

November 30, 1998

Circular Letter No. 98-07

SUBJECT: Tax treatment of Registered Investment Companies and of their Shareholders and Noteholders under the Puerto Rico Internal Revenue Code of 1994, as amended (Code).

Act No. 6 of October 19, 1954, the Puerto Rico Investment Companies Act, as amended, was enacted to provide for the creation, registration, operation and regulation of investment companies, as a means to channel capital investment in an orderly and productive fashion. The Statement of Motives to Act No. 6 specifically states our Legislature's determination that, to do so, it was necessary to enact legislation which "places the holder of securities issued by investment companies in a tax situation identical with that which he would enjoy had he invested his funds directly in the same securities handled by said companies." Section 361 of the Puerto Rico Income Tax Act of 1954, as amended, and its successor, Section 1361 of the Puerto Rico Internal Revenue Code of 1994, as amended (the Code), implement this purpose, by exempting registered investment companies from taxation if they meet certain criteria and maintaining the character and nature of the underlying earnings and profits when distributed as dividends to their shareholders.

This Department is committed to further the organization and operation of registered investment companies (Companies or Company, as the case may be) under the Puerto Rico Investment Company Act in order to promote investments in Puerto Rico. This objective must be reached through full compliance of the tax provisions of the Code, since noncompliance hinders an orderly development of the industry.

In accordance with this objective and within the authority granted and recognized under the Code, this Department rules as follows:

I. In General

1. For purposes of Section 1361 of the Code and this Circular Letter, interest income that is excluded from gross income or otherwise exempt from Puerto

Rico income taxation under provisions other than those of the Code (such as special Puerto Rico laws or federal legislation) shall be treated as income exempt under Section 1022(b) of the Code.

II. Tax Treatment of Companies

1. A Company is exempt from Puerto Rico income taxes if, in accordance with Section 1361(a)(2) of the Code and within the periods established therein, it distributes to its shareholders as taxable dividends or as dividends from industrial development income at least 90% of its net income (as said term is defined in the Code, and as adjusted by Section 1361(a)(1) of the Code). Section 1361(a) of the Code.
2. Operational expenses must be allocated among all revenues of the Company (including items excluded from gross income or exempt from taxation) on a gross to gross basis.
3. Capital gains and losses from the sale or exchange of capital assets (as said term is defined in Section 1121(a) of the Code) shall be disregarded in computing the net income of the Company. Section 1361(a)(1) of the Code.
4. For purposes of determining whether a Company has met the 90% net income distribution requirement of Section 1361(a)(2) of the Code for a taxable year, the Company shall not be required to distribute the amount of earnings and profits attributable to exempt interest income and capital gains derived by it in such taxable year.
5. If for any taxable year a Company does not derive any net income (as said term is defined for purposes of Section 1361(a)(1) of the Code), the Company shall be treated as having met the distribution requirements imposed by Section 1361(a)(2) of the Code for such taxable year.

III. Tax Treatment of Shareholders and Noteholders

A. Corporations and Partnerships

1. Capital gain dividends (as said term is defined in Section 1361(c)(3) of the Code) distributed by a Company shall be treated as long term gains from the sale of capital assets and, therefore, taxed at the 25% alternative capital gain tax rate. Sections 1121(c) and 1361(d) of the Code.

2. Corporations and partnerships shall be entitled to the 85% dividend received deduction granted by Section 1026(a) of the Code with respect to taxable dividends (as said term is defined in Section 1361(c)(4) of the Code). The remaining 15% of taxable income dividends shall be subject to the ordinary Puerto Rico corporation and partnership income tax rates.
3. Corporations and partnerships shall have the annual option to tax taxable dividends (as said term is defined in Section 1361(c)(4) of the Code) distributed out of earnings and profits with respect to which the Company (or a 90% - owned subsidiary thereof) has been subject to the payment of foreign taxes: (i) in accordance with Part II. A. 2. above or (ii) by including in their gross income the amount of taxable dividends, increased by the allocable share of foreign income taxes (within the meaning of Section 1131 of the Code) attributable to such dividends, and claiming the corresponding foreign tax credit provided in Section 1131 of the Code, as provided in Section 1361(b)(1)(B)(iv) of the Code.
4. Exempt dividends (as said term is defined in Section 1361(c)(1) of the Code) shall be excluded from the gross income of its corporate or partnership shareholders. Section 1361(b)(1)(A)(i) of the Code.
5. For purposes of Sections 1018(b) and 1018(b)(2) of the Code, the "adjusted net book income" of a shareholder of a Company shall not include any dividends paid by the Company that qualify as exempt dividends under Section 1361(c)(1) of the Code.
6. Interest paid to corporations and partnerships by a Company on collateralized notes or other collateralized debt securities (Notes) shall be treated as exempt income if the interest received by the Company with respect to the underlying collateral for the Notes: (i) is exempt from income taxes under the Code (other than by virtue of Section 1361(a)(2) of the Code), and (ii) equals or exceeds the interest paid by the Company on the Notes. Noncompliance with this two-pronged test disqualifies for tax exemption and subjects the entire interest paid on the Notes to the ordinary income tax rates.
7. Dividend distributions derived from capital gains, exempt income or taxable income, as the case may be, shall not exceed the amount of current or accumulated earnings and profits attributable to each source.

B. Individuals, Estates and Trusts

1. Capital gain dividends distributed by a Company shall be treated as long-term gain from the sale of capital assets and, therefore, taxed at the 20% capital gain tax rate. Sections 1014 and 1361(d) of the Code.
2. Taxable dividends (as said term is defined in section 1361(c)(4) of the Code) distributed by a Company shall be taxed at the rate of ten percent (10%). A Company must deduct and withhold the tax due from the distribution and deliver the payment to this Department in accordance with Section 1012 of the Code.

To qualify for the ten percent (10%) tax rate, the dividend paid by a Company must be derived from earnings and profits accumulated from investments: (i) in domestic corporations or partnerships, or foreign corporations or partnerships whose gross income effectively connected with the conduct of a trade or business in Puerto Rico is at least eighty percent (80%) of its gross income for the preceding three (3) year period ending with the close of its taxable year preceding the declaration of the dividend; (ii) the income from which constitutes Puerto Rico source income under the Code, provided the proceeds thereof are used to finance or refinance real property located in Puerto Rico or used in the active conduct of a trade or business in Puerto Rico; or (iii) investments subject to United States income taxes under the provisions of the United States Internal Revenue Code of 1986, as amended. If the Company derives income from sources within the United States that qualifies as "portfolio interest" under Section 881(c) of the United States Internal Revenue Code of 1986, as amended, dividends distributed by the Company out of such earnings shall not qualify for the ten percent (10%) tax rate, provided, however, that if the "portfolio interest" income derived by the Company for any given year represents less than ten percent (10%) of the Company's total gross income for such year, such income shall be treated as income that qualifies to be taxed at the ten percent (10%) tax rate provided in Section 1012 of the Code upon distribution. For purposes of determining whether less than ten percent (10%) of the Company's total gross income was "portfolio income", there shall be excluded from gross income, in both the numerator and denominator of the formula, income that is exempt from tax under Section 1022 (b) of the Code.

3. Individuals, estates and trusts shall have the annual option to tax taxable dividends (as said term is defined in Section 1361(c) (4) of the Code) distributed out of earnings and profits with respect to which the Company (or

- 90% - owned subsidiary thereof) has been subject to the payment of foreign taxes: (i) in accordance with Part II. B. 2. above, or (ii) by including in their gross income the amount of the taxable dividends, increased by the allocable share of foreign income taxes (within the meaning of Section 1131 of the Code) attributable to such dividends, and claiming the corresponding foreign tax credits provided in Section 1131 of the Code, as provided in Section 1361(b)(1)(B)(iv) of the Code.
4. Exempt dividends (as said term is defined in Section 1361(c)(1) of the Code) shall be excluded from the gross income of individual, estate or trust shareholders. Section 1361(b)(1)(A)(i) of the Code.
 5. Interest paid to individuals, estates and trusts by a Company on the Notes shall be treated as tax exempt income if the interest received by the Company with respect to the underlying collateral for the Notes: (i) is exempt from income taxes under the Code (other than by virtue of Section 1361(a)(2) of the Code), and (ii) equals or exceeds the interest paid by the Company on the Notes. Noncompliance with this two-pronged test disqualifies for tax exemption and subjects the entire interest paid on the Notes to the ordinary income tax rates or to the special tax rate of 17% provided in Section 1013A of the Code, at the election of the individual, estate or trust.
 6. Dividend distributions derived from capital gains, exempt income or taxable income, as the case may be, may not exceed the amount of current or accumulated earnings and profits attributable to each source.

The above mentioned determinations are applicable to Companies organized after the issuance of this Circular Letter and, in the case of open-ended Companies, to Notes issued and capital contributions made after November 30, 1998. Administrative determinations issued by this Department under the Code prior to the date of issuance of this Circular Letter will continue to be in full force and effect with respect to close-ended Companies organized before December 1, 1998 and, as it relates to open-ended Companies, to Notes issued or capital contributions made on or prior to December 1, 1998.

Remember, Hacienda is at your service.

Xenia Vélez Silva
Secretary of the Treasury