PUERTO RICO

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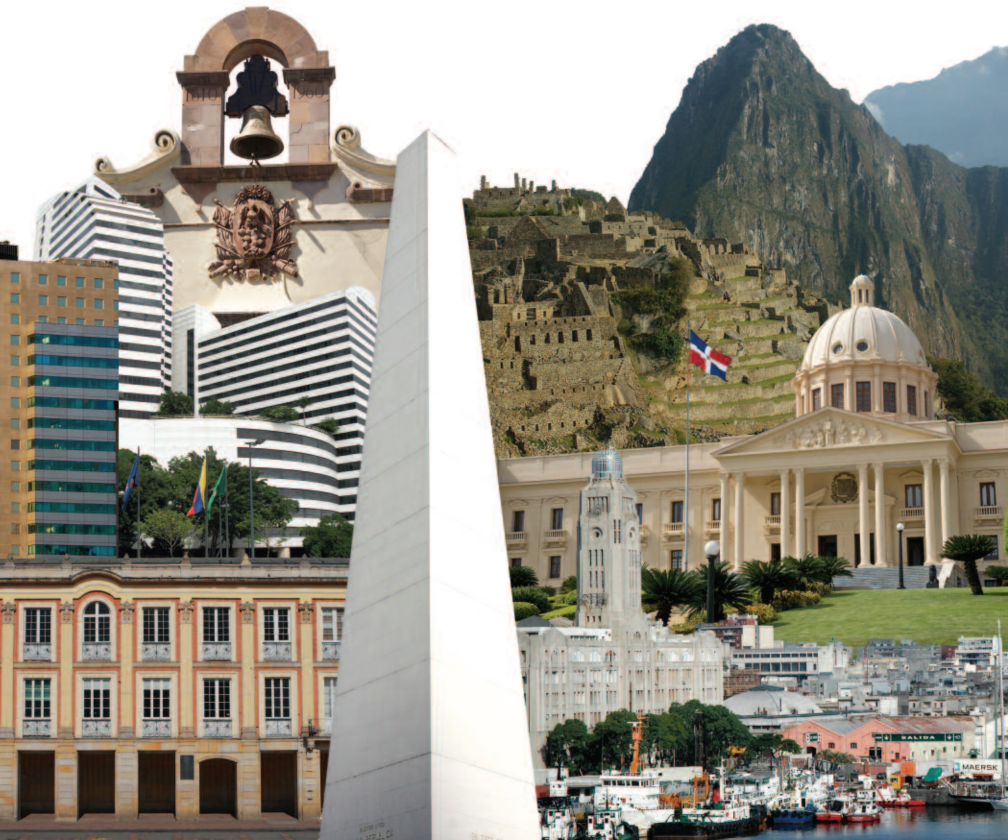

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DOING BUSINESS IN LATIN AMERICA AND THE CARIBBEAN

This publication has been prepared by the lawyers of Meritas firms to provide an overview to foreign investors and business people who have an interest in conducting business in Latin America and the Caribbean. The material in this publication is intended to provide general information only and not legal advice. This information should not be acted upon without prior consultation with legal advisors familiar with the specifics of your particular matter.

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The following currency notations are used in this book.

ARS	Argentinean Peso	DOP	Dominican Republic Peso
BSD	Bahamian Dollar	GTQ	Guatemalan Quetzal
BRR	Brazilian Cruzeiro Real	HNL	Honduran Lempira
KYD	Cayman Dollar	MXN	Mexican New Peso
COP	Colombian Peso	NIO	Nicaraguan Córdoba
CRC	Costa Rican Colón	PYG	Paraguayan Guarani
USD	United States Dollar	UYU	Uruguayan Peso

Please be aware that the information on legal, tax and other matters contained in this booklet is merely descriptive and therefore not exhaustive. As a result of changes in legislation and regulations as well as new interpretations of those currently existing, the situations as described in this publication are subject to change. Meritas cannot, and does not, guarantee the accuracy or the completeness of information given, nor the application and execution of laws as stated.

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In 1493, Christopher Columbus arrived in Puerto Rico and claimed the island for the Spanish Crown. Spain controlled the island for most of the next four centuries until 1898, when it ceded Puerto Rico to the United States as part of the Treaty of Paris, which ended the Spanish-American War.

Puerto Ricans were granted U.S. citizenship in 1917 and the right to elect their own governor in 1947. Puerto Rico approved a constitution in 1952 that was ratified by the U.S. Congress and approved by President Truman the same year. To this day, Puerto Rico remains a commonwealth of the United States.

GEOGRAPHY

Puerto Rico is the easternmost island of the Greater Antilles archipelago in the Caribbean Sea, located approximately 1,050 miles east-southeast of Miami. San Juan, Puerto Rico's capital and principal city, lies on the island's northern coast.

Puerto Rico consists of the main island of Puerto Rico and various smaller islands, including the island municipalities of Vieques and Culebra. The main island is approximately 100 miles (160 km) by 35 miles (60 km) with an area of about 3,400 square miles (8,800 square kilometers). Puerto Rico comprises a mountainous interior surrounded by coastal plains in the north and south.

GOVERNMENT SYSTEMS

Puerto Rico falls within the U.S. federal system and is subject to both U.S. federal and local law. Specifically, the U.S. constitution and most federal laws and regulations apply in Puerto Rico, and the island also has its own constitution, laws and regulations that apply to the extent they are not contrary to federal law.

Puerto Rico's local government, like those of the federal government and the states, includes an executive, a legislative and a judicial branch.

Although Puerto Ricans are citizens of the United States, U.S. citizens living in Puerto Rico do not have the right to vote in presidential elections. They have a nonvoting representative—called a resident commissioner—to the U.S. House of Representatives but no representative to the Senate. Passports are not required for U.S. citizens traveling between Puerto Rico and the United States. International visitors must meet the entry requirements established by the United States.

DEMOGRAPHICS

Puerto Ricans are an ethnic and cultural blend of Spanish, Taíno indian, African and American influences. As of the 2010 census, about 3.7 million people live in Puerto Rico. Natural-born residents are U.S. citizens. The island's major cities have the following populations: San Juan (424,951), Ponce (180,376), Caguas (142,984), Mayagüez (93,730), Trujillo Alto (85,682) and Humacao (60,681).

LANGUAGE AND CURRENCY

Puerto Rico's official languages are Spanish and English and its currency is the U.S. dollar.

MACROECONOMIC INDICATORS

Puerto Rico's economy is centered on high-value services and manufacturing. In 2011, the gross domestic product was approximately USD98.7 billion, with a GDP per capita of USD26,500. As of 2011, the labor force was approximately 1.28 million strong, of which some 1.1 million were employed. Mean household income is over USD27,190.

Exports Value: USD61.7 billion f.o.b. (2010)

Exports Composition: chemicals, electronics, rum, beverage concentrates and medical equipment

Export Partners: US 68.1%, Germany 8.1%, Netherlands 4.7% and Belgium 3.7% (2010)

Imports Value: USD40.8 billion c.i.f. (2010)

Imports Composition: chemicals, machinery and equipment, food and petroleum products

Import Partners: U.S. 51.2%, Ireland 15.5%, Singapore 4.7% and Japan 4.3% (2010)

INFRASTRUCTURE

Ground transportation. Puerto Rico's major cities are connected by a modern highway system. The highway system comprises 387 miles of primary system highways, which are the more important interregional traffic routes, 252 miles of primary urban system highways, 959 miles of secondary system highways, and 3,053 miles of tertiary highways and roads.

Airports. Puerto Rico's air access is by far the best in the Caribbean. Three airports—Luis Muñoz Marín International airport in Carolina (SJU), Rafael Hernandez Airport in Aguadilla (BQN), and Mercedita Airport in Ponce (PSE)—have direct service to the U.S. mainland. Luis Muñoz Marín International

Airport serves as the region's hub, providing service to more than 19 cities in the U.S. and many international destinations in the Caribbean, North America, South America and Europe. The airport receives over 10 million passengers per year, making it the busiest airport in the Caribbean.

Seaports. San Juan is the largest cruise-ship port in the Eastern Caribbean. It is home port to several cruise-ship companies and receives 1.2 million cruise-ship passengers a year.

San Juan, Guayanilla and Mayagüez are the island's principal cargo ports. The port of Ponce is being redeveloped as the island's largest deepwater port and should become one of the Caribbean's principal transshipment facilities within the next few years.

Utilities. The Puerto Rico Electric Power Authority (PREPA) provides electricity service throughout Puerto Rico. The cost of electric power varies depending on the type of industry, voltage level, energy consumption, load factor category and fuel adjustments. Customers of PREPA that qualify under Puerto Rico's economic incentives law are entitled to a tax credit ranging from 3% to 10% of the value of their payments to PREPA.

The Puerto Rico Aqueduct and Sewer Authority (PRASA) provides water and sewer service to most areas of the island. The cost of water depends on consumption and the diameter of the water meter. Most industrial facilities are connected to a two-inch water meter.

Puerto Rico has the necessary infrastructure for VoIP and broadband data connectivity to supply industry needs in landline service, wireless service and Ethernet. Puerto Rico is connected to the mainland United States through the Puerto Rico undersea fiber-optic cable of the American Region Caribbean Optical-ring System. This connectivity provides broadband accessibility for Internet access.

Education. There are 1,319 public and another 500 private primary and secondary schools in Puerto Rico. There are also over 50 institutions of higher learning, including universities, colleges, community colleges and technical institutes. The largest public university in Puerto Rico is the multi-campus University of Puerto Rico. The largest private university systems on the island are the Sistema Universitario Ana G. Méndez, the Pontificial Catholic University, Caribbean University, Carlos Albizu University, Sacred Heart University, Polytechnic University of Puerto Rico, and the multi-campus Interamerican University.

BUSINESS ENTITIES

Puerto Rico recognizes a wide range of business forms, from basic sole proprietorships and general partnerships to special purpose corporate forms and limited liability companies. Investors thus have a variety of options for optimizing liability shield and tax treatment characteristics.

It should be noted that partnerships do not necessarily receive pass-through tax treatment and not all corporations necessarily face double taxation. Instead, partnerships and corporations face taxation both at the partnership/corporate and partner/shareholder levels as the default rule, but both have the option of electing pass-through tax treatment if they meet certain criteria, as explained below.

SOLE PROPRIETORSHIP

A sole proprietorship is a business owned by a single individual who chooses not to form a partnership, corporation or limited liability company. There are no special legal requirements for creating a sole proprietorship other than the normal requirements for starting a trade or business. Sole proprietorships are not juridical entities and cannot enter into contracts or sue or be sued in their own name. Accordingly, a sole proprietorship provides no liability shield for its owner(s) and generally terminates upon the death of its owner(s). Likewise, it is not taxed separately, and all income is passed through to the owner(s). The owner is taxed at the appropriate individual rate.

PARTNERSHIPS

A partnership is an organization of two or more natural persons or juridical entities to carry on a business for profit pursuant to a partnership agreement. Partnership agreements (except those for limited liability partnerships and special partnerships) need not comply with any statutory formalities and need not be recorded in the Puerto Rico Department of State. However, in order to own real property, a partnership must have its partnership agreement incorporated into a public deed prepared by a notary public.

Several types of partnerships are recognized in Puerto Rico, and partnerships may be organized under the Civil Code, the Commercial Code, or the Limited Liability Partnership Act. Generally, however, partnerships have some common characteristics. The civil code treats a partnership as a juridical entity separate from its owners (i.e., the partners). A partner acting within the apparent scope of his authority under the partnership agreement can bind the partnership. Thus, the partnership is liable to a third party for the authorized acts of its partners. Except for partners in limited liability partnerships and limited partners of limited partnerships and special partnerships, the liability of the individual partners is unlimited and joint with respect to losses, damages, disbursements and obligations.

As mentioned above, and unlike in most states, Puerto Rico partnerships do not automatically provide pass-through tax treatment. Rather, partnerships and their partners are subject to tax at the partnership level and again at the partner level to the extent the partnership makes any distributions. However, partnerships that meet certain criteria can elect pass-through tax treatment pursuant to Subchapter K of the Puerto Rico Internal Revenue Code.

CORPORATIONS

Domestic Corporations

Puerto Rico's General Corporation Law is based on Delaware's. In general terms, a corporation is an entity separate and distinct from its shareholders, directors and officers. It has the power to enter into contracts, hold property, and sue and be sued on its own name; it also has continuity of life and free transferability of ownership interests.

Any person or juridical entity can form a corporation by filing articles of incorporation with the Corporate Division of the Puerto Rico Department of State, along with a filing fee.

The management of a corporation is typically carried out pursuant to bylaws, which may be adopted or amended at incorporation by the incorporator(s) or thereafter by the stockholders or, if permitted by the articles of incorporation, by the directors.

Puerto Rico corporations must maintain a designated principal office and agent in Puerto Rico for service of process.

Ownership of a corporation is effected through ownership of the corporation's capital stock, which may be issued in various classes with various rights and restrictions. Shares of corporate stock are personal property. Shareholders typically must hold meetings at least once per year. Nonresidents of Puerto Rico and non-U.S. citizens may own stock and serve as directors and officers of a Puerto Rico corporation.

Corporations must file an annual report on or before April 15. Annual reports must be signed by the corporation's president and treasurer, and in the case of a Puerto Rico corporation whose annual volume of business exceeds USD3 million, must be accompanied by the corporation's balance sheet at the close of the preceding fiscal year, audited by a certified public accountant licensed in Puerto Rico who cannot be a stockholder or employee of the corporation. Corporations incorporated outside Puerto Rico must accompany their annual report with an audited balance sheet regardless of annual volume of business. Each annual report must be accompanied by a fee.

Foreign Corporations

All corporations that are not organized under Puerto Rico laws are considered foreign corporations. Prior to conducting business in Puerto Rico, foreign corporations must register with the Puerto Rico Department of State, which will usually permit a foreign corporation to do business in Puerto Rico as a matter of course, so long as the proposed business is permitted and no other corporation is doing business under the same name.

A foreign corporation that fails to register to do business in Puerto Rico will not be allowed to initiate judicial proceedings in Puerto Rico until it is registered. Indeed, a court may suspend a judicial proceeding until a foreign corporation provides evidence that it is registered to do business in Puerto Rico. Courts can also order a foreign corporation to cease all business activities in Puerto Rico until it is duly registered to do business. Nonetheless, the mere fact that a foreign corporation is not authorized to do business in Puerto Rico will not affect the validity of its corporate actions in Puerto Rico or its right to defend itself in a proceeding in Puerto Rico.

Legal process against the corporation may be served on its authorized resident agent, who must be either a natural or judicial person residing in Puerto Rico, but cannot be a stockholder, officer or director of the corporation.

Professional Corporations

A professional corporation is formed for the purpose of rendering the type of professional services that require a license from the Commonwealth of Puerto Rico. All shareholders must be individuals licensed by the Commonwealth to render the professional services offered by the corporation, and those services must be rendered through the corporation's officers, employees and agents.

Officers, employees and agents of a professional corporation are fully and personally liable for any negligent act or omission, unlawful act, or for any culpable conduct that arises from the rendering of professional services on behalf of the corporation, whether committed by such officer, employee, or agent or by any person under his or her direct supervision or control. In addition, the professional corporation is held jointly liable up to the aggregate value of its assets for the negligent or unlawful acts or for the culpable conduct of its officers, employees and agents while offering professional services on behalf of the corporation. But shareholders who were not involved in the negligent or unlawful act or omission or culpable conduct are not personally liable for the damages caused by them. The professional corporation is not liable for the individual debts of its shareholders. Likewise, shareholders of the professional corporation are not liable for the liabilities of the professional corporation that are not related to negligent acts in the rendering of professional services.

The annual report of professional corporations must certify that its shareholders, directors and officers are duly licensed, certified and registered to render the professional services of the corporation in Puerto Rico. Non-Puerto Rico corporations may not qualify as professional corporations.

Close Corporations

Close corporations provide structural flexibility to corporations owned by a relatively small number of shareholders that do not intend to go public within a short period of time. To qualify as a close corporation, the certificate of incorporation must include, among other clauses, provisions stating that:

- The number of shareholders may not exceed 75 persons;
- All of the issued stock of all classes must be subject to one or more of the following restrictions:
    - A right of first refusal;
    - An obligation on the part of the corporation, any shareholder or any third party to purchase the shares subject to a purchase-sale agreement;
    - The requirement of the consent of the corporation or the shareholder of any kind of restricted security, prior to the transfer of such security; and
    - The prohibition, for a reasonable purpose, on transferring the securities to designated persons or classes of persons.
- The corporation may not make any public offering that qualifies as such under the Federal Securities Act of 1933.

Nonprofit Organizations

The certificate of incorporation of a nonprofit corporation must clearly state that the corporation is organized for nonprofit purposes and is not authorized to issue stock.

Nonprofit corporations are required to file their annual report with the Puerto Rico Department of State, but they pay lower fees, or, in the case of nonprofit religious, fraternal, charitable or educational corporations, no filing fee is required.

Corporation of Individuals

A corporation of individuals is a corporation that meets certain criteria and can elect to be taxed under Subchapter N of the Puerto Rico Internal Revenue Code as an N corporation. In general, an N corporation does not pay any income taxes at the corporate level, and the corporation's income and losses are passed through to its shareholders. This pass-through tax treatment is available, however, only if the shareholders consent to the corporation's election and the corporation meets a number of criteria. Specifically, the stock of a corporation of individuals may be owned only by individuals who are citizens or resident aliens of Puerto Rico, estates and certain trusts. Moreover, the corporation must:

- Be an eligible domestic corporation (including a U.S. entity that engages in trade or business only in Puerto Rico), but not an insurance company, a registered investment company, a special corporation owned by employees, a corporation exempt under any tax incentives or similar acts (except under the Puerto Rico Tourism Development Act of 1993), a financial institution, or a corporation licensed as a capital investment fund;
- Not have more than 75 eligible shareholders;
- Have only one class of stock outstanding.

All of these requirements must be met when the election is made and at all times thereafter. Failure at any time to qualify as a corporation of individuals terminates the election, and as of the date of termination, the corporation is taxed as a regular corporation.

Limited Liability Company

Limited Liability Companies (LLC) are more flexible operationally than corporations but can still provide legal protection for their managers and members. To form an LLC, one or more persons must file a LLC Certificate of Formation with the Puerto Rico Department of State, along with a fee. A foreign LLC may register in Puerto Rico by petition signed by an authorized person following the procedures specified in the General Corporation Act; once registered, it shall have some powers as a domestic LLC, provided that its internal affairs and the liability of its managers and members shall continue to be governed by laws of the jurisdiction where the LLC is organized. LLCs may engage in any lawful activity but must maintain a registered office and resident agent for service of process in Puerto Rico.

The management of an LLC is typically governed by an LLC agreement that sets forth:

- The respective duties of the LLC and its managers and members to each other;
- The LLC's management structure;
- The rights of the managers and members; and
- Their respective share of interest in the LLC profits and losses.

Unless otherwise provided in the LLC agreement, managers and members of an LLC cannot be held personally liable for the LLC's obligations solely by reason of being a manager or member. They may rely in good faith on the LLC's records and upon information presented by other managers, members, officers, committees, employees, or anyone else with respect to whom such reliance is reasonable.

Like partnerships and corporations, LLCs are generally taxed at both the business entity and shareholder levels. But also like partnerships and corporations, LLCs can file for pass-through tax treatment under either subchapter K or subchapter N of the Puerto Rico Internal Revenue Code.

Entities may also organize as business trusts, joint ventures, cooperatives, international banking entities (IBE), insurance companies, real estate investment trusts (REIT), registered investment companies or special employee-owned corporations under the laws of Puerto Rico.

BASIC REQUIREMENTS AND PROCEDURES FOR STARTING A BUSINESS

Requesting and registering an Employer Identification Number

Except for sole proprietorships that do not employ anyone (other than the sole proprietor), every entity engaged in a trade or business in Puerto Rico must obtain a federal Employer Identification Number (EIN) from the U.S. Internal Revenue Service (IRS) by filing Form SS-4. Upon obtaining an EIN, the entity must file with the Puerto Rico Department of Treasury a Form SC-4809, a copy of the certificate of incorporation, and a copy of Form SS-4.

Merchant's Registration Certificate

All merchants seeking to engage in a trade or business in Puerto Rico must register with the Registry of Businesses at the Puerto Rico Treasury Department at least 30 days prior to commencing business operations. The Certificate of Registration issued by the Treasury Department must be placed in a location at the trade or business that is visible to the general public. A merchant may not transfer its Certificate of Registration or Certificate of Exemption unless the transfer is previously approved by the Secretary of Treasury. Any merchant who acquires taxable items for resale or any manufacturing plant may request a certificate of exemption of the sales and use tax. Every certificate of exemption is valid for three years. The exemption certificate is important because every merchant who has been issued this certificate will not have to pay sales tax when he or she purchases the items listed in the certificate.

Compulsory Business Registry

All businesses operating in Puerto Rico must register with the Compulsory Business Registry by July 15 of each year. Registration requires certain statistical information and can be done on the Internet. Forms and information are available from the Puerto Rico Trade and Export Company.

Municipal License Taxes

Within 30 days of commencing operations, a business must provide written notice to the Director of Finance of each municipality in which it has commenced operations and request a provisional license for the quarter in which it commences operations.

Bidders Registry

Any person (natural or juridical) who wants to pursue business with any agency of the executive branch of the Commonwealth of Puerto Rico is required to register with the Bidders Registry, which is administered by the General Services Administration. Among the requirements are the payment of an annual fee, and evidence of the payment of municipal and Commonwealth taxes.

Financial and Accounting Records

As a general rule, a taxpayer must keep and maintain financial and accounting records sufficient to compute both net income under General Accepted Accounting Principles and taxable income under the Puerto Rico Internal Revenue Code.

Audited Financial Statements

Every person engaged in a trade or business in Puerto Rico whose volume of business exceeds USD3 million must file financial statements, certified by a certified public accountant (CPA) licensed in Puerto Rico, along with their income tax, property tax and volume of business returns. All foreign corporations must also file a balance sheet of their Puerto Rico operations, certified by a CPA licensed in Puerto Rico, together with the Annual Corporation Report.

Internal Revenue Licenses

A license from the Puerto Rico Treasury Department may be required to carry out certain activities, including: selling cigarettes, gasoline, vehicles and parts and accessories of vehicles, jewelry, cement, arms and ammunition; operating coin-operated machines; operating duty-free port stores; selling firearms and munitions; and operating public carrier businesses. Such licenses may not be transferred without the authorization of the Puerto Rico Secretary of Treasury. A manufacturer of articles whose sale requires a license is not required to have such license, provided the manufacturing operations are completely apart from any location in which an activity subject to such a license is conducted.

Municipal Revenue Collection Center (CRIM)

In Puerto Rico, property is classified for property tax purposes as real property (land, buildings and structures, and machinery permanently attached to the land or building) and personal property (practically all other property, including intangibles, machinery, money, cattle and shares of stock). The Municipal Revenue Collection Center (CRIM) is responsible for making this classification. The CRIM is also responsible for the valuation and appraisal of all taxable property in Puerto Rico.

Permits and Licenses

Any business seeking to construct a new structure or modify an existing structure must obtain a construction permit and a use permit. A use permit is the authorization for the occupation and use of certain lands, buildings or structures. This permit is required when the construction (for which a construction permit was issued) is completed.

A sanitary license is required for the operation of certain public establishments, including any type of prepared food vendor (fast-food, cafeteria, restaurants, bars, nightclubs, etc.), public pools, vending machines and beauty salons. This license is issued by the Department of Health and can be requested with a use permit or directly from the Department of Health.

An inspection by the Fire Department is required for the construction of a new building or to obtain a use permit for the establishing of a public operation. It must be requested annually.

If a business owns or operates an emergency power plant, it must have a construction and operation permit from the Environmental Quality Board (EQB). An emergency plan for the prevention of diesel spills may also be required.

TAXATION

THE U.S. TAX SYSTEM

Individuals Residing in Puerto Rico

Like residents of the United States, residents of Puerto Rico are subject to federal income tax on their worldwide income. However, U.S. Code Section 933 permits a bona fide individual resident of Puerto Rico to exclude Puerto Rico source income from his gross income for U.S. tax purposes. The determination of bona fide residence in Puerto Rico for income tax purposes is established by the application of three tests established in U.S. Code Section 937: the (a) presence test; (b) tax home test; and (c) closer connection test. Of course, even bona fide residents of Puerto Rico will be subject to U.S. income tax on income from sources outside Puerto Rico.

Puerto Rico Corporations

Puerto Rico corporations are treated as foreign corporations for U.S. income tax purposes. Thus, Puerto Rico corporations are subject to a 30% U.S. income tax withholding on, among certain other types of income: interest, rents, wages, premiums, annuities, compensation, remuneration, emoluments, and other fixed or determinable annual or periodical gains, profits and income from sources within the United States. Dividends received by a Puerto Rico corporation from a U.S. corporation, however, and provided certain conditions are met, are subject to only a 10% U.S. income tax withholding instead of the 30% rate applicable to other foreign corporations. The conditions that must be met for the 10% rate to apply are:

- Foreign persons must not own (directly or indirectly) 25% or more of the stock of Puerto Rico corporation at any time during the taxable year in which the dividend is distributed;
- At least 65% of the gross income of the Puerto Rico corporation is effectively connected with the conduct of a trade or business in Puerto Rico or the United States for the three-year period ending with the close of the taxable year of the Puerto Rico corporation or for such part of said period that the corporation has been in existence; and
- No substantial part of the income of the Puerto Rico corporation is used (directly or indirectly) to satisfy obligations to persons who are not bona fide residents of Puerto Rico or the United States.

Notwithstanding the above, Puerto Rico corporations are subject to regular U.S. tax rates on their income effectively connected to a trade or business in the United States. When using a Puerto Rico corporation, care should be exercised as to the possible applicability of U.S. Internal Revenue Code provisions related to controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies.

United States Corporations

U.S. corporations are taxable in the United States on their worldwide income. Therefore, U.S. corporations that derive taxable income from Puerto Rico sources must include such income as part of their gross income for determining their U.S. income tax liability. If a U.S. corporation decides to establish its operations in Puerto Rico through a Puerto Rico subsidiary, the latter will not constitute part of the consolidated group for purposes of the filing of U.S. income tax returns, since a Puerto Rico corporation is considered a foreign corporation for U.S. purposes.

THE PUERTO RICO TAX SYSTEM

Business Taxes

Sole Proprietorship

A sole proprietorship is taxed on net income from the operation of its trade or business. The net income, generally, is determined using the rules discussed below for corporations. However, the Puerto Rico Code establishes certain exceptions, such as the treatment of the net operating losses. Specifically, the net operating losses suffered by a business operated by an individual as a sole proprietorship may not be used to reduce the net income derived from other business activities conducted by the individual. However, if a husband and wife each own a different principal trade or business, both trades or businesses will be treated as one principal trade or business for purposes of the net operating loss deduction.

Corporate Income Tax

For income tax purposes, corporations, partnerships, limited liability companies, joint ventures and business trusts, among others, are treated the same: there is no flow-through of income or losses to the owners of such business entities, and instead taxes are levied both at the corporate/partnership level and again at the shareholder/partner level when actual distributions are made.

Taxation of Worldwide Income

Puerto Rico corporations are taxed on their total net taxable income derived from any source whatsoever. Basically, the tax is determined by excluding certain items from gross income, excluding the items of income that are taxed at a different rate, reducing the remaining amount by the corresponding deductions, applying the corresponding corporate income tax rate to the amount remaining after deductions to determine the partial tax, applying the special tax rates to the special-tax-rate items to determine the tax on special items, adding the partial tax to the tax on special items to determine the total corporate income tax, and reducing the total corporate income tax by estimated taxes paid, withheld amounts and other credits. The result is the amount of Puerto Rico corporate income tax due.

Source of Income Rules

Personal Services. Compensation paid for personal services performed in Puerto Rico is treated as derived from sources within Puerto Rico.

Rents and Royalties. Income from rents and royalties paid with respect to property located in Puerto Rico, and rents and royalties paid for the use of, or for the privilege of using, within Puerto Rico, intangibles such as patents, copyrights, secret processes, formulae, goodwill, trademarks, trade names and franchises, are treated as derived from sources within Puerto Rico. Also treated as income derived from sources within Puerto Rico are payments made for the right to transmit, within Puerto Rico, television and radio programs, films and other similar property.

Sale of Real Property. Gain from the sale of real property is sourced where the real property is located.

Sale of Personal Property. Gain from the sale of personal property produced, in whole or part, by the taxpayer within Puerto Rico and sold outside Puerto Rico or produced, in whole or in part, by the taxpayer outside Puerto Rico and sold within Puerto Rico is treated as derived partly from sources within and partly from sources without Puerto Rico. Gain derived from the sale within Puerto Rico of personal property purchased by the taxpayer outside Puerto Rico and from the sale of personal property purchased within Puerto Rico by the taxpayer and sold outside Puerto Rico is treated as derived entirely from sources within the country in which it was sold. If the personal property is produced and sold in Puerto Rico, the income from the sale will be sourced in Puerto Rico.

Distribution from Liquidation of a Puerto Rico Corporation. Income derived from the total or partial liquidation of a Puerto Rico corporation or partnership is treated as derived from sources within Puerto Rico.

Distribution from the Liquidation of a Foreign Corporation. Income derived from the partial or complete liquidation of a foreign corporation or partnership is treated as derived from sources within Puerto Rico if 80% or more of the corporation's or partnership's gross income for the three years preceding the liquidating distribution was effectively connected with the conduct of a trade or business in Puerto Rico. However, the income will be treated as from sources within Puerto Rico only in an amount that bears the same ratio to the total amount of the liquidating distribution as the gross income of the corporation or partnership effectively connected to the trade or business in Puerto Rico (excluding income considered in determining the branch profit tax, if applicable) bears to gross income from all sources.

Insurance Premiums. Premiums paid with respect to a contract insuring risks located in Puerto Rico are treated as income derived from sources within Puerto Rico. However, premiums paid on life insurance contracts to a person not engaged in trade or business in Puerto Rico are not treated as income derived from sources within Puerto Rico.

Tax Accounting Period

A tax year generally consists of a period of 12 months. A corporation may select its tax accounting period on or before the due date for the filing of its first income tax return, without considering extensions of time to file. Once a taxable year is selected, that taxable year must continue until the Puerto Rico Department of Treasury approves a change or the law specifically permits otherwise. The tax accounting periods are: (a) the calendar year; (b) a 12-month fiscal year; and (c) 52 and 53 week taxable year.

Tax Accounting Methods
In general, the accounting method used by a corporation to determine its net income for regular business purposes must be used to determine net taxable income for tax purposes. However, the accounting method used by a corporation for tax purposes must be one that clearly reflects income and expenses. The cash-receipt-and-disbursement method, the accrual method, hybrid methods, the installment method, the percentage-of-completion method and the completed-contract method are among the accounting methods allowed for Puerto Rico income tax purposes..

Inventories. The method of inventory used for tax purposes must conform to the best accounting practice in the corresponding trade or business. The term “best accounting practice,” as used in the Puerto Rico Internal Revenue Code, is generally the same as “generally accepted accounting principles.” The most common methods that may be used to identify inventory are:

- The specific identification method
- The first-in first-out method (FIFO)
- The last-in first-out method (LIFO)
- The weighted average cost method

Pursuant to the Puerto Rico Internal Revenue Code, inventories must be valued at the lower of cost or market value. The regulations offer a number of rules regarding the use of the accounting methods and the valuation of inventories of certain businesses such as securities, farming, livestock breeding, mining, manufacturing and retailing.

Reserve Methods. The reserve method for deductions of bad debts is not allowed under the Puerto Rico Internal Revenue Code.

Gross Income
The meaning of gross income is broad and general. The Puerto Rico Internal Revenue Code provides that gross income includes gains, profits and income derived from salaries, wages or compensation for personal services, interest, rent, dividends, partnership profits, securities or the transaction of any business carried on for gain or profit, or gains or profit and income derived from any source whatsoever. All income is taxable income unless specifically excluded.

Capital Gains

Under the Puerto Rico Internal Revenue Code, corporations may elect to have gains that are derived from the sale or exchange of a capital asset:

- Taxed at a fixed income tax rate and have their other income taxed in the regular manner, or
- Included as part of their gross income and taxed at the corresponding ordinary income tax rate.

If the first method of the two described above is chosen, all long-term capital gains and losses are excluded from the gross income that is taxed at the regular Puerto Rico corporate income tax rates. The alternate capital gains tax rate for corporations is 15%. A capital gain or loss is long-term if the capital asset was held by the transferor for more than six months prior to the transfer.

Non-Recognition Transactions

There are certain transactions in which the gain realized is not recognized for tax purposes and therefore excluded from gross income. In general, the reason for not recognizing such gains is that the underlying transaction is not considered sufficient to break the continuity of the investment. This is the case, for example, with certain exchanges of like-kind property, involuntary conversions, corporate reorganizations, transfers to a corporation controlled by the transferor, property received by a corporation in a complete liquidation of its controlled subsidiary, securities exchanged for securities of the same corporation, and transfers of qualified securities to an employee stock ownership plan. The non-recognition of gain in these cases is, in effect, a deferral of the gain by means of assigning the basis of the transferred property to the property being received in the exchange.

Dividend Income

A Puerto Rico corporation's dividends or partnership's distributions are subject to a 10% withholding tax upon distribution. An accumulated earnings penalty tax of 50% may be imposed if a corporation is determined to have been formed or used to prevent the imposition of income tax on its shareholders by accumulating corporate earnings instead of distributing such earnings to the shareholders. If the earnings have been accumulated because the reasonable needs of the business so dictate, the accumulated earnings penalty tax may not be imposed.

Interest Income

The source of interest income is generally determined by reference to the residence of the debtor. The Puerto Rico Internal Revenue Code grants special tax treatment to certain types of interest, such as interest on government bonds and interest on deposits in Puerto Rico financial institutions.

Business Expenses

Expenses incurred by a corporation during the taxable year that are directly connected to its business activities are generally deductible provided they are ordinary, necessary, reasonable and not in violation of public policy. In general, the rules for the deductibility of the business expenses of a corporation closely follow the rules applicable under the U.S. Internal Revenue Code. However, there are certain items that are statutorily nondeductible even though they would otherwise qualify as a business expense. For example, life insurance premiums paid by a corporation on the life of an officer, employee or person financially interested in the trade or business of the corporation, when the corporation is directly or indirectly the beneficiary of the policy, are not deductible.

Organizational Expenses

Organization expenditures, the benefit of which does not have a definite and fixed period of duration, are deductible only when the corporation or partnership is dissolved. When a corporate charter or certificate is issued for a limited time only, the expenses can be amortized over that period. These nondeductible expenditures are generally incidental to the creation of the corporation or partnership, such as legal fees for drafting the corporate or partnership charter, bylaws, minutes of organizational meetings, and original stock certificates, fees for start-up accounting services, expenses of temporary directors and of organizational meetings of directors or stockholders, and state incorporating fees.

Travel and Entertainment Expenses

An employer may deduct the paid or reimbursed travel expenses incurred by its employees while working away from home, provided such expenses are ordinary, necessary and reasonable. These expenses generally include transportation, meals and lodging expenses for business-related travel. The payment or reimbursement by an employer of the commuting expenses of an employee is not deductible as traveling expenses, but is deductible as additional compensation. Expenses incurred by an employee for commuting to and from the place of work are not deductible. Food and entertainment expenses, in addition to being limited by the requirements of being ordinary, necessary and reasonable, are subject to 50% and 25% limitation rules. The 50% limitation rule provides that only 50% of the total of such expenses is allowed as a deduction. The 25% limitation rule requires that the total of such deductions never exceed 25% of the gross income of the person taking the deduction.

Interest

As a general rule, interest is only deductible if the taxpayer has an obligation to pay the interest and it is ordinary and necessary. The Treasury Department has allowed a deduction of interest that is not paid by the obligor if the party paying the interest is benefited by such payment. However, interest related to an indebtedness incurred to purchase obligations, which is exempt from Puerto Rico income tax, is not deductible. The doctrine of "thin capitalization" has been applied frequently at the administrative level in Puerto Rico. Under this doctrine, debt may be treated as equity and interest payments as dividends if certain factors are present. Interest payments are deductible by the corporation but dividend payments are not.

Royalties

Royalty payments are deductible within the category of ordinary and necessary expenses.

Retirement Plan Contributions

Retirement plans can be divided into two types: qualified plans and nonqualified plans. Qualified plans are those specifically covered by the Puerto Rico Internal Revenue Code. These plans offer a special tax treatment to the: (i) employer, who is allowed to deduct contributions made to the plan; (ii) participants, who can defer the employer's contributions until they are actually received; and (iii) the trust that controls and administers contributions to the plan and payments of benefits to the participants, which is treated as a tax-exempt entity. Qualified plans are heavily regulated and are subject to strict reporting requirements.

Taxes

Taxes paid or accrued by persons that are not individuals are deductible unless otherwise excepted. Puerto Rico income tax and all inheritance, estate, legacy, succession and gift taxes are specifically listed as nondeductible. Income taxes, war-profit taxes and excess-profit taxes not imposed by Puerto Rico (i.e., imposed by the United States or any of its possessions, or by a foreign government) are deductible, but only if they are not otherwise claimed as a credit. Federal import duties and Puerto Rico excise taxes on manufactured and imported goods are not deductible (these charges are included as part of the costs of the goods). However, such taxes may be deductible if they qualify as necessary and ordinary business expenses. In such case, they would be deductible as a business expense and not as a tax, and would therefore be required to meet the ordinary and necessary test. Automobile license fees are considered a tax. As such, they do not need to meet the "ordinary and necessary" test.

Depreciation and Depletion

The cost of business assets with a useful life of more than one year may not be deducted in full in the year of acquisition because part of the cost relates to future years. This deduction is generally referred to as depreciation. Inventory and stock in trade are not depreciable property. The three depreciation systems that may be used under the Puerto Rico Internal Revenue Code are straight-line depreciation, accelerated cost recovery system (ACRS), and flexible depreciation.

Obsolescence
Generally, obsolescence is taken into consideration when determining the useful life of property. A special deduction for extraordinary obsolescence may be allowed when the economic life of the property ends prior to the termination of its normal useful life.

Charitable Contributions
Corporations may deduct charitable contributions made within a year to certain organizations, such as religious, charitable, scientific, literary or educational organizations. The amount of charitable contributions made by a corporation during a year may not exceed 5% of its net income, computed without the benefit of the charitable deduction. Charitable contributions made in excess of 5% of net income may be carried over to the following five years. The 5% limitation is not applicable with respect to contributions made to municipalities for purposes of an historical or cultural value, certified as such by the Institute of Puerto Rican Culture or the Cultural Center of the corresponding municipality.

Capital Losses
Corporations and partnerships are only allowed to deduct capital losses to the extent of capital gains, with a five-year carryover of excess capital losses. During the carryover period, the carried-over capital losses are treated as short-term capital losses.

Casualty Losses
Casualty losses sustained by a corporation and not compensated for by insurance or otherwise are deductible. The basis for determining the amount of the loss sustained is the adjusted basis of the lost property.

Bad Debts
Corporations are entitled to an ordinary deduction for business debts that become worthless, or for the part of such debts that become worthless, during the taxable year. To allow the deduction for a bad debt, the taxpayer must have included the amount of such debt as income.

Worthless Bonds and Similar Obligations; Worthless Stock and Right to Acquire Stock
If bonds, debentures, notes, certificates of debt and other similar evidences of indebtedness become worthless during the year, the loss is considered due to the sale or exchange of a capital asset on the last day of the taxable year. In that instance, the corporation holding the worthless securities will have a long-term

or short-term capital loss depending on the length of the period during which the security was held. If the worthless security was held for more than six months, the loss will be treated as a long-term capital loss; otherwise it will be treated as a short-term capital loss. Partial worthlessness and reduction in value due to market fluctuations are not deductible.

Inventory Write-downs
Goods in inventory that are unsaleable at normal prices or unusable because of damage, imperfections, shop wear, change of style, odd or broken lots, or other similar causes may be valued at their bona fide selling price less the direct cost of their disposition. The bona fide selling price is the selling price at which the goods are offered at a date not later than 30 days after inventory date.

Rents
Rental payments made by a corporation are generally considered part of the business expenses of the corporation and, thus, deductible. Property taxes on leased property paid by the lessee pursuant to the terms of the lease are considered additional rent paid by the lessee. The amount of the property tax on the leased property paid by lessee is deductible by the lessor. A person acquiring a leasehold for a specified sum may take a deduction for the proportional amount of the sum for each year based on the number of years remaining in the lease term. Likewise, the cost incurred by the lessee to construct buildings and/or make permanent improvements to the leased property must be capitalized by the lessee and deducted throughout the years remaining in the lease term instead of the depreciation deduction. However, if the useful life of the constructed building and/or the permanent improvement made by the lessee is less than the remaining years in the lease term, the lessee must take the deduction for depreciation during the corresponding useful life. As a general rule, if the lease has an option for a renewal period, such renewal period is not taken into consideration when determining the remaining years of the lease term, unless the lease has already been renewed or there is reasonable certainty that it will be renewed.

Salaries and Wages
All reasonable salaries and wages, as well as commissions, bonuses, fees, compensation payments and other similar payments made for services rendered paid by corporations, are deductible as a business expense.

Other Miscellaneous Deductions
There are a number of other miscellaneous deductions available to corporations including a USD400 deduction for each severely handicapped person employed at least 20 hours a week for at least nine months in the taxable year, up to a maximum of five severely handicapped persons, and an amortization deduction for bond premiums.

Capital Expenditures

The Puerto Rico Internal Revenue Code follows closely the U.S. Internal Revenue Code with respect to capital expenditures. The concept of capital expenditures is also based on the principle that the accounting method used must clearly reflect income. Capital expenditures, instead of being deducted in the year in which they are paid or accrued, are included as part of the basis of the acquired or improved asset. In addition, depending on the asset and the circumstances involved, such capital expenditures will be depreciated, amortized or depleted pursuant to the applicable depreciation, amortization or depletion rules, or included as part of the basis until the asset is sold or disposed of. Amounts paid for securing a copyright, defending or perfecting title to property, architect's services in relation to the construction of a building, and commissions in purchasing securities are capital expenditures.

Loss Carryovers

For purposes of determining the amount of the net operating loss carryover, net operating loss equals the excess of deductions over gross income, subject to certain adjustments. The net operating loss may be carried over to the following seven years.

Tax Credits

Foreign Tax Credits

To mitigate or eliminate the risk of double taxation of the same income, Puerto Rico corporations have the option of either deducting or crediting the income and excess profit taxes paid or accrued during the taxable year to the United States, any possession of the United States, or any foreign country. However, a Puerto Rico corporation may not, in the same taxable year, take a deduction for some of the non-Puerto Rico income tax paid and take a credit for the other non-Puerto Rico income tax paid. When non-Puerto Rico income tax is credited, it is treated as a payment of Puerto Rico income tax except that it may not give rise to a refund. No foreign tax credit is allowed to reduce the accumulated earnings penalty tax. The amount of the foreign tax credit is subject to the per-country limitation and the overall limitation. The excess U.S., possessions, and foreign taxes paid or accrued by the Puerto Rico corporation over the foreign tax credit actually allowed in a taxable year may not be carried back or forward for use in other taxable years. In addition to the foreign income and excess profits taxes paid or accrued, a Puerto Rico corporation may be deemed to have paid the foreign income and excess profits tax allocable to the distributed earnings received from its foreign subsidiary.

Other Credits

Amounts withheld may be used as a credit to reduce the recipient's tax liability. A credit is also available for contributions made to the Educational Foundation for the Free Selection of Schools up to a maximum of USD500 per year. Also, there are certain tax credits available in relation to dividends paid by a corporation operating under a grant of tax exemption if investment requirements are met by the distributing corporation.

Tax Rates and Calculation of Taxable Income

Corporate Income Tax Rates

Puerto Rico corporations and non-Puerto Rico corporations engaged in trade or business in Puerto Rico face a corporate tax rate composed of two parts: a "normal" tax, which is fixed at 20%; and a variable "surtax."

Elimination of the Graduated Tax Rates Benefit

When the net taxable income of a Puerto Rico corporation or of a non-Puerto Rico corporation engaged in trade or business in Puerto Rico exceeds USD500,000 in a taxable year, a 5% additional tax is imposed on the net taxable income in excess of USD500,000 until the maximum tax rate to be paid by the corporation on all its taxable income reaches 39%.

Alternative Minimum Tax

The alternative minimum tax (AMT) is designed to ensure that corporations with substantial economic income may not avoid paying a reasonable amount of income tax by using exclusions, deductions and credits available to them. The Puerto Rico AMT equals the excess of the amount of the tentative minimum tax over the amount of the normal corporate tax plus surtax. The tentative minimum tax is equal to 22% of the excess of net alternative minimum income over the exempt amount. The exempt amount equals USD50,000 reduced (but not below zero) by 25% of the alternative minimum net income over USD500,000. The alternative minimum net income equals the net taxable income subject to certain adjustments. The AMT does not apply to:

- Foreign corporations and partnerships that are not engaged in trade or business in Puerto Rico;
- Special partnerships;
- Corporations of individuals;
- Registered investment companies;
- Real estate investment trusts;
- Special corporations owned by employees;
- Corporations and partnerships operating under a grant of industrial or tourism tax exemption, but only in relation to the income covered by the grant; or
- Corporations or partnerships operating bona fide agricultural businesses, but only to the extent that the income derived from the activity is allowed as a deduction.

However, it is important to mention that payments made to related persons for services not rendered in Puerto Rico and not subject to taxation in Puerto Rico will not be allowed as a deduction for purposes of computing the Alternative Minimum Tax Income. For these purposes, the term "related persons" refers to nonresident aliens or foreign corporations or partnerships not engaged in trade or business in Puerto Rico if there is 50% or more of overlapping ownership.

Assessment and Filing

Corporate Income Tax Return

All Puerto Rico corporations and all non-Puerto Rico corporations that are engaged in trade or business in Puerto Rico are required to file an income tax return and pay the corresponding Puerto Rico corporate income tax on or before the 15th day of the fourth month following the close of its taxable year. An automatic three-month extension of time will be granted to corporations for the filing of income tax returns if the extension request is filed on or before the due date of the filing of the income tax return. The extension must be filed accompanied by the full balance of the income tax due.

Estimated Tax

In addition to the corporate income tax return, every corporation engaged in trade or business in Puerto Rico is required to estimate its tax liability for the current taxable year. The estimated tax may be paid in four installments by the 15th day of the fourth, sixth, ninth and twelfth months.

Consolidated Returns

The Puerto Rico Internal Revenue Code does not provide for the filing of corporate returns on a consolidated basis.

Funding the Corporation

As a general rule, no income is recognized by a Puerto Rico corporation on the original issuance of its stock. However, the Puerto Rico Internal Revenue Code requires that if the transferor consists of more than one person, the number of shares and securities received by each person must be proportional to his interest in the transferred property prior to the transfer. When a corporation assumes the liabilities of the transferor or receives property from the transferor subject to liabilities, such assumed liability is not treated as a receipt of money or other property by the transferor in determining whether the transfer is "solely in exchange of stock or securities." However, for the purpose of determining whether the stock or securities received by the transferors are substantially proportionate to their interest in the transferred property, the assumed liabilities are treated as stock or securities received by transferors. The basis of the stock or securities received by a transferor in a non-recognition exchange with a Puerto Rico corporation is equal to the basis of the property transferred in exchange for the stock or securities, decreased by the amount of money received, increased by the amount of gain recognized, and decreased by the amount of loss recognized by the transferor. The liability assumed by the corporation is treated as money received by the transferor for the purpose of determining the basis of the stock or securities received by the transferor.

Reorganizations

In general, the reorganization rules under the Puerto Rico Internal Revenue Code follow a pattern similar to that of the reorganization rules of the U.S. Internal Revenue Code, with the principle underlying both codes being that no gain or loss should be recognized because the new corporate structure is merely a continuation of the previous corporate structure. The recognition of gain or loss is postponed by means of a carryover of the basis. The reorganization rules are also applicable to partnerships. The Puerto Rico Internal Revenue Code lists the same types of reorganizations as the U.S. Internal Revenue Code, except the Puerto Rico Internal Revenue Code does not list the transfer by a corporation of all or part of its assets to another corporation in a Title 11 bankruptcy filing or a receivership, foreclosure or similar proceeding in a federal or state court. However, the Puerto Rico Internal Revenue Code specifically provides that no gain or loss is recognized in certain exchanges made in connection with the reorganization of an insolvent corporation affected in a receivership, foreclosure or other similar court proceeding, or in a court reorganization proceeding under Section 77B or Chapter X of the federal Bankruptcy Code.

Liquidations

Generally, a gain or loss may be recognized upon the liquidation of a Puerto Rico corporation at both the corporate and shareholder levels. At the corporate level, liquidation will be treated as if the corporate assets are being sold to the shareholder at fair market value. At the shareholder level, the liquidation is treated as an exchange by the shareholder of its shares of stock for the assets received from the corporation. Thus, a gain or loss will be recognized based on the difference between the fair market value of the assets received and the adjusted basis of the shares of stock being surrendered. No gain or loss is recognized upon the complete liquidation of a controlled subsidiary into its parent corporation. In this case, control is the ownership of at least 80% of the total combined voting power and at least 80% of the total number of shares of all other classes of stock. This ownership requirement must exist on the day that the liquidating plan is adopted and must continue to exist until the liquidating distribution is made. If there is only one liquidating distribution, all the property must be transferred to the parent in the same tax year. If there are a series of distributions, all the properties must be transferred to the parent within three years from the close of the taxable year during which the first distribution was made.

Acquisition of Stock with Step-up in Basis of Assets of Acquired Corporation

A corporate tax election is available to an acquiring corporation to step up the basis of the assets in a target corporation, the stock of which it purchased.

Foreign Entities Doing Business in Puerto Rico

A foreign corporation (one that is organized under the laws of a country other than Puerto Rico) may engage in trade or business in Puerto Rico as a division or branch of that foreign corporation or as a separate corporation or subsidiary. Resident foreign corporations are taxed in Puerto Rico on their Puerto Rico source income and on any effectively connected income at the same graduated tax rates as any domestic corporation.

Subsidiary

A foreign corporation that is engaged in a trade or business in Puerto Rico must treat the following as income effectively connected to its trade or business in Puerto Rico:

- All income from sources within Puerto Rico;
- Income attributable to an office or other fixed place of business in Puerto Rico that consists of:
    - Rents or royalties derived from the use outside Puerto Rico of intangibles such as secret processes, formulae, patents, trademarks, franchises and copyrights;
    - Dividends or interest, or gain or loss from the sale or exchange of stocks or bonds or other evidences of indebtedness that is either derived from a banking or financing business or from a corporation trading in stocks or securities for its own account; and
    - Gains or losses derived from the sale or exchange of personal property outside Puerto Rico through the corporation's office or fixed place of business in Puerto Rico (except gains or losses from the sale of personal property that is manufactured outside Puerto Rico and is to be used, consumed, or disposed of outside Puerto Rico).
- Income or gain attributable to the rendering of services or the sale of property in another year if in such other year it would have been treated as effectively connected income; and
- Gain or loss from the sale or disposition of property that is used in connection with a trade or business in Puerto Rico or that ceased to be used in connection with a trade or business in Puerto Rico within the previous 10 years.

The foreign subsidiary will be allowed to deduct the expenses directly allocable to the Puerto Rico business. In addition, a reasonable apportionment of expenses not directly related to any item of income shall be allowed as a deduction. Any actual repatriation of dividends will be subject to a 10% income tax withholding at source. Foreign corporations not having any office or place of business in Puerto Rico must file their Puerto Rico income tax returns on or before the 15th day of the sixth month following the close of their taxable year. However, if the Puerto Rico income tax liability of a foreign corporation was paid in full under the withholding provisions, the foreign corporation will be exempt from the filing requirement. A foreign corporation that is not engaged in trade or business in Puerto Rico, but derives income from real property located in Puerto Rico owned for the production of income, may elect to treat such income as connected to the conduct of a trade or business in Puerto Rico, whether the income is rent or gain from the sale or exchange of the property. If it exercises the election, the foreign corporation not engaged in trade or business in Puerto Rico will be taxed on the real property net taxable income at regular Puerto Rico income tax rates instead of a 29% tax rate on the gross income from the real property. However, the election does not by itself cause any other income received by the foreign corporation not engaged in trade or business in Puerto Rico to be treated as income effectively connected to a trade or business in Puerto Rico.

Branch Profit Tax

Income taxation of a U.S. branch is the same as for a U.S. subsidiary. The only difference will be that a deemed dividend distribution tax (branch profit tax or BPT) will be assessed on the branch upon any advances made to its home office. The BPT rate is 10% of the “dividend equivalent amount.” Broadly speaking, the BPT would be imposed if the earnings and profits derived by the branch were not reinvested in Puerto Rico as of the end of the taxable year. Comparing the net equity at the end of the taxable year and the net equity at the beginning of the taxable year makes the determination whether the amount was invested or reinvested. A foreign corporation is not subject to the branch profit tax in a taxable year if for the current and two preceding taxable years at least 80% of its gross income was effectively connected with a Puerto Rico trade or business. In determining taxable income, the branch will take into consideration items of income effectively connected with the conduct of a trade or business in Puerto Rico. The branch will be allowed to deduct the expenses directly allocable to the Puerto Rico business. In addition, a reasonable apportionment of expenses not directly related to any item of income shall be allowed as a deduction.

Other Reporting Requirements

Informative returns are to be filed for any payment of dividends or any payment in excess of USD500 to individuals for interest, rents, salaries or wages not otherwise reported, premiums, annuities, compensations, remuneration or other fixed or determinable gains, profits and income. Any person who credits or makes payments to an individual of USD500 or more and who becomes obligated to withhold the tax on such payments shall file a return specifying the total amount of interest paid or credited, the tax deducted and withheld, the name, address and the account number of the person to whom the payment or withholding was made. Such return shall be filed on or before February 28 of the year following the calendar year in which the interest was paid.

Tax Withholding

Wages

Withholding is generally applicable to all of an employee's wages for services performed for his employer. Non-cash wages are measured by their fair market value at the time of transfer.

Services

In general, payments made in the conduct of a trade or business or for the production of income in excess of USD1,500 to another person (natural or juridical) for services performed within Puerto Rico are subject to a 7% withholding. The amount withheld should be deposited with the Secretary of the Treasury on or before the 15th day of the month following the close of the month in which the tax was deducted. There are certain exemptions to this requirement. Corporations and partnerships may get a reduced withholding tax of 3% if they are in good standing with the Puerto Rico Treasury Department. A "Partial Relief of Withholding Certificate" must be obtained and remitted to each customer. In addition, there is a "Total Waiver of Withholding Certificate" that provides a total exemption from the 7% income tax withholding to corporations and partnerships that meet certain requirements. Individuals are no longer eligible for the partial relief withholding certificate. Therefore, all payments for services made to individuals are subject to a full 7% withholding. The tax must be deposited on or before the 10th day of the month following the month in which the tax was deducted and withheld. In addition, an informative return must be filed by February 28 of the following year covering such payments and withholdings during the calendar year. Also, a form should be filed summarizing the number of informative returns filed. An Annual Reconciliation Statement of Withholding at Source on Payments for Services Rendered must be filed by the same date. The Puerto Rico Department of Treasury requires that every person that is obliged to file five or more informative returns must do so electronically.

Fixed or Determinable Annual or Periodic Income

A withholding of income tax at source is required to be made on payments of interest, rent, salaries, wages, participation in partnership profits, commissions, premiums, annuities, remuneration, compensation, dividends, or other fixed or determinable, annual or periodical gains, profits and income (but only to the extent that any of the items constitute gross income from sources within Puerto Rico) to nonresident individuals, or nonresident fiduciaries, or foreign corporations and foreign partnerships, not engaged in trade or business within Puerto Rico.

Municipal License Tax

The municipal license tax is imposed on gross income. The tax rate varies depending on the municipality but ranges from 0.2% to 0.5% in the case of nonfinancial businesses. For financial business the tax rate ranges from 1% to 1.5%. This tax is payable directly to the municipality. A number of business activities and types of income are exempt from municipal license taxes. For example, businesses operated by or for the government, businesses with a volume of business of less than USD5,000, income from the sale of agricultural products to farmers, tax-exempt nonprofit organizations, international banking entities and insurance companies, the exporting activities of businesses operating in a tax free zone, income from services performed as an employee, income from the sale of oil and its derivatives to the Puerto Rico Electric Power Authority, and plants engaged in the processing of tuna (provided they employ 300 or more individuals in the same physical facility) are 100% exempt from municipal license taxes. The municipal license tax annual return must be filed every year on or before April 15, or within five working days after April 15. The municipal license tax may be paid in two equal installments. The first installment is paid from July 1 to July 15 after the due date for the filing of the return corresponding to that tax. The second installment is paid from January 1 to January 15 of the year following the year of the due date for the filing of the return. If the total municipal license tax is paid at that time, a 5% discount is applied. Financial statements certified by a CPA licensed in Puerto Rico must be attached to the declarations if the total volume of business is or exceeds USD3 million. Otherwise a copy of the income tax return, stamped on all its pages as received by the Department of the Treasury, should accompany the declaration. After the payment of the first installment, the municipality will issue a municipal license that must be posted in a clearly visible place in the business or service establishment.

Property Taxes

Municipalities may impose, by means of municipal ordinances, a property tax of up to 4% per annum on the appraised value of all taxable personal property in the municipality and up to 6% per annum on the appraised value of all taxable real property in the municipality. Real property taxes and personal property taxes are imposed as of January 1 of each year. Therefore, persons that did not own the property as of that date are not subject to the property tax. Likewise, if the property was owned as of January 1 but was sold during the course of that year, the owner of the property as of January 1 is liable for the payment of the corresponding property tax for that year. Municipalities do not have jurisdiction to impose property taxes on property located outside Puerto Rico. Likewise, property in interstate or foreign commerce is not subject to the Puerto Rico property tax. On the other hand, a property tax may be imposed on property located in Puerto Rico prior to being transported in interstate commerce or after the property finally comes to rest in Puerto Rico. If, on the assessment date, the property is under the control of the carrier and is to be shipped outside Puerto Rico, it is in interstate commerce and thus exempt from property tax. However, if the property had been sold to a buyer outside Puerto Rico but was still in the hands of the seller on the assessment date, the property tax liability for the property remains the responsibility of the seller, even if on the next day it is delivered to the carrier for shipment outside Puerto Rico.

Personal Property Tax

Any natural or juridical person engaged in a Puerto Rico trade or business and that as of January 1 owns personal property used in the trade or business must pay personal property tax to the municipality in which the property is located. The rates depend on the municipality and are imposed on the market value of the property. The market value is initially determined by the taxpayer. Generally, book value is accepted as equivalent to fair market value, but if book value does not reflect fair market value, the municipality may revalue the personal property. Taxable property normally includes cash on hand, inventories, materials and supplies, furniture and fixtures, and machinery and equipment used in the trade or business. A minimum residual value is assigned to items that are substantially depreciated. There are certain exemptions established in the Puerto Rico Internal Revenue Code. A personal property tax return must be filed on or before May 15 of each year in the corresponding regional office of the Municipal Revenue Collection Center, together with the full payment of such tax. If full payment of the personal property tax is received on or before May 15, a 5% discount is allowed. If the volume of business (defined as gross receipts) of the corporation exceeds USD3 million, the property tax return must be reviewed by, and accompanied by financial statements certified by, a Puerto Rico-licensed CPA. The financial statements of foreign corporations engaged in business in Puerto Rico should reflect solely their operations in Puerto Rico. A trial balance of the corporation's business activities in Puerto Rico as of the preceding January 1 is required when the corporation does not have a calendar year closing. The trial balance must be traced to the corporation's accounting records and accompanied by a report from an accountant affirming that the trial balance is in agreement with the books of account of the business.

Real Property Tax

The real property tax is imposed on the value of the property as assessed by the Municipal Revenue Collection Center. The tax is payable semi-annually on July 1 and January 1 of each year. The assessed value is the valuation of property for property tax purposes, which is equal to the fair market value of the corresponding real property in the year 1958.

Excise Tax

The Puerto Rico Code imposes an excise tax on certain articles imported into and manufactured in Puerto Rico. The Puerto Rico Internal Revenue Code has three types of excise taxes. First, there is an excise tax on imports and products manufactured in Puerto Rico. This excise tax is imposed only once on articles imported, sold, consumed, used or transferred in Puerto Rico. This tax is imposed on cement manufactured in or introduced into Puerto Rico, sugar, plastic products, cigarettes, fuels, products derived from oil and hydrocarbon mixture, and vehicles; the tax rates are different for the different products. Second, there is an excise tax on certain transactions, including sales of jewelry, occupancy or rooms in hotels, public shows, and horse-racing winnings; the tax rate varies depending on the transaction. Third, there is an excise tax in the form of licenses for the sale of certain articles or the conduct of certain activities. In addition, there are several exceptions to this general rule and some exemptions to the imposition of the tax.

Manufacturers

In the case of Puerto Rico manufacturers selling their manufactured products in Puerto Rico subject to excise tax, the taxable price in Puerto Rico is equal to 72% of the selling price. The corresponding excise tax rate is then applied to that amount.

Importers

An importer's cost in Puerto Rico shall be the sum of all the costs, excluding those for freight and insurance that make possible the arrival of an article to a Puerto Rico port of entry, regardless of its name or its origin. The cost also includes certain royalties or commissions, plus 10% of the sum of the related costs by reason of freight and insurance. The cost in Puerto Rico shall not be reduced for discounts for prompt payment, or for discounts granted by reason of volume of purchase, by reason of sales volume or considerations of a speculative nature, but it may be reduced for commercial discounts that are granted to reduce the prices stipulated in lists, catalogs, advertisements or other publications to the prevailing market prices or for converting the consumer price into a wholesale or retail price, as long as the Secretary of the Treasury of Puerto Rico determines that such reduction is properly warranted. For these importers the effective tax rate is 6.6% of the cost. Importers of merchandise are required to declare and pay the excise tax at the time of introduction. Additionally, they must file monthly declarations and pay the applicable Excise Tax for imports of goods via the U.S. Postal Service. Importers who satisfy certain requirements and elect to participate in the bonded program will be assigned an excise tax identification number. The identification number is renewable every year. If it is not renewed, the number will be inactivated and the privilege of getting an automatic release of the merchandise in the port will be suspended.

Exemptions

Raw material to be used in Puerto Rico for the manufacture of finished products, excluding hydraulic cement, is exempt from the excise tax. Also considered as exempted articles in transit and for export are those consigned to the dealer/importer with the intent of having them exported. These articles are exempt from the excise tax during the period they are in the custody of the custom authorities or deposited in a bonded warehouse or in a Foreign Trade Zone. Additionally, articles introduced into Puerto Rico or originally acquired in Puerto Rico from a local manufacturer are exempt from the excise tax if they (i) have not been sold, used or transferred in Puerto Rico, or (ii) are in possession of dealers-importers or dealers who have acquired them from manufacturers in Puerto Rico and sold for use and consumption abroad.

Sales and Use Tax

Every merchant engaged in any business that sells taxable items is responsible to collect the Sales and Use Tax (SUT) as a withholding agent. The SUT rate is 7% (5.5% for the Commonwealth of Puerto Rico and 1.5% for municipalities; however 6% is always collected by Hacienda) and in general will apply to the following items:

- Taxable personal property
- Taxable services
- Admission rights

In general, the person that buys, consumes, uses or warehouses for use or consumption a taxable item is the one responsible for the payment of the sales and use tax. However, if the transaction is subject to the sales and use tax and the merchant is required to collect said tax from the buyer as a withholding agent, the merchant is responsible for the payment of the sales and use tax. If the merchant does not meet the obligation of collecting the sales and use tax from the buyer, the Treasury Department may collect the sales and use tax from either the merchant or the buyer. Every merchant must file a Monthly Sales and Use Tax Return on or before the 10th day of the following month in which the tax is collected. The law provides an exemption from the SUT to the resellers on every taxable item acquired for resale and to manufacturing plants on raw material and machinery and equipment for use in the manufacturing process. In order to claim this exemption, the merchant has to request the Certificate of Exemption to the Secretary of the Treasury.

Merchants subject to the Act must keep the following for a period of no less than six years:

- Accounting records
- Papers
- Documents
- Invoices
- Commercial receipts
- Canceled checks
- Payment receipts
- Certificates of exemptions
- Shipping documents
- Evidence of the taxable items received, used and sold
- Collection records
- Any other evidence related to the sales and the amount of the sales tax withheld and paid to the Secretary of Treasury.

Merchants that use the accrual method of accounting may claim a sales tax credit for the sales tax paid on sales that resulted in bad debts. Said credit may be taken in the monthly return after the month in which the account became a bad debt.

Gift Tax

The Puerto Rico gift tax will be imposed based on the fair market value of the property donated less any obligation assumed by the donee as a result of accepting the gift. The donor is the person primarily liable for the payment of Puerto Rico gift tax. However, the recipient may also be held personally liable up to the value of the property received as a result of such gift. For donors residing in Puerto Rico, the Puerto Rico gift tax is applicable to gifts of property located anywhere in the world. For donors not residing in Puerto Rico, the Puerto Rico gift tax is only applicable with respect to gifts of property located in Puerto Rico. An exclusion from the total amount of gifts made during a year is available to a donor with respect to the first USD10,000 donated to each donee. If the property being donated is community property, each spouse, separately, may use the USD10,000 exclusion. The rates of the gift tax and the estate tax are the same, ranging from 18% applicable to taxable gifts up to a maximum rate of 50% for the portion of the value of taxable gifts that exceed USD2.5 million. The gift tax return is due on or before April 15 of the year following the year of the gift.

Estate Tax

Different formulas are used for determining the gift and estate tax of U.S. citizens who did not acquire their U.S. citizenship by being born or naturalized in Puerto Rico and were residents of Puerto Rico at the time of death, and those individuals who were nonresidents of Puerto Rico at the time of death but had certain property located in Puerto Rico.

Under the Puerto Rico Civil Code, the gross estate includes all the property, rights and obligations of the decedent that are not extinguished by death. As a general rule, the estate of a decedent that was a resident of Puerto Rico at the time of death includes all the property of such decedent, wherever located. However, the estate of a nonresident alien or person who was a resident of Puerto Rico at the time of death but did not acquire U.S. citizenship solely by reason of being a citizen of Puerto Rico or being born or residing in Puerto Rico, will be taxed only on the part of the estate located in Puerto Rico. In such cases, the estate tax will equal the maximum foreign estate tax credit granted under the U.S. Internal Revenue Code for the portion of the gross estate located in Puerto Rico. Upon the death of a decedent, an estate tax lien is automatically imposed on all the assets of the decedent. A Release of Estate Tax Lien will not be issued until the estate tax return is filed and all taxes owed by the decedent to the Commonwealth of Puerto Rico (including income taxes) or to its municipalities, have been fully paid. If the outstanding taxes are prescribed, a certificate to that effect must be obtained.

The executor of an estate is the person primarily liable for the payment of the Puerto Rico estate tax. After filing the estate tax return and paying the corresponding estate tax, the executor may ask the Secretary of Treasury that he or she be released from personal liability with respect to the payment of deficiencies. If the Secretary of Treasury does not reply to the request, the executor is released from that liability one year after the date of the filing of the request. The Puerto Rico Internal Revenue Code establishes a limited number of deductions to reduce the gross estate, which depends on the property transferred or the recipient; for example, it grants a deduction from the gross estate equal to the fair market value of property located in Puerto Rico. As a result of this deduction, most estates in Puerto Rico are exempt from Puerto Rico estate tax. Residents of Puerto Rico are permitted a USD400,000 deduction. However, this deduction will be reduced by the amount of the deduction allowed for property located in Puerto Rico. Hence, if the value of the property located in Puerto Rico is equal to or exceeds USD400,000, the fixed exemption will be completely eliminated. The rates of the estate tax are the same, ranging from 18% applicable to taxable estates with a fair market value of USD10,000 or less, up to a maximum rate of 50% for the portion of the value of taxable estates that exceed USD2.5 million. The estate tax return is due on or before 270 days after the decedent's death.

Payroll Taxes

Puerto Rico Income Tax Withholding

Under the Puerto Rico Internal Revenue Code, the employer is required to withhold income tax at source upon the salaries and wages paid to its employees performing services in Puerto Rico. The withholding rates depend upon the personal exemption and credits for dependents claimed in the withholding exemption certificate to be completed by every employee. The Secretary of the Treasury has issued tables for the determination of the tax to be withheld included in an instruction manual. There is no wage limitation for the withholding. Every employer having one or more employees should withhold the tax. The date for depositing the amount withheld will depend on the classification of the employer as a monthly depositor, a biweekly depositor or a next-day depositor.

A monthly depositor is an employer that, during the base period, withheld Puerto Rico income tax of USD50,000 or less on the wages of its employees. Such an employer must deposit the amount withheld on or before the 15th day of the month following the withholding.

A biweekly depositor is an employer that, during the base period, withheld Puerto Rico income tax of more than USD50,000 on the wages of its employees. Such an employer must deposit the amount withheld as follows:

- If the payment of the salary or wage was made on a Wednesday, Thursday or Friday, the deposit must be made no later than the following Wednesday.
- If the payment of the salary or wage was made on a Saturday, Sunday, Monday or Tuesday, the deposit must be made no later than the following Friday.

A next-day depositor is an employer that on any day within a deposit period accumulates USD100,000 or more of Puerto Rico income tax withheld on the salaries and wages of its employees. Such an employer must deposit the amount withheld on the next banking day. From that day onwards such an employer will be considered to be a biweekly depositor.

FICA Tax

The provisions of the United States Federal Insurance Contributions Act of 1935 (FICA) apply in Puerto Rico. Under this act, both employers and employees are required to contribute to the Social Security Fund that was established to provide retirement benefits for all workers. For the year 2009 the tax rate is 7.65% for employer and 7.65% for employee. Each percentage is comprised of 6.2% for social security and 1.45% for hospital insurance. Self-employed individuals are subject to the total 15.3% tax rate on net earnings from carrying on a trade or business. The Social Security Tax is computed on the first

USD106,800 of wages received and the Medicare tax is computed on the total wages, without ceiling. The quarterly return of combined employer and employee social security taxes is due on April 30, July 31, October 31 and January 31. The return along with the payment should be filed with the Internal Revenue Service. The employer must give the employee two copies of Form W-2PR on or before January 31, following the end of the calendar year in which the tax was withheld. Employers must determine how frequently they should deposit the social security taxes every year. Which category an employer is in for a calendar year will be dictated by the amount of employment taxes reported for a one year look back period ending the preceding June 30.

Puerto Rico Unemployment Tax

Each employer pays this tax on the first USD7,000 of annual wages paid, based on an experience rating system. In addition, every employer must pay a special tax of 1% of all taxable wages. However, the special tax together with the experience-based tax would not exceed 5.4% and may be credited against the Federal Unemployment tax mentioned below. The tax must be paid on or before the last day of the month following each calendar quarter along with the quarterly return. The Puerto Rico Department of Labor requires every employer hiring 25 employees or more to file the quarterly payroll tax forms electronically.

Federal Unemployment Tax

The Federal Unemployment Tax Act (FUTA) provisions apply in Puerto Rico as well as in the United States. The tax is imposed on persons who employ one or more individuals for a portion of a day in each of 20 weeks in the current or preceding calendar year, or who pay in the aggregate USD1,500 or more of wages in a calendar quarter of the current or preceding calendar year. The tax must be deposited on or before the last day of the month following each calendar quarter if the tax exceeds USD500. An annual return must be filed on or before January 31. The FUTA tax rate for 2008 is 6.2% (0.8% after a credit of 5.4% for the Puerto Rico unemployment tax) on the first USD7,000 of wages paid to an employee each calendar year. The tax is deposited quarterly. Any excess is deposited with the last quarterly installment along with the annual return Form 940-PR due on January 31. No deposit is required if the tax is USD500 or less. The amount must be added to the tax for the next quarter. Then, in the next quarter, if the total non-deposited tax is more than USD500, it must be deposited. If the liability for the fourth quarter (plus any non-deposited amount from any earlier quarter) is over USD500, the entire amount must be deposited by the due date of the annual return (January 31).

Disability Benefits Tax

The Disability Benefit Act provides benefit payments to employed workers who suffer the loss of wages as a result of disability due to illness or accident not connected with employment. This Act provides a tax of 0.60% on the first USD9,000 of wages paid during the calendar year by an employer to an employee. Both the employer and employee share the tax imposed evenly (the employer is liable for 0.3% and the employee for the other 0.3%). Employers must pay the full amount of the disability benefits tax on or before the last day of the month following each calendar quarter. Payment must be accompanied with the quarterly return. Thus, the filing of the quarterly return and the corresponding payment are due on April 30, July 31, October 31 and January 31.

State Insurance Fund Corporation (FSE)

The Workmen's Accident Compensation Act establishes a compulsory insurance program covering employees who suffer injury, become disabled or lose their lives due to a job-related accident or function. The rate varies according to the type of labor performed by the employee. Rates are revised every year, and the tax is entirely borne by the employer. By July 20 of each year, every employer must file a payroll statement showing the number of employees, occupation or industry classification and the respective total amount of wages paid during the immediately preceding fiscal year ending June 30. At the end of each fiscal year, the manager of the fund compares the payroll reported with that of the preceding fiscal year, upon which the current year's premium is based. The premium is then adjusted accordingly. All employees are legally required to be covered under workmen's compensation insurance. If an employer fails to pay the workmen's compensation insurance premium, that employer will not be covered for the corresponding period and will continue to be liable for such premiums and for the corresponding penalties for late payment. In such cases, employees suffering an accident may still benefit from the services offered by the State Insurance Fund as if the employer had been up to date in its payments. However, in those cases the State Insurance Fund will collect from the uninsured employer all the costs and expenses incurred in relation to the injured employee.

Chauffeurs' Insurance

The purpose of the chauffeurs' tax is to provide insured workers with sickness and disability pensions, a bonus to the insured after reaching the age of 65, and compensation to surviving spouses and children under 15 years of age, in the event of the death of the insured. The sickness, disability or death need not be work-related. No sickness pension is paid if the case is compensated under the State Insurance Fund. However, if the State Insurance Fund compensation is less than the worker would receive under the Chauffeurs' Insurance Fund, the difference will be paid by the Chauffeurs' Insurance Fund. If the employer hires non-executive employees who are required or permitted to operate motor vehicles as part of their responsibilities, chauffeurs' insurance must be paid instead of the Puerto Rico Disability Benefits Tax. Employers pay a tax of 30 cents weekly for each covered employee, who pays 50 cents weekly. The total is withheld by the employer from the covered employees' compensation and is remitted with the quarterly return no later than 15 days after the last day of each calendar quarter. The Puerto Rico Department of Labor requires every employer hiring 25 employees or more to file the quarterly payroll tax forms electronically.

Other Taxes

Alcoholic Beverages Tax

Distillers, rectifiers, producers, manufacturers and importers are generally taxed on distilled spirits, wines with 24% or less alcohol content by volume, imported champagne and sparkling or carbonated wines or imitations thereof, and beer, ale, porter, malt extract and other similar fermented or unfermented products. If wines, champagne and sparkling carbonated wines or imitations thereof have more than 24% alcohol content by volume, they are considered distilled spirits. The tax is imposed on a per-wine gallon or a per-proof gallon. Alcoholic beverage tax rates range from USD0.97 per-wine gallon up to USD31.29 per-proof gallon for the various classifications of distilled spirits, wines, champagne and sparkling wines.

Construction Tax

The Autonomous Municipalities Act of Puerto Rico grants the municipalities the power to impose and collect construction taxes within the territorial limits of the municipality. The construction tax rate varies from municipality to municipality but is generally around 4% or 5% of the cost of the project. The cost of the project for work performed outside Puerto Rico is not subject to the construction tax. Specifically exempted from the construction tax are:

- Projects of nonprofit associations that provide affordable housing to moderate or low-income families that qualify under the National Affordable Housing Act
- Projects of nonprofit associations that provide affordable housing for persons 62 years or older that qualify under the National Affordable Housing Act
- Projects for the construction or rehabilitation of affordable housing qualifying under the New Housing Operation Public and Private Co-Partnership Program
- Projects for the construction of real property for leasing to moderate income families
- Projects for the expansion of buildings that promote, under the industrial incentives laws, the increase of employment and for which the tax exemption decree is still in effect

- Construction projects carried out under the management of an agency of the central government, or its instrumentalities, a public corporation, a municipality or an agency of the federal government.

This last exemption is not applicable to construction projects carried out by a person acting on behalf of, or by contract or subcontract executed with an agency or instrumentality of the central government, municipal government or an agency of the federal government. There are also exemptions for medical facilities.

Occupancy Tax

The room occupancy tax is 9% on the rates charged per furnished room in any building used for the rental of rooms to guests on a daily, weekly or fractional basis, or for a global all-inclusive service. If the building facility or facilities include a duly authorized casino, the room occupancy tax is 11% of the rates charged per room. However, if the facility is authorized by the Puerto Rico Tourism Company to operate as a Puerto Rico inn (*parador*), the tax rate is 7%. Motels are subject to a 9% room tax if the daily rate exceeds USD5 a day. Facilities that operate as all-inclusive hotels are subject to a room tax equal to 5% on the total amount charged per day. Short-term supplementary lodgings that do not qualify as a hotel, condo-hotel, all-inclusive hotel, motel, Puerto Rico inn (*parador*), small inn, guest house or apartment hotel, but are dedicated to the rental of rooms for fewer than 90 successive days, are subject to a 7% tax. These short-term supplementary lodgings may include houses, apartments, cabins and villas. The room tax is to be paid on the 10th day of the month following the month in which it was collected. A monthly return must accompany the tax. Some municipalities have approved municipal ordinances imposing a tax on the guests of hotels, motels, guesthouses, paradores and inns for the rooms that they rent thereat. The municipality of Vieques has approved an ordinance imposing an occupancy tax in that municipality.

Special Tax Treatment Zones

Free Trade Zones

Puerto Rico is within the customs jurisdiction of the United States. Therefore, imports into Puerto Rico from foreign countries are subject to applicable duties under corresponding U.S. customs and imports laws. U.S. customs laws provide for the establishment of free trade zones. There are four free trade zones (FTZ) in Puerto Rico: (1) FTZ No. 61 located in the metropolitan area near the San Juan port facilities; (2) FTZ No. 163 located near the port facilities in Ponce; (3) FTZ No. 7 located in Mayagüez; and (4) sub-zones located throughout the island in certain PRIDCO industrial parks.

Bonded Warehouses
Articles deposited in a bonded warehouse during the period of time they remain deposited are considered as exempted from the excise tax.

INCENTIVES

BUSINESS, MANUFACTURING AND SERVICES

Puerto Rico has long been a destination for investment for industry, although the focus has shifted in recent years from heavy and labor-intensive manufacturing to high-technology, high-value-added and services-oriented enterprises. The Puerto Rico Industrial Development Company is the primary government agency charged with promoting industry, and it is especially focused on attracting and developing high-technology enterprises like biosciences, information technology and professional services.

The Economic Incentives for the Development of Puerto Rico Act (Act 73)

The Economic Incentives for the Development of Puerto Rico Act provides attractive tax and other incentives to foster investment in key sectors of Puerto Rico's economy.

Eligible Businesses
"Eligible businesses" can apply to qualify for incentives under Act 73. In general terms, eligible businesses include: businesses established to manufacture products on a commercial scale; businesses established to render services on a commercial scale for foreign markets or for other eligible businesses in Puerto Rico; and businesses established to engage in a wide range of specific economic activities, such as scientific research and development, the generation of renewable power, recycling, hydroponics, value-added activities pertaining to port operations, software development, manufacture of renewable energy equipment, and others. In some cases, there are other criteria that must be met, but generally a wide range of economic activities will qualify as an eligible business under the Act.

Application for a Decree
Act 73 operates through a tax decree—issued for a period of 15 years—that the government of Puerto Rico grants to approved eligible businesses. The decree identifies and ensures the incentives to which the eligible businesses are entitled. To obtain a decree, an eligible business must submit an application, with all required supporting materials and fees, to the Office of Industrial Tax Exemption. Once the application is duly filed, the decree should be granted or denied within 70 days.

Standard Incentives

Approved eligible businesses qualify for the following benefits:

- Income Tax Rates
  - Typically, eligible businesses are subject to a 4% income tax rate and a 12% withholding tax rate on royalties. Alternatively, with approval from the Secretary of Economic Development, an eligible business may be subject to a 8% income tax rate coupled with a 2% withholding tax rate on royalties.
  - An eligible business engaged in a Novel Pioneer Activity (ie., socially or economically beneficial activities that have not been carried out in Puerto Rico during the previous year) will be subject to a 1% income tax rate.
  - Income from economic activities that create or develop intangible property in Puerto Rico will be subject to a 0% tax rate.
  - An additional reduction of 0.5% from the fixed 4% tax rate will be available to eligible businesses that are established in a low or intermediate industrial development zone.
  - Eligible businesses that locate their operations in Vieques and Culebra shall be totally exempted from the payment of income tax for the first 10 years of their decree, after which they will be subject to a 2% tax rate.
- Withholding Tax Rates on Royalties or License Fees
  - Nonresidents not engaged in trade or business in Puerto Rico will be subject to a 12% withholding tax on royalties or license fee payments for the use of intangible property in an eligible business. This rate may be reduced to 2% by the Secretary of Economic Development.
- Investment Income
  - Eligible businesses are not required to pay taxes on income derived from "eligible investments," which are specified in the Act and typically involve debt and/or equity investments in certain local real estate, business activities and securities.
- Distributions
  - The stockholders or partners of a corporation or partnership with a decree shall be totally exempted from taxes on the distribution of dividends or profits.
  - Gains realized from the sale or exchange of equity shares of an eligible business or of substantially all of the businesses assets, if such sale is executed while the business's decree is still in force, shall be subject to a 4% tax. After the decree

has expired, the tax treatment will be adjusted to limit the benefits to gains generated while the decree was in force.
  - No income tax shall be levied on or collected from the transferor or transferee with respect to the complete liquidation of an exempted business.
- Tax Credits
  - An eligible business that purchases products manufactured in Puerto Rico will be permitted to claim a credit of 25% of the purchase cost, up to a maximum of 50% of its tax liability; for products made from recycled materials, the credit shall be equal to 35% of total purchases up to the 50% limit.
  - Eligible businesses can receive a tax credit for each job created during the first year of operations. The size of the credit will depend upon where the exempted businesses are located: in Vieques and Culebra, the credit is USD5,000 per job; in a low industrial development zone, it is USD2,500 per job; and in an intermediate industrial zone, it is USD1,000 per job.
  - Eligible businesses can receive a credit of 50% of the investment for investments in research and development, clinical trials, toxicology tests, infrastructure, renewable energy and intangible property.
  - Eligible businesses can receive a tax credit of 50% of the investment for investments in machinery and equipment for the generation and efficient use of energy. For eligible businesses that invest to generate energy for their own consumption, the credit will be capped at 25% of the business's income tax. For eligible businesses dedicated to the production and sale of energy in Puerto Rico, the credit will be capped at USD8 million for each eligible business, up to an aggregate maximum of USD20 million for such investments by all eligible businesses per year.
  - All eligible businesses that are industrial clients of the Puerto Rico Electric Power Authority can receive a tax credit of 3% of their electricity payments. A higher credit (3.5%) is available for eligible businesses that retain 25 employees or an average payroll of USD500,000 or more during the taxable year.
  - Eligible businesses can receive a credit for 12% of all payments made for the use or right to use intangible property in their exempt operation in Puerto Rico.

  - Eligible businesses can receive a credit of 50% of the amount of any investment in a "strategic project," as defined in the Act.
  - Investors can receive a credit of 50% (1) of the cash amount used to purchase the majority (50% or more) of the equity interest or operational assets of an exempted business that is in the process of closing operations in Puerto Rico or (2) of the cash amount contributed to a small- or medium-sized business in exchange for corporate stock or partnership interest used for construction or improvements of the physical facilities and purchase of machinery and equipment.
- Real and Personal Property Tax
  - Eligible businesses shall receive a 90% exemption from municipal and Commonwealth property taxes on personal property used in the businesses' development, organization, construction, establishment or operation.
  - For the first five years of operations, eligible businesses shall receive a total exemption from the payment of property taxes on real property used for its central or regional corporate headquarters rendering centralized management services to affiliated entities.
  - Eligible businesses shall receive a complete exemption from real property taxes during the period authorized under the grant to carry out the construction, expansion or establishment of the tax-exempt business, and during the first government fiscal year during which the business would have been subject to property taxes.
  - Eligible businesses can also take advantage of the benefit afforded by the Optional Self Assessment, as described in the Act for real property taxes. This method may be used exclusively for that property which should be properly considered as real property because of the use and location to which it is destined and that is used in the development, organization, construction, establishment or operation of the exempted business; and that property has not been assessed by CRIM.
- Municipal License Tax and Other Municipal Taxes
  - Eligible businesses shall enjoy full exemption from municipal taxes or municipal licenses that apply to the volume of their business generated during the quarter of the government fiscal year in which the exempted business commences operations and continuing for the two following semesters.

  - Eligible businesses shall be fully exempt from any tax, levy, fee, license, excise, rate or tariff imposed by any municipal ordinance on the construction of works to be used by the exempted business within a municipality (such taxes do not include the municipal license tax levied on the volume of business of contractors or subcontractors of the exempted business).
  - Income obtained from investments that qualify shall be totally exempt from municipal licenses, municipal excises and other municipal taxes.
  - Eligible businesses enjoy the following exemptions from municipal licenses, municipal excises and other municipal taxes imposed by any municipal ordinance:
    - ✔ Exempted businesses in Vieques and Culebra shall enjoy 90% exemption.
    - ✔ Small- or medium-sized businesses shall enjoy 75% exemption.
    - ✔ Central or regional corporate headquarters engaged in rendering centralized management services to affiliated entities shall enjoy 100% exemption during five years from the date the exemption begins.
    - ✔ Other businesses shall enjoy a 60% exemption.
- Commonwealth Excise Tax and Sales and Use Tax.

  The following items directly or indirectly introduced or acquired by an exempted business will be totally exempt from Commonwealth excise and sales and use taxes during the life of the decree:

  - Raw material (except hydraulic concrete, crude oil, partially manufactured products, finished oil products, and finished products from any other hydrocarbon mixture) to be used in Puerto Rico to manufacture finished products. Raw materials include: any product in its natural form, derived from agriculture or extractive industries; any product, residual product, or partially manufactured or finished product; and sugar by the bushel or in units of 50 pounds or more to be used exclusively in the manufacturing of products;
  - Machinery and equipment (and accessories thereof) used exclusively in the manufacturing process or in the construction or repair of ships, inside or outside the premises of a manufacturing plant;
  - Machinery, trucks or forklifts used exclusively and permanently to transport the raw material within the circuit of the tax-exempt business;

- Machinery, equipment and accessories used to carry out the manufacturing process, or which the tax-exempt business is under the obligation to acquire as required under federal or Commonwealth laws or regulations for the operation of an industrial unit. The exemption shall not cover machinery, devices, equipment or vehicles used in whole or in part in the administrative or commercial operations of the exempted business, except in those cases in which these are also used in at least 90% in the manufacturing process or in the construction or repair of vessels;
- Machinery and equipment that must be used by an exempted business to comply with environmental, safety and health requirements;
- Machinery, equipment, parts and accessories used in experimental or reference laboratories;
- Machinery, equipment, parts and accessories used in the preliminary phase of region exploration geared to the mineralogical development of Puerto Rico, and the dry docks and shipyards for the construction or repair of vessels;
- Fuel used by the exempted business covered by the Act in the cogeneration of electric power for its own use or for the use of its affiliates;
- Chemicals used by the exempted business in sewage treatment; and
- Energy-efficient equipment, properly certified by the Energy Affairs Administration.

Special Incentives

The following special incentives have been created to encourage the establishment and retention of local and foreign investment in Puerto Rico.

Basic Incentive for Job Creation

Companies that are promoted 132 by PRIDCO, including both local and non-local businesses that meet their commitments related to job creation and retention, receive a basic incentive payment for each employee hired. The incentive is USD400 per employee for new businesses and USD250 per employee for existing business expansions. The company will receive an orientation from PRIDCO and must submit, within a year from the promotion date, certain information for evaluation.

Incentive for Job Creation and Location

In addition to the basic incentive above, companies that are promoted by PRIDCO can receive a location-based incentive for job creation outside of the San Juan metropolitan area. This incentive will be available for local and non-local businesses, and it depends on the geographical location of the company and the number of persons that will be employed. The company will receive an orientation from PRIDCO and must submit, within a year from the promotion date, certain information for evaluation.

Special Aid for the Rescue of a Project

Where a PRIDCO-promoted business intends to cease operations or reduce its workforce by 50% or more, a new owner committed to keeping at least 25% of the employees who are working at the moment of the rescue may be entitled to assistance. The new owner will receive an orientation from PRIDCO and must submit, within six months from the promotion date, certain information for evaluation.

Incentive for Assisted Projects

Established companies that are not promoted by PRIDCO, including both local and non-local businesses, may be eligible to receive special aid for creating jobs that are "additional to" the base employment level established by PRIDCO for this company. The company will receive an orientation from PRIDCO and must submit, within a year from the promotion date, certain information for evaluation.

Incentive for Strategic Projects

Companies that are promoted by PRIDCO that execute projects that have extraordinary importance for the economy of Puerto Rico—i.e., because they create and maintain a large number or high quality jobs, promote new technology, transfer technology business knowledge, or are otherwise considered highly meritorious by the Executive Director and the Board of Directors of PRIDCO—may be eligible for incentives. The company will receive an orientation from PRIDCO and must submit certain information for evaluation by PRIDCO and approval by PRIDCO's Board of Directors.

Incentive for Infrastructure Development and Industrial Building Improvements

Companies that are promoted by PRIDCO may be eligible for an incentive to improve buildings that belong to PRIDCO that are necessary for the companies' operations. As a general rule, the infrastructure incentive is not available for improvements to private buildings unless they can help create and retain jobs, in which case board of directors approval is required. The company will receive an orientation from PRIDCO and must submit certain information for evaluation by PRIDCO, including project drawings, specifications, cost estimates, agency approvals and any other document required for the installation or construction of the improvements. The application for this incentive must be prepared and certified by a licensed engineer or architect.

Incentive for the Puerto Rican Industry Manufacturing of Furniture and Related Products, and the Apparel Industry and Similar Products

This incentive is available for Puerto Rican businesses that have been operating for at least one year in the manufacture of furniture or related products or in the manufacture of apparel or similar products that qualify for the economic incentives provided by the Act No. 8 of 1986. Moreover, this incentive can be granted in addition to other special incentives. Businesses that qualify for the incentive will receive a cash incentive of 3% of eligible sales, up to a maximum amount of USD150,000 per business per year. The incentive can be used to acquire raw materials, machinery or equipment; acquire and/or improve the company's manufacturing facilities; pay production payroll (where the company is not already participating in another reimbursement program); subsidize the lease of buildings housing the manufacturing process; acquire technical assistance, training in new production techniques, administration, promotion, and/or marketing; improve services through computerized equipment; promote the business's services and/or products outside Puerto Rico; make interest payments on loans related to operations; and other purposes established under Act No. 8 1986. To qualify, a company must apply during July or August and submit all required documentation to PRIDCO. The application will be received and evaluated by the Office of Strategic Planning and Economic Analysis. Once it is determined that the company is eligible, it can request the incentive at the end of each trimester.

Incentive for Industries Located in Vieques and Culebra

Companies that are promoted by PRIDCO may be eligible for a cash incentive of up to USD100,000 for establishing and operating a business in Vieques or Culebra. The incentive can be used for maritime, land and aerial transportation of raw material and finished products, including labor costs, tolls and other expenses related to transportation, based on an evaluation by PRIDCO. The eligible company may request the incentive at the end of each trimester, after the commencement of operations has been certified, or at the end of the fiscal year, whichever is more convenient. The application must include detailed costs. The commitments will be formalized through a contract.

Marketing Incentives Program

This matching fund is available to qualified, local, PRIDCO-promoted companies whose sales are greater than USD100,000 per year and whose commencement of operations has been certified. Through this incentive, PRIDCO will reimburse 50% of the cost incurred, up to USD50,000, for publicity, publications, promotional material, market research and for special promotional activities.

The company must submit the application to PRIDCO for evaluation at least 60 days before the promotional campaign or marketing activity will be carried out.

Special Fund for Economic Development

Puerto Rico is focused on attracting research and development to the island. Law 73 established a Special Fund for Economic Development (known as the FEDE). This fund can be utilized for the following programs or uses:

- Scientific research, development of new industrial products or processes, improvement of existing products or processes in nonprofit private educational institutions;
- Special incentives for scientific and technical research and the development of new industrial products and processes, improvement of existing products and processes, research and development directed to bioscience, information technology, biomedics, agricultural biotechnology, aeronautical engineering and renewable energy, among others;
- Industrial incentives program administered by PRIDCO in furtherance of its industrial promotion efforts, including the improvement and development of industrial property;
- The development and establishment of special programs of self-employment or micro-enterprises to integrate persons who are economically disadvantaged into the mainstream of modern socioeconomic development;
- Special incentives for the establishment in Puerto Rico of industries of strategic importance to the government, including the investment in venture capital funds that promote this type of industry, upon authorization by the Economic Development Bank;
- Special incentives for the acquisition of exempted businesses by their management;
- Special incentives for establishing programs to further and promote investment, technology and training of small and medium businesses;
- Financial support to community businesses;
- Special incentives for the establishment and development of the strategic projects in the Act;
- Support for entities or programs dedicated to:
    - furthering the establishment of networks of public Internet access and reducing the digital divide in PR;
    - rendering consulting services in information systems for small or medium businesses;

- establishing incubation centers that provide a support structure and a proper framework for the establishment and development of new companies through specialized resources;
- establishing centers and training programs in information and communication systems for unemployed people throughout the island;
- establishing educational programs at all levels with emphasis on languages, sciences and mathematics.

- Support regional initiatives for purposes of development of companies, research and development, establishment of incubators and other related objectives.

Similarly, the Puerto Rico Science, Technology and Research Trust (the Trust)—an autonomous entity that receives funding from the FEDE and the Scientific Research Fund of the University of Puerto Rico among other sources—provides a financing option for research, development and infrastructure projects in the fields of science and technology. Approximately 30% to 40% of the Trust's annual budget is used to finance corporate activities and projects that impact science and technology research and development in Puerto Rico. Between 30% and 40% is invested in academic projects (to match academic research initiatives), recruiting and retaining scientists, and creating an effective structure to commercialize products. Between 20% and 30% is earmarked for the development of research infrastructure, such as institutes, programs, incubators and more. Applications to the FEDE should be submitted to the Executive Director of PRIDCO. The application must be approved by the board of directors of PRIDCO.

Agriculture

The Agricultural Incentives Law

The Agricultural Incentives Law provides incentives to bona fide farmers and agricultural businesses. To qualify as a bona fide farmer, an applicant must obtain (1) a certification from the Secretary of Agriculture that the applicant is engaged in an agricultural business, as defined by regulation, and (2) a determination from the Treasury Secretary that 50% of the applicant's income derives from this agricultural business. To obtain the certification from the Secretary of Agriculture, the applicant must apply through the Department of Agriculture's regional offices, where local agronomists evaluate and, if appropriate, endorse the application. Then, the application is referred to department headquarters for further evaluation, where it is either denied or approved; if it is accepted, a bona fide agriculture certificate is issued to the applicant.

Annual Bonus for Agricultural Workers

Law 42 of 1971 establishes that the Secretary of Agriculture of the Commonwealth of Puerto Rico will pay an annual bonus to every person who (1) produces agriculture or livestock, (2) maintains a farm or its direct dependencies, or (3) affects the storage, transportation, distribution and marketing of farm produce.

Wage Subsidy Program to Eligible Farmers, Law 46 of 5 August 1989

Law 46 of 1989 subsidizes certain farm wages. Under this law, a farmer initially has to pay farm employees the required wages from his own pocket. The government of Puerto Rico, through the Agricultural Development Administration, will then reimburse the farmer (assuming the farmer otherwise complies with the law) the amount of the wage subsidy.

International Banking Entities (IBEs)

Puerto Rico's International Banking Center law permits the creation of international banking entities (IBE), which are essentially banks located in Puerto Rico that provide financial services to clients outside of Puerto Rico. IBEs are given attractive tax treatment of 0% in income taxes, dividends or other distributions of profits outside of Puerto Rico, distributions on liquidation, municipal license taxes and property taxes. It should be noted that Puerto Rico is considered a foreign jurisdiction under the U.S. International Banking Act of 1978 (IBA) and Puerto Rico IBEs are therefore exempt from the IBA's requirements for domestic financial institutions. Similarly, Puerto Rico IBEs are generally exempt from the U.S. Bank Holding Company Act (BHCA) and thus may be affiliated with commercial institutions (if the IBE accepts demand deposits and issues commercial loans; however, it will be considered a Bank under the BHCA).

International Insurers

Puerto Rico's International Insurer and Reinsurer Act 144 (IIRA) provides for the creation of international insurers, branches of international insurers, international reinsurers and holding companies. Protected cell plans and securitization plans are allowed. To qualify as an international insurer or reinsurer under the IIRA, an insurance company must be approved by the Insurance Commissioner. Generally, an international insurer is one that provides direct insurance only for risks outside of Puerto Rico, although it can provide surplus lines coverage and reinsurance for risks located in Puerto Rico. An international insurer holding company is a Puerto Rico legal entity that holds shares or other securities of an international insurer or another international insurer holding company. A branch is a business unit through which a foreign insurer not organized under Puerto Rico law carries out business transactions along the lines of an international insurer. International insurers, branches and international insurer holding companies are given an attractive rate of 0% on income taxes, branch profit taxes, dividends or other distributions of profits, distribution in liquidation, municipal license taxes and property taxes. In addition, they are not required to file tax returns, and the revenues to nonresidents are also exempt from taxation. A response to a complete application presented before the Office of the Commissioner of Insurance is granted within 60 days.

Public-Private Partnerships 146

Puerto Rico has embraced public-private partnerships as a way to leverage the capital and expertise of the private sector with the management and oversight of the government to provide the public with needed assets and services. Puerto Rico's Public-Private Partnerships Authority is the public entity responsible for implementing public-private partnerships. Among its main functions are:

- Establishing priorities among key projects with high PPP potential;
- Conducting or commissioning analyses as well as feasibility, desirability and convenience studies regarding specific PPP projects;
- Creating and approving regulations to govern procedures leading to the establishment of partnerships;
- Evaluating the terms and conditions of each partnership contract and making recommendations to the PPPA board of directors and the partnering government entity; and
- Entering into direct contracts with third parties for specialized services related to the establishment of partnerships.

The Puerto Rico government plans to utilize PPPs for strategic projects like roadways, power plants and other public infrastructure projects. As of January 2010, some 28 strategic projects had been identified, representing an estimated USD7 billion investment.

Film and Creative Services

The Puerto Rico Film Commission (PRFC) was created in 1999 to develop the film industry on the island, in part by offering incentives to off-island producers looking to film their projects in Puerto Rico. The PRFC's primary incentive is a 40% tax credit. The PRFC also provides incentives for film-industry-related infrastructure projects. The 40% tax credit is calculated on expenditures and is issued in the form of a transferable tax credit. It applies to all payments to Puerto Rico residents for feature films, television series and miniseries (including Telenovelas), film soundtrack recordings, and film infrastructure projects. This "Puerto Rico spent" investment includes (but is not limited to) equipment, crew, actors, travel (if through a local travel agency), hotels, stage ground rental and a percentage of the per diem. The tax credit is limited to 50% of the cash capital contribution. To be eligible, the payments to Puerto Rico residents have to be made by a licensed film entity. The film entity does not need to be organized in Puerto Rico, and it can be a single purpose company established in Puerto Rico or a subsidiary registered to do business in Puerto Rico. At least 50% of principal photography must be shot in Puerto Rico or USD1 million must be spent in Puerto Rico. In order to ascertain the amount of any tax credit that will be granted, a Puerto Rico budget is required. There are production services companies and local unit production managers that can do this work.

The Treasury Department may advance 50% of the estimated tax credit before shooting. In this case, the PRFC and the producer will estimate the tax credit based on the Puerto Rico budget. To obtain this advance, the film entity license must be obtained, the producer must provide a proof of completion bond or letter of credit in favor of the Treasury Department for the amount of the advance, or the PRFC audit must certify that 40% of the Puerto Rico budget has been spent.

Hotel/Hospitality Development

Tax Credits and Tax Exemptions

Puerto Rico's tax incentives package offers hotel developers a competitive advantage over developing in other destinations. The Puerto Rico Tourism Development Act of 1993 is the specific vehicle that depicts the parameters of such benefits. All exempt businesses will be entitled to full exemption from excise taxes on imported articles (except for inventory items) to be used in a tourism activity, provided it is established to the satisfaction of the executive director that a genuine effort was made to acquire such articles in Puerto Rico, but such acquisition was not economically justified taking into consideration quality, quantity, price or availability in Puerto Rico. Under the law, eligible businesses can qualify for a 10-year exemption from various Puerto Rico taxes stated above; the original 10-year term can be extended for an additional 10-year term. To be eligible, the business must be devoted to tourism activities utilizing (i) new facilities; or (ii) existing facilities which have not been used in a tourism activity for three or more years; or (iii) existing facilities for which there will be substantial renovations or expansions.

The Tourism Development Act, commonly referred to as Law 78, also provides for a tax credit of 50% of equity invested (including in land) by a developer, up to a maximum of 10% of the total investment. Specifically, any person who acquires an equity interest in a corporation or a partnership (either directly or indirectly through a Tourism Venture Capital Fund) that operates an exempt tourism business, or who invests in a condo hotel, will be entitled to an investment tax credit equal to 50% of the cash paid for such equity investment.

Land contributed to the corporation or partnership in exchange for an equity interest will also qualify for the investment tax credit. The 50% credit is to be taken in two installments: 25% in the first year of the investment and the other 25% in the second year. Any unused tax credits may be carried forward. The tax credits may be assigned, transferred or sold. The total amount of the investment tax credit that may be taken by all investors cannot exceed 10% of the total cost of the tourist project. If the 10% limitation is exceeded, the equity investors who are the developers of the project (as opposed to passive investors in the project) will be liable for excess investment tax credits taken by them. Any loss from the sale or other disposition of an eligible investment will be considered a capital loss or, subject to certain conditions, such loss may be taken as a credit against taxes during a five-year period. Developers typically sell the tax credits in the local Puerto Rico Capital Market and invest the proceeds into the project. In essence the tax credit lowers the amount of equity the developer must come up with as part of the project's capital structure. Applications for tax exemption under the Tourism Development Act of 1993 are filed with the Executive Director of the Puerto Rico Tourism Company and with the Secretary of the Treasury. Once the application is duly filed, the grant of tax exemption must be issued or denied within 120 days.

Incentives for Local Certified Suppliers

The Puerto Rico Tourism Company reimburses cruise ship owners 10% of food and beverage purchases made from certified local suppliers while the cruise ship is docked at any Puerto Rico port. The cruise ship owner must submit copies of all invoices for purchases from any certified local supplier and a detailed log of its purchase receipts for the end of each calendar month. PRTC will reimburse the cruise ship owner up to 10% of the reported purchases within 30 calendar days after receiving this documentation. During the regular term of this regulation, PRTC will also reimburse the cruise owner an additional 5% for purchases of products from or manufactured in Puerto Rico (as certified by the Puerto Rico Industrial Development Company and the Puerto Rico Department of Agriculture) made while docked at any Puerto Rico port.

Foreign Trade Zones

Puerto Rico has the largest noncontiguous Foreign Trade Zone (FTZ) system in the United States. The system allows companies to obtain significant financial savings, since raw material, components and packaging can be transported tax-free throughout these zones and items shipped abroad after processing are exempt from U.S. taxes. Benefits include:

- Deferment of federal customs duties;
- Deferment of Puerto Rico excise tax;
- No payment of municipal license taxes on exports outside the United States;

- No U.S. customs duties on labor, overhead or profit attributed to FTZ production operations; and
- Reduced time and effort in the activation process.

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