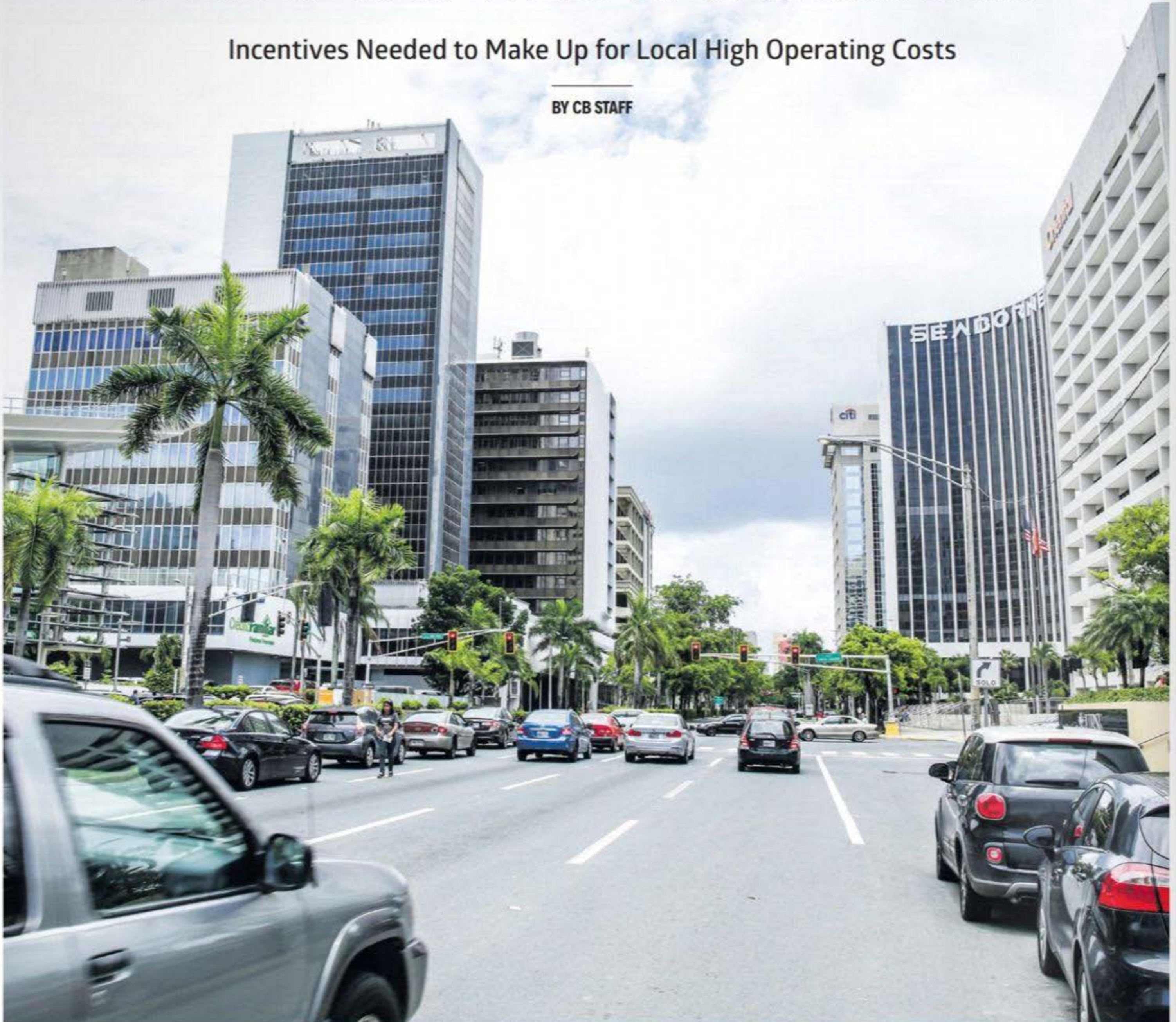


Act 60 Advocates:

Incentives Needed to Make Up for Local High Operating Costs

BY CB STAFF



Despite criticism of tax breaks granted to attract investors to Puerto Rico, the incentives, particularly those aimed at luring export businesses and high net worth individuals, have helped certain local manufacturing operations stay afloat and even prosper while making the island a hub for cryptocurrency and blockchain entrepreneurs.

Puerto Rico's Financial Oversight and Management Board (FOMB) issued an analysis last week of the commonwealth Treasury Department's latest tax expenditures report detailing the loss of government revenue as a result of tax breaks and preferential tax rates to foster local investment and job creation.

The Treasury report identifies 438 tax expenditures that amount to \$23.7 billion, compared with tax expenditures of \$22.5 billion in 2017. Almost two-thirds of the expenditures, \$14.8 billion, are in the form of preferential tax rates for foreign-owned manufacturing companies offered as incentives for operating in Puerto Rico.

Other large tax expenditures include sales and use tax exemptions on food (\$820 million), health services (\$785 million) and educational services (\$717 million), and individual income tax preferential rates under the former Act 22 of 2012, known as the Individual Investors Act (\$342 million).

"In particular, Puerto Rico has (by far) the highest corporate income tax expenditures mainly due to preferential tax rates for foreign corporations, which are not common in US states. Tax expenditures of this magnitude put significant direct pressure on the sustainability of Puerto Rico's underlying tax structure," said the general counsel of the Financial Oversight and Management Board (FOMB), Jaime A. El Koury, in a June 10 letter, which was accompanied by an analysis, addressed to Treasury Secretary Francisco Parés Alicea.

"These wide-spread, ad hoc incentives force the Commonwealth to impose a highly distortionary rate structure (with corporate tax rates as high as 37.5%) on the remaining business base," El Koury continued. "Further, due to the negotiated nature of the tax structure and final tax liability, there is considerable uncertainty and high transaction costs imposed in the process. Uncertainty, transaction costs and a rather predatory default tax structure produces a very poor business investment climate."



The island is a hub for cryptocurrency and blockchain entrepreneurs.

Opportunity Seen

However, two entrepreneurs who have benefitted from the Puerto Rico Incentives Code (Act 60 of 2019)—one a manufacturer and blockchain application developer who relocated to the island, and another who is in food distribution and industrial and retail chemical manufacturing—told Caribbean Business that the tax breaks have allowed them to establish and expand their businesses on the island.

After watching a YouTube video about Puerto Rico's tax incentives, Benjamin M. Brown, a software engineer who had worked in Chicago in health care and business analytics, decided to relocate to San Juan in 2018 and establish Chainwave, which provides software and blockchain services to clients around the world.

Brown was granted Act 60 decrees for the export of services and goods (former Act 20 of 2012), which has a preferential 2 percent to 4 percent income tax; and for individual investors (former Act 22 of 2012), which exempts investment earnings from taxes conditioned on beneficiaries purchasing a home on the island and dwelling here at least 183 days a year.

"I made three trips here before I decided to jump and make the move. I saw the combination of the vibrancy of the city, although it was after the hurricane; it was difficult. But I am an optimist; I saw it as an opportunity to get on the ground level and help rebuild the community and be a part of that growth," Brown said in a virtual

roundtable with Caribbean Business. "When you have a growth mindset, you see through a lot of the negatives to look for opportunities."

The engineer said his decision to relocate to the island was based on the fact that it is "the only place in the world where an American citizen could get such benefits with such a straightforward path."

"I didn't need a passport to travel back and forth from the states. So, it was almost a no-brainer," he said.

Brown started his business in San Juan with two contract engineers. It has grown to 18 employees, including six from the island, while the rest are specialists and remote subcontractors who work overseas. He said that the average salary of his employees is "around \$82,000 per year," adding that the local employees include three software engineers, a project coordinator, a marketing specialist and a sales development representative.

The company generates about \$3 million in gross revenue.

"Last spring, with the blockchain markets the way they were, we shifted to 100 percent blockchain applications development for third parties," he said, adding that his business deals with NFT marketplaces that allow people to trade the non-fungible tokens, which are digital objects created with blockchain technology to mint "unique" versions of, say artwork, but really almost anything that can be digitized.

Blockchain involves storing information secured through cryptography in

an electronic ledger of transactions that are continually updated so that copies of these records, which are stored in computers around the world, can be publicly accessed.

"You can see the transaction to ensure people own what they are supposed to own—a form of digital transaction verification that is immutable. I send you money or digital assets and the transaction is stored forever and cannot be edited by anyone over time," he said. "It is a very secure way to share digital value. We leverage the blockchain for the applications we build for our clients."

Expansion Planned

Brown said that Chainwave has worked with at least one local blockchain business called Multiverse. The other clients are in Norway and on the U.S. mainland.

"We plan to double the size of our team that is located in Puerto Rico by the end of this year with a similar salary range. We are committed to finding talent that can be brought to this space," he said. "We are looking for a great combination of technical and software skills. Blockchain is a nascent industry being positioned in Puerto Rico as a hot spot for blockchain activity that helps us be a leader in blockchain applications."

Brown said that he has invested in real estate on the island and rents out space from his main residence. Chainwave is located in rented office space in Santurce.



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— Benjamin M. Brown,
Founder,
Chainwave

"Day by day, I go out to restaurants a lot, and a lot of the new restaurants that have showed up downtown the past two years or so," he said, adding that he has made required donations of \$5,000 a year to his favorite nonprofit, LimPiaR Foundation, which he said is "very active in getting hundreds of people to clean up the beaches on the island."

The software engineer stressed that this past year he has noticed "a huge influx of entrepreneurs across the board" in commerce and software development as well as in cryptocurrency and blockchain.

"Act 22 is almost flawless in my mind to get talent here. I feel like we are contributing with the requirements for donations and buying property, but, also, it's extremely appealing to get those high-worth individuals down here and creating these businesses," he explained when asked what improvements he would make to the incentive. "It is extremely appealing on the financial side to get those high net worth individuals down here spending money and creating these businesses."

Incentive Fix Opposed

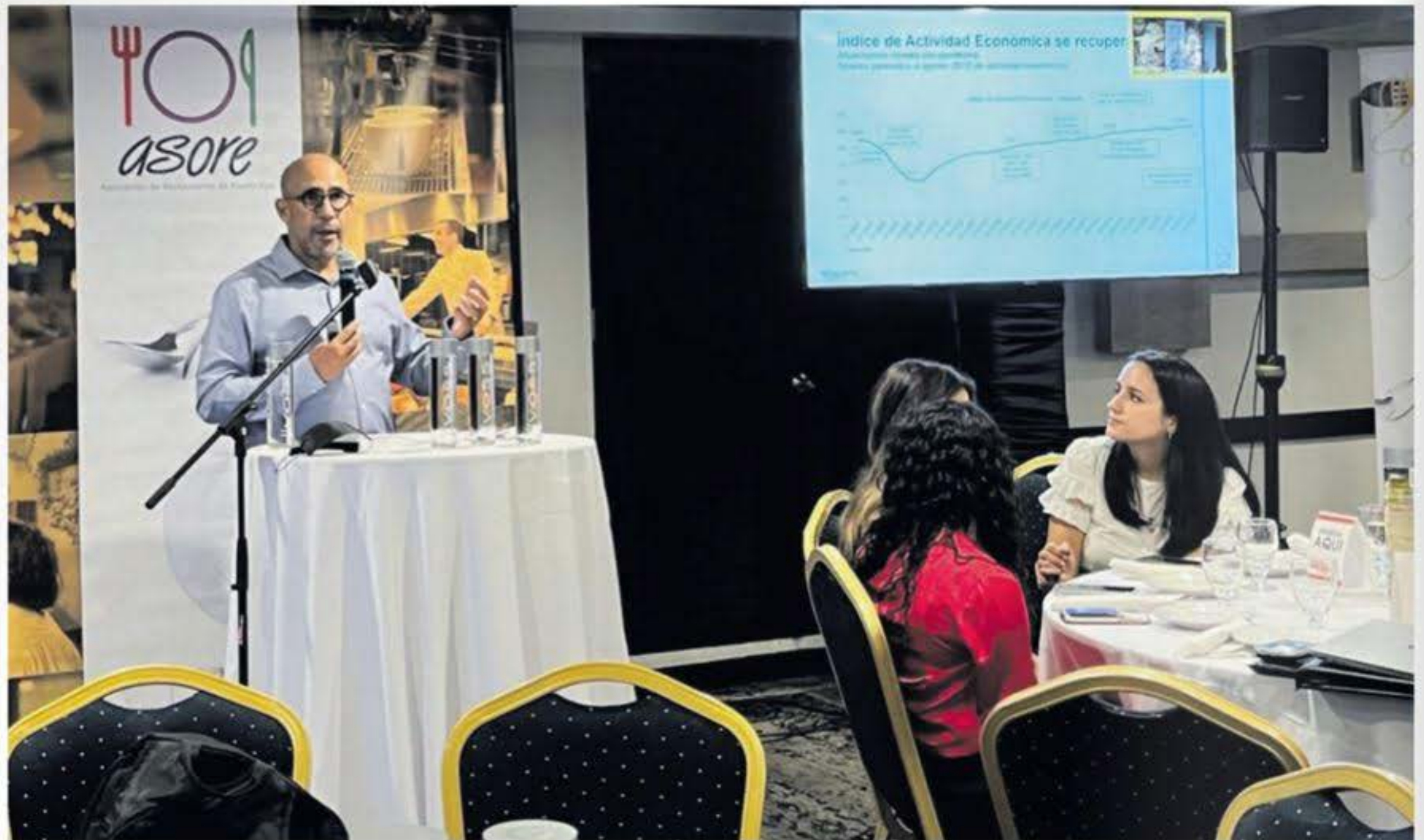
Sen. Juan Zaragoza, chair of the Senate Treasury and Budget Committee, introduced Senate Bill 684 to amend the former Act 22 provision of the Puerto Rico Incentives Code so that future beneficiaries make a minimum investment of \$1 million every three years through the purchase of



For a manufacturing company like ours, power outages are devastating. [...] We have had equipment losses and losses in production due to this kind of power fluctuation.”



– Dan Bigman Montalvo,
CEO,
Gascó Industrial



Economist Gustavo Vélez, Inteligencia Económica

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machinery, equipment or property, as well as the requirement of creating jobs. Decree holders would start paying taxes on earnings and dividends ranging from 5 percent to 10 percent, according to a given amount of investment. The decree would have a 10-year term that could be renewed, instead of the current 15-year term that can be renewed until the end of the decree in 2035.

The proceeds of the tax on earnings and dividends on investments would be deposited in a newly created Capitalization Fund for Small and Medium Sized Businesses, the University of Puerto Rico and Affordable Housing Initiatives.

The bill, co-authored by Senate Minority Leader Thomas Rivera Schatz of the New Progressive Party, was endorsed during hearings by the Economic Development and Commerce Department (DDEC by its Spanish initials), which issues and monitors the decrees. However, House Treasury and Budget Committee Chair Jesús Santa Rodríguez of the majority Popular Democratic Party, reportedly said last week that Zaragoza's bill, as it was filed, has no chance in the lower chamber. He said the bill, which includes additional auditing measures, lacks a study justifying the changes

aimed at making the incentives more economically effective.

When Zaragoza's proposed changes to the individual investors' incentive were explained to Brown, he said he thought they were "fair, if it's designed to encourage direct investment here."

A report commissioned by Economic Development Secretary Manuel Cidre last year and prepared by economist José Caraballo Cueto concluded that Act 20 and Act 22 incentives led to a 3 percent growth in jobs, or about 39,000 additional jobs in Puerto Rico between 2012, the year the incentives were created, and 2017. Economic activity rose 2 percent, or by \$1.25 billion, during the same period.

However, despite the modest gains, the DDEC carried out a first audit of the Act 20 and Act 22 decrees, finding that one-third of the decree holders had failed to submit required annual reports. Moreover, the U.S. Internal Revenue Service set up a unit at the Puerto Rico Treasury Department last year to investigate whether decree holders were using their status as an island resident to avoid federal taxes.

The DDEC's incentives office reported last month that it had revoked 257 Act 22 decrees out of a total of more than 3,300 individual investor decrees due to noncompliance with requirements.

In his testimony before the committee in February, former DDEC chief

and resident commissioner, Antonio J. Colorado, came out against the bill, saying that the Act 20 and 22 incentives have been the fastest creator of jobs on the island, despite the problems with "unreliable and terribly expensive" transportation, electricity and water utilities on the island, as well as the government's slow process of issuing permits.

"The constant changes in rules, with respect to taxes and commercial rules create an environment of uncertainty, which injects risk and paralysis in long-term investment decisions, be it by individuals or corporations," Colorado said in his testimony before the Senate committee, noting that Puerto Rico is at a disadvantage compared with jurisdictions such as the Dominican Republic in terms of labor costs, and to Singapore and Ireland with regard to political stability.

Manufacturing Lifesaver

Another beneficiary of Act 60, specifically the former Act 73 of 2008 incentives for manufacturing production, is Dan Bigman Montalvo, CEO of Gascó Industrial, which makes environmentally friendly detergents, disinfectants and pesticides for industrial and retail use at the company's Gurabo plant. He said that the business, which he purchased from his parents and had started as a food distributor in Bayamón,

received a needed boost from the incentive to avoid going bankrupt.

"Act 73 gives you advantages in manufacturing over other places in the U.S.," he told Caribbean Business during the roundtable when asked about the public impression that the incentive is only available to overseas manufacturers.

Bigman said that Act 60's preferential tax rate of 4 percent, which can go down to 1 percent for products that are exported, "is very favorable and gives us enough money and revenue for expansion. Since 2019, we have tripled our growth."

The chemist said that the tax incentives have allowed the company to make investments in research and development for new products.

Gascó has 38 employees, he said, adding that the company generates about \$6.5 million a year in gross revenue.

"We make packaged goods, seasonings like 'adobo,' food products for health, like hand sanitizer, alcohol and different disinfectants," he said. "We market our products through the food service channel. We make products marketed under the retailers' brand."

Bigman said that plans call for creating another corporation, which would be under Act 20 to export products overseas. Besides the states, the business currently exports to Panama and several islands in the Caribbean.

He said that beyond amending the

island's incentives code, the government should encourage collaboration between local businesses on the island to develop products, which he stressed is "key to growth."

"I have had collaboration with companies in the states and other countries, but none from local entrepreneurs," he said, noting, for example, how local singer, songwriter and producer Bad Bunny "collaborates with every other artist to get a better record."

"We have relationships with other firms on the island and elsewhere. If there is a project we cannot handle, we will contact another company to help us. We refer business to each other," the chemist said.

Enduring Challenges

Still, Bigman stressed that all companies operating on the island have had to face the challenges of unreliable and expensive utility services and a slow permitting process. As a result, Gascó has had to invest \$50,000 in renewable energy projects and acquiring "highly efficient" motors and equipment and LED lighting. He said the facility has a backup generator for when the power goes out, but running a generator is "complicated and expensive."

"For a manufacturing company such as ours, power outages are devastating. The precision equipment does not like fluctuations. We have had equipment



[Community Development Block Grant] funds to move the economy," the economist said. "We need fresh, organic and real capital. But that alone will not solve the problem because [these investors] will be exposed to the same bureaucracy, permit process and utility problems. I think it is a matter of how quickly these investors can set up a business on the island, a capital or real estate fund, set up a factory. There are agricultural projects that could be funded."

Vélez stressed that the DDEC lacks fundamental data to determine how effective these incentives are, particularly which industries are benefiting. "If you do not solve the problems with permits, electric power and investment climate, it will be easier to have investments that generate passive income in a low-interest environment," he said.

Investments by individuals designated as resident investors under Act 60 in real estate and businesses on the island are presently estimated at more than \$4 billion and growing, according to a DDEC-commissioned report prepared by economic research firm Estudios Técnicos in 2019. Planned capital investments were estimated at \$678 million and the number of direct jobs created at over 4,400.

From 2015 through 2021, businesses benefiting from incentives for exporting companies under Act 60 have made estimated tax payments totaling more than \$500 million to the Puerto Rico Treasury Department.

Enacted in 2019, Act 60 was created with the intent of consolidating all previously existing tax benefit laws into a single code, eliminating all incentives deemed obsolete or with little or no real and effective contribution to Puerto Rico's economy. Before Act 60, there were approximately 76 different laws and programs created between 1945 and 2019 that comprised the legal framework of Puerto Rico's economic incentives.

Debate rages over value of tax incentives.

losses and losses in production due to this kind of power fluctuation," he said.

Bigman also raised issues concerning what he called a lethargic process for obtaining permits.

"The number of permits is not too different from other industrialized economies. But it does tend to move too slow in Puerto Rico," he said, noting that the island has the same number of permits as the states and other jurisdictions.

Brown said that the company is leasing office space for its employees in Santurce that is used for team meetups,

although he stressed that his employees "have the option of working from home."

Economist and consultant Gustavo Vélez, who in 2010 participated in the first meetings of a working group created by then-Gov. Luis Fortuño to discuss the creation of these incentives, acknowledged that while it is "too premature" to pass judgment on the incentives, Act 22 is being seen "as more attractive and that is an error."

"We are at a moment in which we should retake the original initiative to attract investment and build call

centers and R&D activity," Vélez, who is president and CEO of consulting firm Inteligencia Económica, told Caribbean Business. "It should create a critical mass of people doing productive activity in Puerto Rico, and connect this to the financial infrastructure of the island."

Nevertheless, for the incentives to yield the most economic activity, the commonwealth government must improve the climate of doing business on the island, particularly the permitting process.

"These people are also exposed to the

obstacles in obtaining permits and all the bureaucracy of the government," he said.

Regarding legislation to revamp Act 22, Vélez acknowledged that "there is no doubt these incentives are bringing economic activity, but the investments should be more closely tied to the local economy."

"I do not see any problem with it. Prospectively, it could be an interesting thing to tie the incentives closer to the economy, which we need. We cannot depend on FEMA and CDBG

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