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## A New Incentives Law for Puerto Rico

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## **A New Incentives Law for Puerto Rico\*\***

On January 24, 1987, the Governor of the Commonwealth of Puerto Rico signed into law the Tax Exemption Act of 1987 (TEA). Thus began a new era of tax exemption.

In 1948 Puerto Rico embarked on a program to encourage economic development in the Commonwealth through private enterprise. Popularly known as Operation Bootstrap, this program provided tax exemptions principally to stateside corporations able to avail themselves of federal tax benefits accorded U.S. corporations principally engaged in the active conduct of a trade or business in a possession of the United States.<sup>1</sup> In addition to providing total exemption from Puerto Rico corporate income taxes for a period of years, the legislation also provided exemptions from Commonwealth property tax and certain municipal property taxes, excise taxes, and licenses. In general, these tax exemptions were available for a corporation manufacturing items not produced on a commercial scale in Puerto Rico prior to 1947.<sup>2</sup>

The 1948 law was reenacted in 1954 with modest changes. In 1963 the tax exemptions were liberalized and expanded to provide new exemptions for periods of time ranging from ten to twenty-five years.<sup>3</sup> In 1978 Puerto Rico's total tax exemption program was changed into a partial tax exemption program, with the exemptions scaling down every five years under the exemption grant from 90 percent to 75 percent, and for the

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\*\*The Editorial Reviewer for this article is Susan F. Harris.

1. Section 262 of the Revenue Act of 1921, Pub. L. No. 67-98, 92 Stat. 227 (reenacted as section 931 of the Internal Revenue Code of 1954, modified as § 936 in 1976, and significantly revised in 1982, with further modifications made by the Tax Reform Act of 1986 (Pub. L. No. 99-514, 100 Stat. 2085) [hereinafter I.R.C.].

2. Industrial Tax Exemption Act of 1948, P.R. LAWS ANN. tit. 13, §§ 221-238 (1955).

3. P.R. LAWS ANN. tit. 13 §§ 252-252j (1977).

extended period grants from the 75 percent to 65 percent and finally to 55 percent.<sup>4</sup> The 1987 Tax Exemption Act retains the partial exemption, but discards the scaling down of the partial exemption.<sup>5</sup> It also makes provisions for prolonging exemption beyond the normal periods with a view to preserving jobs.

## I. Who Qualifies for Exemption?

Nine categories of entities qualify for TEA benefits. The principal categories are industrial units, service units, owners of properties used by exempted businesses, research operations, film production makers, and energy suppliers.

### A. INDUSTRIAL UNITS

Surviving for over a decade and still available for tax exemption is the industrial unit that manufactures a product on a commercial scale that was not produced in Puerto Rico prior to 1947.<sup>6</sup> In view of the economic progress and product development that the world has encountered since 1947, it appears most products made today in commerce would qualify. If, however, the product was one of those made in Puerto Rico prior to 1947, it can still qualify for TEA benefits if it was not produced on a commercial scale in Puerto Rico during the three calendar years preceding the year in which the request for exemption is filed.

The second principal, surviving category qualifying for TEA benefits is the bona fide industrial unit that is established on a permanent basis for the purpose of producing at least one of the many items specifically designated as qualifying.<sup>7</sup> An "industrial unit" is essentially a plant, a factory, machinery, or an ensemble of machines and equipment capable of performing the major operations involved in the production of the items that have qualified for TEA benefits and been identified as such in the TEA grant.<sup>8</sup> Manufacturing or producing a product on a commercial scale means making the product for sale on the market in the normal course of business, in amounts and at prices that justify the operation as a going concern.<sup>9</sup> All or part of the manufacturing process of products covered by an exemption grant, as well as the production of one or more of the

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4. *Id.* §§ 255–255m, (Supp. 1987).

5. Puerto Rico Tax Incentives Act, P.R. LAWS ANN. tit. 13, § 256 (Supp. 1987) [hereinafter TEA].

6. *Id.* tit. 13, § 256a.

7. §§ 256a(d)(2), (d)(3); see Appendix for a listing of the designated items.

8. § 256a(h).

9. § 256a(f).

products, may be performed under a subcontracting arrangement in Puerto Rico.<sup>10</sup> Furthermore, an exempted business need not perform all of the manufacturing or production functions in Puerto Rico if it is not economically feasible to do so.<sup>11</sup>

## B. SERVICE UNITS

Production on a commercial scale, through a service unit in Puerto Rico, of any designated type of service to be used outside Puerto Rico qualifies for TEA benefits.<sup>12</sup> A service unit is a bona fide office, business, or establishment with the necessary capability and expertise to carry out the designated services. At least 80 percent of all of the employees of the service unit must be residents of Puerto Rico. A customer of the service unit may be in Puerto Rico, but the use of the service by that customer must be destined outside Puerto Rico.

## C. OWNERS OF PROPERTY USED BY EXEMPT BUSINESS

Owners of property, real or personal, used by an exempt business in its exempted operations, qualify for their own exemption as an exempted business ("landlord grants").

Ownership of real property (e.g., a factory building), including land and improvements, or parts thereof, made available to and used or owned by an exempted business in its operations may be covered by a TEA grant.<sup>13</sup> Furthermore, any additions of not less than 25 percent of the area of the principal plant will qualify as well. Similarly, ownership of an ensemble of machinery and equipment used by an exempted business can qualify for TEA benefits.<sup>14</sup>

## D. RESEARCH OPERATIONS

Entities engaged in breeding animals for experimental use in scientific and medical research laboratories, and similar uses, qualify for TEA benefits.<sup>15</sup> Operations in the nature of scientific or industrial research and development for the development of a new product or industrial pro-

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10. § 256a(h)(1).

11. § 256a(d)(3). This provision works in harmony with the significant business presence tests of I.R.C. § 936(h)(5)(B)(ii)(II)(Supp. 1988), which only requires that 65 percent of the direct labor costs for making a product be incurred in Puerto Rico. *See also* Treas. Reg. § 1.936-5(a), q.a. 7, ex. 2 (1986).

12. § 256a(d)(4). The various activities that qualify for service exemption are shown in Appendix B.

13. § 256a(b)(1).

14. §§ 256a(b)(2), (d)(5).

15. § 256a(d)(6).

cesses, as well as improvements thereto, likewise qualify for TEA benefits.<sup>16</sup>

#### E. FILM PRODUCTION MAKERS

Entities engaged in the filming and production of short length and feature length movies can qualify for TEA benefits.<sup>17</sup>

#### F. ENERGY SUPPLIERS

Finally, any industrial unit established for the purpose of producing energy on a commercial scale for consumption in Puerto Rico can qualify for TEA benefits.<sup>18</sup> The unit is required to use renewable sources from within Puerto Rico. "Renewable sources" include, but are not limited to, vegetation and other forms of biomass, solid wastes, and direct solar energy and wind. The unit must also obtain the prior approval of the Puerto Rico Office of Energy if the exemption is to be granted.

#### G. SUCCESSOR AND PREDECESSOR RELATED BUSINESSES

If a company has enjoyed or is currently enjoying tax exemption benefits under the TEA or prior laws, subsequent tax exemption grants may contain terms and conditions tied in with the earlier grants. The issuance of the later grant (that of the successor business) is subject to the condition that operations under the earlier grant or grants (that of the predecessor business) not have ceased within the six-month period preceding the request for the later grant.<sup>19</sup> The operations, with respect to the earlier grant, if not terminated prior to the six months preceding the request for the new grant, will be required to maintain a level of employment on an annual average basis equivalent to that which it had for the three tax years preceding the year in which the new exemption request is filed.<sup>20</sup> This requirement can be waived in the case of extraordinary circumstances. The employment of the new operations, after the first year, must be greater than 25 percent of the average annual employment of the earlier grant or grants for the three years preceding the year in which the new grant is applied for.<sup>21</sup> Failure to meet these conditions is typically sanctioned by intercompany tax accounting adjustments, whereby the deficiency in jobs of the predecessor is remedied by the successor assigning the commen-

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16. § 256a(d)(7).

17. § 256a(d)(8).

18. § 256a(d)(9).

19. § 256f(a).

20. § 256f(a)(2).

21. § 256f(a)(3).

surate income to the predecessor.<sup>22</sup> This may or may not result in a tax deficiency, depending upon whether the predecessor's grant is still in effect or not, and if in effect, the tax exemption rate compared to that of the successor grant.

A predecessor and successor business may not share or use common physical facilities, machinery and equipment, inventory, supplies, trademarks, patents or marketing outlets, when they have a value of \$25,000 or more.<sup>23</sup> This restriction, however, may be waived by the Governor when it is established that it is in the best interests of the Commonwealth of Puerto Rico to do so in view of the nature of the facilities, the number of jobs involved, the payroll, the required investment, the geographical location where the project is to be established, or other factors that merit the waiver. Failure to meet these conditions is also typically sanctioned by intercompany tax accounting adjustments, whereby the income commensurate with the unauthorized use of the assets is assigned to the predecessor.<sup>24</sup> A resulting tax deficiency, depends upon whether the predecessor's grant is still in effect or not, and if in effect, the tax exemption rate compared to that of the successor grant.

A business is a successor business if it will be carrying out an economic activity substantially similar to that specified in the exemption grant of the predecessor business.<sup>25</sup> A prior grant is deemed to be that of a predecessor business if there is a common proprietary ownership of at least 25 percent between the two businesses.<sup>26</sup> A single corporation seeking an additional tax exemption grant would constitute a successor and predecessor business within itself if the activities to be carried out under the second grant constitute an economic activity substantially similar to that specified in an earlier grant.

## II. The TEA Benefits

The principal tax exemption benefits under the Puerto Rico Operation Bootstrap program continue to be with respect to income tax, property tax and certain municipal excise and license taxes.

### A. INCOME TAX

Except for the industrial development income that an entity earns from investing its exempted profits in stipulated eligible activities, an exemption

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22. § 256f(b)(1).

23. § 256f(a)(4).

24. § 256f(b)(2).

25. § 256a(1).

26. § 256a(k).

grant confers a 90 percent exemption from Commonwealth income tax.<sup>27</sup> The applicable tax rates for income tax purposes are the income tax rates applicable on January 24, 1987.<sup>28</sup> The industrial development income that the entity earns from investing the funds generated by its exempted operations, in stipulated eligible activities, is fully (100 percent) exempt.<sup>29</sup>

The industrial development income of an exempted business is comprised of:<sup>30</sup>

- the net income derived from the operations covered by its exemption grant;
- the income earned on investment of its exempted profits in stipulated eligible activities;
- the net income derived from the sale of patents, royalties or other rights related to activities or intangible property resulting from its exempted operations;<sup>31</sup>
- currency exchange profits attributable to the sale in foreign countries of products covered by its exemption grant;<sup>32</sup>
- dividends or partnership profits paid out of exempted profits of an exempt corporation or partnership;<sup>33</sup> and
- business interruption insurance proceeds, provided that the employment level is not reduced as a result of the incident that gave rise to the insurance payment.

### 1. *Special Deductions*

For any year in which an exempt business has net industrial development income of less than \$500,000 and has maintained an average employment of no less than fifteen persons for that year, the first \$100,000 is fully tax exempt.<sup>34</sup> If exempt businesses under common control qualify

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27. § 256b(a).

28. § 256b(p).

29. § 256b(j)(3); *see* Appendix C for the stipulated investments.

30. § 256a(a).

31. To the extent that this income is derived from exploitation of the intangible property outside Puerto Rico, this net income would be fully exempt when earned by a corporation not organized under the laws of the Commonwealth. P.R. LAWS ANN. tit. 13, §§ 3119(c)(4), 3231(c)(1976).

32. To the extent that these profits are realized from contracts entered into and liquidated outside Puerto Rico, this net income would be fully exempt when earned by a corporation not organized under the laws of the Commonwealth. 13 P.R. LAWS ANN. Reg. art. 3119(a)-6. However, as such the gain would be deemed to be from a U.S. source for federal income tax purposes and, therefore, subject to federal income tax. I.R.C. § 865(e) (Supp. 1988).

33. Subsequent distributions by the exempt business receiving the dividend or partnership profits distribution are exempt from further Commonwealth income tax. § 256c(h).

34. § 256b(a)(1).

for this \$100,000 full exemption, the \$100,000 exemption must be allocated among them. For this purpose, exempt businesses are considered to be under common control when more than 50 percent of the exempt business is owned by the same stockholders. A single corporation with more than one exemption is entitled to only one full exemption of \$100,000.

In the alternative, an exempt business may deduct an additional 15 percent of its production payroll when computing its net industrial development income as long as its net income for the year is less than \$20,000 per production job.<sup>35</sup> For this benefit there is neither an industrial development income cap nor minimum employment requirement. The sole requirement is the per production job net income cap of \$20,000. This special deduction, however, may only be applied to the extent of one-half of the pretax industrial development income. Any unused amount is lost. It may not be carried forward for future application.

The production payroll is comprised of the salaries and wages paid to company personnel who are directly related to the manufacturing of the products covered by the exemption grant. It does not include executive salaries nor payments for services rendered by independent firms.

## 2. *Net Operating Losses*

Losses realized by an exempt business in operations covered by its exemption grant may be carried forward and applied against the net industrial development income of subsequent years.<sup>36</sup> The loss, however, is deductible only to the degree that the income would have been taxable in that year. For example, under the general rule, a loss realized when the exempt business is 90 percent exempt will be deductible against the taxable portion of the net industrial development income of a subsequent year only to the extent of 10 percent of the loss. The loss realized under one exemption grant of a corporation with multiple exemption grants, however, may be used as a deduction against the taxable portion of net industrial development income generated by any of its exemption grants.

Losses incurred in operations not covered by an exemption grant are deductible only against income not covered by an exemption grant.<sup>37</sup> The application of these losses is controlled by the Puerto Rico income tax laws.

If an exempted business is realizing exempt profits while its parent company is realizing operating losses that absorb the profits of the exempted business, and the parent company is under a bankruptcy pro-

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35. § 256b(a)(2).

36. § 256b(k)(2).

37. § 256b(k)(1).



ceeding, the Governor may suspend tax payment requirements on the net industrial development income when earned (the current tax).<sup>38</sup> The amount of suspended tax is limited, nevertheless, to that portion of the taxes otherwise due that the average employment of the exempt business for the year in which the consolidated loss was realized bears to the average employment of the exempt business for the preceding three tax years. The suspended tax is subject to recapture if the parent company recovers its losses.

### 3. *Special Additional Tax*

In addition to the income tax otherwise due on the 10 percent of the net industrial development income realized by an exempt business, if the exempt business generates industrial development income in excess of \$1 million in any taxable year, it is required to pay a special additional tax of .00075 on its sales volume.<sup>39</sup> The special additional tax is limited to one-half of 1 percent (.005) of the net industrial development income.

## B. PROPERTY TAX

All property of an exempt business used in the development, organization, construction, establishment, or operation of the economic activities covered by its exemption grant is 90 percent exempt from Commonwealth and municipal real and personal property tax.<sup>40</sup> Intangible personal property in the nature of a patent or production license or trademark is fully exempt. Likewise, personal property used by a service unit in the nature of stocks, bonds, or other securities is also fully exempt. The applicable tax rate is the rate in force on the January 1 date of appraisal and imposition of the tax.

## C. OTHER TAXES

An exempt business is conferred a 60 percent exemption on municipal license fees, excise taxes, and other municipal taxes levied by municipal ordinance.<sup>41</sup> The applicable tax rate is that rate which would otherwise be imposed on the date the decree is signed. Accordingly, municipal tax levied by ordinances issued subsequent to the decree signature date would not be applicable.

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38. § 256b(a)(3).

39. § 256b(a).

40. § 256b(b).

41. § 256b(c).

### III. Duration of Benefits

The length of the exemption period depends on where the exempt business is established in Puerto Rico.

#### A. GENERAL RULES

The period of exemption ranges from ten to twenty-five years, as follows:<sup>42</sup>

<b>Industrial Development Zone</b>	<b>Years</b>
High	10
Intermediate	15
Low	20
Vieques and Culebra	25

The exemption period starts, for income and municipal license taxes, at the time the exempt business is deemed to have commenced operations. The exempted business is expected to commence operations on a commercial scale within one year from the decree signature date.<sup>43</sup> Extensions for commencing operations may be granted for just cause up to five years from that date. The business is fully exempt from the municipal license tax during the period that the decree may authorize for carrying out the construction or establishment of the business.

The property tax exemption also starts from the date of commencement of operations. The exemption begins on January 1 of the year the exempt business owns or uses its industrial development property for the first time. The industrial development property of the exempt business, however, is fully exempt during the period the decree may authorize for carrying out the construction or establishment of the business.

#### B. FLEXIBLE EXEMPTION PERIODS

An exempt business under the TEA has the option of selecting the specific years to be covered under its exemption grant with respect to industrial development income.<sup>44</sup> For example if the company has a fifteen-year exemption grant and it elects not to have the benefits apply to its fourth year of operations, upon entering its fifth year of operations it will

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42. § 256b(d).

43. § 256h(h).

44. § 256b(f).

still have twelve years of exemption with respect to its industrial development income remaining.

Losses incurred in a suspended year may be carried over and applied as a carry forward loss deduction only against industrial development income generated under the same grant for which the suspension was elected.<sup>45</sup> Nevertheless, the funds that may be invested in stipulated eligible activities to give rise to fully exempt income include the funds generated in a suspended year.<sup>46</sup>

#### C. OWNERS OF PROPERTY USED BY EXEMPT BUSINESS

As a general rule, the exemption period of landlord grants, with respect to industrial development income, is suspended when the industrial development property is on the market to be leased to an exempt business, is vacant, or is leased to a nonexempt business.<sup>47</sup> A landlord's grant exemption period for income tax and municipal license tax is measured and consumed solely on the basis of the time that it is used by an exempt business. The property tax exemption runs the normal course for expiration once it begins, despite the fact that the facilities are not being used by an exempt business for the period on a consistent basis.

If the exemption grant of the tenant expires prior to the expiration of the landlord's grant, the landlord's grant will continue and will expire in due course. An exception to this rule is triggered when the tenant's grant is revoked and the landlord had knowledge of the facts that give rise to the revocation.

If the landlord's grant period expires before the expiration of the grant of an exempt manufacturing business using the industrial development property, the landlord may obtain a 50 percent exemption on property tax for the period while the property continues to be used by the exempt manufacturing business tenant.

#### D. INTERRUPTION IN THE EXEMPTION PERIOD

If an exempt business ceases operations for just cause, it may subsequently resume operations without the period during which it was not in operation being discounted from its total exemption period.<sup>48</sup> In order to do so it must demonstrate to the satisfaction of the Governor that the reopening of its operations as an exempt business will be in the best social and economic interests of the Commonwealth.

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45. § 256b(k)(3)(B).

46. § 256a(j)(4).

47. § 256b(g)(2).

48. § 256b(1).

#### IV. Distributions

Generally, the TEA reviews and taxes four methods by which industrial development income may be distributed or realized by investors in an exempt business. The first two methods entail transfers of the income to the investors either through current or liquidating dividends. To encourage the reinvestment of funds generated by exempt operations, the tax otherwise imposed on these two forms of distribution is reduced upon compliance with stipulated investment procedures. The third method, looked upon as a distribution of exempt profits, is the sale of stock of an exempt business. Special tax treatment is also accorded gains realized on the sale or exchange of stock of a corporation operating under an exemption grant. Finally, a distribution is deemed to have been made of industrial development income meriting preferential tax treatment when payments are made by the exempt business for the use of intangible property in the operations covered by the exemption grant.

##### A. CURRENT DIVIDENDS

Dividends paid out of industrial development income earned under a TEA grant are subject to a flat income tax of 10 percent.<sup>49</sup> Commonly referred to as the "tollgate tax," the tax is withheld from the dividend payment and remitted directly to the Puerto Rico Treasury Department.

Dividends paid by an eligible business are deemed to be paid out of its industrial development income.<sup>50</sup> This rule applies even after its exemption grant has expired. The eligible business may elect to specify the distribution as being paid, in whole or in part, from other earnings and profits. Nevertheless, if the eligible business has accumulated earnings and profits when its exemption period begins, dividends are irrebuttably attributed to that source until those prior earnings have been fully distributed. When paying a dividend from earnings and profits accumulated after the commencement of its operations under its exemption grant, the eligible business may specify the amount, year from which to be distributed, and nature of the income to be distributed.

The tax withheld and remitted to the Puerto Rico Treasury on behalf of individual stockholders is fully creditable by those individuals against the Puerto Rico income tax due under the Puerto Rico Income Tax Act even though the dividends are not included in the taxable income of the individual.<sup>51</sup> As a practical matter, this provision can, with adequate planning, make such dividends fully exempt for Puerto Rico residents.

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49. § 256c(a).

50. § 256c(e).

51. § 256c(a)(1).

The Governor may waive the tax on current dividends paid out of industrial development income earned in its first five years of exemption by an exempted business engaged in an exempt manufacturing activity which requests or obtains its exemption grant by January 24, 1988.<sup>52</sup> This waiver is also available to an exempt business engaged in exempt operations in connection with leather or imitation leather goods, as well as leather tanning and finishing operations. It is also available for wearing apparel operations, provided the cutting is done in Puerto Rico (unless the Governor permits otherwise), and glove and shoe operations.

In order to qualify for this waiver, the exempt business must establish operations by January 24, 1989. The Governor, however, may extend this to January 24, 1990. In addition, the applicant must establish to the satisfaction of the Governor that the waiver is merited in view of the substantial employment it will provide, the total investment required, and any other benefit that the Commonwealth will receive. The exempt business is also required to invest 25 percent of its industrial development income for each of the first five years of exemption in eligible activities (see Appendix C) and hold the respective year's investment for five years.

### 1. *Investment Credits*

By complying with certain investment requirements, an exempt business organized under the laws of one of the states may employ an investment strategy that will allow it to reduce its tollgate tax considerably.

No tollgate tax is due on dividends distributed under the following circumstances.

1. Dividends paid from interest earned on:<sup>53</sup>
  - a. notes of the Commonwealth or any of its instrumentalities or political subdivisions;
  - b. mortgages secured by the Puerto Rico Housing Bank and Finance Agency, acquired after March 31, 1977;
  - c. loans or other mortgage guaranteed securities granted under any pension or retirement system of a general character established by the Puerto Rico Legislature, or the municipalities, agencies, instrumentalities, and corporations of the Commonwealth, acquired after March 31, 1977.
2. Dividends paid from industrial development income invested in the above investments for more than eight years.<sup>54</sup> Investments made in obligations of the Commonwealth or any of its instrumentalities

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52. § 256c(a).

53. P.R. LAWS ANN. tit. 13, § 3022(b)(7) (1976 & Supp. 1987).

54. *Id.* §§ 3026(a)(1)(B), 3231(a)(2)(A).

or political subdivisions held for more than five years may be sold or otherwise disposed of by the exempt business without its being deemed to have violated the eight years holding period requirement as long as within thirty days of disposing of the original investment it reinvests the principal in any of the above three stipulated investments.

3. Dividends paid from industrial development income invested in certain housing obligations issued under the auspices of the Government Development Bank for Puerto Rico for more than eight years.<sup>55</sup> Equivalent amounts of industrial development income, however, may be distributed tollgate tax free over the eight years that the exempt business is required to hold the investment. The amount that may be distributed free of the tollgate tax is that amount of the investment that the actual holding period bears to the requisite eight years holding period.
4. Dividends paid from years in which one half of the total amount of industrial development income earned that year is invested in eligible activities for ten years.<sup>56</sup>
5. Dividends paid from years in which one half of the industrial development income earned that year is invested in the following items for more than eight years:<sup>57</sup>
  - a. bonds and other obligations of the Commonwealth, its instrumentalities, or political subdivisions;
  - b. securities guaranteed by the Commonwealth, its instrumentalities, or political subdivisions, or by pension or retirement funds of the Commonwealth;
  - c. mortgages on housing guaranteed by the Housing Bank and constructed after January 1, 1986.

If any of the above investments is redeemed before the eight years holding period is met, the eligible business is deemed to have met the requisite holding period.

In addition, the eligible business has the opportunity to tailor the tollgate tax to a rate lower than 10 percent, without reducing it to zero on a portion or all of its industrial development income for any year. The tollgate tax is reduced by 10 percent for each year over five years, but not over ten years, on industrial development income invested in eligible activities for over five years.<sup>58</sup> For example, if any eligible business has net industrial

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55. *Id.* §§ 3026(a)(1)(C), 3231(a)(2)(B).

56. § 256c(b)(2).

57. § 256c(b)(4).

58. § 256c(b)(1).

development income, after payment of the current income tax, of \$1 million and invests \$200,000 for over five years (but not for over six years), the tollgate tax on the \$1 million is as follows:

Amount not invested	\$800,000 @ 10%	\$80,000
Amount invested	\$200,000 @ 5%	<u>10,000</u>
Total tollgate tax		\$90,000
Effective tollgate tax rate		<u>9%</u>

If the \$200,000 were to be invested for over ten years, the result would be as follows:

Amount not invested	\$800,000 @ 10%	\$80,000
Amount invested	\$200,000 @ 0%	<u>-0-</u>
Total tollgate tax		\$80,000
Effective tollgate tax rate		<u>8%</u>

If the amount invested is at least one half of the industrial development income for the year, the 10 percent per annum credit is applicable to all of the industrial development income of the year, and not just the amount thereof which is invested.<sup>59</sup>

For example, if an eligible business has net industrial development income, after payment of the current income tax, of \$1 million and invests \$500,000 for over five years (but not for over six years), the tollgate tax on the \$1 million is as follows:

Amount not invested	\$500,000 @ 5%	\$25,000
Amount invested	\$500,000 @ 5%	<u>25,000</u>
Total tollgate tax		\$50,000
Effective tollgate tax rate		<u>5%</u>

If the \$500,000 were to be invested for over nine years (but not for ten years), the result would be as follows:

Amount not invested	\$500,000 @ 1%	\$ 5,000
Amount invested	\$500,000 @ 1%	<u>5,000</u>
Total tollgate tax		\$10,000
Effective tollgate tax rate		<u>1%</u>

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59. § 256c(b)(2).

It should be noted, however, that had the 50 percent investment in this last example been held for the additional period of months to qualify as having been held for ten years or had it been invested in the stipulated government obligations for more than eight years, the tollgate tax would have been zero.

The amount not required to be invested may be distributed at any time. If the investment is not held for the requisite period to qualify the distribution at the rate at which it was made, the eligible business is liable for the tax differential.<sup>60</sup>

## 2. *Special Credits*

Three special credits are also available to be used to reduce the TEA tollgate tax. They are generated by plant expansion, local purchases, and research and development in Puerto Rico.

A credit against the tollgate tax may be taken in the amount of 5 percent of the investment by the eligible business made by payment of principal of any debt incurred by it in acquiring, constructing, or expanding real property used by it in its activities covered by its grant in excess of its investment in such property as of January 1, 1986.<sup>61</sup>

A credit is also available to be taken against the tollgate tax in the amount of 10 percent of the incremental purchases the eligible business makes of products manufactured in Puerto Rico from unrelated parties.<sup>62</sup>

A special credit is also allowed in the amount of 25 percent of the incremental research and development undertaken by the eligible business in Puerto Rico with respect to new products or industrial processes.<sup>63</sup>

The three special credits may not be taken concurrently. The credits, or any amount thereof not taken may be carried forward indefinitely. Their annual application is limited to one half of the tollgate tax.

## 3. *Distributions by Exempt Corporations or Partnerships*

Dividend or partnership profit distributions of industrial development income made by an exempt business to its stockholders or partners are subject to the tollgate tax only once.<sup>64</sup> If the exempt business is itself a partnership or joint venture, the partners or coventurers (which can be corporations) are considered themselves to be an eligible business. Under these circumstances, distributions from the partnership to the partners do not give rise to a tollgate tax. The tollgate tax is incurred when the

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60. § 256c(c).

61. § 256c(d)(1).

62. § 256c(d)(2).

63. § 256c(d)(3).

64. § 256c(h)(2).



respective partners in turn distribute that industrial development income to their respective stockholders or partners.

If, on the other hand, the eligible business does not include its equity holders, the sole tollgate tax incident arises when the eligible business distributes the industrial development income to those equity holders.<sup>65</sup> For example, a dividend payment by an eligible business from industrial development income to a corporate stockholder is taxed when that dividend is paid. The subsequent distribution, in turn, by the corporate stockholder to its stockholder is not subject to Puerto Rico tax.

#### B. LIQUIDATING DIVIDENDS

A distribution of industrial development income upon complete liquidation of an exempt business is generally subject to a 10 percent tollgate tax.<sup>66</sup> The tax consequences on accumulated earnings and profits distributed in a complete liquidation, not comprised of industrial development income, is controlled by the Puerto Rico Income Tax Act.<sup>67</sup>

If a current dividend distribution would have been taxed at a lower rate because the eligible business was pursuing an investment commitment that qualified the current distribution for the lower tollgate tax, the lower tax rate would be applicable to the liquidating dividend comprised of the industrial development income that would have qualified for the lower rate.<sup>68</sup>

Furthermore, if at the time the liquidating distribution is made, the requisite holding period for the investments made has not yet been met, the transferee of the investments may fulfill compliance with that requirement by holding the investments for the remaining period necessary to meet the holding period requirement.<sup>69</sup>

#### C. SALE OR EXCHANGE OF STOCK

Gain or loss realized on the sale or exchange of stock of a corporation that has an exemption grant is recognized in the same proportion as the industrial development income is subject to tax.<sup>70</sup> Thus, if a corporation is an exempt business with an exemption grant in effect conferring 90 percent income tax exemption, 10 percent of the gain realized on the sale of the stock of that corporation is subject to Puerto Rico income tax. If the seller is an individual residing in Puerto Rico who is required to pay

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65. § 256c(h)(1).

66. § 256e(a).

67. § 256e(e).

68. § 256e(b).

69. § 256e(f).

70. § 256c(f)(1).

tax on the gain to any jurisdiction other than Puerto Rico, the gain is subject to a flat 10 percent tax.<sup>71</sup>

If the sale of the stock occurs after the exemption grant has expired, the recognized gain is the lower of the book value of the stock or the taxable portion of the accumulated industrial development income as of the expiration date of the grant, less distributions subsequently made therefrom and the basis of the stock.<sup>72</sup> Any profit in excess of this amount is subject to the rules of the Puerto Rico Income Tax Act.

#### D. ROYALTIES

Payments made by an exempt business for the use or privilege to use patents, formulas, technical knowledge, or other intellectual or similar property in Puerto Rico is subject to a tollgate tax of 10 percent.<sup>73</sup>

### V. Special Items

The TEA contains a couple of provisions new to the incentives law approach for stimulating economic development. One supplants an earlier related law, while the other responds to the need to encourage more capital investments from individuals in the private sector.

#### A. EXPORTS TO FOREIGN COUNTRIES

The TEA incorporates and enhances a 1964 law that granted certain exemptions to persons exporting to foreign countries products made in Puerto Rico.<sup>74</sup> For purposes of this provision of the TEA, a foreign country is any country other than the United States, its territories, and possessions.

Under the TEA, persons exporting products manufactured in Puerto Rico to foreign countries are conferred a 90 percent exemption from

71. This appears to be an attempt to circumvent the United States 1986 Tax Reform Act change to the source of income rules whereby nonresident U.S. citizens are subject to federal income tax on gains realized outside the United States unless a tax of not less than 10 percent is paid on that gain to a foreign jurisdiction, including Puerto Rico. I.R.C. §§ 865(g)(2), (h)(3). Nevertheless, the way the TEA directs itself to the issue, the 10 percent tax imposed could be looked upon as a soak-up tax, in which case it would not be considered a foreign tax. Treas. Reg. § 1.901-2(c).

72. § 256c(f)(2).

73. § 256c(i). Unless clarified or amended, this can cause a significant problem to stateside corporations operating in Puerto Rico under I.R.C. § 936. As part of the price for receiving the tax sparing benefits of I.R.C. § 936, certain of these companies are required to make payments to affiliated entities for the use of such intellectual property. I.R.C. § 936(h)(5)(C)(i)(I). Such companies requesting TEA exemption grants should seek to have their grant clarify this.

74. P.R. LAWS. ANN. tit. 13 § 253 (1986).

income tax.<sup>75</sup> In addition, a 50 percent exemption on Commonwealth and municipal real and personal property taxes and on municipal license fees and other municipal taxes is conferred.

The exemption is for fifteen years, and begins with the tax year for which the taxpayer duly notifies the Puerto Rico Secretary of the Treasury and the Director of the Office of Industrial Tax Exemption of its intent to avail itself of this provision of the law. This notification must be filed no less than sixty days prior to the close of the tax year for which the election first applies. Unlike the request for a tax exemption grant under the broad provision of the TEA, this export exemption election is less problematic in its processing.

Current and liquidating distributions are subject to the same terms and conditions of an exempt business that has obtained an exemption grant. That is, distributions of earnings and profits from the export operations are subject to the 10 percent tollgate tax. That tax may be reduced or eliminated, however, by compliance with the investment criteria that allow the tollgate tax on distribution by eligible businesses with an exemption grant to be reduced or eliminated. An exempt business with an exemption grant may elect the benefits of the export election once its exemption grant expires.

#### **B. CAPITAL INVESTMENT LOSSES**

Individuals are allowed a deduction on their individual income tax return filed under the Puerto Rico Income Tax Act for losses realized on certain capital investments in an exempt business.<sup>76</sup> In order for the loss to be deductible, the operations of the exempt business must have been financed, in part or in whole, or guaranteed by the Economic Development Bank for Puerto Rico. The investment must also have been authorized by that government development bank.

The Economic Development Bank will determine at what time the investment constitutes a loss. The deduction for the loss may not exceed one half of the individual's net income for the taxable year in which the loss is claimed. That portion of the loss that cannot be taken because of this annual limitation may be carried forward indefinitely until fully used.

### **VI. Grant Extensions, Updates, and Revisions**

The TEA continues the trend to encourage businesses exempt under prior laws to voluntarily become covered by the most recent law. It also

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75. § 256b(o).

76. § 256b(k)(4).

continues the preferred treatment traditionally accorded certain industries which are understood to be highly labor intensive.

A. EXTENSION OF GRANTS FOR TEXTILE, APPAREL,  
LEATHER, AND SHOE OPERATIONS

At any time before the due date of the Puerto Rico income tax return for the year in which its exemption grant expires, an exempt business that manufactures textiles, wearing apparel, shoes, or articles made from leather or imitation leather may file a request for an additional ten years of exemption.<sup>77</sup> The request should be accompanied by data establishing full compliance with its current decree and the applicable laws.

During the extended ten-year period the exempt business is conferred a 90 percent income tax exemption on its industrial development income. It is conferred a 75 percent exemption with respect to the Commonwealth and municipal real and personal property taxes and on municipal license fees and other municipal taxes.<sup>78</sup> It is required to maintain an average employment during the ten years of no less than 80 percent of its average employment for the three taxable years preceding the extension.<sup>79</sup>

If the exempt business received its decree under the 1978 Industrial Incentives Act, where it was conferred an exemption on a scaling down basis from 90 percent for five years and 75 percent for the next five years, and it is still in its first five-year period, this extension may be requested prior to the due date for filing the Puerto Rico income tax return for the fifth year of its current exemption grant.<sup>80</sup> An exempt business in its second five-year period at the 75 percent exemption level, after having had the first five years at the 90 percent exemption level, may also apply for the ten-year exemption conferring the 90 percent exemption on income tax and 75 percent exemption on all other taxes.<sup>81</sup> If for the first five years of exemption under the 1978 law, based upon negotiations at the time of obtaining its current grant, the exemption accorded the exempt business was less than 90 percent then the tax rate for the ten additional years accorded by the TEA will be the rate at which the current grant provided exemption for the first five years of its term.<sup>82</sup>

Current and liquidating distributions of industrial development income accumulated as of December 31, 1986, by exempt businesses that qualify for this ten-year extension are subject to the tollgate tax provisions of the

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77. § 256b(m).

78. § 256b(m)(1).

79. § 256b(m)(3).

80. § 256b(m)(2)(A).

81. § 256b(m)(2)(B).

82. § 256b(m)(B).

law under which its current grant was issued.<sup>83</sup> Dividend distributions of industrial development income accumulated after that date are also covered by the law under which the current grant was issued, whereas liquidating distributions of post-1986 accumulated industrial development income are covered by the TEA provisions.<sup>84</sup>

## B. CONVERSIONS

An exempt business, operating under an exemption grant issued pursuant to an earlier law, may request permission to avail itself of the TEA.<sup>85</sup> The conversion must be requested by January 24, 1988, and may be effective either for the full tax year in which requested, or any part thereof, or for the immediately following tax year.<sup>86</sup>

If the exempt business, including service units, is operating under an exemption grant issued after December 31, 1984, and had not operated under an exemption grant prior to then, it may request to convert its grant to one issued under the TEA for the period of time remaining under the current grant.<sup>87</sup> The exemption accorded under the conversion grant will be fixed for that remaining period at the same percentage in effect in the current grant for each of the taxes.<sup>88</sup>

If the exempt business is operating under a grant issued before January 1, 1985, it may request conversion of its current grant to one issued under the TEA for the period of time remaining under the current grant. If the Governor exercises the discretion accorded him by the TEA, upon satisfaction that to allow the conversion would be in the best socioeconomic interests of the Commonwealth, the exemption accorded under the conversion grant will be fixed for that remaining period at the same percentage in effect in the current grant for each of the taxes.<sup>89</sup>

If the exempt business is operating under an exemption grant issued after January 1, 1985, which was obtained as a result of negotiations with respect to operations covered by a grant issued before that date, it may also request conversion of its grant to one covered by the TEA. The percentage of exemption to be accorded under the converted grant, however, is subject to the discretion of the Governor and will depend upon the facts and circumstances that will allow the Governor to determine

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83. § 256b(m)(C).

84. § 256b(m)(4).

85. § 256b(i).

86. § 256b(i)(8).

87. § 256b(i)(1).

88. This could be more advantageous vis-à-vis the municipal license tax which was fully exempt under the 1978 law, while it is only 60 percent exempt under the TEA.

89. § 256b(i)(2).

that the rate conceded is in the best socioeconomic interests of the Commonwealth.<sup>90</sup>

In any event, all conversion grants are subject to the Governor setting special terms and conditions. These can include either special employment requirements or imposing limits on the tax exemption percentages or taxes covered.<sup>91</sup>

The current distribution of all industrial development income accumulated as of the conversion date, and accumulated thereafter, is subject to the current distribution provisions of the law under which the grant was issued.<sup>92</sup> Distributions made in total liquidation of the exempt business are covered by the provisions of the law under which earned. Industrial development income accumulated prior to the effective date of the conversion of the current grant are, upon total liquidation of the exempt business, taxed pursuant to the law under which the current grant was issued.<sup>93</sup> The liquidating distributions made from industrial development income accumulated after the effective date of the conversion are covered by the provisions of the TEA.

Upon conversion of a grant issued under prior law to one covered by the TEA, the exempt business can generally avail itself of the provisions of the TEA that are not inconsistent or in conflict with the provisions thereof.<sup>94</sup> For example, in addition to the provisions concerning distributions, the payroll deduction available under converted grants is limited to the payroll deduction allowed under the prior law under which the current grant was issued.<sup>95</sup>

### C. RENEGOTIATED GRANTS

In lieu of converting its grant, an exempt business operating under an exemption grant issued pursuant to prior law, may renegotiate its grant.<sup>96</sup> Renegotiation will not be considered by the Governor unless the exempt business can demonstrate that as a result of the renegotiation it will increase its employment by at least 25 percent of its average employment during the three taxable years preceding the year in which the request for renegotiating its current grant is filed. Renegotiation will also not be considered unless the business can show that it will make a substantial investment in its current operations that will help to maintain the economic and labor stability of the

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90. § 256b(i)(3).

91. § 256b(i)(4).

92. § 256b(i)(5), (i)(6).

93. § 256b(i)(7).

94. § 256b(i)(9).

95. § 256b(a)(2)(C).

96. § 256b(h).

industrial unit or any other factors or circumstances that will advance the socioeconomic interests of the Commonwealth.

Renegotiation will take into consideration the employment of the exempt business, the place where it is located, the additional investment to be made and the jobs to be created, the remaining period of exemption under the current grant, the tax benefits already received, and the financial capacity of the exempt business. The renegotiated grant may impose, among other things, specific employment requirements, a period of exemption, and a percentage of exemption limitations.

The current distribution of all industrial development income accumulated as of the effective date of the renegotiated grant, and accumulated thereafter, is subject to the current distribution provisions of the law under which the grant was issued. Nevertheless, if the employment of the exempt business under the renegotiated grant will exceed 50 percent of its average employment during the three taxable years preceding the year in which the request for renegotiation of its current grant is filed, the Governor may waive the tax on current dividends paid out of industrial development income earned in the first five years of the renegotiated grant. In addition, the applicant must establish that the waiver is merited in view of the total investment required and any other benefit that will be received by the Commonwealth.

If the renegotiation occurs by January 24, 1988, industrial development income accumulated prior to the effective date of the renegotiated grant may be distributed in total liquidation pursuant to the provisions of the law under which the current grant was issued. Industrial development income accumulated after the effective date of the renegotiated grant distributed in total liquidation of the exempt business is covered by the TEA provisions. If the renegotiation takes place after January 24, 1988, the TEA provisions with respect to distributions made in total liquidation of the exempt business apply to all of the industrial development income of the exempt business, irrespective of when earned.

#### D. GENERAL EXTENSIONS

An exempt business, irrespective of under which law its grant was issued, may request an extension of its grant for ten additional years.<sup>97</sup> The request for this extension must be filed within the eighteen-month period terminating on the due date of the Puerto Rico income tax return to be filed for the year in which its exemption grant is otherwise due to expire. The request should be accompanied by data establishing full com-

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97. § 256b(c), (j).

pliance with its current decree and the applicable laws. A second extension of an additional ten years may also be requested.<sup>98</sup>

The general extension accords an income tax exemption of 75 percent with respect to its industrial development income.<sup>99</sup> Income earned on investments in eligible activities continues exempt at 100 percent. The exemption with respect to the Commonwealth and municipal real and personal property taxes and on municipal license fees and other municipal taxes is 50 percent.<sup>100</sup>

The current distribution of industrial development income accumulated as of the effective date of the extended grant is subject to the current distribution provisions of the law under which the current grant was issued.<sup>101</sup> Industrial development income accumulated after the effective date of the extension is subject to a tollgate tax of 5 percent.<sup>102</sup> If, however, the exempt business invests at least one half of the industrial development income it earns in any year during the extension period for at least five years, current distributions from that year or years are subject to a tollgate tax of only 2 percent. Failure to hold the investment for the requisite five years subjects the distributions to the 5 percent tax rate.

Industrial development income accumulated prior to the effective date of the extension may be distributed in total liquidation pursuant to the provisions of the law under which the current grant was issued.<sup>103</sup> Industrial development income accumulated after the effective date of the extension distributed in total liquidation of the exempt business is covered by the TEA provisions.

The exempt business is required to maintain an average employment during the ten years extended period of no less than 80 percent of its average employment for the three taxable years preceding the extension.<sup>104</sup> This requirement, however, may be adjusted, dispensed with, or otherwise modified when the exempt business establishes, to the satisfaction of the Governor, that extraordinary circumstances so merit. Extraordinary circumstances contemplate a cause of exceptional nature, such as strikes, war, action of the government or the elements, fire, or any other cause beyond the control of the exempted business.<sup>105</sup> During the extension period, the exempt business can generally avail itself of the

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98. § 256b(j)(8).

99. § 256b(j)(1).

100. § 256b(j)(2).

101. § 256b(j)(4).

102. § 256b(j)(3).

103. § 256b(j)(5).

104. § 256b(j)(6).

105. § 256a(n).



provisions of the TEA which are not inconsistent or in conflict with the provisions relating to the extension period.<sup>106</sup>

## VII. Requesting Exemption

### A. PROCESSING EXEMPTION REQUESTS

Application for exemption under the TEA is filed, under oath, with the Office of Industrial Tax Exemption (OITE).<sup>107</sup> The Director of the OITE is authorized to hold public or administrative hearings with respect to a request for exemption if he deems such hearings necessary.<sup>108</sup> Upon obtaining exemption, the exempt business is required to carry out its exempted operations substantially in the manner represented by it in the application for exemption.<sup>109</sup> Substantial changes in the way it carries out the operations may be approved by amendment to the grant.

Copies of the application for exemption must be sent to the Economic Development Administration, which is required to file a report sustaining the eligibility of the applicant for exemption under the law.<sup>110</sup> A copy of the application is being sent to the Puerto Rico Treasury Department and to those agencies that would have an interest in the eligible project in view of its nature.

Upon receipt of the eligibility report from the Economic Development Administration, a draft of the exemption grant must be prepared by the OITE and circulated to the interested agencies, as well as to the Secretaries of the Department of Justice and of the Department of Labor and Human Resources. The Governor, however, may approve the grant without having received comment from the various agencies. As in prior laws, a tax exemption grant issued under the TEA is considered to be in the nature of a contract between the exempt business and the Commonwealth.<sup>111</sup>

No requests for exemption under prior law may be filed as of January 24, 1987.<sup>112</sup> Grants issued under the 1978 program may continue to be amended pursuant to that law. Applications filed under prior law before January 24, 1987, may continue to be processed under that law or under the TEA, at the election of the applicant.

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106. § 256b(j)(7).

107. § 256f(e).

108. § 256f(c).

109. § 256f(g).

110. § 256f(j).

111. § 256f(f).

112. § 256k.

## B. DENIAL OF EXEMPTION

An exemption request may be denied if it is determined that the proposed operations will not result in the best socioeconomic interests of the Commonwealth.<sup>113</sup> Among the factors to be taken into consideration in making this decision to deny the request for exemption are the nature of the physical facilities, the number of jobs, the amount of the payroll, the amount of the investment, the place where the project is to be located, and its environmental impact.

An exemption request may also be denied if it is determined that the proposed project is in conflict with the public interest of the Commonwealth.<sup>114</sup> Proposals that would be considered to be in conflict with the public interest are those that:

- substantially and adversely affect the employees of an enterprise under related control operating in any state of the United States;<sup>115</sup>
- entail an applicant not considered to be organized as a permanent bona fide business, in view of the reputation of the persons controlling it; or
- compete or replace, because of the exemption, other operations in Puerto Rico not eligible for exemption.

In the last case, however, exemption may be conferred if it is determined that by doing so substantial benefit will be derived by the Commonwealth in view of the investment, technology, and new job opportunities involved. Upon doing so, the adversely affected other operations may also be granted exemption.

An exemption grant may be issued limiting the benefits thereof to production for export only when it is determined that local demand for the product is being adequately met.<sup>116</sup>

An applicant whose request for exemption has been denied may request reconsideration from the Governor. The request should be filed within ninety days of having received the notification of denial, and should be accompanied by the pertinent facts and arguments in response to the denial.

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113. § 256g(a).

114. § 256g(b).

115. Whereas the specific closing of a stateside plant in order to open exempt operations in Puerto Rico would be a cause of public interest concern, if the definitive decision is to close the stateside plant and go elsewhere, among the alternatives of which is Puerto Rico, the public issue concern would typically not be as prevalent.

116. § 256g(e).

All decisions and findings of the Governor with respect to a request for exemption are final. No judicial or administrative appeal or other proceeding is available.<sup>117</sup>

### **VIII. Revocation of an Exemption Grant**

An exemption may be revoked for cause.<sup>118</sup> The exempt business, however, is entitled to a hearing before the Director or before a Special Examiner appointed for the purpose of the hearing. The result of the hearing is to be presented to the Governor with recommendation for action. In addition, the interested agencies may similarly file reports for the Governor's action.

#### **A. PERMISSIVE REVOCATION**

A grant may be permissively revoked under three circumstances:

- failure by the exempt business to comply with its obligations under its grant, the law, or the regulations;
- failure by the exempt business to commence operations on a timely basis; and
- failure by the exempt business to produce the exempted products on a commercial scale, or suspension of operations for more than thirty days.

Suspension of operations for more than thirty days may be approved by the Governor.<sup>119</sup> In absence of the approval, the grant terminates as of the date of the infraction by the exempt business.

#### **B. MANDATORY REVOCATION**

An exemption grant is subject to mandatory revocation if it has been obtained through false or fraudulent representation about the nature of the eligible business, the nature or extent of the manufacturing or production process performed in Puerto Rico, the use to be given to the industrial development property, or any other facts or circumstances that were taken into consideration in the approval of the issuance of the grant.<sup>120</sup> Violation or attempted violation of the TEA successor-predecessor provisions is also cause for mandatory revocation.

A mandatory revocation is effective retroactively to the commencement of the receipt of benefits under the grant. Accordingly, all taxes become due with the corresponding interest and penalties.

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117. § 256j(a).

118. § 256g(c).

119. § 256g(c)(1)(C).

120. § 256g(c)(2).

The determination by the Governor to invoke a mandatory revocation is subject to judicial review.<sup>121</sup> In order to procure the judicial review, the affected exempt business must file an appeal with the Superior Court of Puerto Rico, San Juan Part, within thirty days after the final decision or adjudication by the Governor. Pending action by the court, the effectiveness of the mandatory revocation may be suspended if the exempt business places a bond with the Secretary of the Treasury for all taxes due, plus interest and penalties. The decision of the Superior Court is subject to review by the Puerto Rico Supreme Court.

### **IX. Transfers of an Exempt Business**

If a change, direct or indirect, in the control of an exempt business is carried out without the prior approval of the Governor, with limited exception the exemption grant benefits automatically terminate as of the date the change took place.<sup>122</sup> The Governor, however, may reinstate the grant retroactively to the date it had otherwise terminated.

Changes in proprietary interest of the exempt business which do not result in a change, direct or indirect, in the control of the business are required to be reported to the Director of the OITE within thirty days. The only such change not required to be reported is the transfer of shares of a corporation that owns (namely, shares of the parent company) or conducts (namely, the exempt company) an exempt business that does not result in the acquiring stockbroker becoming a 10 percent or more holder of the stock of the company. This exception, however, must have been previously granted by the Governor.<sup>123</sup>

### **X. Reporting Compliance Requirements**

The TEA includes a series of reporting compliance requirements that appeared in prior laws. It also adds some new ones that will assist the Government in measuring the effectiveness of the program attaining the Operation Bootstrap goals.

#### **A. GOVERNMENT AGENCY REPORTS**

The OITE and the Economic Development Administration are respectively required to render two reports each year to the legislature on the

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121. § 256j(b).

122. § 256d.

123. As a matter of procedure, publicly held companies establishing subsidiaries to operate in Puerto Rico under the TEA should request this waiver from reporting stock transfers as part of their grant.

activities and achievements of the tax exemption program.<sup>124</sup> The reports are to cover the exemption applications filed and those approved, the businesses established, compliance with the commitments by the exempted businesses, and the effects of the grants on the reduction of unemployment in Puerto Rico.

The Secretary of the Treasury is required to submit a report every six months to the legislature on the tax behavior of the exempted businesses, including a comparison with the preceding year and a forecast for the next three years.

## B. EXEMPT BUSINESS REPORTS AND COMPLIANCE

As in the past, an exempt business is required to file an income tax return for its exempted operations separate and apart from the income tax return it may otherwise be required to file covering operations and income realized outside the scope of its exemption grant.<sup>125</sup> It is also still required to maintain in Puerto Rico its accounting records with respect to its exempted operations, as well as any other records with respect to all other Puerto Rico taxes to which it is subject.<sup>126</sup>

The exempt business is further required to file duly completed reports and surveys for the preparation of economic studies and statistics requested by the Economic Development Administration, as well as by the Commissioner of Finance.

## XI. Conclusion

The TEA responds to the changes that have occurred in the federal taxation of companies operating in Puerto Rico, and Puerto Rico's own facts and circumstances since approval of the 1978 program. Opportunities have been enhanced, although not necessarily simplified. The accountability requirements imposed on the government agencies will allow a fine tuning of Operation Bootstrap on a more current basis, which should allow Puerto Rico to continue to meet its challenge of the times.

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124. § 256h(k).

125. § 256i(a).

126. § 256i(b).

## Appendix A

### Designated Articles (§ 256a(e))

(e) Designated articles. This term includes the following manufacturing operations:

1. Articles of straw, reed and fibers, as well as ceramics and artificial flowers.
2. Sporting goods and fishing tackle.
3. Bedsprings, mattresses, and rugs.
4. Articles of leather or imitation leather, as well as leather tanning and finishing of skins.
5. Bodies or chassis for trailer vehicles.
6. Candles, soaps and paints of all kinds.
7. Food products that are substantially processed, would have been eligible for tax exemption under prior laws, or which were not produced on a commercial scale in Puerto Rico prior to January 1, 1978.
8. Products derived from slaughtering including, among others, the products of the slaughtering of fowl and rabbits, and the packing house products that use the products derived from slaughtering operations as raw material.
9. Cigars and cigarettes.
10. Perfume, cosmetics and other toilet preparations.
11. Wearing apparel, provided the cutting is done in Puerto Rico, unless exempted by the Governor for just cause; hosiery, gloves and shoes.
12. Edible oils and fats.
13. Polishing and other processing of precious and semiprecious stones.
14. Glass articles and metal containers.
15. Paper board, paper pulp and boxes, cardboard containers and other cardboard receptacles, except corrugated cardboard, boxes, containers and receptacles produced from the same.
16. Animal food.
17. The publishing of books when they are printed in Puerto Rico; and the printing and binding of books. When the facilities are also used to produce other types of printing such as, among others, brochures, magazines, newspapers, forms and cards, the industrial unit shall be eligible for exemption only on the net income of the business derived from the publication, printing and binding of books.

18. Distilled spirits for export and shipping to the United States if they are considered products of Puerto Rico under the applicable federal laws. The applicable period shall be 15 years, regardless of the area in which the industrial unit is located. In the case where they have been produced in Puerto Rico prior to 1975, the following shall be eligible for tax exemption:
  - a. the income obtained as a result of the increase over the annual average production in proof gallons, for the five years of the business ended on June 30, 1974;
  - b. the real and personal property acquired after June 30, 1975, that are being used to obtain such increase; and
  - c. the license fees, excises and other municipal taxes applicable to the volume of business resulting from such increase.
19. Production of sand derived from industrial processes through the grinding of stone, which complies with standards of applicable specifications.
20. Commercial fishing operations to supply raw material to the canneries or packing-houses established in Puerto Rico, and as raw material for the elaboration of other products in Puerto Rico.
21. All types of furniture, as well as wooden articles that are carved, elaborated or lathed, including souvenirs, decorations, balustrades and other wooden articles for decorative or functional use.
22. Processing, dubbing and editing of short and feature-length films.
23. Planting and cultivation through the process of hydroponics, as well as intensive cultivation of mollusks, crustaceans, fish or other aquatic organisms through the process of agriculture, provided these operations are carried out under standards and practices approved by the Department of Agriculture of the Commonwealth of Puerto Rico or by the Corporation for the Development and Administration of Marine, Lacustrine and Pluvial Resources, as the case may be.

## **Appendix B**

### **Designated Services (§ 256a(i))**

Designated services include any of the following economic activities:

1. Commercial and mercantile distribution.
2. Investment banking and other financial services.
3. Publicity and international public relations, excluding an income that is generated from contracts with the Commonwealth of Puerto Rico, its agencies, departments, instrumentalities and municipalities.
4. Economic, scientific or managerial and auditing consultation.
5. Commercial art and graphic services.
6. Insurance and reinsurance.
7. News syndicates.
8. Catalog sales.
9. Assembly, bottling and export packing operations.
10. Electronic data processing centers.
11. Repair and general maintenance of maritime vessels and aircraft, as well as any type of machinery and equipment, including electric, electronic and watch repair equipment.
12. The production of engineering and architectural blueprints and plans and related services to be used in the construction of projects to be located outside Puerto Rico.
13. Photographic, dental, optical and ophthalmological laboratories.
14. Prefabricated houses of any matter.
15. International marketing centers devoted principally to providing, through rental charges, service charges or other type of agreement, space and services, such as secretarial, translation and data processing, communications, marketing and other consulting services to enterprises engaged in, or otherwise related with, the purchase and exportation of products or rendering of services for markets outside Puerto Rico, including export and marketing companies, aggregate and commercial consulates, government agencies responsible for foreign trade, exchange and exhibition centers for products and services.



## Appendix C

### Designated Eligible Activities (§ 256a(j)(1))

1. The interest and dividends on eligible funds invested by the exempted business in:
  - a. obligations issued or guaranteed by the Commonwealth of Puerto Rico, or any of its instrumentalities or political subdivisions; and loans or loan participations issued or guaranteed by the same;
  - b. loans for the financing of construction, acquisition or improvements to housing in Puerto Rico;
  - c. loans for the construction, expansion or acquisition of buildings or land, and for the acquisition of machinery and equipment or for working capital utilized in exempted business. The borrowing exempted business shall not qualify for the benefits of this subsection (j) with respect to the investments it shall make, up to the amount of the unpaid balance of its loan for working capital;
  - d. obligations issued by the Puerto Rico Conservation Trust, provided that upon issuing said obligations the Secretary has not revoked his determination of the same as a non-profit trust pursuant to the terms and conditions established by the Commissioner;
  - e. capital obligations or preferred stock, as authorized by Act No. 55, 12 May 1933, as amended, known as Puerto Rico Banking Act, as well as capital obligations issued by financial institutions, provided that the total capital raised through capital obligations or outstanding preferred stock be invested in Puerto Rico pursuant to the terms and conditions established by the Commissioner;
  - f. obligations issued by any subsidiary of the Farm Credit Banks of Baltimore directly or indirectly engaged in financing loans to farms and farmers in Puerto Rico, including loans to rural residents to finance rural housing, loans to cooperatives owned and controlled by farmers and engaged in marketing or distributing farm produce, the purchase of materials, to providing services to farm businesses and the acquisition of loans or discounts of notes previously granted;
  - g. loans for the financing of maritime and air operations directly connected with industry and commerce in Puerto Rico, including but not limited to the money used in the construction, acquisition and maritime vessels or ships;

- h. any other obligation or loan that the Commissioner may designate, with the approval of the public sector members of the Financial Board and the Administrator;
  - i. the Commissioner is hereby authorized to issue regulations necessary for the administration of this subsection, with the approval of the public sector members of the Financial Board and the Administrator.
2. Interest on eligible funds deposited or invested by exempted business in institutions engaged in the banking business, savings and loan associations, saving securities brokerage houses and other similar institutions doing business in Puerto Rico which the Commissioner, with the approval of the public sector members of the Financial Board and the Administrator, determines to be institutions eligible to receive such funds. The regulation on eligible institutions shall take the following factors, among others into consideration:
- a. that the eligible funds are invested in Puerto Rico by the institutions receiving them;
  - b. that the aforementioned funds are channeled into activities that stimulate production, income and employment in the Commonwealth of Puerto Rico, such as commercial, industrial, agricultural and construction loans or loans for the conservation of natural resources.

Regulations promulgated under equivalent provisions of previous laws shall continue in effect until the new regulation hereby provided is approved.

In the event the Commissioner determines that an institution has ceased to be eligible to receive said funds, such determination shall not prevent the interest derived therefrom, invested prior to the institution's loss eligibility, from continuing to be treated as eligible interests hereunder, until the maturity of said investment.

3. Income obtained from investments that qualify under this subsection and under the regulations hereby provided, as well as the securities attesting to such investments, shall be totally exempted from income taxes, from the payment of property taxes and municipal license fees, excises or municipal taxes. The expiration of the exemption or extension period hereunder of the borrower or the lender prior to the maturity date of the loan, or even when the exemption period of the borrower has not commenced, shall not prevent the interest paid by the borrower or derived by the lender from being treated as income from eligible funds hereunder.

