of Puerto Rico Act). The bill and its drafters found strong opposition from many of the industrial sectors that were to be fostered

by it. On November 9, 2007, Act 168 was approved to extend the effectiveness of TIA and set forth a game plan for the future of Puerto Rico's industrial incentives program. TIA was extended until June 30, 2008, and an order was given for the establishment of a task force comprised of industry and professional associations, government agencies, professionals in the fields of economics, law and public accountancy. The group was to propose legislation to be approved by the House of Representatives by May 15, 2008, the Senate by May 25, 2008, and the legislative assembly by May 31, 2008. Not an easy task.

Then serving as Assistant Secretary of Internal Revenue for the Puerto Rico Treasury Department, I was asked to focus on the proposed legislation from the fiscal policy and administrative efficiency angle until mid January 2008. Thereafter, as Chair of McConnell Valdés LLC's Tax Practice Group, I was granted the opportunity to contribute to the proposed legislation viewed with the prism of tax and operational effectiveness. My great appreciation to Edgardo Fábregas, President, and William Riefkholl, Executive Vice President, of the Puerto Rico Manufacturers Association, for making the experience possible. I trust that this experience will serve to give you an advantaged perspective on Puerto Rico's tax incentives legislation.

The recently enacted Economic Incentives for the Development of Puerto Rico Act³ ("EIDA") inherits many concepts from its predecessor, TIA. EIDA also incorporated

many concepts from H.B. 3798. In addition, the process set forth by Act 168 did lend itself to an unprecedented level of participation by local and foreign industry and the opportunity to gain very valuable insight and feedback from industry leaders in forums such as the Pharmaceutical Industry Association-sponsored Chief Tax Executive Summit held in Puerto Rico and forums sponsored by McConnell Valdés LLC, which were held both in Washington DC and San Juan on the subject.

As you read EIDA, you should keep in mind some of its principal goals: (i) provide a stable and attractive business destination to the traditional manufacturing activities in Puerto Rico. For this group, EIDA purports to maintain Puerto Rico as a tax advantaged manufacturing destination with the additional non-tax benefit of a legal structure intended to foster the emergence of a strong local base of service-oriented businesses that will, regardless of the tax advantages, make Puerto Rico a preferred business location; (ii) provide incentives for the development of a strong local manufacturing related value chain industry; (iii) eliminate administrative hurdles faced by businesses currently on the Island, such as municipal challenges of tax grants and backed up property tax assessments; (iv) promote research and development activities on the Island; and (v) address the high cost of energy.

Effective on July 1, 2008, one major change of EIDA is that, contrary to prior incentives statutes, it does not include a "sunset

provision”, making EIDA probably the last “permanent” industrial incentives legislation to be seen by many of us. EIDA will provide tax incentives for industrial units engaged in the production of a manufactured product on a commercial scale, as well as to certain service providers. Eligible businesses under EIDA include:

- (i) a broader definition of manufactured product than that found in TIA and any predecessor legislation;
- (ii) a revamped definition of service businesses which may be engaged in:
 - (a) the rendering of designated services for export markets;
 - (b) the local rendering of services provided to members of high impact clusters;
 - (c) the local rendering of key services for exempt manufacturing businesses.
- (iii) eligibility for the export of any previously ineligible product;
- (iv) energy generation on a commercial or at consumer level;
- (v) construction of affordable housing.

Once a commercial activity is considered an “eligible business”, the principal exemption benefits provided by EIDA are related to income tax, property tax, municipal license tax, other municipal taxes, excise taxes and sales and use taxes. The exemption period will be 15 years, regardless of the business location.

The benefits available under EIDA are as follows:

1. **Income Taxes**

- (a) IDI - Income derived from the operation of an eligible activity or designated service declared exempt under a grant, is referred to as industrial development income (“IDI”). The income tax rate at which IDI will be taxed will be either a flat rate of 4% or 8% if an alternative tax is chosen and, subject to certain conditions, granted.

The two options are available without any specific investment/employment requirements. The income tax scenario (4% or 8%) to be applied to the exempt business will be irrevocable once it is determined by the Secretary of Economic Development.

EIDA may provide a reduced tax rate of 1% for pioneer activities that have not been performed in Puerto Rico prior to the twelve-month period ending on the date of filing of the application for the grant. Moreover, IDI from pioneer activities for which intangibles were created or developed in Puerto Rico may enjoy a 0% income tax rate. Pioneer status is based on the unique nature of the particular exempt business, the technology used, the significant investment in plant, machinery and equipment of the business, the integration of research and development and technological improvements as part of such industrial operations, and the substantial employment it provides, or any other benefit or factor that merits such determination.

The applicable income tax rate can be reduced by an additional 0.5% for eligible activities established in low or intermediate development zones.

(b) **Special Deductions:**

- (i) An immediate deduction equal to 100% of expenses associated with the acquisition, purchase or construction of machinery, equipment, buildings and structures to be used in the exempt manufacturing operations or services. This deduction is considered as a method of accelerated depreciation. As a word to the unwise, the use of investment tax credits for the acquisition, purchase or construction of machinery, equipment, buildings and structures may limit the use of this accelerated depreciation.

- (ii) Net operating losses from exempt operations may be deducted against the income generated by the same exempt operations that created such losses or by income from exempt operations as provided by other grants of industrial tax exemption. Any loss in excess of profits can be carried forward against IDI generated in future years until exhausted. Upon expiration of the exemption period, net operating losses can be applied against taxable income subject to certain limitations provided under the Puerto Rico Internal Revenue Code of 1996, as amended (“PR Code”).

- (c) **Income Tax Credits** - The exempt business may enjoy the following income tax credits which are further covered in detail in this edition of Tax Perspectives: (i) credit equal to 25% of purchases of locally-manufactured products (35% if made from recycled materials); (ii) credit for job creation; (iii) credit of 50% of cash investments in research and development; (iv) credit of 50% of cash investment in equipment or machinery for the generation of energy from renewable sources. (v) credit up to 10% of payments to the Puerto Rico Electric Power Authority (“PREPA”) for energy consumption; (vi) credit equivalent to 12% of payments to nonresidents in Puerto Rico for the use of intellectual property in the exempt operations; (vii) credit of 50% of cash investments in the design, development, construction or infrastructure required to operate a strategic project.⁴ (viii) credit of 50% of cash used to purchase 50% or more of the stock or operating assets of an exempt business in the process of shutting down its Puerto

Rico operations. In addition, the cash investment in the acquisition of stock of small or mid-size businesses may qualify for this credit.

(d) Sale or Transfer of Tax Credits -

Some of the credits granted by EIDA are transferable. The regulations dealing with the sale and transfer of tax credits under EIDA have not been approved as of the date of this publication. Nevertheless, we foresee that they will be similar to those followed by grantees enjoying credits under the Tourism Development Act of 1993, as amended. Namely, the transferor and the transferee must notify the Secretary of the Treasury ("the Secretary") of such transfer in a sworn statement. A copy of such sworn statement must be attached to the income tax return for the year of the transfer. The sworn statement must contain the information required by the Secretary via regulations.

(e) Withholding Taxes -

Royalties paid by the exempt business for the use in Puerto Rico of intangible property in its exempt operations are subject to a preferential withholding tax rate of 12% or 2% if an alternative tax is elected.

(f) Taxes on Distributions -

Dividends distributed from current or accumulated IDI are exempt from Puerto Rico income taxes.

(g) Capital Gains on Sale of Business

- As in TIA, any gain from the sale or exchange of stock in an exempt business is subject to a reduced rate of 4% if the sale takes place during the exemption period. Now, the sale of substantially all assets of the exempt business enjoys the same treatment.

2. Property Taxes -

As with TIA, EIDA provides for 90% exemption from real and personal property taxes during the exemption period. However, EIDA provides an optional self-assessment of taxes on real property (classified as such by its use) that has not been assessed by the Municipal Revenue Collection Center ("CRIM") at 35% of book value. The assessment value should range between 10% and 25% of property cost depending on the estimated useful life. The exempt business that elects this self-assessment option must pay estimated real property taxes for the year of self-assessment and the previous four years or the shorter period applicable (payable in two equal installments).

3. Municipal License Taxes -

The exempt business generally will be 60% exempt from municipal license taxes during the exemption period. Small or mid-size businesses in operation before applying for a grant of industrial tax exemption under EIDA will enjoy 75% municipal license tax exemption on the volume of business in excess of the average volume generated during the three-year period prior to the date of application. Certain activities will be 100% exempt from municipal license taxes during the first five years of operations. Also, EIDA provides the exempt business an option to reduce the statute of limitations period to 3 years, in lieu of the period provided in Section 19 of the Municipal License Tax Act, in exchange for payment of the total municipal license tax liability and waiving the 5% discount for prompt payment.

4. Excise Taxes and Sales and Use Taxes -

EIDA provides 100% excise tax and sales and use tax exemption for most articles introduced or acquired directly or indirectly by a business holding a grant of industrial

tax exemption. The exemption does not cover construction materials and prefabricated buildings; electrical materials and water pipes installed in the buildings; lubricants, grease, waxes and paints not related to the manufacturing process; lamp posts or spotlights installed in parking areas; and treatment plants and electric power substations.

5. Excise Taxes on Construction

- Exempt businesses that hold a grant and their contractors and subcontractors may enjoy full exemption benefits from any tax, levy, fee, license, excise, rate or tariff imposed by any municipal ordinance on the construction of works to be used by said exempt business within a municipality.

6. Other Municipal Taxes -

In general, EIDA provides a 60% exemption from other municipal taxes imposed by any municipal ordinance in effect during the period of exemption.

EIDA is the latest statute in a long line of incentives legislation that has formed part of Puerto Rico's industrial incentives proposition. If anything, EIDA enjoys consensus and the unity of purpose of the multi-sectorial group that drafted it. With the promotional efforts currently undertaken by the Puerto Rico Industrial Development Company, we foresee success in this most recent, and probably last, Puerto Rico Industrial incentives package. **M&V**

¹ Act No. 135 of December 2, 1997, as amended.

² See S.B. 2112 of June 18, 2007.

³ Act No. 73 of May 28, 2008.

⁴ Strategic projects, include the "...construction of plants for the production of energy that use alternative fuels and renewable sources. Provided that after the third year of this Act's effective date, every plant that requests the benefits of this Act under this paragraph shall be of renewable resources and after the sixth year of this Act's effective date every plant that begins operations according to what is provided in this subsection must be of renewable sources".

"PIONEER INDUSTRIES" VS. "PIONEER ACTIVITIES": A PIONEER CHALLENGE

by: Esteban R. Bengoa, Special Counsel, McConnell Valdés Tax Practice Group

A pioneer is someone who ventures into unknown or unclaimed territory to settle; someone who leads the way into new areas of thought, research and development.

During these last few years, it has been hard to attract new industries to invest in our economy. Our mishap is not local: it is global. Thus, in our attempt to regain our competitive edge, Puerto Rico has had no other choice but to come up with one of the most aggressive tax incentive structures since Operation Boot Strap. That is what a pioneer does.

About seven years ago, TIA was amended to provide tax benefits to "core pioneer industries" that establish operations in Puerto Rico. Pioneer industries, defined as those with a novel or innovative technology

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not used in Puerto Rico before January 1, 2000, and that had significant impact in Puerto Rico's economy, were eligible to qualify for income tax rates on their IDI between 2% and 0%. Eligibility depended on factors such as: (i) the nature of the jobs to be created and the substantial investment in plant, machinery and equipment, (ii) the substantial concentration of the production of one or more products for the international market, (iii) the development of high levels of scientific, technological and managerial skills of its employees, and (iii) the integration of research, development and technological improvements as an important part of such industrial operations, (iv) the tax impact in general, including the payment of taxes withheld at the source on royalties when the new technology is transferred to be used in Puerto Rico, and (v) on the payment of license fees, leases and rents.

Now in 2008, EIDA also provides tax benefits to businesses that establish "novel pioneer activities" on the Island. Under EIDA, however, the income tax rate is set at a fixed 1% and eligibility for such reduced rate depends on whether the proposed activity has or not been performed in Puerto Rico prior to the twelve month period ending on the date of the filing of the application for the grant. On the other hand, pioneer activities for which intangibles were created or developed in Puerto Rico may enjoy a 0% income tax rate. Under EIDA, pioneer status is based on some of the factors set in TIA, that is: (i) the unique nature of the particular exempted business, (ii) the technology used, the significant investment in plant, machinery and equipment of the business, (iii) the

integration of research and development and technological improvements as part of such industrial operations, (iv) the substantial employment it provides, or (v) any other benefit or factor that merits such determination.

The applicable income tax rate can also be reduced by an additional 0.5% for eligible activities established in low or intermediate development zones. EIDA provides that current industrial zones will remain unaltered until the Secretary of Economic Development re-examines such classifications after July 1, 2008.

The enactment of EIDA, besides its obvious "pioneer activities" provisions discussed earlier, is altogether a novel legislation targeted to revive the world's interest in Puerto Rico in order to inject into our economy new industries, technology and ideas. It is a balanced structure that will benefit new prospective industries that invest in Puerto Rico as well as Puerto Rico itself.

Interestingly enough, the word "pioneer" comes from the French word pionnier, which in turn comes from the Old French peonier, meaning "foot soldier".

Let's march together towards the Reconquest of our economy. **M&V**

¹The American Heritage Dictionary of the English Language, Fourth Edition, 2000.

NEW INCOME TAX CREDITS PROVIDED BY EIDA: AN OPPORTUNITY TO REDUCE OPERATIONAL COSTS

by: Rubén Muñiz, Associate, McConnell Valdés Tax Practice Group

One of the most significant changes introduced by EIDA is the potential reduction of taxation or operational costs through various new income tax credits.

The new income tax credits are targeted to reduce costs related to business expenditures such as the purchase of products manufactured in Puerto Rico, creation of jobs, research and development, generation of energy, energy costs, and use of intangible property in Puerto Rico. EIDA also introduced an investment tax credit for investment in strategic projects (electricity, water and sewer). Some of these credits are available to grantees under TIA and some are even transferable, which, in effect are as close to a cash grant as the legislation can come.

Credit for the Purchase of Products Manufactured in Puerto Rico

Grantees under EIDA or under TIA are entitled to claim a credit for the purchase of products manufactured in Puerto Rico. (including components and accessories) acquired from unrelated parties, equal to 25% of such purchase during the taxable year in which the credit is claimed. In the case of purchases of products manufactured from recycled materials, the credit available is equal to 35% of such purchases.

The credit may be claimed against grantee's income tax on IDI up to a maximum of 50% of said tax and any excess can be carried forward to subsequent taxable years until exhausted. This credit is not transferable.

Although the credit is available to grantees under previous tax incentives statutes, it cannot be claimed jointly with any special

deduction or credit of analogous nature under previous statutes. However, this provision is a marked improvement on the similar provision included in TIA, as it does away with the limitation that required increased purchases over a floating 3 year average and increased the usage limitation from 25% to 50% of taxes on IDI.

Job Creation Credit

Exempt businesses under EIDA commencing operations after July 1, 2008, are entitled to a credit against their IDI for each job created during the first year of operations. The amount of the credit varies depending on the industrial development zone ("IDZ") where the business is located: Vieques and Culebra - \$5,000; low IDZ - \$2,500; and, intermediate IDZ - \$1,000, for each job created.

The grantee will be required to maintain, for each of the subsequent 3 years, an average employment level equal to or greater than the employment level that generated the credit. The credit is not transferable and any excess may be carried forward for four years.

R&D Investment Credit

Grantees under EIDA or under TIA are entitled to claim a credit equal to 50% of an eligible investment made in Puerto Rico. after the approval of EIDA. At the grantee's option, the credit may be claimed against the income tax on its IDI or against operational costs of the exempt business (electricity, water and sewer).

An eligible investment means the amount of cash used by the exempt business or any affiliate in research and development

activities, including operating expenses, clinical trials, toxicology tests, infrastructure, renewable energy, or intellectual property. The funds may be obtained from a loan guaranteed by the exempt business, any affiliate and/or their assets.

The credit must be used in at least two installments if used against the income tax on IDI, and may be carried forward until exhausted. This credit is transferable and the moneys or properties received from the exchange of the credit are exempt from Puerto Rico income taxation up to the amount of the credit transferred.

Energy Generation Credit

Grantees under EIDA or under TIA are entitled to claim a credit equal to 50% of an eligible investment made in Puerto Rico after the approval of EIDA.

For purposes of this credit, an eligible investment means the amount of cash used to purchase machinery and equipment to generate energy with alternate fuels (to oil). After the third year of EIDA's effective date, only purchases of machinery and equipment to generate energy from renewable sources will qualify for the credit.

The investment can be made either to generate energy for consumption of the exempt business or for generation of energy for sale at commercial scale. When the eligible investment is made to generate energy for its own consumption, the credit is limited to 25% of the income tax on IDI. When the eligible investment is made to generate energy for sale at commercial scale, the credit is limited to

eight million dollars for each exempted business, up to an aggregate maximum of 20 million dollars per taxable year. EIDA does not have carryover provisions for any unclaimed excess credit.

Energy Cost Reduction Credit

To tackle the continued rise in operational costs related to the cost of energy consumption, Grantees under EIDA or under TIA are entitled to claim a credit up to 10% of the payments made to PREPA for net industrial electric energy consumption against its income tax on IDI. The credit starts with a base credit equal to 3% of the payments. Then two additional credits of 3.5% are available to exempt business with an average employment of 25 persons or more and if payroll exceeds \$500,000, respectively, for a maximum credit of 10%. Commencing in year 2013 the maximum credit allowed will be reduced at a rate of 1% per year, until year 2017.

The maximum amount of the credit is \$75 million dollars per year, up to a maximum of \$600 million dollars during a 10 year period. This translates to a first-come first-serve system in which businesses interested in the credit, must not delay in filing their claim.

This credit is not transferable and may be carried over until four years after fiscal year 2017-18.

Intellectual Property Transfer Credit

Exempted businesses under EIDA are entitled to claim a credit equal to 12% of the payments to nonresident persons of Puerto Rico, for use or right to use intangible property in the exempt operations in Puerto Rico. In the case of exempt businesses subject to the flat 8% income tax rate and the 2% withholding tax on royalty payments, the maximum amount of the credit is 2%.

This credit is not transferable and may be carried over up to 8 years. In its

operation, this credit serves to offset an exempted business' Puerto Rico income tax liability on its IDI by an amount equal to the withholding taxes paid on applicable payments to nonresident persons.

Strategic Projects Investment Credit

Grantees under EIDA or under TIA are entitled to claim a credit equal to 50% of their eligible investment in strategic projects against income tax on its IDI or against operational costs of the business related to electricity, water and sewage.

An eligible investment in strategic projects means the amount of cash used by the business or an affiliate in the design, development and construction of dams, reservoirs and all infrastructures necessary for their operation or for the operation of the strategic project. The funds may be obtained from a loan guaranteed by the exempt business, any affiliate and/or their assets.

The credit is limited to 50% of the income tax liability determined for the year (limitation is not applicable if credit is claimed against utilities). This credit is transferable and the moneys or properties received from the exchange of the credit are exempt from Puerto Rico income taxation up to the amount of the credit transferred. Further, any excess may be carried forward until exhausted.

The adjusted basis of any asset for which the credit is claimed must be reduced by the amount of the credit claimed. The moneys or properties received from the exchange of the credit are exempt, up to the amount of the credit transferred.

Industrial Investment Credit

Any person that makes an eligible investment is entitled to claim an income tax credit equal to 50% of the cash invested in the purchase of 50% or more of the stock or operating assets of an exempt business,

under EIDA or any incentives act, which is in the process of shutting down operations. This credit is not applicable to investments made with cash proceeds from a loan guaranteed by the exempt business or its assets.

The credit is to be claimed in at least two installments: 50% of the credit in the year when the eligible investment is made and the balance in subsequent years. It is limited to a maximum of eight million dollars per exempt business and 20 million dollars in the aggregate per fiscal year. The exempt business must maintain operations for at least 10 years or a recapture of the credit will be applicable.

The credit is transferable and any excess may be carried over until exhausted. The moneys or properties received from the exchange of the credit are exempt, up to the amount of the credit transferred.

In addition to the limitations that apply to the individual credits, EIDA provides a general limitation on the use of credits that requires that any small or medium size business pay a minimum of 1% of its IDI, a locally owned business pay a minimum of 3% of its IDI, and all others 4% of their IDI, taking into consideration the sums deposited with the Puerto Rico Treasury Department as taxes withheld on payments to nonresidents. Any decision to apply for a new grant or for a conversion under EIDA must be made after a thorough analysis of the benefits that could be applicable to a particular business. Certainly, the opportunities to reduce operational costs as provided by EIDA through these new tax credits must be seriously considered. **M&V**

¹EIDA Article 1, Section 5 (a).

²EIDA Article 1, Section 5 (b).

³EIDA Article 1, Section 5 (c).

⁴EIDA Article 1, Section 5 (d).

⁵EIDA Article 1, Section 5 (e).

⁶EIDA Article 1, Section 5 (f).

POWER BOOST: ENERGY INITIATIVES UNDER THE ECONOMIC INCENTIVES FOR THE DEVELOPMENT OF PUERTO RICO ACT

by: Xenia Vélez Silva, Special Counsel, McConnell Valdés Tax Practice Group, Former Secretary of the P.R. Treasury Department, Member, Steering Committee

Other than the flexible work week, which was taken off the table almost immediately after HR 4350 was introduced, no other provision of EIDA was more controversial or generated louder discussion than those relating to the production, use and distribution of energy. And little wonder – such provisions represent a tectonic shift in what had until then been Puerto Rico’s energy policy: 100% reliance on PREPA to meet the Island’s power needs. Private energy producers, such as Eco-Eléctrica in Peñuelas and AES in Guayama, were required to sell their production to PREPA, at a price essentially determined by PREPA¹ and, other than certain co-generation facilities intended to ensure the stable energy levels required by participating large exempt businesses, industry in Puerto Rico, like the population at large, has had to depend solely on PREPA.

And PREPA depends on fossil fuels, specifically oil, to produce over 70% of its electricity output.² Recent increases in the barrel of oil coupled with PREPA’s high operating costs, have caused Puerto Rico’s power cost per kilowatt to be inordinately higher when compared with that in other countries, increasing the cost of doing business here and, consequently, hobbling our ability to attract new operations to the Island.

To address this situation, EIDA adopts a multi-pronged approach, designed to: (1) alleviate the problem through, in effect, a ten-year energy subsidy; (2) promote the

Private energy producers, such as Eco-Eléctrica in Peñuelas and AES in Guayama, were required to sell their production to PREPA, at a price essentially determined by PREPA and, other than certain co-generation facilities intended to ensure the stable energy levels required by participating large exempt businesses, industry in Puerto Rico, like the population at large, has had to depend solely on PREPA

acquisition of energy efficient equipment by exempted businesses, as well as of power generation equipment by private businesses, whether for their own use, for use in common or for general distribution; (3) foster the construction and operation of power production facilities that use alternate fuel sources, particularly from renewable resources; (4) create a system to distribute privately-generated electricity through PREPA’s grid (known in the industry as “wheeling”); and (5) establish an agile, independent forum to address controversies between such private producers and PREPA.

Easing the Pain

Section 5(e) of EIDA is intended to provide instant relief from the high cost of electricity through a credit against the income tax on IDI. The credit ranges from 3% to 10% of the amounts paid by the exempted business to PREPA for the net electricity consumption of the eligible business during the taxable year, and is available to any exempted business, whether under the Act or prior laws, that is an “industrial client” of PREPA³.

The base credit is 3% of the amounts paid to PREPA for “net energy consumption” in connection with the operation of the eligible business. EIDA does not define what constitutes payments for “net energy consumption”; clearly, however, amounts “paid” to PREPA with other credits available under EIDA would not be eligible payments for this credit.

If the exempted business has had an average employment of 25 employees or more during the taxable year, it can claim an additional 3.5% credit. And if average payroll during the taxable year has been \$500,000 or more,⁵ the available credit is increased another 3.5%, for a total credit of 10%. Beginning in 2013, the maximum credit allowable will be reduced, as follows:

Taxable Year	Maximum Credit Allowable
2013	9%
2014	8%
2015	7%
2016	6%
2017	5%
2018 onward	0%

The credit is not transferable and cannot result in a tax refund. Unused credits can be carried over to subsequent years, but any unused credit at the close of fiscal year 2017-2018 (presumably the government's fiscal year ending June 30, 2018) may only be carried over to the next four (4) taxable years.

EIDA further provides that the aggregate amount of credits available is limited to \$75 million per government fiscal year, up to \$600 million for the 10-year life of the credit. No provisions are made as to how the limit will be allocated among claimants, which suggests that it may very well be on a "first come, first serve" basis.

Buy Energy Smart!

Similar to TIA, EIDA allows current expensing of costs associated with the acquisition or construction of buildings, structures, machinery and equipment to be used to manufacture the products or render the services declared exempt.⁷ Machinery

and equipment used in the manufacturing process are also exempt from Puerto Rico excise and sales and use taxes ("SUT"). EIDA has extended this excise and SUT exemption to energy efficient equipment, provided the equipment has been certified as such by the Energy Affairs Administration.⁸ Since the federal Environmental Protection Agency ("EPA") and the U.S. Department of Energy already have in place a program to identify energy efficient equipment⁹, it will be logical to assume that the Puerto Rico Energy Affairs Administration would accept such determination for Puerto Rico purposes.

Power for Business, By Business For Use by the Exempted Business

Under Section 5(d) of EIDA, an exempted business, whether under EIDA or prior law, that acquires machinery and equipment for the production of electricity from alternate fuel sources can claim as a credit 50% of the cash so invested. Generation equipment that uses coal or natural gas will qualify for the credit through June 30, 2011; thereafter, only machinery and equipment using renewable resources will be eligible for the credit.

An investment made before the filing of the exempted business' tax return for a taxable year (including extensions) will entitle the exempted business to claim the credit against its income tax on IDI for such taxable year. The credit is, however, limited to 25% of the exempted business' tax liability for the year. Moreover, no credit is allowable with respect to investments made with cash from a loan "guaranteed by the exempted business or its assets." Since only investments made by an exempted business qualify for the credit, this suggests that only self-financed power generation projects will qualify for this benefit.

For Sale to Others

The production of energy from alternate fuels, whether or not on a commercial scale, is an eligible business that qualifies for tax exemption under EIDA. Thus, for example, a business that supplies energy to a private industrial park, or even to a shopping center, could qualify for a tax exemption grant and the benefits afforded under the Act. From July 1, 2011, however, only production from renewable resources –solar, wind, geothermic, hydroelectric, biomass, solid waste, hydrogen and the like– will qualify as an eligible business.

The Section 5(d) credit described above is also available to energy-producers-for-sale, with one important distinction: the amount of the credit is limited to \$8,000,000 per exempted business, and \$20,000,000 in the aggregate per government fiscal year. It should be noted that Section 5(d) also provides that, in the case of energy-producers-for-sale, "the provision of paragraph (d) of Section 6 shall apply," as well as those in Section 6(e)(1), for purposes of the Section 5(d) credit. The intention presumably was to require that the basis of the assets be adjusted for the amount of the credit and, more importantly, to allow energy-producers-for-sale to sell or transfer the 5(d) credit. Unfortunately, while the reference to 6(e)(1) does result in basis adjustment, Section 6(d) relates to a requirement that PRIDCO's Executive Director certify that the business to be acquired is in the process of shutting down operations, which requirement is clearly inapplicable to an investment in machinery and equipment for the production of electricity. Unless and until EIDA is amended, however, the Section 5(d) credit remains untransferable.

If You Build It, They Will Come

The construction of power generation plants that use alternate fuel sources is a “Strategic Project” under EIDA. As such, it is an “eligible business” that qualifies for the tax exemption benefits under the Statute. Moreover, 50% of the cash invested by an exempted business (whether under EIDA or prior laws) or any of its affiliates in such a project will be available as all credit against income tax pursuant to EIDA Section 5(g).

Unlike the limitation placed for purposes of the Section 5(d) credit, the cash invested in the Strategic Project can be from financing, secured or guaranteed by the exempted business or its assets, or any affiliated company or its assets. The exempted business can use the Strategic Project credit to offset up to 50% of its income tax liability under EIDA or prior tax incentives laws; any unused credit can be carried over to future years until exhausted. The exempted business can also use this credit to offset its electricity, water and sewer expenditures.

Furthermore, the investor can sell or transfer the Strategic Project credit; the amounts received in exchange therefor will be exempt from Puerto Rico income taxation.

As in the case of the Section 5(d) credit, after June 30, 2011, only projects for power generation from renewable resources will constitute Strategic Projects.

No Double Dipping!

EIDA makes it crystal clear that the credits and, in the case of machinery and equipment for use in the exempted operation, the special deductions are mutually exclusive with respect to each investment. Thus,

no credit is available under Section 5 with respect to property that has been subject to the accelerated depreciation in Section 4(b), and no credit would be available under Section 5(d) for the acquisition of power generation equipment if the exempted business has included such costs as part of the Strategic Project for purposes of Section 5(g).

Wheeling and Dealing

EIDA orders PREPA to “identify and implement” a system that will allow exempted businesses that are private power producers under Section 2(d)(1)(H) to sell electric power to other businesses through wheeling, that is, using PREPA’s grid by January 2, 2010. Some have interpreted this language as merely requiring that a study be ready by such date. I beg to differ: the statutory language is clear - the system must be implemented by January 2, 2010. PREPA has 18 months to get ready.

Who Guards the Chicken Coop?

EIDA creates the Energy Affairs Administration under the Department of Economic Development and Commerce (the “DEC-EAA”) and orders that, no later than September 1, 2008, all powers, functions, employees, property, equipment and funds of the Administration Energy Affairs existing under the Department of Natural and Environmental Resources (“DRNA-AEA”) be transferred to DEC-EAA.

This would be just another internal government reorganization, except that the Act also empowers the DEC-EAA to:

1. Determine, approve and establish, if not agree to by the parties, the wheeling fees private generators will pay PREPA for use of the grid; and

2. Determine, approve and establish, if not agree to by the parties, the price at which PREPA will purchase electricity from private producers. In this regard, any controversy between the private producer and PREPA as to cost, terms and conditions for the purchase of power will be addressed by arbitration; The arbitrator will be named by the Executive Director of the DEC-EAA.

EIDA also creates Wheeling Committee, comprised of: one representative from each of the Department of Economic Development and Commerce, Department of Consumer Affairs, Puerto Rico Treasury Department, PREPA and DEC-EAA, and two representatives from the private sector to be name by Governor. This committee is intended to assist the Executive Director of the DEC-EAA to carry out his/her functions.

Clearly, EIDA has laid the ground work for a new era in the generation and distribution of energy in Puerto Rico. Ladies and gentlemen, let’s power up.^{M&V}

¹Federal law, specifically the Public Utilities Regulatory Policy Act of 1978, commonly known as PURPA, mandates that state-owned utilities, such as PREPA, purchase power from qualifying facilities at a price equal to the public utility’s “avoided cost,” that is, the estimated cost the utility would have incurred to produce an equivalent amount of electrical power. Since only PREPA can determine what its “avoided cost” is, in fact, determines the price at which it buys electricity from private power producers.

²Presentation by PREPA’s Executive Director at the 2007 Puerto Rico Credit Forum.

³An “industrial client” is one served at a transmission voltage of 38,000 to 115,000 volts and that has a contract with PREPA for such service.

⁴EIDA does not specify if the \$500,000 average payroll is on a weekly, monthly or quarterly basis; this issue must be addressed in regulations.

⁵Section 4(b) of EIDA.

⁶Section 9(a)(9) of EIDA.

⁷See, energystar.gov

RENEGOTIATIONS UNDER EIDA

by: Esteban R. Bengoa, Special Counsel, McConnell Valdés Tax Practice Group

EIDA provides that any grantee, under such statute or under previous ones, may request the renegotiation of its grant if it shows that it will:

- Increase its average employment¹ by twenty-five percent (25%) or more; or
- Make a substantial investment² in its existing operation (as of 07-01-08) of twenty-five percent (25%) or more in property devoted to industrial development.

Notwithstanding, EIDA provides that if a grantee cannot comply with any of those two requirements it can submit the necessary evidence to the Office of Industrial Tax Exemption purported to convince the Government to issue a new renegotiated grant with tax benefits adjusted to those provided under EIDA and within the limits set forth therein. So, technically a grantee can obtain a fixed tax rate on its IDI of less than four percent (4%), if approved by the Secretary of Treasury. Such renegotiated fixed rate shall be applicable only with respect to the annual IDI that exceeds the base period income for the duration of the old grant³.

The following grantees, however, will not be subjected to the “base period income” limitations described above:

- Grantees under TIA that are enjoying a fixed income tax rate of not greater than 4%, but not lower than 2%⁴. EIDA also provides that such grantees may obtain a renegotiated grant providing a fixed income tax rate on their net IDI

So, technically a grantee can obtain a fixed tax rate on its IDI of less than four percent (4%), if approved by the Secretary of Treasury. Such renegotiated fixed rate shall be applicable only with respect to the annual IDI that exceeds the base period income for the duration of the old grant

equal to the rate imposed in their TIA grant;

- Grantees engaged in “novel pioneer activities”;
- Grantees located in low or intermediate industrial development zone; and
- Grantees located Vieques and/or Culebra.

Base period income shall be taxed every taxable year pursuant to the provisions of TIA grant for the remainder of the exemption

period of such grant. Dividends or profit distributions of IDI, and the liquidation of the grantee shall also be taxed pursuant to The TIA grant.

IDI derived from 2(j) investments (“2(j) income”) shall also be subject to the provisions of the TIA grant, for the remainder of its exemption period, up to an amount not exceeding the 2(j) income of the base period, including, but not limited to, the tax on dividends or distributions of profits from industrial development income and the tax on liquidation applicable to the distributions of such 2(j) income. **M&V**

¹The average is computed based on the last 3 taxable years prior to the date of filing of the application for the grant. Employment is defined as the number of persons that are (i) residents of Puerto Rico (ii) who work on a permanent basis (iii) in full-time regular shifts rendering services in the operations of the grantee even if they are not directly on grantee’s payroll (such contracted employees – i.e., hired from others; e.g. leasing agencies, cafeteria, security guards, cleaning and maintenance services, but not including persons such as consultants or independent contractors).

²Existing investment is determined according to the book value of the property, devoted to industrial development, computed with the benefit of the allowable depreciation under the straight-line method, taking into account the useful life of said property determined according to Subtitle A of the PR Code, in lieu of any other accelerated depreciation allowable by law.

³“Base period income” is defined as the highest amount resulting from comparing the IDI for the last taxable year prior to the date of the application for renegotiation, excluding 2(j) investment income, with the annual average IDI computed under old grant, but excluding 2(j) investment incomes, for the three (3) taxable years with the highest industrial development income, of the five (5) taxable years prior to the date of filing of the application, or shorter applicable period.

⁴The Secretary of Development shall require, in exceptional cases, that the exempted business maintains an employment level equal to or greater than eighty percent (80%) of its average employment for the 3 taxable years prior to the application or may require a minimum tax payment equivalent to the average tax paid in said period.

“Base period 2(j) income” is defined as the annual average IDI derived from 2(j) investments for the 3 taxable years with the highest income from such 2(j) investments, of the 5 taxable years prior to the date of the application, or the shorter applicable period.

IN THE NATURE OF A CONTRACT...

by: Rafael Fernandez Suarez, Of Counsel, McConnell Valdés Tax Practice Group

Through the years grantees have had to deal with this phrase and struggle their way through the courts when defending against attacks from municipalities trying to collect outrageous deficiencies created by the never-short-of-ideas contingency fee advisors, or as commonly known,

Provided, that once a grant is issued under EIDA, no agency, political instrumentality, political subdivision, public corporation, or municipality, be it autonomous or not, of the Government of Puerto Rico that is not the Secretary of Economic Development or the Governor, may challenge the legality of said grant or any of its provisions

the “bounty hunters”. The uncertainty of having to engage in an adversarial role with governmental sub-units such as agencies, political instrumentalities, political subdivisions, public corporations or municipalities to enforce the terms of a contract executed through direct negotiation with the Executive Branch was presented to both, the Steering Committee and the Technical Committee while drafting EIDA, as one of the top impediments for additional investment in Puerto Rico. This article explores the impact of the steps that were taken to improve Puerto Rico’s economic incentive proposition in this regard.

The Grant as a Contract

The phrase “in the nature of a contract” has been a fixed source of problems in the tax incentives statutes for many years since it implied that the grants issued by the Commonwealth of Puerto Rico to an investor are not necessarily a contract but should be treated as such. This particular source of headache has been eliminated by EIDA.

Section 14 of EIDA ends the potential problem since it clearly indicates that the grants of tax exemption will be considered a contract between the grantee, its shareholders, partners or owners and the Government of Puerto Rico and said contract will be law among the parties. It also adds language that should be of help in the solution of many disputes with municipalities or other government agencies that may decide to challenge a particular clause in a tax grant by indicating that the grant will be interpreted liberally

in a manner consistent with the purposes of the statute. Further, it indicates that the Secretary of Economic Development has the discretion to include, in the name and in representation of the Government of Puerto Rico, such terms, conditions, concessions and exemptions which are consistent with the purpose of EIDA and that promote the creation of employment considering the circumstances of each case.

This, by itself, may not look significant, but when taken together with other provisions of EIDA and when compared with the language also included by the Legislature in the Autonomous Municipalities Act (indicating that when interpreting the authority given by the Legislature to the municipalities for the imposition of taxes in their jurisdiction the law should be interpreted liberally), provides fertile ground for new jurisprudence. The fact that it has been clearly stated that, in the execution of this contract, the Secretary is not limited to the boundaries created by the specific exemption provisions in the act and that, at his discretion, he could include additional specific terms, conditions, concessions and exemptions consistent with the purpose of EIDA is a major improvement over previous acts.

The End is in Sight

EIDA also includes an updated provision regarding the finality of the decisions and determinations of the Secretary. Although similar provisions were included in predecessor statutes, in the same paragraph EIDA adds a sentence to the effect that:

“Provided, that once a grant is issued under this Act, no agency, political instrumentality, political subdivision, public corporation, or municipality, be it autonomous or not, of the Government of Puerto Rico that is not the Secretary of Economic Development or the Governor, may challenge the legality of said grant or any of its provisions.”

To date, the first sentence of the paragraph has not persuaded Puerto Rico courts to force municipalities to abstain from

This new language provides that when a municipality has an objection regarding the approval of a grant, the Office of Industrial Tax Exemption will consider such objection and, as it deems necessary, will notify the parties and concerned agencies for the administrative action to be taken

challenging grants or their clauses. In fact, municipalities have argued that they are to be considered third parties affected by the Secretary’s actions of granting a particular benefit that may impact municipal taxation in any way. By including the second sentence in this same paragraph, the Legislature has achieved two goals. First, by specifically adding the agencies that cannot challenge the terms of a grant, including the municipalities, it adds to the general statement indicated in the first sentence to the effect that against the decisions of the Secretary there should not be any judicial or administrative review. Second, it clearly states that the municipalities are not a third party affected by the grant but are an integral part of the government of Puerto Rico which henceforth cannot challenge itself.

To further close the circle, and in consideration of the municipalities’ argument that the interagency consideration of a grant under predecessor legislation did not give municipalities an effective opportunity to be heard before the execution of a grant, the Legislature added a paragraph in Section 13 (B) of EIDA. This new language provides that when a municipality has an objection regarding the approval of a grant, the Office of Industrial Tax Exemption will consider such objection and, as it deems necessary, will notify the parties and concerned agencies for the administrative action to be taken. Once said objection is given the appropriate attention, the Director will render a determination as necessary and will submit the case to the Secretary for its final consideration. Although the Regulations under EIDA have not been approved as of this date, a procedure for an administrative hearing could be included under this paragraph to allow municipalities a final chance to be heard and present any evidence that would

be appropriate before a final decision is made in connection with the grant. By providing for this additional forum the disputes that could be raised in the future, once a grant is approved, are substantially reduced and the stability of the program could be improved.

Although without courts to uphold the law no amount of additional text in a legislation will eliminate all controversies that could be raised by a municipality or by government agencies or instrumentalities against a grantee of tax exemption, we understand that the provisions cited above will add a significant force in favor of granting finality and stability to Puerto Rico’s economic development program. In this regard, EIDA has taken great steps to provide the kind of stability that investors are looking for in an island that is trying to maintain its ground in the international arena. **MV**

¹ Certain contingency fee based arrangements are permitted to Puerto Rico municipalities pursuant to Art. 3.009 of the Autonomous Municipalities Act of 1991, Act No. 81 of August 30, 1991.

² Section 13 (f) of Act No. 135 and similar provisions of predecessor legislation stated that “Tax concessions under this Act will be considered in the nature of a contract between the concessionaire, its shareholders, partners or owners and the Government of Puerto Rico....”.

³ See Section 1 (3) of EIDA-Declaration of Public Policy, which reads “ Guarantee a relationship between the Industries and the Government of Puerto Rico, which is based in the stability, certainty and credibility...”, Section 13(a)(2)(B), which reads “In the case that any municipality raises any objection in connection with a draft of grant referred to it, the Office of Industrial Tax Exemption, will consider such objection, as it deem appropriate,..... and will notify the parties....for the pertinent action. Once the controversy is entertained, the Director will make the corresponding determination and will submit the case to the Secretary.....for its final consideration.” and Section 14(c)(1) which reads “...Provided, once a grant is approved under this Act, no agency, public instrumentality, political subdivision, public corporation, or municipality, be it autonomous or not, of the Government of Puerto Rico, except for the Secretary of Economic Development or the Governor, may question the legality of said grant or any of its provisions”.

⁴ Art 1.004 of the Autonomous Municipalities Act.

⁵ Municipal powers of taxation extend in the most part to property taxation under the Municipal Property Tax Act of 1991, municipal license taxation under the Municipal License Tax Act of 1973 and construction taxes under the Autonomous Municipalities Act of 1991.

SHOULD I BE TEMPTED INTO SWAPPING WITH EIDA?

by: Esteban R. Bengoa
Special Counsel, McConnell Valdés Tax Practice Group

Keeping a long marriage together is never an easy endeavor. Academy Award winning actress Simone Signoret once said that “chains do not hold a marriage together. It is threads, hundreds of tiny threads which sew people together through the years.” Politician James H. Boren said that “A dress that zips up the back will bring a husband and wife together.” Despite their opposite views on the subject, they share one thing: attraction is what keeps an enduring relationship going forward.

EIDA attempts just that: to lure new investors, yes, but also to attract existing grantees into continuing their already established relationship with Puerto Rico and to encourage them to convert their grants to EIDA.

EIDA provides that any grantee whose grant was issued under prior tax exception and/or incentives statutes may request¹ that its grant be converted to take advantage of the benefits of EIDA for the rest of its tax exemption period; subject, however, to certain limitations, to wit: (i) the grantee shows that it is in compliance with all applicable legal provisions, and (ii) the exemptions granted in the converted grant are not greater than those afforded under EIDA.

EIDA presents two alternate doors for grantees who wish to walk into its benefits. The first one: For grantees that have not commenced operations as of July 1, 2008; the second: For those enjoying incentives and exemptions under a grant issued on or before January 1, 2008. In both, the tax benefits on income, property, municipal license (“patente”), excises and SUT taxes of EIDA will step in. But, for those in need to walk through the second door, their access

to the income tax benefits will be restricted. Base period income limitations will escort such grantees during their first four years of their stay. So what can a grantee find in EIDA that will suit its needs?

In general, IDI derived under the converted grant will be either a fixed rate of 4% or 8% if the alternate tax regime is negotiated.² The two options are available without any specific investment/employment requirements. The income tax scenario (4% or 8%) to be applied to converted grant will be irrevocable once it is determined by the Secretary of Economic Development.

As stated, those grantees that are enjoying incentives and exemptions under a grant issued on or before January 1, 2008 will be subject -- under the converted grant -- to the tax following tax benefits and limitations of EIDA:

- The fixed income tax scenario (4% or 8%) available under EIDA shall only apply to the grantee’s excess net income (under the converted grant) over the average net income of the production and sales generated under the grant to be converted during the three (3) taxable years prior to the date of filing of the application for the converted grant (the “base period income”).
- Base period income shall be subject to the tax rates provided by the PR Code. That is, grantees will be exempted up to the limits provided in their respective tax exemption grants.
- The base period income shall be adjusted, reducing such amount by 25% annually, until reduced to 0 % by

the fourth taxable year of the effective date of the converted grant.

- In considering the applications for conversion, the Secretary of Economic Development (with the prior recommendation of governmental agencies and municipalities that issue reports on proposed converted tax grants) shall establish the terms and conditions that she/he deems necessary and convenient in the best interests of Puerto Rico, within the limits provided in EIDA, and may impose special employment requirements, and/or limit the percentage of exemption, the taxes to be covered under the converted grant, provide a fixed tax rate on IDI not higher than 7%, and/or require and provide any other term or condition necessary and convenient in accordance with the purposes of EIDA.
- Profits accumulated under the grant to be converted may be distributed after the effective date of the conversion in accordance with the tax treatment provided in such grant. Upon total liquidation, accumulated IDI may also be distributed according to the tax treatment provided in such grant.

So, the temptation of the additional benefits of EIDA should only catch your attention if -- together with the income tax adjustments and base period limitations -- they suit your business and tax model needs. **M&V**

¹The application for conversion needs to be submitted to the Office of Industrial Tax Exemption on or before June 30, 2009. The effective date of the converted grant may be set from the first day of the taxable year of the application, but not before July 1, 2008, and until the first day of the next taxable year, at the option of the grantee.

²The choice between tax rates on IDI affects the rates of Puerto Rico withholding taxes on certain payments to non-residents.

THUMBS UP TO CONSTRUCTION COMPANIES: CONSTRUCTION OF SELF-SUSTAINABLE COMMUNITIES AND AFFORDABLE INTEREST HOUSING INCLUDED AS ELIGIBLE BUSINESS

by: *Janelle Reyes,*
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With the enactment of EIDA, for the first time in the history of the Puerto Rico Tax Incentives Program, housing construction and development activities have been included as an eligible business. These activities consist of (i) construction of affordable interest housing and (ii) planning and development of self-sustainable or partially sustainable communities. This inclusion shows willingness to promote sustainable development and attention to economic, social, and environmental factors. It further provides new planning opportunities to housing developers and contractors.

The novelty of this eligible activity forces us to rethink the typical legal forms and tax structures used in the development and construction business in Puerto Rico, which are foreign to predecessor industrial incentives acts. Examples of these include, the use of Special Partnerships (which are ineligible as exempt businesses under EIDA), accelerated depreciation and the completed contract method of accounting. Thus, typical structures for these activities include the use of a pass-through or tax-free entity with the additional benefit of, subject to the requirements of the PR Code, allowing partners or shareholders to offset other income with initial partnership losses.

Qualifying Projects

Under EIDA, "Self-sustainable communities" are defined as housing projects with the capacity to satisfy their own energy, water and solid waste management needs. Whereas "partially sustainable" are those housing projects with capacity to satisfy at least 75% of their water needs, development of an adequate sanitary infrastructure, solid waste management needs and use of alternate techniques for production of energy to supply at least the common areas of the housing project.

Supplying power to a self-sustainable community requires the construction or installation of power plants certified to be used as a means of alternate energy production and as to their proper functioning in the location they are installed. Said certification must be issued by an Electrical Engineer or a Certified Electrician, both licensed and members of their respective professional associations, and registered with the Energy Affairs Administration. These professionals must have the specialized knowledge regarding installation of generation equipment based on any type of renewable energy.

Construction of affordable or private housing requires prior endorsement from the Department of Housing of Puerto Rico ("Department of Housing"). Upon receiving an application for endorsement, the Department of Housing must consider and issue a determination within 45 days. If no determination is issued within the terms provided, the application will be considered approved.

The Eligible Activity and Limitations on Benefits

Previously Ineligible Activity

When evaluating the potential benefits of EIDA, care must be taken to factor in certain limitations included in the statute. Section 3(f) of EIDA limits, during the first four years after the enactment of the law, the effectiveness of its reduced taxation on industrial development income for business that were previously ineligible for incentives under predecessor legislation. Nonetheless, the limitation specifically refers to the manufacturing or service activities of businesses described in Section 2(d)(1)(B) of EIDA, which deals with industrial units established with permanent character for the production of a manufactured product on a commercial scale.

As drafted, both activities in this category (the construction of affordable interest housing, and the planning and development of self-sustainable or partially sustainable communities) seem to be considered as services rendered within Puerto Rico. The consequence would be that the limitation of benefits for previously ineligible businesses would apply.

Pyramiding of Incentives

Lastly, EIDA provides that petitioners receiving tax benefits or incentives under any other special law of the Commonwealth of Puerto Rico may not be considered as an eligible business under this statute, with respect to the activity for which they enjoy such tax benefits or incentives.

Nonetheless, these same construction activities may qualify for certain incentives either directly granted by special laws of the U.S. Congress or by local agencies with funds granted by the federal government. A reading of the clear language of EIDA supports the position that an eligible business will be able to receive such tax benefits or incentives in addition to the benefits afforded to it by EIDA.

Planned Development

The Puerto Rico Industrial Development Company and the Puerto Rico Treasury Department are in the process of drafting regulations under EIDA. We expect that such regulations will address many of the items that are considered in this article. In the meantime, a thorough benefit analysis and careful planning of the structure with which to undertake a project for these new activities should be made in order to maximize the benefits that have been granted by the Government of Puerto Rico. **MV**

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