KPMG

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Commonwealth of Puerto Rico
Tax Reform Assessment Project

Case for Change

May 6, 2014

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1 Introduction

On August 17, 2013, the Governor of the Commonwealth of Puerto Rico issued an Executive Order creating a Tax Reform Advisory Group to analyze the current tax system, its rules and administration and report its conclusions and recommendations to build an effective and fair tax system. The Executive Order explicitly recognized the need to take measures to address the fiscal crisis facing the Commonwealth. It also implied that those measures should not have an adverse impact on the working class or consumers.

The Executive Order enumerated a number of specific factors to be considered:

- The interaction of the components of the state and local tax system and its impact on individuals and businesses;
- The need to restructure, eliminate or extend these components to achieve the desired revenue objectives and simultaneously facilitate economic development
- Analysis of existing tax preferences to determine their effectiveness, elimination or restructuring to align them with the Commonwealth's economic development plan
- Analysis of the current system's promotion of equity in the distribution of the tax burden between the working class and the business and industrial base of the economy
- Evaluation of the current structure of tax administration to improve compliance and efficiency
- Comparison of the tax structure of Puerto Rico with successful tax structures of countries with similar economic and social priorities, and
- The views of diverse interest groups.

The members of the Tax Reform Consultative Group are:

1. Melba I. Acosta Febo, Secretary of the Treasury and President of the Group
2. Carlos Rivas, Director of the Office of Management and Budget
3. Jose V. Pagan, President of the Government Development Bank for Puerto Rico
4. Alberto Baco, Secretary of Economic Development and Commerce
5. Antonio Fernos, Economist
6. Juan Zaragoza, CPA
7. Ismael Vincenty, Attorney
8. Jorge Canellas, President of the PR Chamber of Commerce (to be replaced on July 1, 2014 by Jose Izquierdo)
9. Federico Torres, Labor Union Leader
10. Jose Orta, Executive Director of the Treasury Commission of the Senate
11. Luis Cruz, Executive Director of the Treasury Commission of the House of Representatives

On March 18, 2014, KPMG contracted with the Treasury to make a full assessment of the Puerto Rican tax structure and to develop a full report and set of alternative scenarios for Treasury to evaluate for a simplified tax system that will provide the desired revenues through a more streamlined and effective system that should also result in more effective oversight.

On the same date, the KPMG team met with the Secretary of the Treasury and her colleagues to discuss in more detail the parameters of the engagement. The Secretary stated that her goals for the project were to:

- Bring in sufficient revenue

- Make Puerto Rico competitive
- Have an equitable distribution of the tax burden, and
- Create a more efficient tax administration

1.A The Case for Change

This document constitutes the "Case for Change" with respect to the major components of the Puerto Rico tax system, specifically the individual income tax, the corporate income tax and the major sales and excise taxes, to achieve the stated goals of the Governor's Executive order and the Secretary's objectives. It will also address the existing property tax.

The document will first review the current Puerto Rico budgetary situation and fiscal outlook, with relevant data on trends with respect to major economic variables. It will then provide an historical and current review of revenue sources. The final section will discuss the case for change with respect to each of the discrete revenue sources identified above.

2 Current Economic Conditions in Puerto Rico

The recent performance of the Puerto Rican economy provides a convincing case for policy reform designed to support a recovery in economic growth, providing opportunities for growth in household incomes and the welfare of its population. A significant element of any solution is taxation reform. While tax reform is not the only element of economic policy that should be addressed, it is a necessary part of the foundation on which economic growth will be generated. In light of the worrying accumulation of public sector liabilities, courageous and forward-looking reform to the revenue side of the government's budget is a necessary, but not sufficient, condition for economic recovery. Moreover, reducing uncertainty in Puerto Rico's fiscal position will assure stakeholders that Puerto Rico is a stable and secure destination for investment and business.

Data with respect to the following areas provide the economic context for the project:

- Gross Domestic / National Product
- Decline in Employment and Labor Force
- Low Labor Force Participation Rate
- High Levels of Personal Consumption
- Decline in Investment
- Government Spending
- Industry Segments
- Population Decline
- Balance of Trade
- Balance of Payments
- Debt
- Budget Deficits
- Sources of Tax Revenue

2.A Gross Domestic/National Product

Puerto Rico has experienced lethargic economic growth (including significant decline in some sectors) since 2007. Nominal Gross National Product (GNP) grew from $60.6 Billion to $70.7 Billion during the period from 2007 to 2013, at a rate of about 2.6 percent per year. [1] In real terms, given annual price inflation of about 1.9 percent over the same period, real growth

[1]Source: Planning Board's 2013 Economic Report to the Governor, Statistical Appendix.

during the period is roughly 0.7 percent per year. [2]

A key macroeconomic relationship for Puerto Rico is that between GNP and Gross Domestic Product (GDP). As shown in Table 1 below, there is a significant gap between GNP and GDP, with GNP at 68.6 percent of GDP (around $32.4 Billion) for 2013. GNP is a measure of the production of the citizens of Puerto Rico both inside and outside Puerto Rico, while GDP is a measure of the total production of Puerto Ricans and foreigners (including the US) within Puerto Rico. By definition, GDP includes income that would accrue to foreigners as well as Puerto Ricans as long as production occurs within the Commonwealth's borders. GNP therefore is a better measure of the output that enhances the welfare of Puerto Rico residents.[3] Stated differently, the gap between GNP and GDP is a measure of the outflow of value created within Puerto Rico going to foreign jurisdictions.

Table 1. Relationship between Gross National Product (GNP) and Gross Domestic Product (GDP) ($ millions)[4]

	GNP	GDP	GDO-GNP	GNP as % of GDP
2003[5]	$48,492	$75,834	$27,342	63.9%
2007	$60,643	$89,524	$28,881	67.7%
2013	$70,740	$103,135	$32,395	68.6%

2 All references to real values throughout this document are based on the estimates of the GDP deflator provided by the Planning Board.

3 Narrowing the gap between GDP and GNP, as long as both are growing would increase the welfare of Puerto Rican citizens.

4 Ibid.

5 The 2003 figures are from Planning Board's 2012 Economic Report to the Governor, Statistical Appendix.

By way of comparison, Ireland and Singapore, two countries that also have significant imports and domestic manufacturing, had ratios of 82.9 and 98.3 percent, respectively for 2010.[6]

2.B Decline in Employment and Labor Force (2007-2013)[7]

Total employment has fallen from 1.263 to 1.030 Million, a decline of 233,000. At the same time, the labor force has decreased from 1.413 to 1.197 Million, a decline of 216,000 persons, and the number of persons unemployed has increased from 150,000 to 167,000. Collectively, these figures lead to an overall increase in the unemployment rate from 10.6 to 14.0 percent.

2.C Low Labor Force Participation Rate (2007-2013), Puerto Rico vs. US

In addition to a fall in the labor force and increase in unemployment, the labor force participation rate, which represents the portion of the population actively seeking employment, has fallen from 48.6 to 41.2 percent, an unusually low level.[8] The United States, for example, had a participation rate of 63.3percent in 2013.[9] This is a major issue that needs to be further understood and addressed in order to improve the output potential of the economy.

2.D High Levels of Personal Consumption

Personal Consumption expenditure has increased from $52.1 Billion in 2007 to $62.5 Billion in 2013, an annual growth rate of 3.1 percent per year and one similar to the growth rate of GNP.[10] Given the macroeconomic performance of Puerto Rico, this is somewhat puzzling. Whatever the reason, growth in consumption at a higher rate than GNP is not sustainable in the long run, and is already supported to a significant extent by government transfers (evidenced by

6 Source: FRED Economic Data, Federal Reserve Bank of St. Louis

7 Source: Planning Board's 2013 Economic Report to the Governor, Statistical Appendix.

8 Ibid.

9 Source: Bureau of Labor Statistics.

10 Source: Planning Board's 2013 Economic Report to the Governor, Statistical Appendix.

the increase in transfer payments to households of $6.9 Billion between 2007 and 2013[11]).

2.E Decline in Investment[12]

During the period 2007 to 2013, nominal investment fell at an average annual rate of 2.9 percent (from $11.7 to $9.8 Billion) with the largest reduction coming from housing construction (from $2.3 billion to $761.9 Million in 2013 -- an average decline of 16.9 percent per year). This reduction in investment represents an unhealthy trend that needs to be reversed for long run economic growth.

2.F Government Spending[13]

Government spending rose from $10.5 to $10.7 Billion from 2007 to 2013, an increase of approximately 0.3 percent per year in nominal terms and a decline of 1.5 percent in real terms. Despite the real decrease in government spending, public sector liability has been accumulating during the period, further highlighting the inadequacy of revenues to support government expenditure.

2.G Industry Segments[14]

The economy of Puerto Rico is experiencing significant change in its industrial structure. While output in the manufacturing sector has increased by roughly 4.1 percent per year in nominal terms over the period (reaching $47.9 Billion in 2013), output in the utilities and finance and insurance sectors, two important components of the economy, has declined by 3.8 percent and 2.4 percent respectively per year, an approximately $1.4 Billion reduction in output from the two sectors. Administrative services and support, which contributed $1.8 Billion to output in 2013, has been growing at a rate of approximately 4.9 percent per year during the period.

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11 Ibid.

12 Ibid.

13 Ibid.

14 Ibid.

2.H Population Decline[15]

Puerto Rico's population has decreased by approximately 4.4 percent over the course of the period from 2007 to 2013, at an annual rate of roughly 0.8 percent. Based on the 2009 American Community Survey, there is net migration from Puerto Rico to the United States.

2.I Balance of Trade[16]

Merchandise exports have been increasing at a rate of approximately 0.7 percent per year during the 2007-2013 period, reaching $62.4 Billion in 2013. The largest category of exports (by a significant margin) is pharmaceutical products, with $43.9 Billion of pharmaceutical sector goods exported in 2013. The export market in this sector has grown faster than overall exports, at approximately 3.0 percent annually.

Imports of goods have stayed relatively constant during the period, at approximately $45 Billion per year. Imports are largely made up of manufactured goods, primarily chemicals and pharmaceutical goods. When seen in combination with the structure of exports, this highlights the nature of Puerto Rico's pharmaceutical manufacturing base – imports of intermediate goods to be used in the production of largely exportable goods, with significant outflows of capital income to offshore corporate entities.

As exports have risen while imports have remained relatively constant, the merchandise trade balance has increased from $14.7 Billion to $17.4 Billion, an annual average rate of growth of 2.9 percent.

2.J Balance of Payments[17]

While the balance of trade in goods has been favorable to Puerto Rico, there is a significant net outflow of income of $33.6 Billion ($0.4 Billion inflow of investment income and $34.0 Billion outflow) in 2013.

15 Ibid.

16 Ibid.

17 Ibid.

To complete the story, there has also been an increase in transfer payments from $11.4 Billion to $17.4 Billion, an increase of $6 Billion from 2007-2013. This is largely due to an increase in payments to individuals by the US Federal Government. The impact of the $17.4 Billion transfer payment is to create a positive balance. However, in 2013, there has been a significant net capital outflow of $4.8 Billion. While there is some variability in this net balance over time, it is not sustainable to rely on Federal Government transfers to shore-up the balance of payments in the long term.

The Table below summarizes the trade situation in 2013:

Table 2. 2013 Balance of Payments ($ Billions)

Sale of Goods and Services	**74.8**
Purchase of Goods and Services	-87.3
Balance	**-12.5**
Net Transfers	17.4
Balance	**4.9**
Net Capital Outflow	-4.8

2.K **Debt**[18]

Puerto Rico's debt has increased significantly over the period, growing from $42.8 Billion in 2007 to approximately $74 Billion in 2014[19], an increase of approximately 7.2 percent per year.

18 Ibid.

19 The total public sector debt in 2014 includes $71.9 Billion as of December 31, 2013 plus an additional $3.5 Billion debt issued in 2014.

These figures are aggregates of public enterprise, central government, and municipal debt. Debt for public enterprises accounts for 75 percent of overall debt and has grown most rapidly at approximately 8.6 percent annually. Debt for the central government is 19.0 percent of overall debt and has grown at a much lower rate of 2.6 percent.

2.L Budget Deficits[20]

Puerto Rico has faced significant fiscal challenges since 2000, including an imbalance between General Fund revenues and expenditures. This imbalance peaked to a historically high level of $2.87 Billion in 2009. The government has reduced its deficits since then by pursuing deficit reduction policies. The budgetary deficit results for FY2013 was $1.29 Billion, according to preliminary results. The continuation of successful reduction in the deficits will depend upon the government's ability to increase revenue and lower expenditures.

2.M Sources of Tax Revenue[21]

Puerto Rico's sources of tax revenue have changed significantly from 2007 to 2013, particularly becoming more reliant on the revenue from Law 154.

20 Source: Commonwealth of Puerto Rico: Financial Information and Operating Data Report, October 18, 2013.

21 Ibid.

Table 3. Puerto Rico Tax Revenue Sources

Tax	2007	2007 Share of total tax revenue	2013	2013 share of total tax revenue
Individual Income Tax	$3.1 Billion	38.6%	$2.1 Billion	27.3%
Corporate Income Tax	$2.0 Billion	25.0%	$1.3 Billion	16.9%
Sales and Use Tax	$0.6 Billion	7.5%	$0.6 Billion	7.8%
Excise Tax	$1.1 Billion	13.6%	$2.6 Billion	33.8%
Total[22]	**$8.0 Billion**		**$7.7 Billion**	

22 The total includes taxes that are not included in the table.

3 The Case for Change

This section first surveys the perceptions of various stakeholders about the current system. It then reviews the major structural components of the current individual, business, sales and excise and property tax with the preliminary goal of identifying areas in which structural changes can promote the revenue, distributional and economic goals of the Treasury.

One caveat is necessary at the outset. As noted above, an important goal of this project is to recommend policies that will enhance the competitiveness of the Puerto Rican economy. "Competitiveness is the degree to which a nation can…produce goods and services that meet the tests of international markets while simultaneously maintain or expanding the real income of its citizens.[23] While a tax system can enhance or restrict the competitiveness of an economy, it cannot by itself alter other fundamental elements, such as the composition of the labor force, infrastructure, energy costs, legal stability, access to markets, investment, savings, technological development and government regulation that contribute to that economy's competitive position.

3.A **The Views of the Stakeholders**

Prior to preparing this report, the KPMG team met with 25 groups and individuals[24] who had been invited by the Secretary of the Treasury to present their views on the following topics:

1. The effectiveness of the current tax system to incentivize the productive, industrial, and entrepreneurial base of the Puerto Rican economy.
2. What is the greatest inefficiency of the current tax system to promote economic development in Puerto Rico?
3. The interaction between the state and municipal tax systems and its impact on individuals, business owners and industries, and thus the economic development of Puerto Rico.

23fn[President's Commission on Competitiveness, Global Competition, The New Realities, Vol.1, January, 1985, p.6]

24 Melba Acosta Febo, Karolee Garcia, Tony Flores, Yanis Blanco Santiago, Maria Irizarry, Edwin Rios, Angel Marzan, Antonio Medina Comas, Jaime Yordan-Frau, Juan Zaragoza, PR Chamber of Commerce, PR Industrial Association, PIA, Food Marketing and Distribution Chamber, PR Products Association, United Center of Retailers, PR Hotel & Tourism Association, Community Pharmacies Association, Restaurant Association, PR Economist Association, PR Society of Certified Public Accountants, PR Association of Financial Analysis, PR Lawyers College – Tax Committee, PR Banks Association, PR Insurance Companies Association, PR Mortgage Bankers Association, PR General Contractors Association, PR Homebuilders Association, PR Engineer College, Colegio de Arquitectos y Paisajistas, Jose Ventura, Etienne Durand, Juan Agosto Alicea, Jose Fernandez, Carlos del Rio

4. Their preference, if any, between various forms of consumption tax, i.e., the general excise tax, sales and use tax (IVU) and the added tax or value added tax (VAT).
5. Evidence of the cost- benefit of existing tax credits.
6. Tax policies for economic development adopted by other countries that Puerto Rico should emulate.
7. The type of industry/economic activity that Puerto Rico should continue to stimulate or start to stimulate to promote its economic development.
8. The model of tax system Puerto Rico should promote/implement:
    - Emphasis on income taxes
    - Emphasis on consumption taxes
    - Broad base and low rates
    - High rates and subsidized basis
    - Contributory exemptions / exclusions in order to encourage economic activity versus to provide tax fairness

In general, the responses to the first two topics identified structural complexity, instability, internal inconsistency, inefficient administration and inadequate enforcement as general shortcoming of existing law. Specific responses focused on the perceived negative effects of a high corporate tax rate for domestic corporations, the Patente Nacional and the related failure to have an articulated transfer pricing policy, Law 154, the personal property tax and the outdated valuation base for the real property tax. The responses also noted a culture of tax evasion, promoted by a lack of adequate enforcement personnel, technology and process, particularly the inability to reconcile information received from multiple taxing jurisdictions. Those observations are noted here, but their analysis is within the scope of the workstream that will focus on tax administration.

Those who chose to comment on the third topic noted the negative effects of the need to comply with potentially different rules and filing regimes in 78 municipalities as well the central government.

Responses to the fourth topic varied. One consistent theme was the unnecessary complexity that resulted from three different consumption tax regimes (excise taxes, IVU and IVA). Another theme was broadening the consumption tax base by eliminating special exemptions and increasing revenues by raising the rate. While there was no consensus as to which form of consumption tax was preferable, a number of respondents favored a broad based VAT with no exemptions. The ability to avoid the IVU was noted. Concern was expressed over whether Treasury was prepared to implement the IVA on July 1, 2014, both structurally with respect to avoiding cascading taxes and administratively with respect to filing requirements.

With respect to topic 5, virtually all respondents agreed that existing credits, exemptions and other preferences should be subjected to cost-benefit and compliances analyses. While there was uniform sentiment that preferences should be reduced, none were specifically identified.

With respect to topic 6, there were no suggestions as to what alternative economic development policies should be considered or adopted.

In discussing topic 7, manufacturing, tourism and agriculture were identified as industries or economic activities that should be promoted. In particular, the negative effect of uncertainty resulting from Law 154 was noted.

Finally, with respect to the topic 8 Puerto Rico should promote, most agreed that a broad based, low rate tax was to be preferred. A number suggested increasing consumption tax rates and using the increased revenue to reduce income taxes.

3.B The Components of the Puerto Rican Revenue Structure

The report now turns to a discussion of the elements of existing law. It will first review economic data with respect to the components of the tax base. It will then discuss the particular taxes that comprise the tax base.

In the aggregate, Puerto Rico collects less tax as a percentage of GDP than any of the countries examined. Table 4 shows select countries tax revenue collections as a percentage of GDP. In particular, there is a stark difference in tax collections between Puerto Rico and other competitive jurisdictions such as Singapore and Ireland.

Table 4 on the next page lists Tax Revenue as a percent of GDP.

Table 4. Tax Revenue as a percent of GDP[25]

	2005	2006	2007	2008	2009	2010	2011	2012
The Bahamas	12.8%	14.4%	14.5%	15.5%	14.4%	13.9%	16.5%	15.7%
Cyprus	45.4%	47.7%	54.1%	51.0%	25.8%	25.9%	25.8%	25.5%
Greece	20.3%	20.5%	20.8%	20.4%	19.6%	20.0%	21.3%	22.5%

25 Source: World Bank

Hong Kong SAR, China[26]	12.4%	12.5%	13.9%	12.7%	12.5%	13.5%	14.2%	
Ireland	25.0%	26.4%	25.5%	23.2%	21.2%	21.1%	22.2%	23.2%
Iceland	28.1%	28.1%	27.3%	24.3%	21.5%	21.9%	22.2%	23.2%
Israel	27.0%	26.6%	26.6%	24.1%	22.1%	22.8%	23.1%	22.1%
Malta	60.8%	63.5%	65.9%	27.2%	27.8%	27.0%	26.9%	27.5%
New Zealand	30.6%	32.4%	30.5%	32.2%	31.4%	28.2%	28.4%	29.3%
Portugal	20.6%	21.3%	21.7%	21.4%	19.6%	20.1%	21.4%	20.9%
Singapore	11.8%	12.1%	13.0%	14.0%	13.3%	13.2%	13.8%	14.5%
Puerto Rico[27]	8.78%	8.85%	8.92%	7.87%	7.14%	6.80%	7.12%	7.89%

26 2012 data is unavailable for Hong Kong SAR, China

27 Puerto Rico's data is from Planning Board’s 2013 and 2012 Economic Report to the Governor, Statistical Appendix.

Table 5 below shows tax revenue by type as a percentage of GDP for select countries.

Table 5 .Tax Revenue by Type as a Percent of GDP, 2012[28], [29]

	Taxes on Income, Profits, Capital Gains	Taxes on Goods and Services	Taxes on International Trade	Other Taxes	Social Contributions	Grants and Other Revenues
The Bahamas		2.3%	8.8%	3.0%		1.6%
Cyprus	6.6%	8.7%	0.0%	1.0%	5.9%	
Greece	4.3%	6.5%	0.0%	0.9%	7.2%	3.6%
Ireland	8.8%	7.2%	0.0%	0.7%	4.2%	2.3%
Iceland	6.3%	9.1%	0.2%	1.2%	2.8%	3.5%
Israel	6.2%	7.3%	0.2%	1.1%	3.8%	3.8%

28 Source: KPMG calculations using World Development Indicators: Tax Revenue as a share of GDP, GDP (current US$), and Central Government revenues.

29 (1)Certain compulsory transfers such as fines, penalties, and most social security contributions are excluded. Refunds and corrections of erroneously collected tax revenue are treated as negative revenue. (2)Note that Puerto Rico's tax revenue above does not include revenue from non-common wealth sources such as Federal grants, customs duties, and US excises on off shore shipments.

Malta	9.1%	9.1%	0.0%	0.8%	5.2%	3.3%
New Zealand	10.6%	7.3%	0.6%	0.0%	0.9%	10.0%
Portugal	4.6%	6.9%	0.0%	0.4%	6.5%	2.5%
Singapore	5.1%	3.5%		2.8%		3.2%
Puerto Rico[30]	4.50%	3.31%		0.08%		

Table 6 on the next page shows tax revenue by type as a percentage of total tax revenue for select countries.

30 Puerto Rico's data is from the Planning Board's 2013 and 2012 Economic Report to the Governor, Statistical Appendix.

Table 6. Types of Tax Revenue as a Percentage of Total Revenue

Types of Tax Revenue as a Percentage of Total Revenue, 2012[31],[32]						
	Taxes on Income Profits and Capital Gains	Taxes on goods and services	Taxes on International Trade	Other Taxes	Social Contributions	Grants and other revenue
Bahamas, The		15%	56%	19%	..	10%
Cyprus	26%	34%	0%	4%	23%	..
Greece	19%	29%	0%	4%	32%	16%
Iceland	27%	39%	1%	5%	12%	15%
Ireland	38%	31%	0%	3%	18%	10%
Israel	28%	33%	1%	5%	17%	17%
Malta	33%	33%	0%	3%	19%	12%
Puerto Rico[33]	32%	24%	2%	5%	0%	37%
New Zealand	36%	25%	2%	0%	3%	34%
Portugal	22%	33%	0%	2%	31%	12%
Singapore	35%	24%	-	19%	..	22%

3.B.1 Individual Income Tax

In FY2013, individual income tax receipts constituted 27% of internal source tax revenues. The payment of both personal income tax as well as corporate income tax is highly dependent on a limited number of taxpayers. Table 7 shows that there are a little over 1 million tax returns filed

31 Source: World Development Indicators, World Bank

32 Certain compulsory transfers such as fines, penalties, and most social security contributions are excluded. Refunds and corrections of erroneously collected tax revenue are treated as negative revenue.

33 Based on data from Table 27 in Statistical Appendix prepared by Planning Board

in Puerto Rico. Of those one million tax returns, 8.7 percent or 90,193 pay about 78.2% of the $2.07 Billion tax bill. More than half of the returns pay almost no tax and the remaining 38.9 percent pay about 21.6% of the tax bill. Therefore, it is evident that the greatest part of the income tax burden falls on the top 8.7 percent of income earners with a very small burden on the lower income brackets, most paying little or nothing. As a comparison, in the United States in 2010, the top 34.9 percent of the income earners (with income greater than $75,000) paid 84.8 percent of the individual income taxes, while 12.0 percent of the returns (with income less than $25,000) paid 0.43 percent of the income taxes. More than half the returns (incomes between $25,000 and $75,000) paid about 14.8 percent of the taxes. [34]

Table 7. Individual Income Tax Payments and Distribution by Income Level[35]

Personal Income Tax Payments ($Millions) by Income Groups					Number of Tax Returns by Income Group			
	2012		2007		2012		2007	
<20,000	4	0.20%	164	5.80%	544,354	52.40%	541,331	51.50%
20-60,000	446	21.60%	875	30.80%	404,152	38.90%	428,621	40.80%
>60,000	1618	78.20%	1802	63.40%	90,193	8.70%	81,323	7.70%
	2,068		2,841		1,038,699		1,051,275	

34 Source: Internal Revenue Service, Statistics of Income Tax Statistics, http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Returns.

35 Source: Department of Treasury (Puerto Rico)

4 Overview of the Current Tax System

4.A Individual Income Tax

Individual residents of Puerto Rico are subject to Puerto Rico income tax on their worldwide income. An individual is a resident of Puerto Rico for income tax purposes if the individual is domiciled in Puerto Rico.[36] An individual is presumed to be a resident of Puerto Rico for tax purposes if the individual has been present in Puerto Rico for at least 183 days during a taxable year.[37] Nonresident individuals not engaged in a trade or business in Puerto Rico is subject to Puerto Rico income tax only on income from Puerto Rico sources.[38]

A resident individual's income tax liability includes: (1) the regular tax on "net income"; (2) the amount of tax paid at preferential rates on certain items of income; and (3) the alternative minimum tax. Net income means "gross income" reduced by certain exemptions, deductions, and income subject to preferential tax rates.[39] Individuals must calculate "adjusted gross income" to determine the amount of certain deductions and exemptions allowed in computing net income. Individuals may reduce their tax liability by certain tax credits.

4.A.1 Gross Income

Gross income means all income, gains, or profits from whatever source received or derived, other than certain items specifically excluded from gross income.[40] Items of gross income include: compensation for personal services, interest, dividends, capital gains, trade or business income, and income from certain pensions or annuities.[41]

Items excluded from gross income include: life insurance; gifts and inheritances; compensation

36 PRIRC § 1010.01(a)(30).

37 Id.

38 PRIRC § 1091.01 and .02.

39 PRIRC § 1031.05.

40 PRIRC § 1031.01.

41 PRIRC § 1031.01(a).

for injuries or sickness; income from discharge of certain debts; child support payments; federal social security payments; certain death benefits; and net long-term capital gain from the sale of certain new construction property.[42]

The Code and laws of Puerto Rico also provide an exemption from gross income for over 40 categories of income. Key exemptions include: interest on certain debt obligations; certain amounts paid by an employer under a flexible benefits plan; employer contributions to health insurance plans; dividends received from certain organizations; lottery prizes; income from pensions or annuities; unemployment compensation; distributions from nondeductible individual retirement accounts; and gain from the sale or exchange of a principal residence or qualified property by certain individuals.[43]

4.A.2 Adjusted Gross Income

Adjusted gross income is determined by subtracting certain "above-the-line" deductions from gross income (after exemptions).[44] These deductions primarily are for business and investment related expenses, as well as for alimony payments.[45]

4.A.3 Deductions from Adjusted Gross Income

In determining net taxable income, the Code also allows numerous "below-the-line" deductions from adjusted gross income. Key deductions available to individuals not engaged in a trade or business include: home mortgage interest; charitable contributions; interest on student loans; contributions to certain retirement or pension accounts; medical expenses above a certain threshold; contributions to an education or health savings account; and casualty losses on a principal residence not covered by insurance.[46] Additional deductions are available for individuals engaged in a trade or business.

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42 PRIRC § 1031.01(b). The exclusion for new construction property is found in Acts 132-2010 and 216-2011, as amended.

43 PRIRC § 1031.02.

44 PRIRC § 1031.03.

45 Id.

46 PRIRC § 1033.15.

If an individual taxpayer has $20,000 or more of income subject to preferential tax rates (discussed below), below-the-line deductions are disallowed to the extent allocable to income subject to preferential tax rates.[47]

The Code generally also allows a personal exemption deduction of $3,500 ($7,000 for married taxpayers filing joint returns), and a $2,500 dependent exemption deduction with respect to certain minor and elderly dependents.[48]

4.A.4 Regular Tax on Net Income

Regular income tax for resident individuals is determined by applying the tax rate schedule to net taxable income. The tax rate schedule is broken into five income tax brackets. The brackets for taxable years beginning in 2014 are:[49]

Net Taxable Income	Tax
Not over $12,000	0%
Over $12,000 but not over $26,000	7% of the excess over $12,000
Over $26,000 but not over $42,750	$980 plus 14% of the excess over $26,000
Over $42,750 but not over $62,750	$3,325 plus 25% of the excess over $42,750
Over $62,750	$8,325 plus 33% of the excess over $62,750

Nonresident alien individuals not engaged in a trade or business in Puerto Rico generally are taxed at a flat rate of 29% on income from sources within Puerto Rico,[50] except that dividends are taxed at 10%[51] and the distributive share of income from a corporation of individuals is

47 PRIRC § 1033.20.

48 PRIRC § 1033.13.

49 PRIRC § 1021.01(a)(4).

50 PRIRC § 1062.08.

51 Id.

taxed at 33%.[52]

4.A.5 Income Subject to Preferential Tax Rates

The Code provides special preferential tax rates—or allows individuals to elect special tax rates—for certain items of income. Some of the special tax rates include:

- 10% rate on long-term capital gains;[53]
- 10% (or 17%) rate on interest from deposits in certain types of accounts;[54]
- 10% rate on eligible dividend distributions from certain corporations;[55] and
- 20% rate on distributions from certain retirement accounts.[56]

4.A.6 Alternative Minimum Tax

Certain resident individuals are subject to an alternative minimum tax equal to the excess of the tax on alternative minimum net taxable income over their regular tax liability.[57] Very generally, alternative minimum net taxable income is computed in the same way as net taxable income, except that certain exemptions and deductions from gross income are disallowed.[58]

52 PRIRC § 1062.11.

53 PRIRC § 1023.02.

54 PRIRC § 1023.04.

55 PRIRC § 1023.06.

56 PRIRC § 1023.09.

57 PRIRC § 1021.02.

58 Id.

The tax on alternative minimum net taxable income for taxable years beginning in 2014 is determined based on three brackets:

Alternative minimum net taxable income	Tax
$150,000 but not over $250,000	10%
Over $250,000 but not over $500,000	15%
Over $500,000	24%

4.A.7 Tax Credits

An individual may reduce his or her tax liability by available tax credits. The Code and laws of Puerto Rico provide numerous tax credits, including both refundable and nonrefundable credits. Tax credits are allowed for, amongst other things, investments in certain industries (*e.g.*, film or tourism) or qualified investment funds,[59] investments in certain housing and development projects,[60] and the purchase of a new or existing home.[61] The Code also provides an earned income credit for certain individuals with earned gross income below $27,500,[62] a personal credit for certain low-income senior citizens 65 years or older,[63] and a personal credit for certain low income pensioners. Additional credits are available for individuals engaged in a trade or business.[64]

59 See, e.g., Acts 78-1993, 225-1995, 3-1987, 46-2000, and 27-2011.

60 See, e.g., Acts 98-2011, 212-2002, and 140-2001.

61 PRIRC § 1052.03 and .04.

62 See, e.g., Acts 78-1993, 225-1995, 3-1987, 46-2000, and 27-2011.

PRIRC § 1052.01.

63 PRIRC § 1052.02(a).

64 PRIRC § 1052.02(b).

The tax on alternative minimum net taxable income may be reduced only by foreign tax credits, but the excess of such tax over regular tax may be reduced by all applicable credits.[65]

4.A.8 Filing Obligations

The following categories of individuals must file Puerto Rico income tax returns: (1) every individual resident of Puerto Rico who is an individual or married taxpayer and has gross income (after exemptions) over $5,000; (2) every individual nonresident of Puerto Rico for all or part of the year who is a citizen of the United States and who has Puerto Rico source gross income (after exemptions) in excess of $5,000, unless the tax on the income has been fully paid at source; (3) every alien individual nonresident of Puerto Rico who has taxable Puerto Rico source gross income for the taxable year, unless the tax on the income has been fully paid at source; and (4) every individual whose alternative minimum net taxable income is $150,000 or more.[66] Individual taxpayers who are not required to make estimated tax payments may elect to pay their annual tax liability in two installments.[67]

4.A.9 PRELIMINARY ANALYSIS

Attached to this Report as Exhibit A is a preliminary compilation of the provisions of the Puerto Rican tax code that constitute tax expenditures. For purposes of this report, the definition of tax expenditures is taken from the U.S. Congressional Budget and Impoundment Control Act of 1974 (the "Budget Act"). Tax expenditures are "revenue losses attributable to provisions of the… tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability[68]."

"Tax expenditures include any reductions in income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers.

Special income tax provisions are referred to as tax expenditures because they may be considered to be analogous to direct outlay programs, and the two can be considered as

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65 PRIRC § 1021.02.

66 PRIRC § 106.01.

67 PRIRC § 1061.17.

68 Congressional Budget and Impoundment Control Act of 1974 (Pub. L. No. 93-344), sec. 3(3).

alternative means of accomplishing similar budget policy objectives. Tax expenditures are similar to those direct spending programs that are available as entitlements to those who meet the statutory criteria established for the programs.[69]"

Tax expenditures alter economic or social behavior. Thus it is important to understand who they affect, how much they cost and how they operate in order to assess their effect. Once identified, the tax expenditure can be analyzed as a direct spending program. Those eligible for the program can be identified and, if sufficient data exist, the cost of the provision can be compared to its benefits.

The home mortgage interest deduction is a prime example of a tax expenditure. A tax on economic income does not allow the deduction of expenses that produce non-taxed income. Home mortgage interest is an expense related to exempt income — the imputed rental value of the home it finances. Thus, it is a tax expenditure. The next step is to analyze the deduction as a government spending program. The deduction is available only to those who own their homes, not to those who rent. Thus, it encourages homeownership. But while it is available to all taxpayers who have mortgages on their homes, the value of the deduction increases as the taxpayer's tax bracket increases. When translated into a government program to subsidize housing, it is a program that provides greater government subsidies to high income taxpayers than to lower income taxpayers and provides no subsidy at all for homeowners who do not have tax liability.

The example illustrates an important point about tax expenditures that are delivered as deductions, exemptions or exclusions from income: they are worth more the higher a beneficiary's tax bracket. That may be how some government spending programs would be designed, but not many.

Economic efficiency, spending reductions and/or increased revenues could occur through the repeal or reduction of tax expenditures. But one must be clear about how much can realistically be accomplished by that form of base broadening. The largest individual tax expenditures are retirement savings incentives, the exclusion for employer-provided health insurance, and the home mortgage interest deduction, step-up in basis at death, interest exclusions and capital income rate preferences. Apart from the political constituency that supports each of those items, one must recognize that many of them are spending programs that cannot simply be cut off without real economic consequences. The notion that revenues can be increased simply by

69 Joint Committee on Taxation, Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates, JCX-15-11 (February 28, 2011)

eliminating many of them is naive. However, they could be redesigned to provide benefits in a more rational way: for example, turning them into refundable credits that phase out as incomes rise.

In the next phase of the project the individual tax expenditures identified in Appendix A will be analyzed with the goal of recommending how they should be treated in a reformed income tax.

4.B **Business Tax**

In FY13 corporate income taxes constituted 16.7% of internal tax revenues. Non-resident withholdings constituted 12.8% of internal tax revenues. Receipts attributable to Law 154 constituted an additional 21.8% of internal tax revenues. The total contribution of the corporate sector (excluding partnerships) was 51.3% of internal tax revenues.

Table 8 shows that 54.4 percent of the $3.95 Billion of tax revenue from Corporations raised by Puerto Rico comes from as few as seven companies. In addition, the share of tax revenue paid by the top seven corporations of the total tax revenue paid by all foreign corporations is 76.3 percent.[70] This highly concentrated tax base is a clear exposure for Puerto Rico, making it dependent on a very narrow base.

Table 8. Tax Revenue from Corporations ($ Millions)[71]

	Law 154	Non-Resident Withholding	Income Tax	Total Corporate Tax Revenue	Percentage of Total
Top 7 Corporate Taxpayers	1,342	516	287	2,145	54.40%
All Others	336	466	999	1,801	45.60%
Total	1,677	983	1,287	3,947	

70 This is not shown in Table 7 above.

71 Source: Department of Treasury (Puerto Rico)

The discussion of the corporate tax involves examination of five separate categories: the basic corporate tax, the gross receipts tax (Patente Nacional) on certain corporations, Law 73 which grants tax preferences to certain qualified activities, Law 154 which imposes an excise tax (in lieu of an apportioned income tax) on certain purchases by parents of certain Puerto Rican controlled corporations and exemptions granted to specific sectors of the economy, Analysis of the relationship of the existing corporate tax structure to the competitiveness of the Puerto Rican economy is an important and difficult issue, particularly given the long history of tax subsidies (as compared to outright appropriations) to influence economic behavior, the current reliance of the government on the revenues generated by Law 154 and the importance of the economic presence of the businesses most affected by that Law.

4.B.1 Taxation of Corporations

The description that follows focuses on the corporate income tax. Appendix B contains a description of the tax structure applicable to other business entities. The relationship of these tax regimes to the overall taxation of business income will be examined in subsequent reports.

4.B.2 General rules for corporations

Gross income less exclusions and exemptions

As with individuals, the gross income of corporations includes all gains and compensation for services performed, income from sales and dealings in properties, rent, interest, dividends, partnership profits, transactions in securities, and any other gains, profits, and income derived from any source whatsoever. Gross income does not include, however, excluded items such as the receipt of certain insurance proceeds (e.g., from crop insurance or workmen compensation insurance) or income from the cancellation of debt that occurs under a bankruptcy proceeding or while the debtor is insolvent (subject to attribute reduction).

Gross income is reduced by exempted items such as interest on certain obligations, including those issued by the United States and any of its states and Puerto Rico. In addition, business may qualify for various tax incentives designed to stimulate economic development and reduce unemployment. Businesses qualifying for such incentives may obtain certain relief from Puerto Rico income, property, and municipal taxes. The income that is exempted under such tax incentives laws is excluded from gross income when determining the Puerto Rico corporate income tax liability.

There also 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. Such is the case, for example, with certain exchanges of like-kind property, certain involuntary conversions, certain corporate reorganizations, transfers to a corporation controlled by the transferor, property received by a corporation in a complete liquidation of its controlled subsidiary, securities exchange for securities of the same corporation, and certain transfers of qualified securities to an employee stock ownership plan. The nonrecognition 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.

Net taxable income

The net taxable income of a corporation is determined by reducing gross income less exclusions and exemptions by allowable business deductions and a few special deductions (e.g., a $400 deduction for each severely handicapped person employed during at least 20 hours a week for at least nine months in the taxable year). Expenses incurred during the taxable year by a corporation 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 which 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. Likewise, insurance premiums paid to an insurer not authorized to contract insurance in Puerto Rico and/or through an agent or broker not authorized to practice as such under the Insurance Code of Puerto Rico, are not deductible. Food and entertainment expenses also are subject to certain limitations (e.g., only 50% of the total of such expenses are allowed as a deduction and the total of such deductions cannot exceed 25% of the gross income of the person taking the deduction). In addition, corporations and partnerships are only allowed to deduct capital losses to the extent of capital gains, with a five year carryover of the excess capital losses.

A corporation's net operating loss may be carried over for up to 90 percent of the corporation's liability in a subsequent year and for differing periods depending upon when the loss was incurred. If a corporation acquires, by reorganization or by the liquidation of a controlled corporation, substantially all the assets and liabilities of the acquired corporation, the net operating loss of the acquired corporation may only be used to reduce the net income of the acquiring corporation derived from the same commercial activity or trade or business that generated the loss. Also, if a corporation undergoes a change in ownership, the use of its net operating loss in subsequent years may be limited.

Capital expenditures are included as part of the basis of the acquired or improved asset. 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.

Corporate tax rates

Puerto Rico income tax liability is generally determined by applying the corresponding Puerto Rico income tax rate to net taxable income. The regular tax rate for corporations ranges from 20% to 39%. Corporations and partnerships are subject to an alternate minimum tax of 20% in certain situations when the regular tax liability is less than the alternative minimum tax liability. For taxable years commencing after December 31, 2012, the alternative minimum tax liability of Puerto Rico corporations and partnerships having gross revenues of $1 million or more includes an additional tax component based on gross revenues. This is the Patente Nacional. The applicable tax rate on the gross revenues component of the Patente Nacional ranges from

0.2% to 0.85%, depending on the level of gross revenue of the entity. The tax base also includes 2 percent if the value of related party transfers of tangible property plus 20% of the value of related party services.

In addition, certain items of income are taxed at special rates, and the tax on such items must be computed separately and added to the income tax on the net taxable income not subject to special rates. For example, beginning July 1, 2007, net long-term capital gains may be taxed at the flat tax rate of 15%. In addition, dividends paid to non-Puerto Rico corporations or partnerships that are not engaged in a trade or business in Puerto Rico from Puerto Rico earnings are generally subject to a flat 10% tax. Non-Puerto Rico corporations or partnerships operating in Puerto Rico thus may be subject to a 10% branch profit tax and the withdrawal from doing business in Puerto Rico by a non-Puerto Rico Corporation is considered a taxable event. An accumulated earnings penalty tax 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.

Tax Credits

The income tax liability that is actually due is finally determined by deducting allowable tax credits from the amount of income tax determined in the manner described above. Allowable tax credits include 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 (subject to a per-country limitation and an overall limitation). A Puerto Rico corporation may, in addition to the foreign income and excess profits taxes paid or accrued, be deemed to have paid the foreign income and excess profits tax allocable to the distributed earnings received from its foreign subsidiary. For this deemed foreign tax paid rule to apply, the Puerto Rico corporation must own a majority of the voting stock of the foreign subsidiary. As described briefly below, Puerto Rico also offers significant investment tax credits to persons that invest in certain activities, such as tourism, agriculture and waste disposal and treatment.

4.B.3 The Tax Incentive Acts (Law 73 and Law 135)

The Economic Incentives for the Development of Puerto Rico Act ("Law 73") became effective on July 1, 2008. The latest in a series of economic incentive measures, Law 73 replaced the Tax Incentives Act of 1998 ("Law 135"), which continues to apply to a number of grants that were issued prior to 2008. While there are differences between the two, the substantive parameters are generally the same. Because it is the statute that governs current grants, the discussion will focus on Law 73.

Under Law 73, exemption grants are issued to qualifying businesses by the Office of Industrial Tax Exemption. The Puerto Rican Industrial Development Company ("PRIDCO") is responsible for the promotion of the incentives program.

Law 73 provides reduced tax rates on net industrial development income of exempt businesses and reduced withholding tax rates on payments made by exempt businesses (generally 4% and 12%, respectively, or alternatively, 8% and 2%, respectively), as well as additional deductions for acquiring, constructing or remodeling certain buildings, structures, machinery and equipment and credits for purchases of Puerto Rico manufactured products, for special eligible investments, for investment in energy producing machinery and equipment, for reduction of energy costs and for investment in strategic projects. Dividends or profit distributions by an exempt business of industrial development income to its shareholders or partners are not subject to tax. In addition, the Law provides a 90% exemption from property taxes, 100% exemption from municipal license taxes during the first 3 semesters of operations and at least 60% thereafter, and 100% exemption from excise taxes and sales and use taxes with respect to the acquisition of raw materials and certain machinery and equipment used in exempt activities. The length of the exemption period generally is 15 years and generally may be extended for an additional 10 years. Businesses eligible for the exemption include manufacturing and service units, owners of properties used by exempt businesses, research operations, energy suppliers, recyclers, value-added activities related with the Las Americas Port and various other ports, software developers, renewable energy equipment assemblers, certain specified strategic projects, the construction of social interest housing and the planning and development of self-sustainable housing projects, and repair, maintenance and overhaul of aircrafts

4.B.4 Other Tax Incentives

Other tax incentives are listed in Appendix A

4.B.5 Law 154

Corporations that are not resident in Puerto Rico are subject to income tax in Puerto Rico only to the extent that such corporations have income that is effectively connected with the conduct of a trade or business in Puerto Rico. Puerto Rico source income is generally treated as effectively connected with the conduct of a trade or business in Puerto Rico.   Income that is not Puerto Rico source income is treated as effectively connected with a Puerto Rico trade or business only if such income is attributable to an office or fixed place of business in Puerto Rico.

Law 154 expands the circumstances when a related person will constitute an office of fixed place of business of a nonresident individual, foreign corporation or partnership. It establishes additional conditions based on the quantity and types of transactions that occur between the related party and the nonresident individual, foreign corporation or partnership.   It provides that, where a foreign corporation (a "Purchaser") purchases goods from a related company that manufactures personal property or performs services in Puerto Rico (a "Seller") that account for (*a*) at least 10 percent of the total gross receipts of the Seller from the sale of personal property manufactured or produced and services performed in Puerto Rico by the Seller, or (b) at least 10 percent of the total costs of personal property and services acquired by the Purchaser, for the taxable year or any of the three preceding taxable years, then a portion of the gains, profits, and income of the Purchaser from the sale or exchange outside Puerto Rico of personal property manufactured or produced in whole or in part within Puerto Rico by the Seller will be treated as Puerto Rico source income that is effectively connected with the conduct of a Puerto Rico trade or business. The resulting income is subject to Puerto Rico tax.

The portion of the Purchaser's income that is treated as Puerto Rico source is determined under one of two provisions. Under the first provision (the "Formulary Provision"), the portion of the income treated as Puerto Rico source income is determined by multiplying the total income of the Purchaser by a percentage based on a formula. The formula is based on four equal factors –purchases, sales, property, and payroll. The percentage is computed by taking an average of four fractions: (1) purchases in Puerto Rico divided by total purchases; (2) sales in Puerto Rico divided by total sales; (3) property in Puerto Rico divided by total property; and (4) Puerto Rico payroll divided by total payroll. The sum of these fractions divided by four is multiplied by the Purchaser's total income to determine the amount of Puerto Rico source income. If any taxpayer believes that the apportionment to Puerto Rico determined under this formula results in a greater portion of its total income than is reasonably attributable to business or sources within Puerto Rico, the Purchaser is entitled to file a statement of its objections and propose an alternative method of apportionment as it believes to be proper under the circumstances.

Second, a simpler computation is provided where a Purchaser is unwilling or unable to provide adequate documentation regarding the information necessary to apply the four factors in the Formulary Provision properly and is unable to demonstrate a sufficient alternative formula or method as allowed by that provision. This alternative treats 50 percent of the income from the sale or exchange of property manufactured or produced in whole or in part within Puerto Rico as Puerto Rico source income.

Law 154 also applies where the Purchaser engages in transactions involving personal property manufactured or produced in whole or in part in Puerto Rico or services performed in Puerto Rico by the Seller with respect to which the Purchaser earns commissions or other fees that account for at least 10 percent of the total amount of commissions or other fees earned by such Purchaser for the taxable year or any of the three preceding taxable years. In addition, Law 154 applies where the Seller engages in sales of personal property manufactured or produced in whole or in part in Puerto Rico or performs services in Puerto Rico that are facilitated by the Purchaser that, together with the transactions described in the three other 10-percent tests, account for at least 10 percent of the total gross receipts of the Seller or at least 10 percent of the total gross receipts of the Purchaser for the taxable year or any of the three preceding taxable years. An anti-abuse rule applies to disregard any transaction, or series of transactions, where one of the principal purposes of such transaction or series of transactions is the avoidance of any of the 10-percent tests described above.

Law 154 imposes an alternative excise tax on purchases made by Purchasers from Sellers whose gross receipts exceed $75,000,000. The excise tax is imposed on such Purchasers in lieu of the· income tax that would otherwise result from the application of the new source rules. The excise tax is imposed on the Purchasers, but is collected and remitted by the Sellers.

The excise tax is applied on "the acquisition of personal property and services," defined as ''tangible property" and "services ... in connection with the manufacture or production of tangible property." It applies only where the Purchaser has, or is treated as having, an office or other fixed place of business as modified by the new source rule, and acquires personal property and services from a related person whose gross receipts exceed $75,000,000, and only where the transactions with the related party account for either (*a*) at least 10 percent of the total gross receipts of the Seller from the sale of personal property manufactured or produced and services performed in Puerto Rico by the Seller, or (*b*) at least 10 percent (by cost) of the total amount of personal property and services acquired by the Purchaser, for any of the three preceding taxable years.

The excise tax also applies where a person provides distribution or facilitation services for or on behalf of a related person, including services on a commission or commissionaire basis, that account for at least 10 percent of the total amount of commissions or other fees earned by such person for any of the three preceding taxable years. It also applies in the case of transactions that are facilitated by a person where such transactions, together with the transactions described in the other three 10-percent tests, account for at least 10% of the total gross receipts of the related party or at least 10% of the total gross receipts of the person for any of the three preceding taxable years. The excise tax also contains an anti-abuse rule that disregards any transaction, or series of transactions, one of the principal purposes of which is the avoidance of the 10% tests described above.

The excise tax provides a credit for any taxes imposed by a U.S. state with respect to the same transaction to which the Excise Tax applies, subject to certain limitations and documentation requirements.

As originally enacted the excise tax was to be phased out and eliminated after 2015. However it has been extended at a 4% rate through 2017.

Purchasers subject to the excise tax sought clarification of the question whether the tax was eligible for the foreign tax credit for U.S. tax purposes. In Notice 2011-29, 2011-16 IRB 663, the U.S. Internal Revenue Service ("IRS") stated that the excise was novel and that the determination of creditability "requires the resolution of a number of legal and factual issues." Until those issues are resolved the IRS will not challenge a taxpayer's claim that the tax is creditable. Moreover, if the IRS subsequently determines that the tax is not creditable, that determination will apply prospectively only.

4.B.6 PRELIMINARY ANALYSIS

The appropriate taxation of business income poses one of the most challenging issues to be resolved by the project. As a practical matter, there are two separate problems. The first is the tax structure applicable to the income earned by Puerto Rican owned entities. The second is the structure applicable to the Puerto Rico source income of subsidiaries of foreign investors. The latter is difficult because of the large share of revenue attributable to these companies and the likely tax sensitivity of their investments in Puerto Rico.

The tax structure applicable to Puerto Rican corporations that are not eligible for benefits under Laws 135 and 73 is relatively straightforward. The principal tax expenditures associated with the computation of corporate taxable income are listed in Appendix A and will be analyzed in the subsequent stages of this project. In addition the specific exemptions and credits for which Puerto Rican businesses are eligible will also be analyzed.

The principal issue for domestic corporations is the Patente National, the recently enacted corporate alternative minimum tax determined on the basis of gross receipts plus a portion of disallowed deductions attributable to related party transactions. The objective of this alternative minimum tax is to assure that businesses with significant revenues in Puerto Rico make an appropriate tax contribution to the general revenues. However, an unapportioned gross receipts tax has the potential to subject high volume, low margin businesses to tax liabilities that far exceed the amounts that would be due if the tax base was income. Indeed it is possible for entities with no taxable income to be responsible for significant tax payments on the basis of their gross receipts. Such a scenario is viewed as an unacceptable result.

Assuming the Patente National was enacted principally to assure that inbound businesses with significant Puerto Rican revenues pay a "fair share" of tax, the question is whether the income reported by these companies represents an accurate measure of their Puerto Rican economic income. Many stakeholders suspect that inter-company charges have been manipulated to reduce their Puerto Rican income. If that is true, one part of the solution lies in the creation of appropriate transfer pricing rules to assure that income is attributable to Puerto Rico is properly calculated. Other issues and potential solutions may emerge as the issue is examined. However, it appears at this stage of the analysis that the scope and incidence of the Patente Nacional is leading to unintended consequences that need to be corrected.

The second set of corporate tax issues relates to the income of Puerto Rican entities eligible for preferences under Laws 135 and 73 (the "Incentive Acts"). There are two aspects of this issue. The first is the scope and maintenance of the preferences granted under the Incentive Acts. The second is Law 154.

Inbound investment in Puerto Rico has long been encouraged by tax subsidies. Law 73 is the latest iteration of that subsidy program pursuant to which the Puerto Rico government enters into contracts ("grants") with eligible entities that provide the income tax benefits described above. It is generally believed that in the absence of the benefits granted under Law 73, existing businesses would reduce or eliminate their activities in Puerto Rico and the procurement of new inbound investment would be severely hampered. Given the direct revenue contribution, as well as the significant economic contribution, made by these companies that would be an unacceptable result. Thus, as a starting point, the project assumes that in order to maintain and attract inbound investment, Puerto Rico must maintain a robust subsidy program. However, the optimal design features of such a program may lie outside the tax area. That possibility will be explored subsequently, together with an analysis of how, if at all, the existing tax preferences may be improved.

Law 154 is a different matter. Faced in 2010 with increasing revenue needs and limited by the grants in its ability to increase the tax burden on the eligible companies, the Government sought an alternative means to raise revenue from the inbound sector. After reportedly considering and rejecting a unified reporting and formulary apportionment regime Puerto Rico adopted the income source rule and related excise tax that is described above. The circumstances of enactment—over a weekend, reportedly with no prior notice to the affected taxpayers—together with what could be described as the indirect overriding of the tax limitations agreed upon in the grants decrees led to serious objections by the inbound investors. Moreover, doubts as to the long run creditability for U.S. foreign tax credit purposes of the excise tax have introduced another measure of uncertainty into the calculation of the total Puerto Rican tax burden to be borne by the inbound sector.

As noted above, the Law 154 excise tax has been extended at a 4% rate through 2017. After 2017 the new sourcing rules will apply in all cases. The inbound sector is adamant that the sourcing rules not go into effect. However, the Government is faced with a dilemma. It needs the revenue from Law 154 (currently estimated at approximately $2 billion for FY 2015) and the inbound sector appears to be the only viable current source that can supply the bulk of that revenue. Assuming the inbound sector would agree to continue to bear its current aggregate tax burden net of U.S. foreign tax credits, one challenge is to find an alternative to raise that revenue in a way that will satisfy the requirements of the inbound sector for stability in the amount of its tax burden.

4.C Sales and Excise Taxes

Sales and use taxes constituted 7.1% of internal tax revenues. Excise taxes, excluding revenues from Law 154, constituted 11.9% of internal tax revenues.

The provisions of Subtitle D of the Puerto Rico Internal Revenue Code of 2011 (the "Act") govern the imposition and administration of a sales and use tax in Puerto Rico.

The Act levies a 6% sales tax on every sale of a taxable item in Puerto Rico.[72] Further, the Act levies a use tax, at the same rate, on the use, storage, or consumption of a taxable item in Puerto Rico (collectively, the "IVU").[73] From July 1, 2014, use tax will also be imposed on the importation of taxable items for resale (the "IVA").[74] IVU receipts secure Puerto Rico Sales Tax Revenue Bonds issued by the Puerto Rico Sales Tax Financing Corporation (COFINA).

The term "taxable item" includes tangible personable property, taxable services, and admission fees.[75]

The Act also requires the 78 Municipalities to levy a sales and use tax at the rate of 1% on the same tax base and with the same limitations – effectively bringing the sales and use tax rate to 7%.[76]

In addition to the requirement to impose the 1% tax on the same base as the principal sales and use tax levied by the central government, the Municipalities have the right to levy the tax

72 PRIRC § 4020.01

73 PRIRC § 4020.02

74 PRIRC § 4010.01(rr)

75 PRIRC § 4010.01(aa)

76 PRIRC § 6080.14

on food, which is exempt from tax under Subtitle D.

The tax is levied on all tangible personal property other than:

- Money;
- Certain vehicles and vessels;
- Certain petroleum products; and
- Electricity and water. [77]

The tax also is levied on all services and admission fees other than:

- Services rendered to a person in business (with the exception of certain defined services including bank charges, cleaning and laundry services, certain leasing of motor vehicles, telecommunication services, waste pickup services, security services, and certain repair and maintenance services);
- Services provided by the Government of Puerto Rico;
- Defined professional services and certain tax return services;
- Educational services;
- Certain financial services (including insurance services);
- Healthcare services; and
- Services rendered by businesses with a turnover of less than US$50,000. [78]

The Act sets out a hierarchy of sourcing rules for determining whether the sale is taxable in Puerto Rico.[79]

The primary liability for the payment of the tax rests with the person who purchases, uses, consumes, or stores a taxable item for consumption in Puerto Rico. However, the Act requires merchants to act as withholding agents for the collection and remittance of the tax.[80]

A merchant is defined as any person engaged in the business of selling taxable items in Puerto Rico. A person is deemed to be engaged in the business of selling taxable items in Puerto Rico

77 PRIRC § 4010.01(gg)

78 PRIRC § 4010.01(nn)

79 PRIRC § 4020.03

80 PRIRC § 4020.04

when the person satisfies the conditions listed in Section 4010.01(h).

4.C.1 Exemptions

The Act provides a number of exemptions. Exemptions can be based on:

- The nature of the good or service being supplied; or
- The person by whom or to whom the good or service is being supplied. [81]

Key exemptions based on the nature of the good or services being supplied include:

- Taxable items sold for use or consumption outside of Puerto Rico;
- Taxable items introduced to Puerto Rico for a temporary period;
- Promotional material;
- Admission to school athletic events;
- Food and prescription drugs;
- Equipment for the disabled;
- Leasing of real property;
- Child care and elderly care services;
- Funeral services;
- Solar electric equipment;
- Certain healthcare equipment;
- Uniforms, materials and textbooks; and
- Items introduced into Puerto Rico as a result of transfer of a residence.

Key exemptions based on the person by whom or to whom the good or service is being supplied include:

- Manufacturing plants on the purchase or raw material or equipment;
- Government agencies on the purchase of taxable items;
- Sales made by churches; and
- Certain sales made by manufactures or wholesalers.

A manufacturer of a taxable item can apply to the Secretary of the Treasury for an exemption from withholding tax on sales made to a wholesaler or retailer made before July 1, 2014.[82]

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81 PRIRC § 4030.01 to PRIRC § 4030.21

82 PRIRC § 4020.05(a)(2)

A wholesaler can apply to the Secretary for an exemption from withholding tax on sales it makes (prior to July 1, 2014) to resellers who hold certificates issued under Sections 4030.02 (a tax exemption certificate or an Eligible Reseller Certificate) or 4050.04 (a Reseller Certificate), where at least 80% of its sales are made to such resellers.[83]

A merchant may be relieved of the requirement to withhold tax on sales to merchants holding an Eligible Reseller Certificate.[84]

A manufacturing plant or eligible reseller may request an Exemption Certificate or an Eligible Reseller Certificate exempting it from the payment of the sales and use tax in respect of the purchase of items for sale to persons who may acquire the goods exempt from tax for sale as a non-taxable item in establishments authorized under the Puerto Rico WIC program or for export.[85]

4.C.2 Credits

A registered merchant holding a Reseller Certificate can claim a credit for sales tax paid on purchases of taxable items for resale.[86] This credit is limited to 70% of the tax paid unless the merchant has complied with Section 6054.02 relating to the establishment of a business-related demand deposit account for the remittance of sales tax. If this section is complied with, a credit of 100% of the tax paid may be claimed.

Any merchant who acquires goods for resale may request a Reseller Certificate which will identify the reseller as being able to claim a credit.

Credits may be carried forward until used in full. If the merchant can demonstrate that, due to the nature of the merchant's business, this credit will never be used, the Secretary may authorize a refund of the accumulated credits.

Various other credits are available for items such as bad debts, merchandise returns, and

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83 PRIRC § 4020.05(a)(3)

84 PRIRC § 4020.07(d)

85P RIRC § 4030.02

86 PRIRC § 4050.04

purchases of products manufactured in Puerto Rico.

4.C.3 Reporting

Merchants are required to file monthly sales and use tax returns and make payments by the tenth of the month following the month in which the transactions occurred.[87]

Eighteen of the 78 Municipalities have entered into a collection agreement with the PR Treasury which allows a Merchant to report both the central sales and use tax and the Municipality sales and use tax in the same return. Merchants are required to file separate Municipality sales and use tax returns for the other 60 Municipalities if they have reportable transactions in those Municipalities. After July 1, 2014 the 18 municipalities will begin the collection of their own sales and use tax.

Further, Merchants are required to file returns for each Merchant Registration. A Certificate of Merchant Registration is required for each business location.[88]

4.C.4 Preliminary Analysis

The current system is a hybrid consumption tax, with elements of a retail sales tax (the IVU) and a value added tax (the IVA). The long term viability of that structure must be examined, taking into account the distribution of the tax, the weaknesses of the current system that are discussed below, and the restrictions on change that may be imposed by the COFINA bond indentures.

Conversations with stakeholders have indicated concern about the introduction by the IVA of what is, in substance, a credit/invoice VAT. The concerns centered on administrative costs and the impact such a regime could have on Puerto Rico's economic and political relationship with the United States (which does not have a VAT).

On the other hand, the stakeholders supported broadening the consumption tax base through the elimination of exemptions, increasing the tax rate (perhaps in conjunction with income tax rate reductions), simplifying administration, and taking measures to enhance compliance.

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87 PRIRC § 4041.02 and PRIRC § 4042.03

88 PRIRC § 4060.01

Within the context of the broader examination discussed above, a number of specific matters need to be examined:

Compliance and Administration

There is evidence of a large underground economy with sales tax evasion affecting all aspects of society. This evasion appears to be driven, in part, by the complexity of the law and, in part, by the impression that the cost of compliance is greater than cost of evading, particularly due to reporting obligations in multiple municipalities.

- *Multiple Returns* - The requirement to file sales and use tax returns by location rather than by entity creates avoidance opportunities and imposes significant compliance costs for merchants, particularly given the requirement not only to file a return with the central government (including the 18 participating municipalities) but also in up to 60 other municipalities. The possibility of a single national return combined with a revenue sharing mechanism should be explored.
- *Inconsistent Administration* - Inconsistency between the municipalities in the administration of the tax, combined with a lack of information sharing between the municipalities and Treasury, hampers decision making and gives rise to differences in interpretation of legislation. For example, there are inconsistencies in determining the point in time a merchant is considered to have commenced trading – upon first sale, some first payment of payroll, or upon lying of first stone of the establishment.
- *Measures to Enhance Compliance at the Retail Sales Level* - The implementation, in connection with the introduction of the IVA, of a credit mechanism and computer system for matching credits claimed by purchasing merchants against sales reported by vendor merchants will introduce an element of self policing into the system. However, that system does not create an incentive to report at the retail level, where a credit for a prior purchase is irrelevant if the retailer simply fails to report the taxable transaction. Thus, a mechanism must be created to ensure that retailers meet their sales tax collection and remittance obligations.

Exemptions

The current sales and use tax base is relatively broad. Nonetheless, current exemptions should be reviewed to determine whether they are meeting their intended economic or social objectives or whether the objectives could be better met through alternative mechanisms (e.g., transfer payments under a social welfare scheme). While exemptions may be a justifiable mechanism to reduce the regressive nature of a consumption tax on items such as food, they increase the complexity of the tax regime and cost of administration by raising the inevitable issues associated with whether a particular good or service should fall within the exemption.

Exemption Certificates and the Credit System

The current state of the law with respect to exemption certificates and the implementation of a credit system to implement the IVA is extremely uncertain.

As an historical matter, prior to Act 40 of 2013, exemption certificates were issued to resellers to allow them to acquire goods exempt from tax where those goods were intended for resale. However, due to a lack of Treasury resources to manage the approval and issuance of those certificates, many merchants received exemption certificates for which they were not eligible.

Further, there was evidence that many merchants were using the exemption certificates to purchase goods that they did not intend to resell.

Act 40 eliminated exemption certificates in favor of a credit mechanism (i.e., merchants acquiring goods for resale would be charged sales tax but would be eligible to claim a credit for the tax paid). Merchants would be issued a Reseller Certificate that would identify them as eligible to claim a credit on their return for sales tax incurred on their purchases. The rationale was that merchants would be less likely to fraudulently claim a credit on a sales and use tax return than they would be to misuse an exemption certificate.

Local wholesalers and manufacturers argued that they were competitively disadvantaged because this structure created an incentive for retailers to import goods which were free of tax. To eliminate this distortion, the law was amended relieve manufacturers and wholesalers from the obligation to charge and remit sales tax on sales made to resellers.

The debate over Reseller Certificates was rendered moot by the enactment of the IVA which imposes a tax on imported goods at the point of entry. The effective implementation of the IVA requires the creation of a credit mechanism to assure that the tax does not cascade through the supply chain.

The success of that credit mechanism, in which taxpayers are seeking credits or refunds (both in terms of mitigating opportunities for fraud and instilling taxpayer confidence that their money will be repaid), is highly dependent upon the processes the administration puts in place. Such processes can include prescriptive documentation requirements for evidencing a transaction, reporting requirements, robust and transparent refund/credit review procedures, and compensating taxpayers for late paid credits or refunds.

The credit mechanism to implement the IVA on July 1, 2014 has not yet been fully tested for administrative and operational functionality. Thus, there is an element of uncertainty with respect to the effectiveness and efficiency of the proposed system. The credit system must be reviewed to determine whether it is operating effectively in the IVA regime.

4.D **Property Taxes**

Although not within the specific scope of the project, property taxes have been raised as an issue by a number of the stakeholders.

Property taxes are imposed by both the Commonwealth and municipal governments. The Commonwealth tax is 1.03% of the appraised value of real and personal taxable property. Municipalities may impose taxes up to 4% of the value of taxable personal property and up to 6% of the value of taxable real property located in the municipality. In addition, municipalities may impose property taxes for the purpose of servicing debt issued by the municipality. The Municipal Revenue Collection Center ("CRIM") is responsible for collecting, receiving and allocating property taxes. CRIM is also responsible for the valuation and appraisal of property subject to tax.

The assessed value of person property is the market value of the property on January 1 of each year. The assessed value of real estate is equal to the value of the property in 1958.

Various exemptions apply.

4.D.1 Preliminary Analysis

Stakeholders object to the personal property tax in general, but more specifically the inclusion in the tax base of business inventories. The real property tax base is significantly undervalued. It has been suggested that the real property tax base be revalued and the revenue from such a revaluation (and possible rate revision) be used to eliminate the personal property tax and perhaps augment general revenues.

5 Conclusion

The foregoing constitutes preliminary observations with respect to areas in which the existing tax structure could be changed. As a general observation, removing incentives from the tax system will promote a more efficient economy. As noted above, tax incentives represent disguised government spending. They create incidence inequities and intrude in market decisions. The revenue loss cannot be accurately measured, nor can the benefits be assessed. Where possible these incentives should be eliminated and replaced (if at all) with direct spending programs in which the anticipated economic benefits of the tax incentives can be replicated and results of the expenditures observed and quantified. Properly structured, these direct spending programs can give certainty to the entities to which the economic benefit is important, thus removing one of the important articulated obstacles to long run economic growth. In pursuing this path, Puerto Rico would introduce transparency into governmental economic decisions, allowing the affected constituencies to observe and assess the results.

More specifically, the broad question of the appropriate form and level of consumption taxation must be examined. The impact of the Patente Nacional must be measured and its structure analyzed. The entire tax incentive regime must be evaluated in terms of its effectiveness and structure. In particular, Law 154 must be addressed, keeping in mind the revenue needs of the Commonwealth. Finally, the existing property tax regime should be addressed. These will all be the subject of subsequent reports, which will also contain a macroeconomic projection of the economic consequences of suggested changes.

6 Appendix A

6.A Preliminary List of Income Tax Expenditures Under the Code

		Individuals **(Non-business)**	**Individuals Engaged in Business**	**Corporations**
EXCLUSIONS FROM GROSS INCOME				
PRIRC § 1031.01(b)(3)	Compensation for personal physical injuries or sickness	X		
PRIRC § 1031.01(b)(4)	Death benefits received by heirs or beneficiaries of members of certain public retirement or pension systems	X		
PRIRC § 1031.01(b)(5)	Certain scholarships for studies received from the Commonwealth of PR, its agencies, instrumentalities, and political subdivisions	X		
PRIRC § 1031.01(b)(6)	Literary, journalistic, scientific, and artistic prizes for industrial, agricultural, or professional development	X		
PRIRC § 1031.01(b)(7)	Federal social security for old-age and survivors	X		
PRIRC § 1031.01(b)(8)	Proceeds from crop insurance	X	X	X
PRIRC § 1031.01(b)(9)	Amounts received by nursing homes for monthly basic subsidy under the Families with Children Service Program		X	X

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	of the Family and Children Administration			
PRIRC § 1031.01(b)(10)	Income from discharge of indebtedness by reason of:			
PRIRC § 1031.01(b)(10)(A)(i)	Bankruptcy under Title 11 of the U.S. Code	X	X	X
PRIRC § 1031.01(b)(10)(A)(ii)	Taxpayer insolvency	X	X	X
PRIRC § 1031.01(b)(10)(A)(iii)	Certain student loan debt	X		
PRIRC § 1031.01(b)(10)(A)(iv)	Reorganization of certain mortgages on a taxpayer's qualified residence	X		
PRIRC § 1031.01(b)(11)	Certain annuity income	X	X	X
PRIRC § 1031.01(b)(12)	Prizes of the Sales and Use Tax Enforcement Plan	X	X	X
EXEMPTIONS FROM GROSS INCOME				
PRIRC § 1031.02(a)(1)(A)(ii)	The amount received by the insured on educational policies on the termination or liquidation of the insurance, up to $10,000	X		
PRIRC § 1031.02(a)(1)(A)(iii)	Amounts received by a nonresident individual or a foreign corporation or partnership not engaged in trade or business in PR under an annuity contract issued by an international insurer	X		
PRIRC § 1031.02(a)(2)(A)	Life insurance premiums paid by an employer on	X		

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	behalf of an employee for coverage up to $50,000			
PRIRC § 1031.02(a)(2)(B)	Amounts paid or accrued by an employer for the benefit of an employee under a flexible benefits plan	X		
PRIRC § 1031.02(a)(2)(C)	Payments for dependent care paid or accrued by an employer for the benefit of an employee pursuant to a flexible benefits plan	X		
PRIRC § 1031.02(a)(2)(D)	Employer contributions to employee's health or accident plans	X		
PRIRC § 1031.02(a)(3)	*Interest on the Following Instruments:*			
PRIRC § 1031.02(a)(3)(A)	Obligations from the U.S. Government, or any of its states, territories or political subdivisions	X	X	X
PRIRC § 1031.02(a)(3)(B)	Obligations of the Government of PR or any instrumentality of political subdivision	X	X	X
PRIRC § 1031.02(a)(3)(C)	Securities issued under the Agricultural Loans Act of 1971	X	X	X
PRIRC § 1031.02(a)(3)(D)	Certain mortgages secured by the National Housing Act of 1934, as amended, that were executed on or before 2/15/73	X	X	X
PRIRC § 1031.02(a)(3)(E)	Certain mortgages on residential property located in PR issued after	X	X	X

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	6/30/1983 and before 8/1/97, secured by the National Housing Act of 1934 or the Servicemen's Readjustment Act of 1944			
PRIRC § 1031.02(a)(3)(F)	Mortgages on newly constructed residential property located in PR, issued after 7/31/97, in conjunction with the first transmission of the mortgaged property to a new owner, and secured by the National Housing Act of 1934 or the Servicemen's Readjustment Act of 1944	X	X	X
PRIRC § 1031.02(a)(3)(G)	Mortgages originated to provide permanent financing for the construction or acquisition of social interest housing	X	X	X
PRIRC § 1031.02(a)(3)(H)	Mortgages insured under the U.S. Jones Farm Tenant Act of 1937, as amended	X	X	X
PRIRC § 1031.02(a)(3)(I)	Certain obligations secured or guaranteed under the Servicemen's Readjustment Act of 1944, that were executed on or before 2/15/73	X	X	X
PRIRC § 1031.02(a)(3)(J)	Securities issued by certain cooperative associations (up to $5,000 interest per year)	X	X	X
PRIRC § 1031.02(a)(3)(K)	Deposit accounts in PR	X	X	

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	(up to $2,000 per year)			
PRIRC § 1031.02(a)(3)(L)(i)	Obligations issued by the PR Conservation Trust	X	X	X
PRIRC § 1031.02(a)(3)(L)(ii)	Obligations issued by the PR Housing and Human Development Trust	X	X	X
PRIRC § 1031.02(a)(3)(L)(iii)	Obligations issued by the San Juan Monuments Patronage	X	X	X
PRIRC § 1031.02(a)(3)(L)(iv)	Obligations issued by the PR Education and Rehabilitation Society	X	X	X
PRIRC § 1031.02(a)(3)(M)	Loans granted a PR bank or financial institution to a special corporation owned by employees ("SEOC"), which proceeds are used for certain qualified investment purposes in PR			X
PRIRC § 1031.02(a)(3)(N)	Loans from a PR bank or financial institution to a person for the acquisition and payment of membership certificates as an ordinary, extraordinary, or corporate member of an SEOC			X
PRIRC § 1031.02(a)(3)(O)	Loans from a PR bank or financial institution to a person for the purchase or investment by and for himself of preferred stock in an SEOC			X

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
PRIRC § 1031.02(a)(3)(P)	Loans up to $250,000 to certain small and medium size businesses that are used for certain purposes, provided the loan meets the requirements of the Community Reinvestment Act of 1977			X
PRIRC § 1031.02(a)(3)(Q)	Loans up to $250,000 to shareholders of certain small and medium size businesses that are used to satisfy capital requirements			X
PRIRC § 1031.02(a)(4)(A)	Dividends received by corporations from industrial development income which are derived from interest on: (i) obligations of the Government of PR or any of its instrumentalities and political subdivisions; (ii) mortgages by the PR Housing Bank and Finance Agency acquired after 3/31/77; and (iii) loans or other mortgage-guaranteed securities granted under any pension or retirement system of a general character and acquired after 3/31/77			X
PRIRC § 1031.02(a)(4)(B)	Dividends received by an individual from a limited dividends corporation that qualifies under PRIRC § 1101.01(a)(6)(A)	X	X	

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
PRIRC § 1031.02(a)(4)(C)	Dividends received by PR residents from a domestic cooperative association	X	X	X
PRIRC § 1031.02(a)(4)(D)	Dividend distributions made by an International Insurer or an International Insurer Holding Company as provided under Article 61.240 of the PR Insurance Code	X	X	X
PRIRC § 1031.02(a)(5)	Certain payments for rent and utilities received from a priest or minister	X	X	X
PRIRC § 1031.02(a)(6)	Incentives received by farmers from the Government of PR for the purchase of certain items or the construction of certain facilities	X	X	X
PRIRC § 1031.02(a)(7)	Income derived by a lessor of real property on the termination of a lease attributable to the value of improvements made by a lessee	X	X	X
PRIRC § 1031.02(a)(8)	Recovery of bad debts, prior taxes, surcharges, and other amounts that did not result in a reduction of the taxpayer's tax	X	X	X
PRIRC § 1031.02(a)(9)	Stipends received by certain physicians during the internship period under a contract with the Department of Health of PR or with any municipality or political	X		

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	subdivision thereof			
PRIRC § 1031.02(a)(10)	Amounts received as mustering-out payments with respect to service in the military or naval forces of the U.S.	X		
PRIRC § 1031.02(a)(11)	Income received by news agencies, press syndicates or other press services from newspapers and radio broadcasting enterprises as rents or royalties for the use or publication of, or for the right to use or publish in PR, literary or artistic property of said agencies or syndicates	X	X	X
PRIRC § 1031.02(a)(12)	Prizes from the Lottery of PR and the Additional Lottery	X		
PRIRC § 1031.02(a)(13)	Income from pensions or annuities, up to the applicable limitation	X		
PRIRC § 1031.02(a)(14)	Amounts received by pensioners of certain PR pension funds as the Christmas Bonus, Summer Bonus, and Medicine Bonus	X		
PRIRC § 1031.02(a)(15)	Racetrack winnings in hippodromes in PR	X		
PRIRC § 1031.02(a)(16)	Gain by an individual 60 years or older from the sale or exchange of his principal residence	X		
PRIRC § 1031.02(a)(17)	Certain income related to the operation of an employee's owned	X	X	X

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	special corporation			
PRIRC § 1031.02(a)(18)	Cost of living allowance received by employees of the U.S. government who work in PR, up to the amount exempted under the U.S. IRC	X		
PRIRC § 1031.02(a)(19)	Unemployment compensation from the U.S. or PR governments or a U.S. state	X		
PRIRC § 1031.02(a)(20)	Compensation received from active military service in a combat zone	X		
PRIRC § 1031.02(a)(21)	Income earned by MLB, the NBA, the WNBA, or any of their teams or affiliates attributable to games played in PR	X	X	X
PRIRC § 1031.02(a)(22)	Income earned by participants in the Caribbean Series of Professional Baseball held in PR	X		
PRIRC § 1031.02(a)(23)	Income derived by the International Insurer or by a Holding Company of the International Insurer, subject to the provisions of section 61.240 of the Insurance Code of PR	X	X	X
PRIRC § 1031.02(a)(24)	Payments in the nature of a subsidy received under section 1860D-22 of the Social Security Act, as amended	X		
PRIRC § 1031.02(a)(25)	Dependent care payments received by certain employees under	X		

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	the 1996 Act for the Creation of Child Day Care Centers			
PRIRC § 1031.02(a)(26)	Compensation received by an eligible researcher or scientist for services rendered to a superior level educational institution to perform eligible scientific research	X		
PRIRC § 1031.02(a)(27)	Compensation received by an eligible researcher or scientist for services rendered in the District established under Article 7 of Act 212-2004, as amended	X		
PRIRC § 1031.02(a)(28)	Rents from the rental of buildings in the historic zone	X	X	X
PRIRC § 1031.02(a)(29)	Amounts received by members of the Legislature of the Government of PR as reimbursement for certain expenses	X		
PRIRC § 1031.02(a)(30)	Amounts received by members of the Legislature of the Municipalities as reimbursement for certain expenses	X		
PRIRC § 1031.02(a)(31)	Income from any of the activities described in section 12(a) of the 1989 International Banking Center Regulatory Act carried out by any International Banking Entity duly licensed to carry out such activities			X

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	under such Act			
PRIRC § 1031.02(a)(32)	Compensation paid by a foreign person to citizens and nonresident aliens for technical services rendered for the production of film projects	X		
PRIRC § 1031.02(a)(33)	Amounts received by an employee from an employer as reimbursement for certain work related expenses	X		
PRIRC § 1031.02(a)(34)(D)	Receipts of shipowner's mutual protection and indemnity associations		X	X
PRIRC § 1031.02(a)(34)(E)	Compensation of employees of foreign governments or international organizations	X		
PRIRC § 1031.02(a)(34)(F)	Income from buildings rented to the Government of PR that are used for certain public purposes, or in the construction of buildings to be leased to nonprofit entities to be used for certain public purposes, with respect to lease agreements in effect on 11/22/10	X	X	X
PRIRC § 1031.02(a)(34)(G)	Income derived from the resale of personal property or services whose acquisition by the taxpayer was subject to tax under PRIRC § 3070.01 or § 2101 of the	X	X	X

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	1994 Code			
PRIRC § 1081.03(d)	Distributions from non deductible individual retirement accounts	X		
PRIRC § 1023.06(j)	Distributions of Amounts Previously Notified as Deemed Eligible Distributions under PRIRC § 1023.06(j)	X	X	X
PRIRC § 1040.08(e)(1)(A)	Accumulated gain from nonqualified options to acquire stock over which the taxpayer has prepaid the tax	X		
NON-BUSINESS DEDUCTIONS IN COMPUTING INDIVIDUAL'S NET INCOME				
PRIRC § 1033.15(a)(1)	Home mortgage interest paid or accrued to acquire, refinance, improve or construct a property that constitutes a qualified residence	X		
PRIRC § 1033.15(a)(2)	Interest paid to a housing cooperative association by certain individuals	X		
PRIRC § 1033.15(a)(3)	Charitable contributions	X		
PRIRC § 1033.15(a)(4)	Medical expenses paid not compensated by insurance or in any other form, which exceed 6% of adjusted gross income	X		
PRIRC § 1033.15(a)(5)	Interest paid or accrued during the taxable year on student loans to cover certain expenses at the university level of the taxpayer, his spouse, or	X		

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	dependent			
PRIRC § 1033.15(a)(6)	Contributions made to certain government pension or retirement systems to the extent that such contributions were included in the gross income of the individual	X		
PRIRC § 1033.15(a)(7)	Contributions made to a qualified individual retirement account	X		
PRIRC § 1033.15(a)(8)	Cash contributions to an educational contribution account for the benefit of a child or certain other blood relatives	X		
PRIRC § 1033.15(a)(9)	Contributions to a health savings account	X		
PRIRC § 1033.15(a)(10)(A)	Losses on real property used as taxpayer's principal residence caused by fire, storm, or other casualty, and not compensated by insurance	X		
PRIRC § 1033.15(a)(10)(B)	Losses of automobiles, furniture, fixtures, and certain other household goods caused by earthquakes, hurricanes, storms, tropical depressions and floods, and not compensated by insurance	X		
PRIRC § 1033.05(d)	Wagering losses to the extent of wagering gains	X		

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
PRIRC § 1033.16	Special deduction for low-income individuals whose principal source of income consists of certain income described in PRIRC §§ 1031.01(a)(1) – (5)	X		
BUSINESS DEDUCTIONS				
PRIRC § 1033.12	Deduction by bona fide farmers of 90% of farmer's net income from its agricultural business		X	X
PRIRC § 1033.01(b)(3)	Deduction equal to 50% of the federal self-employment tax paid to the U.S. for the year		X	
PRIRC § 1033.01(b)(4)	Deduction for health insurance paid by a self-employed individual, whose gross income in the year does not exceed $500,000, for himself and his family, provided said insurance is extended to all his employees		X	
PRIRC § 1040.12	Election to deduct accelerated depreciation for certain property acquired in taxable years beginning after 6/30/95		X	X
PRIRC § 1040.11	Election to use flexible depreciation for certain property acquired before 6/30/95		X	X
PRIRC § 1033.11	Deduction of $400 per person for up to five severely handicapped persons employed for certain periods			X

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
PRIRC § 1033.10	Deduction for charitable contributions and gifts to certain eligible entities			X
PRIRC § 1033.19(a)	85% deduction for dividends received by domestic corporations taxable under the Code			X
PRIRC § 1033.19(a)(1)(D)	100% deduction for dividends received from a controlled corporation (as defined in PRIRC § 1010.04(a)(1)) taxable under the Code			X
PRIRC § 1033.19(a)(1)(A)	100% deduction for dividends received by a small business investment company operating in PR under the Small Business Investment Act of 1958 from a domestic corporation taxable under the Code			X
PRIRC § 1033.19(a)(1)(B) and (C)	100% deduction for dividends attributable to the principal derived from industrial development income accrued during taxable years beginning before 1/1/93 and invested in certain obligations			X
TAX CREDITS				
PRIRC § 1052.01	Earned income credit against the income tax of individual residents of PR who generate earned gross income of less than $27,500 and who are not claimed as a dependent	X		

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
PRIRC § 1052.02(a)	Compensatory personal credit of $400 for individual residents of PR who are 65 years or older, are not claimed as a dependant, and have gross income under $15,000	X		
PRIRC § 1052.02(b)	Personal credit of $300 for every individual with low income who is a pensioner of certain pension plans	X		
PRIRC § 1052.03	Credit for a portion of the purchase price of a newly constructed house	X		
PRIRC § 1052.04	Credit for a portion of the purchase price of an existing house	X		
PRIRC § 1051.05	Credit against dividends derived from industrial development income received by U.S. corporations engaged in trade or business in PR for a certain percentage of investments made by the corporation in PR between 1977 and 1993			X
PRIRC § 1051.06	Credit in lieu of a deduction for contributions to the Santa Catalina Palace Patronage	X	X	X
PRIRC § 1051.07	Credit for an eligible business that increases the purchases of Puerto Rican agricultural products in substitution of imported products for the local sale		X	X

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
PRIRC § 1113.14	Credit for portion of the purchase price paid for an ordinary or extraordinary membership in a SEOC	X		
PRIRC § 1051.05	Credit against the tax on dividends derived from industrial development income received by U.S. corporations engaged in trade or business in PR, corresponding to the 3% of the investment made by the subsidiary prior to 1/1/93 in the acquisition, construction, and expansion of buildings and other structures used in manufacture, which exceeds the investment in such properties possessed by the subsidiary as of 3/31/77			X
PRIRC § 1051.09	Credit for the purchase by an eligible business of eligible products manufactured in PR		X	X
1994 PRIRC § 1040D	Credit for purchase of products manufactured in Puerto Rico for export		X	X
1994 PRIRC § 1040E	Credit for purchase of products manufactured in Puerto Rico for local sale and consumption		X	X
1994 PRIRC § 1040F	Credit for the increase in purchases of Puerto Rican agricultural products		X	X
1994 PRIRC § 1040J	Credit for purchases of certain products		X	X

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	manufactured by Puerto Rico firms			
1994 PRIRC § 1040C	Tax credits for the purchase, manufacture and installation of solar electric equipment	X	X	X
PREFERENTIAL TAX RATES				
PRIRC § 1023.02	10% tax rate on long-term capital gains for individuals, trusts, and estates	X	X	
PRIRC § 1023.03	15% tax rate on long-term capital gains for corporations			X
PRIRC § 1023.04	Election by individuals, trusts, and estates to pay reduced rate of tax (10% or 17%) on "non-exempt" interest from deposits in certain types of accounts	X	X	
PRIRC § 1023.05	Election by individuals, estates, corporations, partnerships, and trusts to pay 10% tax rate on "non exempt eligible interest" on debt obligations issued by certain corporations and partnerships or on certain mortgages on residential property located in PR	X	X	X
PRIRC § 1023.06	10% tax rate on "eligible distributions" of dividends received by individuals, trusts, and estates from certain corporations	X	X	

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
PRIRC § 1023.07	20% tax rate on the total amount of remuneration received by a resident or NRA for personal services rendered in PR as an employee or independent contractor of an MLB baseball team, an NBA/WNBA basketball team, or the MLB/NBA organizations.	X	X	X
PRIRC § 1023.08	Election to treat as long-term capital gain the total amount includible in gross income under a variable annuity contract issued by an eligible insurance company			
PRIRC § 1023.09	Election to treat the amount of the distribution from an employee's trust that is considered long-term capital gain under PRIRC § 1081.01(b)(1) as subject to the reduced tax rate provided in that section or as ordinary income, whichever is more beneficial	X		
MISCELLANEOUS ITEMS				
PRIRC § 1034.01	Individual taxpayers may use capital losses to offset $1000 of ordinary income	X		
PRIRC § 1040.07	Use of LIFO inventory method		X	X
PRIRC § 1034.02(a)(5)	Stepped-up fair market value basis for certain property acquired from a	X		

		Individuals (Non-business)	Individuals Engaged in Business	Corporations
	decedent			
PRIRC § 1034.04(b)(8)	Nonrecognition treatment on like-kind exchanges		X	X

6.B Income Tax Expenditures in Other Legislation

Jobs Now Act (Act 1-2013)	
§ 4.5(a)	10% tax rate on income from the first year of operations of a qualifying new business with a Special Agreement; 15% tax rate for second year
§ 4.5(b)	100% deduction for losses incurred during the first two years of a business operating under an Agreement against income earned during the first 10 years
Individual Investors Act (Act 22-2012)	
Article 3	100% exemption for all interest and dividends received by new residents of Puerto Rico,
Article 4	100% exemption for all long-term capital gains accrued after becoming a new resident
Export Services Act (Act 20-2012)	
§ 4(a)	4% tax rate on export services income derived by eligible businesses with an exemption decree
§ 6(a)	100% exemption from income tax on distributions to shareholders attributable to export services income
International Financial Center Regulatory Act (Act 273-2012)	
§ 6(a)	4% tax rate on qualifying income of international financial entities with exemption decrees
§6(i)	6% fixed income tax rate on dividends and pro rata share of benefits of the corresponding IFE for shareholders or partners of an IFE that are residents of Puerto Rico

§6(c)	100% exclusion from income and withholding tax for interest, financing charges, and partnership profits received from an IFE (items treated as foreign source income)
Puerto Rico Film Industry Economic Incentives Act (Act 27-2011)	
§ 8.1(a)(1)(A)(ii)	4% income tax rate on income derived by a qualifying film entity from the exploitation of film or infrastructure projects
§ 8.1(a)(1)(A)(iii)	6% to 10% tax rate on certain income of studio operators
§ 8.1(a)(1)(B)	100% exemption from income tax on distributions to shareholders attributable to qualifying film related income
§7.3(b)	Tax credit for a portion of Puerto Rico Production Expenditures or infrastructure investments
Tax Incentives Act for Investment in Facilities of Reduction, Disposition and/or Treatment of Solid Waste (Act 159-2011)	
	Credit for investment in reduction, disposal and / or treatment of solid waste
Real Estate Market Stimulus Act of 2010 (Act 132-2010); Act 216-2011, as amended; Act 68-2013	
§ 3(b) of Act 132-2010, as amended	100% exemption from income tax for the net long-term capital gain from the sale of new construction property acquired between September 1, 2010 and August 31, 2015
§ 2(a) of Act 132-2010	100% exemption from income tax for rental income derived from the lease of a new construction property or qualified residential property
The Puerto Rico Green Energy Incentives Act (Act 83-2010; 13 LPRA §§ 10421 et seq.)	
§ 2.9(a)	4% tax rate on green energy income of exempt businesses
§ 2.9(b)	12% withholding tax rate on royalties from exempt businesses to nonresident persons
§ 2.9(c)(1)	100% exemption from income tax on distributions to shareholders attributable to green energy income
§ 2.9(c)(2)	4% income tax rate on gain from the sale of an interest in an exempt business during the exemption period
§ 2.11(a)	25% credit for purchases of products made in Puerto Rico (35% credit for products made from recycled materials)
§ 2.11(b)	Job creation credit

§ 2.11(c)	Credit for investment in R&D
Puerto Rico Tourist Development Act of 2010 (Act 74-2010; 23 LPRA §§ 6341 et seq.)	
§3(a)(1)(A); 23 LPRA § 6342(a)(1)	90% exemption for qualifying tourism development income; 100% exemption for tourism income from Vieques or Culebra
§3(a)(1)(F); 23 LPRA § 6342(a)(3)	12% withholding tax rate for royalty payments to nonresident persons for the use of tourism-related IP in Puerto Rico
§3(a)(1)(B); 23 LPRA § 6342(a)(1)(B)	100% exemption from income tax on distributions of tourism development income from exempt businesses
§3(a)(1)(C); 23 LPRA § 6342(a)(1)(C)	Partial exemption on sale of shares of tourism business that continues operations
§5(a); 23 LPRA § 6344(a)	Credit for 50% of qualifying tourism industry investment
Economic Incentives Act for the Development of Puerto Rico (Act 73-2008; 13 LPRA §§ 10641 et seq.)	
§ 3(a); 13 LPRA § 10643(a)(1)	Flat tax rate of 4% or 8% on industrial development income of exempt businesses (0% in some cases)
§ 3(b); 13 LPRA § 10643(b)(1)	2% or 12% withholding tax rate on royalty payments to nonresident persons for the use of IP in Puerto Rico
§ 4(b); 13 LPRA § 10644(b)	100% current deduction for certain acquisition, remodeling, and repair expenses
§ 4(a); 13 LPRA § 10643(a)(1)	Additional deduction for training expenses
§ 5(a); 13 LPRA § 10645(a)	25% credit for purchases of products made in Puerto Rico (35% credit for products made from recycled materials)
§ 5(b); 13 LPRA § 10645(b)	Credit for job creation
§ 5(c); 13 LPRA § 10645(c)	Credit for R&D investments
§ 5(d); 13 LPRA § 10645(d)	Credit for investment in energy producing machinery and equipment
§ 5(e); 13 LPRA § 10645(e)	Credit for reduction of energy costs
§ 5(f); 13 LPRA § 10645(f)	Credit for investment in the transfer of technology

§ 5(g); 13 LPRA § 10645(g)	Credit for investment in strategic projects
§ 6; 13 LPRA § 10646	Credit for industrial investment
§ 3(d); 13 LPRA § 10643(d)(1)	100% exemption from Puerto Rico income tax on distributions of industrial development income from exempt businesses
§ 3(d); 13 LPRA § 10643(d)(1)	4% rate of tax on gain on the sale of stock of an exempt business or substantially all of its assets during the exemption period (4% rate continues to apply for sales after the exemption period, but subject to the book value of the stock or assets)
Integral Development of the Book Industry in Puerto Rico Act (Act 516-2004)	
§ 4	Exemption from income tax for income received by Puerto Rican authors from copyrights, up to $10,000
§ 8	Exemption from income tax for income received by designers and translators in connection with the production of books, up to $6,000
§ 5	50% income tax exemption for income of publishers
§ 6	10% income tax exemption for income of printers
§7	15% income tax exemption for income of booksellers
International Insurers and Reinsurers Act (Act 399-2004)	
Article 61.240	100% exemption from income tax for income derived by an international insurer or an international insurer holding company
Article 61.240	100% exclusion from gross income for dividends, interest, and partnership distributions received by an international insurer or an international insurer holding company
Article 61.240	100% exemption from withholding tax on dividends and partnership distributions from an international insurer or international insurer holding company to a nonresident person
Urban Centers Revitalization Act (Act 212-2002)	
21 LPRA § 1095g(F)	75% or 100% tax credit for costs of eligible construction or improvement projects in urban centers
21 LPRA § 1095g(D)	100% tax exemption on interest received by individuals or financial institutions from loans to finance projects to revitalize urban centers

21 LPRA § 1095g(C)	10% exclusion from gross income for income from parking lot operations
21 LPRA § 1095g(B)	Additional 15% payroll deduction for businesses that transfer operations to an urban center
21 LPRA § 1095g(A)	Additional deduction for 5% of salary of newly created jobs
Investment in Housing Infrastructure Act (Act 98-2001)	
21 LPRA § 1095g(E)	Credit for investment in housing infrastructure recommended by the Housing and Treasury Departments
Special Act for the Creation of the Santurce Theater District (Act 178-2000)	
§ 11	Tax credit for investments in certain projects in the Santurce Theater District
§ 8(f)	50% income tax exemption on net income from ticket sales for certain cultural and artistic performances during the first 5 years after new construction or substantial rehabilitation
	Additional deduction from net income equivalent to 5% of the minimum wage applicable to each new job created for a period of 5 years
	Special deduction from net income equal to 10% of the rent paid for a 10-year period
The Puerto Rico Capital Investment Funds Act of 1999 (Act 46-2000)	
	Credit for investments in qualified investment capital funds for high-risk projects, businesses, or activities
Act for the Development of the Film Industry (Act 362-1999)	
	7% tax rate on qualifying income of film entities
	Tax credit for investments in film projects
	100% exemption from income tax on dividends received from a qualifying film entity
Puerto Rico Tax Incentives Act of 1998 (Act 135-1997; 13 LPRA §§ 10101 et. seq.)	
§ 3(a); 13 LPRA § 10102(a)	Flat tax rate of 2% to 7% on industrial development income of exempt businesses
§ 6(k); 13 LPRA § 10105(k)	10% withholding tax rate on royalties from an exempt business to a nonresident person for the use of IP in Puerto Rico

§4(b); 13 LPRA § 10103(b)	Additional deduction for training expenses
§4(c); 13 LPRA § 10103(c)	Additional R&D deduction
§4(e); 13 LPRA § 10103(e)	100% current deduction for certain acquisition, remodeling, and repair expenses
§4(f); 13 LPRA § 10103(f)	Deduction (in lieu of credit) for purchases of products made in Puerto Rico
§5(b); 13 LPRA § 10104(e)	Tax credit for purchases of products made in Puerto Rico
§5(a); 13 LPRA § 10104(a)	Tax credit for losses of U.S. parent
§3(b); 13 LPRA § 10102(b)	Tax credit for individual shareholder's share of the income tax paid by the exempt business on industrial development income
§2(p); 13 LPRA § 10101(p)	Tax credit for purchase of exempt business ceasing operations
§5(c); 13 LPRA § 10104(c)	Partial tax credit for payment of royalties and license fees
§7(a); 13 LPRA § 10106(a)	100% exemption from Puerto Rico income tax on distributions of industrial development income from exempt businesses
§7(c); 13 LPRA § 10106(c)	4% rate of tax on gain on the sale of stock of an exempt business during the exemption period
Special Act for the Development of Castaner (Act 14-1996)	
	90% income tax exemption for income from the sale of tickets to certain fairs and sporting events
	Additional deduction from net income equivalent to 5% of the minimum wage applicable to each new job created for a period of 5 years
	Special deduction of 15% of the rent paid by businesses in certain areas of Castaner
Agricultural Tax Incentives Act of 1995 (Act 225-1995; 13 LPRA §§ 10401 et seq.)	
§10(a); 13 LPRA § 10408(a)	90% income tax exemption for agricultural income of bona fide farmers
Special Act for the Rehabilitation of Rio Piedras (Act 75-1995; 23 LPRA §§ 7001 et seq.)	

23 LPRA § 7012(b)	50% income tax exemption for income from the sale of tickets for artistic and cultural shows in the Rio Piedras District
23 LPRA § 7012(a)	Special deduction for 10% of rent paid for 10 years
23 LPRA § 7011	Additional deduction from net income equivalent to 5% of the minimum wage applicable to each new job created for a period of 5 years
Ley de Zona Historica (Act 7-1995)	
§ 3	100% exemption from income tax for income from the rental of property in the historical area
Puerto Rico Tourist Development Act of 1993 (Act 78-1993)	
	Credit for direct investments or investments in securities in a qualified tourist investment capital fund
Special Act for the Rehabilitation of Santurce (Act 148-1988; 23 LPRA §§ 226 et seq.)	
§ 10	Additional deduction in computing taxable income equal to 5% of the wages of each newly created full time job
§ 11	Special deduction for 10% of rent paid during the first 10 years
Solid Waste Authority Act (Act 70-1978; 12 LPRA § 1318a et seq.)	
§ 21; 12 LPRA §1318a	Credit for 50% of an eligible investment in the construction of facilities for the treatment or disposal of waste
Hospitals Tax Exemption Act (Act 168-1968; 13 LPRA §§ 371 et seq.)	
§1; 13 LPRA §371	Credit for 15% of payroll
§7; 13 LPRA §375b	10% tax rate on distributions to shareholders out of exempt income
§2; 13 LPRA § 372	50% exemption from income tax on interest income from certain bonds issued with respect to the construction or expansion of hospitals
Miscellaneous	
Act 58-2013	Exemption from gross income for income from overtime worked by a Puerto Rico police member
Act 98-2006	Credit for the 2006 extraordinary tax
Integral Development of the Special Planning	100% income tax exemption

Institute of Cano Martin Pena Act (Act 489-2004)	
Act 324-2004	Exemption from gross income for wages received by public employees for overtime work in emergency situations
Voluntary Act of Puerto Rico (Act 261-2004)	Exclusion gross income for meal or trip allowances paid for voluntary services under the Voluntary Act of Puerto Rico, up to $1,500
Creation of Assisted Living Housing Projects for the Elderly in Puerto Rico Act (Act 244-2003)	100% income tax exemption on a percentage of income accrued during the first two years of operations
Puerto Rico Conservation Easement Act (Act 183-2001)	Credit for the establishment and donation of a conservation easement
Credit for Investment in New Construction or Rehabilitation of Social Interest Housing Act (Act 140-2001)	Credit for investment in the construction or rehabilitation of rental housing projects for low or moderate income families
Act 109-2001	Tax credit to investors in an exempt business that is in the process of closing its operations in PR
Act 290-2000	Tax credit for contributions to former governors foundations
Act 213-2000 (Affordable Housing Projects)	100% income tax exemption on income received by the project developer of new homes from the sale of units to elderly or disabled persons
Rental Housing Program for Elderly Persons with Low Income Act (Act 165-1996)	90% income tax exemption for income received by an owner of a rental housing project for the elderly
Partnership of Public and Private Sector for New Housing Operation Act (Act 47-1987)	Exemption from income tax for rental income received by an owner of a multifamily project of social interest (building or group of buildings with 10 or more housing units), up to 10% return on capital invested in the acquisition, construction or rehabilitation of the property Exemption from income tax of up to $5,000 of gain on the sale of a unit to a low or moderate income family, and up to $2,500 of gain on the sale to a middle-class family

7 Appendix B

7.A General rules for partnerships

Before the enactment of the P.R. Code on January 31, 2011, partnerships were taxed in Puerto Rico in the same manner as corporations. Chapter 7 of the P.R. Code changes the previous regime by providing flow through income taxation for partnerships. The Chapter 7 provisions of the P.R. Code are similar in all material respects to the Subchapter K provisions of the United States Internal Revenue Code of 1986 (the "Code") but do not include the special rules for electing large partnerships.

The character and timing of the partnership results are generally determined by the partnership as an entity. Partnership income is computed as if the partnership were individual, but specified items that are not properly taken into account by the partnership as an entity (e.g., the personal exemption, foreign taxes, charitable contributions, the net operating loss and the deductions from adjusted gross income allowed only to individuals) are excluded. The partnership's results can be specially allocated to the partners regardless of their profit and loss or capital ratios, so long as such allocations have substantial economic effect. The partners have an outside basis in their partnership interests that is affected by the results but may differ from their ratable shares of the partnership's inside basis in its assets. The partnership has its own tax year and method of accounting, but its choices are constrained by the tax status of its partners. Moreover, partners may deal with the partnership in an independent capacity, and may receive payments for services or return on capital in a semi-independent capacity.

7.B Special rules for certain entities

The following entities are subject to the special rules described below.

7.B.1 Limited Liability Companies

In general, limited liability companies (LLCs) (whether formed in Puerto Rico or a state of the United States) are taxed in Puerto Rico as corporations.

7.B.2 Special Partnerships

However, certain corporations and LLCs may qualify as special partnerships, which generally are taxed like partnerships.

To qualify as a special partnership, the entity is required to:

- Derive at least 70% of its gross income for each taxable year from sources within Puerto Rico; and
- Derive at least 70% of its gross income from one of the following activities: construction, land development, rehabilitation, sale and/or lease of buildings or structures (except for leases of residential property to related persons), manufacturing, tourism (including the operation of casinos), agriculture, exportation, production of feature films, construction, operation, or maintenance of public roads and their attached facilities, or the production of energy from sustainable or alternative renewable sources.

If the qualifying activity is the production of feature films, the requirement that 70% of the special partnership's income be derived from sources within Puerto Rico does not apply. Corporations and LLCs that operate under a grant of industrial tax exemption do not qualify as a special partnership, unless engaged in business related to the production of energy. However, corporations and LLCs that operate under a tourism, agricultural or green energy tax incentives grant, or under the Public and Private Sector Copartnership for the New Housing Operation Act, may qualify as a special partnership.

Special partnerships are responsible for the withholding of Puerto Rico income tax on a partner's estimated distributive share of special partnership income. The rates of withholding vary depending on the partner (e.g., the withholding rate is 33% for partners that are individual residents of Puerto Rico or the United States, 39% for partners that are Puerto Rico corporations (or non-Puerto Rico corporations engaged in trade or business in Puerto Rico), 29% for nonresident aliens or corporations).

7.B.3 Corporations of Individuals

Certain corporations, partnerships and LLCs also may qualify as corporations of individuals. Corporations of individuals are similar to Subchapter S corporations in the Code. As a general rule, a corporation of individuals is treated as a passthrough entity for Puerto Rico income tax purposes.

An entity qualifies as a corporation of individuals if:

- It is organized under the laws of the Commonwealth of Puerto Rico, the laws of any state of the United States, or the laws of the District of Columbia;
- It has no more than 75 shareholders;
- Its shareholders are individuals, estates, and certain trusts;
- It has one class of stock; and
- It elects to be a corporation of individuals and is determined by the Puerto Rico Treasury Department to qualify as a corporation of individuals.

A corporation is not eligible to qualify as a corporation of individuals if it is:

- An insurance company;
- A registered investment company;
- A special corporation owned by employees;
- Operating under a grant of industrial tax exemption;
- An exempt organization;
- A financial institution; or
- An investment capital fund.

Corporations of individuals may elect the method of accounting, the method of computing depreciation, and the tax year. All elections made at the corporate level apply at the shareholder level. However, the election to take a foreign tax credit or a foreign tax deduction is left to each shareholder separately. Shareholders of a corporation of individuals are taxed on the distributive share of the ordinary income of the corporation of individuals and on the distributive share of certain separately considered items for the tax year that ends with or within the shareholder's tax year. The character of any income item included as the distributive share of a shareholder in a corporation of individuals must be treated as if such item of income was directly realized by the shareholder. Corporations of individuals are responsible for withholding 33% of the estimated amount of distributions to a shareholder, whether resident or nonresident of Puerto Rico.

Although a corporation of individuals is treated as a passthrough entity and is generally not taxed as a corporation, corporations of individuals, in some cases, are subject to corporate-level income tax. In particular, a corporation that converts from a regular corporation into a corporation of individuals will be subject to a corporate-level tax on the net recognized built-in gains on assets carried over from the regular corporation for a 10-year period. The rate of tax applicable to net recognized ordinary built-in income is 39%. The 15% alternative capital gains rate does not apply to the built-in gains that would otherwise qualify as a capital gain.

7.B.4 Real Estate Investment Trusts

A real estate investment trust (REIT) generally is exempt from Puerto Rico income tax if it meets all the requirements for qualifying as a REIT for Puerto Rico tax purposes and during the year distributes to its beneficiaries 90% of its income.

To qualify as a REIT, the entity must meet the following requirements:

- It is a corporation, partnership, trust, or association;
- It has 50 or more shareholders or partners during at least 335 days over a 12-month period;
- It is managed by one or more trustees or directors;
- The capital is evidenced by shares of transferable certificates;
- Except for the provisions relating to REITs, it is treated for tax purposes as a Puerto Rico corporation;
- It does not qualify as a financial institution or as an insurance company;
- It files an election to be treated as a REIT together with its income tax return or has an election made for a previous taxable year;
- After the end of the first semester of the first year of the REIT, 50% or more of the total value of all the outstanding shares or participation certificates are owned by more than five individuals;
- 95% or more of the gross income of the REIT must be derived from:
  - Dividends;
  - Interest;
  - Rents from real property;
  - Gain from the sale or other disposition of securities or real property (including interests in real property and interests in mortgages on real property) that is not inventory;
  - Amounts received or accrued as consideration for entering into agreements: to make loans secured by mortgages on real property; or to purchase or lease real property;
  - Gains from the sale or disposition of real property; and
- 75% or more of the gross income of the REIT must be derived from:
  - Rents derived from real property located in Puerto Rico;
  - Interest on obligations secured by mortgages on real property or rights to real property located in Puerto Rico;
  - Gain from the sale or other disposition of real property that is not of the type of property that qualifies as inventory;
  - ividends or other distributions derived from, and gains derived from, the sale or other

disposition of shares of transferable stock, certificates, or participation in another REIT;

- o Amounts received or accrued as consideration for entering into agreements to make loans secured by mortgages on real property and/or rights to real property located in Puerto Rico, and/or to buy or lease real property and/or rights to real property located in Puerto Rico.

7.B.5 Registered Investment Companies

A registered investment company (RIC) also generally is exempt from Puerto Rico income tax if it meets all the requirements for qualifying as a RIC for Puerto Rico tax purposes and during the year distributes to its shareholders 90% of its income.

To qualify as a RIC, the entity must meet the following requirements:

- 75% of its gross income should be derived from "eligible sources"; and
- by the end of each quarter, 60% of its assets should produce income from "eligible sources" or be governmental securities.

Eligible sources are defined as activities of the private sector with the potential to be particularly effective in the creation of jobs, excluding activity existent as of July 31, 2013. The Secretary of Economic Development shall define, through regulations, what would constitute an eligible activity under this Section, using as guidelines:

- The job creation and preservation potential of such economic activity in Puerto Rico;
- The economic support that such economic activity may provide to a geographical area in need of capital investment in Puerto Rico;
- The public interest related to such activity in Puerto Rico, giving priority to tourism, manufacturing, scientific research, and technology development; and
- Whether such activity promotes the raising of Puerto Rican capital.

The Regulations established shall include among the eligible activities certain investments in eligible businesses, which include:

- The export of goods or services from Puerto Rico;
- The development of new technologies and processes in Puerto Rico;
- The development of intellectual property rights in Puerto Rico;
- The trading and marketing of new goods and services in Puerto Rico;
- Tourist activities; and
- The acquisition of facilities of closed manufacturing plants, with the intent of rehabilitating the same, to operate a business similar to the one previously operating in such facilities.

7.B.6 International Banking Entity

An International Banking Entity (IBE) and the distribution of its earnings to foreign shareholders generally are exempt from Puerto Rico income, property and municipal license taxes. An IBE is one that operates as a unit of a bank organized under the Banking Act of Puerto Rico for which net income, derived from the authorized activities described below, exceeds 20% of the bank's total net income. The term "excess net income" means the amount of net income in excess of 20% of the total net income derived during the taxable year by the bank of which the international banking entity is a unit. The "excess net income" of IBEs is subject to the regular income tax rates applicable to corporations.

Qualification as an IBE requires:

- A person or a unit of a person, other than an individual;
- A minimum capital of $5 million of which at least $2 million must be fully paid at the time the license is issued (such amounts may be less if properly requested and authorized);
- A principal office in Puerto Rico;
- Not less than $300,000 of unencumbered assets or acceptable financial securities (such amount may be less if properly requested and authorized), with an aggregate market value equal to or greater than the amount of unencumbered assets that the IBE is required to hold physically in Puerto Rico;
- The employment, on a full-time basis, of a minimum of four persons working at the business office in Puerto Rico (fewer employees working in Puerto Rico may be allowed if this is properly requested and authorized);
- The carrying on of permitted transactions;
- A name that includes the word "International," "Foreign," "Overseas,"or another similar word that connotes the international nature of the activities of the IBE; and
- A license to operate as an IBE.

In general, an IBE may be authorized to carry on certain commercial banking activities, certain transactions in relation to securities and insurance, certain fiduciary services, financial leasing, clearinghouse activities, management, and other activities from a location within Puerto Rico but for clients and use outside Puerto Rico.

An IBE may not:

- Accept deposits or borrow money from individuals residing in Puerto Rico, entities organized under the laws of Puerto Rico or with their principal place of business located in Puerto Rico, or the government of the Commonwealth of Puerto Rico, except the Government Development Bank for Puerto Rico (GDB), the Economic Development Bank for Puerto Rico (EDB), and other international banking entities;
- Make, procure, place, secure, or service loans, if any of the proceeds of such loans are to be used in Puerto Rico (except that an IBE may participate in the granting or securing of loans originated by the GDB or the EDB and may finance projects in areas of priority to the government of Puerto Rico, with the corresponding authorization);
- Issue, confirm, or give notice of letters of credit if any of the proceeds are to be used in Puerto Rico and both the issuer and beneficiary are foreign persons (except in the case of export financing transactions in which the beneficiary is a resident of Puerto Rico, an entity organized in Puerto Rico or that has a principal place of business in Puerto Rico, or the government of Puerto Rico);
- Discount bills of exchange (unless all proceeds will be used outside of Puerto Rico and both the drawer and the beneficiary are foreign persons);
- Purchase or hold any of its own stock, unless previously authorized by the Commissioner of Financial Institutions;
- Make loans to its directors, employees or stockholders, (unless authorized in writing by the Commissioner of Financial Institutions); or
- Place, underwrite, insure, or reinsure risks or objects in Puerto Rico.

7.B.7 International Financial Entities

An International Financial Entity (IFE) is entitled to these tax benefits in Puerto Rico (for a period of 15 years with 2 possible 15-year extensions):

- 4% fixed income tax rate;
- 100% exclusion of interest, financing charges or participation in partnerships benefits, which will not be considered gross income from Puerto Rico sources; therefore, will not be subject to taxation or withholding provisions for nonresidents of Puerto Rico;
- 6% fixed income tax rate on dividends and pro rata share of benefits of the corresponding IFE for shareholders or partners of an IFE that are residents of Puerto Rico;
- 100% tax exemption on all real and personal property belonging to an IFE; and
- 100% tax exemption on the payment of municipal license taxes.

If the IFE operates as a unit of a bank, any net income derived by the IFE in excess of the 20% of total net income derived by the bank for which the IFE operates as a unit (including the income derived by the unit), will be subject to the regular tax rates for corporations. Also, 7.5% of the funds collected from an IFE's income tax will be deposited in the Special Fund for the Development of Export and Promoter Services of the Department of Economic Development and Commerce, created by the “Export Services Act” to promote growth of services and other eligible businesses in Puerto Rico.

Qualification as an IFE requires:

- A person or a unit of a person, other than an individual;
- Authorized capital stock of not less than $5 million, with at least $250,000 fully paid at the time the license is issued; and
- Employment of a minimum of four persons at its business office or offices in Puerto Rico.

With the Commissioner's approval, the IFE may:

- Participate in syndicated nonconforming loans with local banks. This activity will be permitted for the year 2012 and the following five calendar years;
- Acquire classified or nonperforming/distressed loans from local banks. This activity will be permitted for the year 2012 and the following two calendar years. However, the sale of any property that served as guarantee for said loans could be performed after such period, that is, after December 31, 2014;
- Accept deposits from foreign persons;
- Accept properly collateralized deposits or borrow duly secured money from the Governmental Development Bank and the Economic Development Bank; and
- Establish branches outside of Puerto Rico, in the United States mainland and its possessions, or in other foreign countries.

Some other permitted transactions are:

- To make or place deposits in, and otherwise give money as a loan to the Governmental Development Bank, the Economic Development Bank, any other IFE or any other bank;
- To make, procure, place, guarantee or provide loan servicing to foreign persons, with some exceptions;
- To issue, confirm, give notice, negotiate or refinance letters of credit, provided that the client and the beneficiary requesting the letter of credit is not a domestic person;

- To issue, confirm, give notice, negotiate, or refinance letters of credit in transactions for the financing of exports, even if the beneficiary is a domestic person;
- To discount, rediscount, deal or otherwise trade in money orders, bills of exchange and similar instruments, provided that the drawer and the original debtor, are not domestic persons;
- To invest in securities, stocks, notes and bonds of the Government of Puerto Rico;
- To carry out any permitted transaction in the currency of any country, or in gold or silver, and to participate in foreign currency trade;
- To underwrite, distribute, and otherwise trade in securities, notes, debt instruments, drafts and bills of exchange issued by a foreign person for final purchase outside of Puerto Rico;
- To engage in any financial activity outside of Puerto Rico, which would be allowed by a bank holding company or by a foreign subsidiary of a United States bank;
- To act as fiduciary (executor, administrator, etc.) after obtaining a special permit from the Commissioner, provided that such fiduciary services are not offered to, nor inure to the benefit of domestic persons;
- To acquire and lease personal property at the request of a lessee who is a foreign person;
- To trade securities outside of Puerto Rico, on behalf of foreign persons;
- To act as a clearinghouse in relation to financial contracts or instruments from foreign persons;
- To organize, manage and provide management services to financial entities located outside of Puerto Rico, such as investment companies and mutual funds, provided that the shares or participation in the capital of such companies are not distributed directly by the IFE to domestic persons;
- To participate in granting and securing loans originated and/or secured by the Governmental Development Bank and the Economic Development Bank;
- To finance, through loans or financial securities, projects in those areas of priority for the Government of Puerto Rico, in those cases designated as extraordinary by the Secretary of the Treasury and the Commissioner; and
- To provide financial services, such as asset management, management of investment alternatives, management of activities related to private capital investment, management of coverage funds or high risk funds, management of pools of capital, trust management that serves to convert different groups of assets into securities, and escrow accounts management services.

7.B.8 Special Employee-owned Corporations

The following items are excluded from the gross income of a Special Employee-owned Corporation (SEOC):

- The income credited to the collective reserve account and to the social account; and
- The income credited in the corresponding internal capital accounts of the regular and/or special members that is capitalized.

An additional incentive is offered to SEOCs that create new jobs. If the SEOC creates from three to five, six to 10, or 11 or more, new jobs during the year, a 15%, 20%, or 25%, respectively, additional deduction based on the annual payroll or income advances is granted. If the SEOC is engaged in manufacturing, is not operating under a grant of industrial tax exemption, has taxable income exceeding $200,000, and has maintained an average employment or working position for ordinary members of 20 or more persons during the taxable year, it may take an additional flat deduction of $40,000. An SEOC engaged in manufacturing that does not operate under a grant of tax exemption and that during the taxable year derives a total net income of less than $20,000 per manufacturing job or working position for ordinary production members may opt, instead of the flat $40,000 deduction, to take a deduction equal to 15% of the payroll or total advance production income up to a maximum of 50% of the credit notices for productivity and patronage distributed to regular and special members.

The SEOC is a hybrid between a regular corporation and a cooperative. An SEOC may have regular members (natural persons employed by the SEOC), special members (e.g., customers of the SEOC), and corporate members, but the regular members must control the management of the SEOC. An SEOC must have an internal capital account for each member, a collective reserve account, and a social account.