

BUSINESS LAW NOTES

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10% Capital Gains Tax on Sales of "Property Located in Puerto Rico"

By: Ricardo Muñiz

The Puerto Rico Internal Revenue Code has finally been amended to reduce the income tax rates payable on long term capital gains derived from the sale of property located in Puerto Rico.

Pursuant to Act No. 24 of April 11, 2001 ("Act No. 24"), as amended by Act No. 45 of June 22, 2001, the income tax rate on capital gains

has been reduced in half, from 20% to a 10%, when the sellers are individuals, estates and trusts, and the capital assets sold constitute "property located in Puerto Rico." Similarly, when capital gains are derived by corporations or partnerships, the long term capital gains tax rate has been reduced from 25% to 12.5%. This tax rate reduction also applies to the income tax that must be withheld by any person that buys property located in Puerto Rico from persons that are not residents of Puerto Rico.

Act No. 24 defines the term "property located in Puerto Rico" as including solely the following capital assets:

- real property located in Puerto Rico, such as your house, apartment or second home;
- shares of stock of Puerto Rico corporations and participations in partnerships organized in Puerto Rico;
- bonds, notes and other obligations issued by the

- Commonwealth of Puerto Rico, its municipalities and their instrumentalities and public corporations;
- bonds, notes and other obligations issued by individuals that are residents of Puerto Rico and by corporations and partnerships organized in Puerto Rico;
- bonds, notes or other obligations guaranteed by real property located in Puerto Rico; and,
- shares of stock of corporations and participations in partnerships, as well as bonds, notes or other obligations issued by foreign corporations or partnerships that derived 80 % or more of their gross income from Puerto Rico sources during the three year period before the sale.

When structuring and planning for the sale of a business, taxpayers must recognize and properly take into consideration that capital gains derived from the sale of intangible assets (such as goodwill) and tangible personal property will not qualify for the reduced capital gain rates and will continue to be subject

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TAX LAW

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to the 20% and 25% tax rates. The sale of shares of stock of corporations not organized in Puerto Rico, such as most of the corporations and mutual funds traded in the stock markets worldwide also will not qualify for the lower tax rates.

Certain lump sum distributions from—qualified pension plans, however, will not constitute gains derived from the sale of “property located in Puerto Rico,” and will continue to be subject to the 20% capital gains tax rate. The Governor has recently stated her intention however to propose that Act No. 24 be amended to include those gains among those entitled to the 10% tax rate.

The reduced capital gains tax rates are only applicable to transactions realized after December 31, 2000, regardless of the taxable year of the taxpayer.

Furthermore, because Act No. 45 refers to “transactions realized” after December 31, 2000, any gains attributable to transactions realized prior to January 1st, 2001, in which recognition or payment of all or part of the income was deferred to a date or year after

"The reduced capital gains tax rates are only applicable to transactions realized after December 31, 2000..."

December 31, 2000, will be subject to the 20% or 25% tax rates even if the payment is actually received and the gain is realized after that date. For example, the gain by an individual on a sale made on December 1, 2000, with payment of 100 % of the purchase price deferred to June 1st, 2001 will not enjoy the reduced 10% tax rate, even though the gain is recognized in year 2001.

One of the stated objectives of Act No. 24 is to promote economic activity by “diminishing the reluctance to sell capital assets,” as taxpayers will now be more likely to sell capital assets that constitute property located in Puerto Rico. This tax reduction will not only promote additional economic activity in Puerto

Rico, but it should also reduce tax evasion with respect to the taxation of capital gains.

Finally, the tax rate reduction also applies to the income tax that must be withheld by a person that buys real property or shares of stock (if the gain constitutes income from sources within Puerto Rico) which qualify as property located in Puerto Rico, from U.S. individuals that are not residents of Puerto Rico. ■

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STOCK OPTIONS: A DEVELOPING COMPANY'S SACE IN THE HOLE

By: Luis R. Rosas

The success of a growing enterprise hinges in large measure on its ability to retain its key employees—those who are considered especially important to the future of the company. As the business expands and the necessity for additional infusions of capital increases, however, it becomes increasingly difficult to assure the services of those key employees without depleting an ever larger portion of the company's vital cash resources. Thus, the question arises: how can a company entice its key employees to remain with the company and fuel its growth without compromising the company's badly needed liquidity.

Equity compensation programs are among the most effective tools available to a development-stage company in its efforts to retain its talent base. By providing key employees with an opportunity to acquire a proprietary interest in the business, a company can motivate its high-level employees to remain in its employ—through the alluring prospect of an equity participation in the company's success—while preserving its cash reserves.

Stock option plans are among the most frequently employed equity compensation devices by high-growth-potential enterprises to achieve these objectives.

"Equity compensation programs are among the most effective tools available to a development-stage company in its efforts to retain its talent base."

A stock option plan sets forth the terms and conditions pursuant to which the company grants the participating employee the opportunity to purchase equity shares of the company. Generally, stock options allow participants to purchase shares of the company at a determined per share purchase price known as the "exercise or strike price," and only during a predetermined period known as the "exercise period."

Historically, stock option plans have been employed successfully by publicly-held companies and companies whose long-term growth strategy calls for an initial public offering. The inherent value of the stock option lies in the employees' ability to acquire shares of a company at a strike price usually fixed at an amount somewhere below the fair market value of the shares, or, if the granting company is already publicly-held, at fair market value. Thus, once the company goes public—or, in the case of a publicly-held company, when the fair market value of the shares is higher than the strike price—the employee can readily sell his or her shares, realizing the implicit gain resulting from the difference between the strike price and the fair market value of the option shares at the time of the sale.

Even if a company's growth strategy does not foresee a public offering, a properly designed stock option plan may still be a viable compensation vehicle if the company's shareholders' exit strategy calls for the company

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to be sold to an unrelated third party at some point in the future. In that scenario the employee would have an incentive to remain a part of the company's growth, because of the prospect of an exit transaction in which the employee's shares would be sold to the acquiring third party at fair market value. Alternatively, if the company's shareholders do not foresee a sale of their business, adequate cash-out and buy-back provisions should be incorporated into the stock option plan, to provide employee shareholders with a return while adequately managing the financial impact of future redemptions by the company of the option shares.

The decision to implement a stock option plan should be considered in light of several factors, including the nature of the business, the company's long and short term growth strategy, and the company's financial position at the time the stock option plan is to be implemented.

In Puerto Rico, compensatory stock options fall into two categories: qualified stock

options ("QSOs") and non-qualified stock options ("NQSOs"). The tax treatment of a stock option will be determined by whether or not the stock option satisfies certain re-

"The decision to implement a stock option plan should be considered in light of several factors, including the nature of the business, the company's long and short term growth strategy, and the company's financial position at the time the stock option plan is to be implemented".

quirements set forth by the Puerto Rico Internal Revenue Code (the "PR-IRC").

Under the PR-IRC, for a stock option to be qualified, it must meet the following requirements: (i) the option must be granted pursuant to a plan approved by the company's shareholders within the twelve month period prior or subse-

quent to the date of adoption of such plan by the company's board of directors—which plan must set forth the aggregate number of shares which may be issued pursuant to the exercise of the options and the employees and/or directors eligible to receive the options; (ii) the exercise period (the period during which the participants may exercise the options) must not exceed ten (10) years from the date the option is granted; (iii) the exercise price may not be lower than the book value per share (fair market value per share in the case of publicly held companies); (iv) the aggregate book value (determined at the time

the option is granted) of the shares that may be acquired for the first time in any calendar year, pursuant to an option, may not exceed one-hundred thousand dollars (\$100,000). Also, in order for the qualified stock option plan to enjoy the tax treatment described below, the company must obtain a ruling from the Puerto Rico Treasury Department.

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QSOs offer substantial tax benefits to employees participating in a qualified stock option plan. First, upon exercising the QSO, the employee does not recognize any taxable income. This means that, although technically the employee has received property worth more than what he or she has paid for it, the employee will not include in his taxable income the gain resulting from the difference between the aggregate exercise price and the aggregate fair market value of the shares he or she purchases pursuant to the NQSOs. This implied gain will be deferred until the employee sells or exchanges the option shares. Moreover, upon selling or exchanging the shares, the gain realized in such transaction will be taxed at the preferential ten percent (10%) capital gains rate, assuming the employee holds on to the shares for more than six (6) months after exercising the QSO. The company, on the other hand, is not entitled to a deduction on the grant nor on the exercise of the QSO.

"...because stock options are considered securities under both federal and Puerto Rico laws, the options granted pursuant to a stock option plan must either be registered under federal or local laws, or an applicable exemption from registration must be identified."

Finally, because stock options are considered securities under both federal and Puerto Rico laws, the options granted pursuant to a stock option plan must either be registered under federal or local laws, or an applicable exemption from registration must be identified. In some cases, a ruling from the Commissioner of Financial Institutions will be required.

In the event that the stock option plan does not meet any of the PR-IRC qualification requirements, the treatment of such non-qualified stock option plan will be as follows: upon exercising the NQSOs, the employee will be deemed to have received "ordinary income" for Puerto Rico income tax purposes; accordingly, the employee will recognize taxable income equal to the difference between the aggregate exercise price and the aggregate fair market value of the shares he or she purchases pursuant to the NQSOs. Furthermore, the company may deduct as compensation expense this difference in the value of the option shares.

In sum, the implementation of a stock option plan by a developing enterprise is a strategic decision which entails a myriad of financial and legal considerations. Indeed, not every development-stage company can or should implement a stock option plan. However, provided the plan is adequately structured, it can be an invaluable element in a developing company's success formula. ■

COPORATE LAW

REGULATION OF INSURANCE BUSINESS BY FINANCIAL INSTITUTIONS PROPOSED

By: Loyda Rivera- Torres

The Office of the Commissioner of Insurance of Puerto Rico is proposing the promulgation of Rule 74 to regulate the methods, acts and practices of financial institutions and their affiliates in the sale, solicitation, offer, and marketing of insurance products.

Article 2(1) of the proposed rule defines a financial institution as “..any bank, savings and loan association, institution dedicated to the business of receiving deposits and lending money in Puerto Rico and any entity or corporation in which any of the referred institutions has, directly or indirectly, a substantial economic interest or relationship as owner, subsidiary or affiliate, or any entity or corporation that possesses, directly or indirectly, a substantial economic interest in any of the referred institutions.” The term also includes any employee, officer, director or representative of financial institutions

Article 3 of the proposed rule provides that financial institutions that want to be engaged in the insurance business must (i) become, or be affiliated with, a financial holding company (as such term is defined in section

103(p) of the Gramm-Leach-Bliley Act) and (ii) establish or acquire for such purposes a corporate entity organized under the laws of, and with principal office in, Puerto Rico, which has the required license from the Commissioner. The proposed rule, however, is not applicable to an

"[T]he insurance affiliate must maintain all records...separate from any other record, accounting books, files and documents related to depositary activities."

affiliate or subsidiary of a bank organized pursuant to the National Bank Act (12 U.S.C. § 92).

The license required for the insurance affiliate by the proposed rule is an agent license (or agency license for corporations) or a general agent license. For individuals or natural persons conducting business on behalf of such agency or general agent, the license required is a solicitor's license.

Article 6 of the proposed rule establishes that the insurance affiliate must maintain individual records regarding the insurance business, which must be kept at its principal place of business, separate from where the records containing information regarding extensions of credit are kept. This separate record keeping requirement is not applicable to transactions which require the acquisition of credit insurance or hazard insurance for their approval. Moreover, the insurance affiliate must maintain all records, accounting books and files, including all documents and communications regarding complaints of clients, and any other document related to insurance transactions, separate from any other record, accounting books, files and documents related to depositary activities; and such records must be available and accessible at any moment for inspection by the Commissioner.

The insurance affiliate may engage in the Insurance Business within the premises of an affiliated financial institution, but in an area that is physically segregated from the areas where credit is extended and depositary activities take place. The area must be accessible, clearly identified and separate from all other areas of the branch.

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Although the proposed rule does not require a license for those who make referrals of clients to persons duly licensed to engage in the insurance business, it establishes that those referrals are to be made only after the client has expressed interest in obtaining information regarding available insurance products. The proposed rule also establishes that the only information that the person making the referral may provide to clients is: (i) the location of the area designated for the sale of insurance products; (ii) the name of any employee, officer, director or representative of the insurance affiliate licensed to engage in the Insurance Business;

and (iii) the name of the person making the referral. Any additional information must be provided by persons duly licensed to engage in the insurance business in areas exclusively designated for such purposes within the premises of the financial institution.

The proposed rule also establishes that persons who make referrals could receive a “nominal fixed compensation” for such services. Payment of that compensation must be made regardless of whether or not the insurance transaction that motivated the referral is eventually closed.

Additionally, the proposed rule (i) establishes strict disclosure requirements, that include both form and content specific requirements; (ii) imposes requirements applicable to the sharing of financial information among subsidiaries; (iii) regulates the practices and policies of the insurance affiliate regarding confidential information, including the disclosure to third parties of clients’ health and insurance coverage information; (iv) sets penalties for violations of the proposed rule, including sanctions for unfair business practices and discrimination; and (v) regulates the form and content of the advertising materials of the insurance affiliate.

RECENT CORPORATE TRANSACTIONS

In June, 2001 AMG&B represented TJAC, Inc. in the closing of a \$130,000,000 debt refinancing of various of its shopping centers.

In June, 2001 AMG&B acted as tax and corporate counsel of AIG Global Real Estate Investment Corp. and Fremont Realty Capital in the acquisition of four shopping centers in Puerto Rico for approximately \$150,000,000.

In June, 2001 AMG&B represented Banco Bilbao Vizcaya Argentaria Puerto Rico in connection with the issuance of a letter of credit in the amount of \$65,000,000, supporting in part the issuance by El Nuevo Día of \$130,000,000 in AFICA Bonds.

In April, 2001 AMG&B represented RG Premier Bank of Puerto Rico in connection with the grant to Aquarius Time Shares of a \$10,000,000 revolving line of credit for the construction of time shares in Dorado.

In June, 2001 AMG&B represented Enron Corporation in the sale of Progasco Inc. to CHRD, Inc. for approximately \$12,000,000.

In July, 2001 AMG&B acted as counsel for Wyndham International in the closing of a \$180,000,000 hotel refinancing of the Wyndham El San Juan property, for which Lehman Brothers Bank FSB acted as lender.

ENVIRONMENTAL LAW

EIS REQUIRED FOR EARTH EXTRACTION PERMITS

By: *María de Lourdes Rodríguez*

Two recent Supreme Court of Puerto Rico opinions have left no doubt that an environmental impact statement is required prior to the issuance by the Department of Natural and Environmental Resources (“DNER”) of an earth extraction permit or the renewal of an earth extraction permit in coastal zone areas.

In Municipio de Loíza v. Sucesión Marcial Suárez, 2001 TSPR 84, the Supreme Court gave a limited reading to the exemption from environmental review requirements contained in the Sand, Gravel and Stone Act and related regulatory provisions for extractions “incidental” to the project or that are “not significant or substantial.”

Marcial Suárez involved an residential construction project in Barrio Medianía Baja in the Municipality of Loíza. The project included construction of an 18 “cuerda” artificial lake involving the extraction of 600 cubic meters of soil daily for a total of 118,890 cubic meter per year. The lake occupied one-third of the parcel where the housing project was to be constructed. The extracted soil was to be sold for profit.

As part of the Planning Board’s site approval process, the DNER had initially commented that “due to the magnitude of the area to be developed and the potential impact of the extraction of soil for the construction of the artificial lake, where the freatic level will be affected, an Environmental Impact Statement should be required”. Upon the developer’s request for reconsideration, the DNER modified its initial position and merely stated that compliance with flood-prone zone regulations and an earth extraction permit would be required, without mentioning environmental impact review requirements of any kind. The approval of the siting consultation was subsequently issued with a negative environmental impact determination, with EQB’s concurrence. The earth extraction permit was subsequently issued by the DNER.

Reversing the lower courts’ dismissal of the Municipality of Loíza’s request for injunctive relief to enjoin extraction activities, after all permits (including ARPE permits) had been granted, the Supreme Court asserted that in Puerto Rico the preservation of the quality of the environment and natural resources is of constitutional rank, and that article 4(c) (environmental review proceedings) of the Environmental Public Policy Act

was enacted to ensure governmental compliance with the constitutional mandate. Citing prior case law, the Court referred to the proponent agency’s obligation to consider significant environmental impacts “in depth” and to inform the general public of its findings. The Court also stated that given the various legislative resolutions and administrative (DNER) orders aimed at protecting the already degraded Loíza area from further deterioration associated with earth extraction, and the magnitude of soil extraction and associated documented impacts involved, the contention that an earth extraction permit was not required or that, if required, did not require an environmental impact statement, could not stand.

In a prior case, the Supreme Court reached the same result regarding environmental review requirements for renewal of a sand extraction permit. Díaz Alvarez v. Depto. de Recursos Naturales, 99 TSPR 7.

An additional important aspect of Marcial Suárez is that it supports the ability of the public to attack the validity of permits after the statutory period for seeking judicial review has lapsed, which sets a dangerous precedent and creates uncertainty in the plans of developers and investors. The government permits, including the environmental review approval, were successfully attacked collaterally through an extraordinary proceeding (i.e. injunction), without resume to Law 324 of November 6, 1999 which amended the Administrative Procedure Act to stipulate that administrative decisions are only reviewable through a timely request for judicial review.

OFFICE NEWS

Edwin J. Seda-Fernández, director of AMG&B's labor law department, was a key speaker at an April 27, 2001 “Advanced Seminar on Sexual Harassment in the Workplace” sponsored by the University of Puerto Rico Law School Trust. On June 21, 2001, Mr. Seda-Fernández was a panelist at a seminar on “Fundamental Issues in Puerto Rico Human Resources Law,” sponsored by the National Business Institute, in which he covered the legal aspects of the hiring process, employee handbooks and manuals and record-keeping.