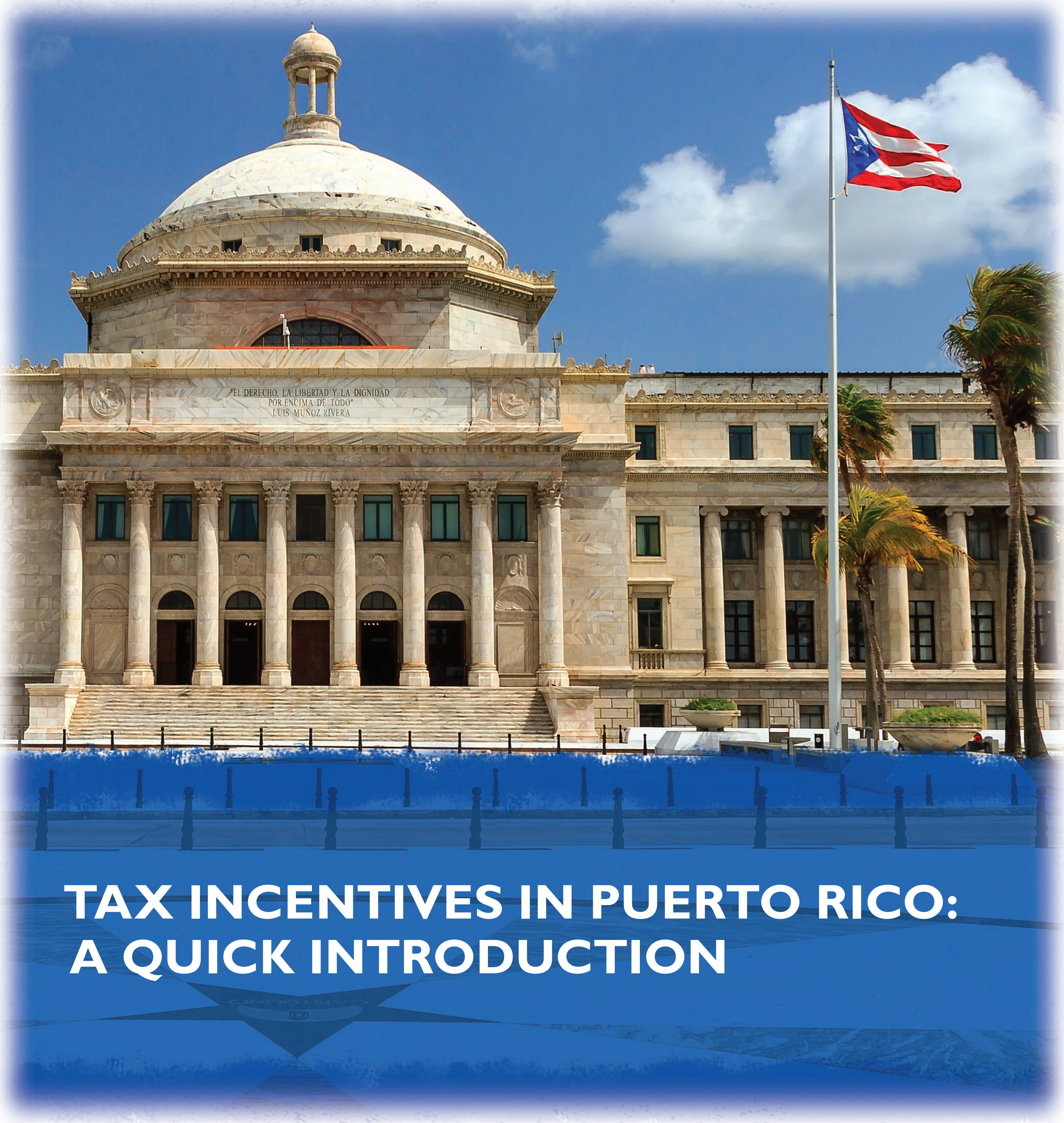

TAX INCENTIVES IN PUERTO RICO: A QUICK INTRODUCTION

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TAX INCENTIVES IN PUERTO RICO: A QUICK INTRODUCTION

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To promote, attract and develop key industries, sectors and activities, Puerto Rico offers a spectrum of economic incentives, among them low fixed income tax rates, partial and/or total tax exemptions, income tax credits and special deductions.

The manufacturing, tourism, construction, telecoms, export services, renewable energy, film, banking and financial services industries are among the sectors that may enjoy the benefits provided under Puerto Rico's incentives laws.

In this overview, we take a quick look at ten of the most significant of these tax incentives – and, for each area, the legislative groundwork, the process of applying for an incentive and the nature of the available incentives.

I. MANUFACTURING ACTIVITIES

Act No. 73-2008, also known as the Economic Incentives for the Development of Puerto Rico Act, generally provides tax incentives to businesses that are established in Puerto Rico for manufacturing products on a commercial scale and to businesses engaged in a wide range of specific economic activities, such as scientific research and development, recycling, hydroponics, intangible property licensing, and software development – these are collectively called Act No. 73 Eligible Activities.

The process

To obtain a 15-year Act No. 73-2008 tax exemption decree, the interested party (the Act No. 73 Business) must submit an application to the Office of Industrial Tax Exemption (OITE), which is part of the Department of Economic Development and Commerce (DDEC).

If the application is approved, DDEC then issues an Act No. 73 Decree to the Act No. 73 Business, laying out the terms and conditions with which the Act No. 73 Business shall comply. These terms may involve employment requirements, capital investments, production levels or sales revenues. An Act No. 73 Decree constitutes a contract between the Government of Puerto Rico, the Act No. 73 Business and its owners.

The incentives

An Act No. 73 Decree provides for the following tax incentives:

1. An income tax rate of 4 percent on the net income derived from the Act No. 73 Eligible Activities covered by the Act No. 73 Decree, and a 12 percent income tax withholding rate on certain royalty payments made by the Act No. 73 Business; ***or*** an 8 percent income tax rate on the net income derived from the Act No. 73 Eligible Activities covered by the Act No. 73 Decree and a 2 percent income tax withholding rate on certain royalty payments made by the Act No. 73 Business[1]
2. No income tax on any dividend distributions that the Act No. 73 Business makes from its earnings and profits derived from Act No. 73 Eligible Activities
3. A 4 percent capital gains tax on gains realized on the sale or exchange, while the Act No. 73 Decree is in force, of (i) the shares/membership units of the Act No. 73 Business or (ii) all or substantially all of the assets used by the Act No. 73 Business in carrying out its Act No. 73 Eligible Activities
4. A 60 percent exemption from municipal license taxes on the volume of business derived from the Act No. 73 Activities, except that a 100 percent exemption applies during the first three semesters of operations
5. A 100 percent exemption on real property taxes during the first government fiscal year in which the property is subject to real property taxes; and a 90 percent exemption thereafter
6. A 90 percent exemption on personal property taxes
7. A 100 percent exemption on municipal construction excise taxes imposed on the construction of property to be used in the Act No. 73 Eligible Activities
8. A 100 percent exemption on Commonwealth of Puerto Rico excise taxes and on sales and use taxes on certain raw materials and machinery and equipment used exclusively in the Act No. 73 Eligible Activities[2]
9. A 100 percent special deduction for costs incurred in the purchase, acquisition or construction of buildings, infrastructure, machinery and equipment for use by the Act No. 73 Business in the Act No. 73 Eligible Activities and
10. Tax credits for the purchase of products manufactured in Puerto Rico, job creation, investments in infrastructure, intellectual property, and research and development, among others. Some of these tax credits may be transferable and, thus, may be sold[3]

1. In addition, a 0 percent or 1 percent income tax rate may be requested in certain circumstances (e.g., novel pioneer activities).

2. This includes machinery and equipment that the Act No. 73 Business is required to acquire to comply with any Puerto Rico or US laws or regulations.

3. If an Act No. 73 Business makes use of the special deduction, it may not avail itself of the tax credit for the same project that gave rise to the special deduction. On March 7, 2017, the Puerto Fiscal Agency and Financial Advisory Authority (AAFAF) issued Administrative Order No. 2017-01, which, among other things, orders the Puerto Rico Treasury Department Secretary to conduct an inventory of the tax credits that have been granted and requires tax credit holders to inform the tax credit amounts, including providing supporting evidence. The term "granted credit" includes, but is not limited to tax credits authorized under Section 6 of Act 73-2008.

The provisions of Act No. 154-2010, as amended, may apply to an Act No. 73 Business that manufactures products that are sold to non-Puerto Rico members of an affiliated group, or that provides certain manufacturing services to non-Puerto Rico members of an affiliated group. In general, Act No. 154-2010 provides that the member of the affiliated group will be subject to Puerto Rico income tax on a portion of the income derived from the sale of such products, or, in lieu thereof, will be subject to an excise tax imposed on the acquisition of such products and/or services.

II. GREEN ENERGY ACTIVITIES

Act No. 83-2010, also known as the Puerto Rico Green Energy Incentives Act, aims to promote the production of renewable energy.

This act provides tax incentives to businesses that engage in eligible green energy activities. These may include producing and selling green energy; installing machinery and equipment for the production of green energy; and leasing property used for the production of green energy.

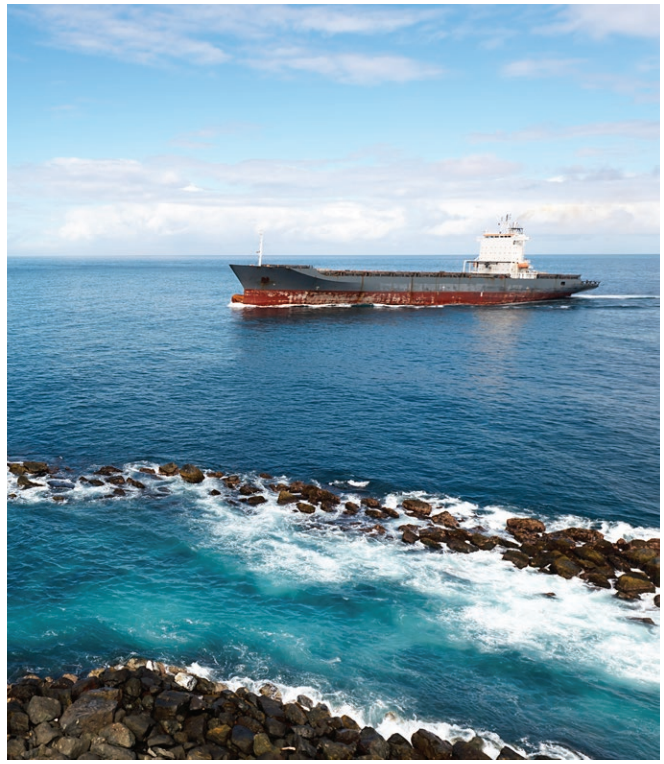
The process

One positive aspect of this incentive is that an eligible business may obtain a tax exemption decree, called the Act No. 83 Decree, which is viable for 25 years. The interested party, called the Act No. 83 Business, submits an application to the OITE. Once the application is approved, the DDEC issues an Act No. 83 Decree which lays out the terms and conditions with which the business shall comply (*e.g.*, employment requirements, capital investments, production levels, sales revenues). The Act No. 83 Decree constitutes a contract between the Government of Puerto Rico, the Act No. 83 Business and its owners.

The incentives

This Decree sets out the following tax incentives:

1. A 4 percent income tax rate on the net income derived from the Act No. 83 Eligible Activities covered by the Act No. 83 Decree and a 12 percent income tax withholding rate on certain royalty payments made by the Act No. 83 Business
2. No income tax on dividend distributions the Act No. 83 Business makes out of its earnings and profits derived from the Act No. 83 Eligible Activities
3. A 4 percent capital gains tax on gains realized on the sale or exchange, while the Act No. 83 Decree is in force, of (i) the shares/membership units of the Act No. 83 Business, or (ii) all or substantially all of the assets used in the Act No. 83 Business
4. A 60 percent exemption from municipal license taxes on the volume of business derived from the Act No. 83 Activities, except that a 100 percent exemption applies during the first three semesters of operations



5. A 100 percent exemption on real property taxes during the first government fiscal year in which the property is subject to real property taxes and a 90 percent exemption thereafter
6. A 90 percent exemption on personal property taxes
7. A 100 percent exemption on municipal construction excise taxes imposed on the construction of property to be used in the Act No. 83 Eligible Activities
8. A 100 percent exemption on Commonwealth excise taxes and sales and use taxes on certain raw materials, and machinery and equipment used exclusively in the Act No. 83 Eligible Activities[4]
9. A 100 percent special deduction of costs incurred in the purchase, acquisition or construction of buildings, infrastructure, and machinery and equipment for use by the Act No. 83 Business in the Act No. 83 Eligible Activities and
10. Tax credits for the purchase of products manufactured in Puerto Rico, for job creation and green energy research and development investments. The research and development tax credit may be sold.[5]

III. EXPORT SERVICES

Act No. 20-2012, the Act to Promote the Exportation of Services or Export Services Act, promotes the establishment of export service operations in Puerto Rico. It provides tax incentives to businesses exporting services from Puerto Rico to persons outside of Puerto Rico with no nexus to Puerto Rico.

Among the export services under Act 20-2012 (collectively called the Act No. 20 Eligible Activities) are:

- research and development
- advertisement and public relations
- consulting
- investment banking, asset management and other financial services
- professional services such as legal, accounting, architectural and engineering services, among many others

The process

A tax exemption decree under Act No. 20-2012 will remain in effect for 20 years. To obtain one, the interested entity must submit an application to OITE. If the application is approved, the DDEC will issue an Act No. 20 Decree to the service provider—which is then regarded as an Act No. 20 Business. The Act No. 20 Decree sets out terms and conditions with which the Act No. 20 Business shall comply. Notably, within two years from the date it begins business operations in Puerto Rico an Act No. 20 Business must employ five full-time-equivalent employees.

The incentives

An Act No. 20 Decree provides for following tax incentives:

1. A 4 percent income tax rate (may be reduced to 3 percent in certain cases) on the net income derived from the Act No. 20 Eligible Activities covered by the Act No. 20 Decree
2. No income tax on dividend distributions the Act No. 20 Business makes out of its earnings and profits derived from the Act No. 20 Eligible Activities
3. A 60 percent exemption from municipal license taxes on the volume of business derived from the Act No. 20 Eligible Activities and
4. A 90 percent exemption on certain export services activities (and a 100 percent exemption during the first five years).

4. It includes machinery and equipment that the Act No. 83 Business is required to acquire to comply with any Puerto Rico or US laws or regulations.

5. See Footnote No. 3 above.

IV. INDIVIDUAL RESIDENT INVESTOR

The Individual Investors Act, Act No. 22-2012, was enacted to promote the relocation of individual resident investors (IRI) to Puerto Rico.

The process

To qualify as an IRI under Act No. 22-2012, an individual shall not have been a resident of Puerto Rico during the six-year period ending on January 17, 2012. In addition, the individual must purchase residential property within two years after becoming a Puerto Rico resident, and must open a bank account at a bank or credit union located in Puerto Rico.

The non-Puerto Rico individual must file an application with OITE to obtain an Act No. 22-2012 tax exemption decree.

The incentives

The DDEC generally will issue the Act No. 22 Decree granting the non-Puerto Rico individual the following tax incentives through December 31, 2035:

- A 100 percent tax exemption from Puerto Rico income tax on all dividends
- A 100 percent tax exemption from Puerto Rico income tax on all interest and
- A 100 percent tax exemption from Puerto Rico income taxes on net long-term capital gain in connection with securities accrued after the IRI becomes a Puerto Rico resident.

We note that a reduced 5 percent tax on long-term capital gains applies to gains realized related to securities the IRI held prior to becoming a Puerto Rico resident (the Non-PR Holding Period) and disposed of at least ten years after the IRI became a Puerto Rico resident (the PR Holding Period), but before January 1, 2036.

The 5 percent tax applies only on the gain attributable to the appreciation in value during the Non-Puerto Holding Period, whereas the gain attributable to the appreciation in value during the PR Holding Period would be 100 percent exempt.[6] The alternate basic tax, which ranges from 10 percent to 24 percent, may apply.

V. BANKING AND FINANCIAL ACTIVITIES

Act No. 273-2012, the International Financial Center Regulatory Act, was enacted to help make Puerto Rico a financial industry hub.

This act offers incentives to financial institutions that provide services to non-Puerto Rico persons.[7]

The process

Those interested in operating as an international financial entity (IFE) under Act No. 273-2012 must first submit an application to the Office of the Commissioner of Financial Institutions (OCFI) for a permit to organize an international financial entity. The IFE application shall include (i) information about the personal history of its proposed owners, officers and directors; (ii) a detailed business plan; and (iii) a list of the specific activities (Act No. 273 Authorized Activities) the IFE expects to carry out once it obtains the license to operate as an IFE.[8]

6. If the IRI sells such securities within ten years after becoming a Puerto Rico resident, any long-term gain attributable to the Non-Puerto Rico Holding Period would be subject to the regular capital gains tax rate in Puerto Rico for individuals, which currently is 15 percent.

7. Act No. 273-2012 generally prohibits providing services to Puerto Rico persons.

8. We further note that once the OCFI issues the IFE License, the IFE can only provide the services that it was authorized to provide per the IFE License, unless it requests and obtains written authorization from the OCFI's Commissioner (to provide other services allowed by Act No. 273-2012.

If the IFE application is approved, the OCFI may then issue a license to operate the IFE. This license will describe the activities in which the IFE may engage in and will be accompanied by a letter listing certain requirements, including minimum capital requirements.

Once the IFE license has been issued, in order to enjoy the tax incentives established in Act No. 273-2012, the IFE must next obtain a decree from the DDEC. The decree will include the terms and conditions that the entity must comply with. This decree constitutes a contract between the Government of Puerto Rico, the international financial entity and its owners.

The incentives

In general, the decree will be for a term of 15 years and will allow the following benefits:

1. A 4 percent income tax on the net income realized from the Act No. 273 Authorized Activities
2. A 100 percent income tax exemption on dividends distributed by the IFE to non-Puerto Rico residents or IRIs
3. A 6 percent tax on dividends the IFE distributes to Puerto Rico residents other than IRIs
4. A 100 percent exemption on real and personal property taxes and municipal license taxes.

VI. PRIVATE EQUITY FUNDS

Act No. 185-2014, also known as the Private Equity Funds Act, has two aims: to promote investment in entities that do not have access to public capital markets and to attract capital investments to Puerto Rico.

The process

In general, Act No. 185-2014 provides that any limited liability company or partnership – domestic or foreign – ngaged in the business of investing in such instruments as notes, bonds or stock (not traded or quoted in the public markets when acquired) may elect to be treated as a private equity fund (PEF), subject to certain conditions. Among other requirements, this limited liability company or partnership must have an office in Puerto Rico and must enter into a contract with a registered investment advisor who is engaged in trade or business in Puerto Rico.

Under the act, the PEF must notify the Puerto Rico Treasury Department of its election to be treated as a PEF on or before the last day of the third month after its creation.

The incentives

In general, Act No. 185-2014 provides the following tax benefits:

1. The PEF is treated as a partnership for Puerto Rico income tax purposes. Accordingly, a PEF is not subject to Puerto Rico income tax; instead, the investors are subject to Puerto Rico with respect to their distributive share of the income of the PEF.
2. The share of an accredited investor of dividends and interest derived by the PEF is subject to a Puerto Rico fixed income

tax rate of 10 percent. Nevertheless, interest or dividend income derived by the PEF and that is exempt from Puerto Rico income tax is also exempt for the accredited investors.

3. An accredited investor's share of capital gains derived by a PEF is exempt from Puerto Rico income tax.
4. Capital gains from the sale of the private equity fund interest are subject to a Puerto Rico fixed income tax rate of 5 percent. However, if total gross proceeds are reinvested in a Puerto Rico private equity fund within 90 days from the date of the sale, such capital gains are not subject to Puerto Rico income tax.
5. In the case of registered investment advisers, general partners and private equity firms, interest and dividend income is subject to a Puerto Rico income tax rate of 5 percent and capital gains are subject to a 2.5 percent tax rate.
6. Special rules exist for deductions with respect to the initial investment in the PEF.

VII. INTERNATIONAL INSURERS AND REINSURERS

The International Insurers and Reinsurers Act of Puerto Rico, Act No. 399-2004, was enacted to promote the exportation of insurance and reinsurance services to markets outside of Puerto Rico. Generally, an international insurance company operating under Act No. 399-2004 (International Insurer) only insures risks outside of Puerto Rico, but may also provide surplus lines coverage and reinsurance for risks located in Puerto Rico.

The process

An insurance company interested in establishing an International Insurer must first submit an application for a certificate of authority to the Office of the Commissioner of Insurance (OCI). If the application is approved, the OCI may issue a certificate of authority operate under Act No. 399-2004. In addition, the OCI and the DDEC will issue a decree which will constitute a contract between the Government of Puerto Rico, the International Insurer and its shareholders.

The incentives

The Act No. 399 Decree, which is valid for 15 years, grants the International Insurer the following tax incentives, among others:

1. The first $1.2 million of net income derived by the International Insurer is exempt from Puerto Rico income tax; the net income that exceeds this base amount will be subject to a 4 percent Puerto Rico income tax
2. Dividends distributed by an International Insurer are totally exempt from Puerto Rico income tax and
3. A 100 percent exemption on real and personal property taxes and municipal license taxes.

VIII. FILM INDUSTRY

Act No. 27-2011, the Puerto Rico Film Economic Incentives Act, was designed to set forth an adequate framework for developing the Puerto Rico film industry.

Act No. 27-2011 eligible activities include the production and/or post-production of projects such as short-films, regular films, documentaries, series, mini-series, music videos, commercials, video games, and TV productions such as reality shows. Collectively, these are called Act No. 27 Eligible Projects.

The process

A film development company or studio operator interested in benefiting from Act 27-2011 should submit an application with the Puerto Rico Film Commission to obtain a tax decree, which will provide full detail of tax rates and conditions provided by Act 27-2011 and will be considered a contract between the Government of Puerto Rico and the applicant.

The incentives

Act No. 27-2011 provides, among others, the following tax benefits:

1. A 4 percent income tax rate on the net income derived from the Act No. 27 Eligible Projects[9]
2. A 90 percent exemption on real and personal property taxes for property used in the Act No. 27 Eligible Projects
3. A 100 percent exemption on dividend distributions the Act No. 27 Business makes out of its earnings and profits derived from the Act No. 27 Eligible Activities
4. A 100 percent exemption on municipal license taxes and municipal construction excise taxes

Among other tax incentives available for the film industry are a 40 percent tax credit on local production expenditures and a 20 percent tax credit on production expenditures on nonresident talent, provided they are subject to income taxation in Puerto Rico.

In addition, there are incentives for film industry-related infrastructure projects. A minimum spending requirement per project is required to apply for these benefits.[10]

9. In the case of studio operators, as such term is defined in Act No. 27-2011, the reduced income tax rate ranges from 6 percent to 10 percent.

10. See Footnote No. 3 above.

IX. HOTEL AND HOSPITALITY INDUSTRY

The Puerto Rico Tourism Development Act of 2010, Act No. 74-2010, was designed to promote the establishment of tourism-development projects throughout Puerto Rico. Under this act, the following business activities generally should qualify as eligible tourism activities:

1. Owning and/or operating (a) hotels, condo hotels, timeshares/vacation clubs, hostels or guesthouses, excluding the operations of casinos; (b) theme parks, golf courses, marinas for tourism purposes or port facilities in areas that promote tourism activities; (c) natural resources as a source of entertainment value; and (d) other entertainment or recreational tourism-related facilities
2. Operating a rental/leasing business which rents or leases property to be used in carrying out these activities and
3. Acquiring an existing Act No. 74 Business and making substantial renovations thereto.

The process

To obtain a 10-year Act No. 74-2010 decree, the interested party must file an application with the Puerto Rico Tourism Company and then file a copy of the application with the Puerto Rico Treasury Department.

The incentives

The Act No. 74 Decree grants the Act No. 74 Business the following tax exemptions, among others:

1. A 90 percent exemption on the net income derived from Act No. 74 Eligible Activities[11]
2. A 12 percent withholding tax on royalty payments made to non-Puerto Rico residents as a result of Act No. 74 Eligible Activities[12]
3. Distributions that the Act No. 74 Business makes out of its earnings and profits derived from the Act No. 74 Eligible Activities are subject to a one-time tax in Puerto Rico at the regular Puerto Rico income tax rates applicable to such distribution; any further distributions will not be subject to tax
4. A 90 percent exemption on real and personal property taxes
5. A 100 percent exemption on municipal license taxes for new businesses; and a 90 percent exemption for existing businesses
6. A 100 percent exemption on municipal construction excise taxes and
7. A 100 percent exemption on sales and use tax on the acquisition of certain items used in the Act No. 74 Eligible Activities.

Furthermore, Act No. 74-2010 provides for the granting of investment tax credits. In general, a person who makes an eligible investment is entitled to a credit equal to 50 percent of the cash paid for the equity investment or 10 percent of the tax credit. However, the exempt business may elect the alternate investment tax credit, which is limited to the 30 percent of the total cost of the project or 40 percent of the total cost of the project, as may be the case.[13]

11. A 100 percent income tax exemption applies if the income is derived from Act No. 27 Eligible Activities in Vieques or Culebra.

12. In lieu of the 12 percent withholding tax, a 2.9 percent withholding tax would apply in certain cases.

13. See Footnote No. 3 above.

X. PUBLIC PRIVATE PARTNERSHIPS UNDER THE P3 ACT

Act No. 29-2009, also known as the Public-Private Partnership Act of 2009, as amended (the P3 Act), was enacted with the goal of attracting investments in projects to improve Puerto Rico's infrastructure. The P3 Act and its regulation comprise one of the most robust legal frameworks for P3s in the Americas.

The P3 Act created the Puerto Rico Public-Private Partnership Authority (the Authority) as a public corporation and affiliate of the Government Development Bank for Puerto Rico.

The act sets out certain areas, called "Priority Projects," where P3s are to be expressly authorized as a matter of policy. These cover a broad range of construction, operation and maintenance projects, among them reservoirs and dams, energy plants, tourist and sports facilities, and wireless communication networks.

In relevant part, the P3 Act provides property tax exemptions for facilities subject to a P3 contract and any property used exclusively in, or for, the facility subject to the P3 contract if it is acquired, built or owned by the partnering government entity and is made available to the operator. The private partner may enter into agreements with municipalities to establish exemptions from municipal license fees, excise taxes or municipal taxes.

This is a broad area of law. Other provisions of the tax regime in Puerto Rico may be used to maximize exemptions and other incentives that may be applicable to the project or the private partner.

To learn more about the processes and the incentives available for P3 projects, please see our related handbook, *Public-Private Partnerships in Puerto Rico*.

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