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Corporate Tax

Puerto Rico

O'Neill & Borges LLC

chambers.com

2019

Law and Practice

Contributed by O'Neill & Borges LLC

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O'Neill & Borges LLC is a full-service law firm with more than 85 lawyers in over 30 practice areas. The tax team has substantial experience in income tax, tax-exemption, sales and use tax, excise tax, property tax, and local taxes such as the municipal licence tax. It offers the full range of tax services, including tax audits and tax planning related to initial structuring, M&A, reorganisations, and liquidation/withdrawals. The attorneys have notable experience in negotiating with the Puerto Rico Treasury Department for closing agreements and obtaining rulings on complex issues. They are also active in the analysis of and application for economic and tax incentives, and in the negotiation of tax exemption agreements for different industries, including manufacturing, tourism and hotel development, R&D, export, aviation and aerospace, film, and energy. Members of the tax practice group have participated in the drafting of various important tax statutes.

Authors

Amaya Iraolagoitia is a member of the firm's corporate department, and specialises in tax, tax incentives and tax litigation. She represents and advises clients in various sectors, including pharmaceuticals, medical devices, export services, blockchain, financial services, distribution, and software development.

Cristina Ivelisse Morazzani Jové is a member of the Corporate department, and advises on a wide range of corporate and Puerto Rico tax matters. She regularly assists clients in the establishment of operations in Puerto Rico, including electing the most advantageous corporate structure and developing strategies to reduce Puerto Rico taxes in connection with their Puerto Rico operations. She has substantial experience in conducting reorganisations, negotiating ruling requests and closing agreements with the Puerto Rico Treasury Department and the municipalities of Puerto Rico, representing clients in audits conducted by the Puerto Rico Treasury Department and the municipalities of Puerto Rico, and negotiating and amending tax-exemption grants.

Ismael Vincenty advises on all Puerto Rico tax matters, including income, property, licence, and sales and use taxes. He has extensive experience in the establishment of tax-exempt operations in Puerto Rico, M&A transactions, financial restructurings, bankruptcies, and special vehicles such as hedge funds and REITs. He regularly represents clients before the Puerto Rico Treasury Department and in tax litigation cases before the Puerto Rico courts.

Michelle Marichal-Soderberg is a member of the firm's corporate department, and specialises in general corporate law, tax and tax-exemption, employee benefit plans, and the tourism and hospitality industry.

1. Types of Business Entities Commonly Used, Their Residence and Their Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses commonly adopt a corporate form to do business in Puerto Rico. An entity organised as a corporation would be considered a per se corporation for Puerto Rico income tax purposes.

The principal elements to classify an entity as a corporation for Puerto Rico income tax purposes are: (i) perpetual existence – continues to exist regardless of the changes of its members or participants; (ii) centralised administration – its business operations are directed by one person, a committee, a board or any other organism acting with representative capacity; and (iii) limited liability – its owners have limited liability for the debts and liabilities of the entity.

As an alternative, businesses can form a limited liability company ("LLC"). Except under certain circumstances, LLCs are treated by default as corporations for Puerto Rico income tax purposes. See discussion below in **1.2 Transparent Entities** for exceptions to this default rule. Similar to corporations, LLCs may also exist regardless of the changes of its members and provide limited liability to the members, but it provides more flexibility with respect to the manage-

ment of business, the allocation of profit and loss, and the income tax treatment.

1.2 Transparent Entities
The entities commonly used as transparent entities for Puerto Rico income tax purposes are partnerships or LLCs with an election to be treated as partnership for income tax purposes. Commencing 10 December 2018, only non-Puerto Rico LLCs with an election to be treated as a pass-through entity (ie, partnership or disregarded entity) in another jurisdiction are treated by default as a partnership for Puerto Rico income tax purposes. Even if there is only one member, there is no disregarded entity classification under Puerto Rico law. The Puerto Rico trade or business of an entity treated as a partnership for Puerto Rico income tax purposes is imputed to its owners with respect to their distributive share in the net income of the partnership.

Because of the flexibility they provide, we have seen an increase in the use of LLCs to do business in Puerto Rico and as investment vehicles.

Other types of pass-through entities for Puerto Rico income tax purposes are corporations of individuals and special partnerships.

1.3 Determining Residence
A corporation organised under the laws of the Commonwealth of Puerto Rico is a resident corporation even it does no business and owns no property in Puerto Rico. A foreign corporation engaged in trade or business within Puerto Rico is considered a resident foreign corporation.

A partnership engaged in trade or business within Puerto Rico is considered a resident partnership, and a partnership not engaged in trade or business within Puerto Rico is considered as a nonresident partnership.

The determination of whether an entity is engaged in a trade or business in Puerto Rico is based on all facts and circumstances in the applicable taxable year. Certain de minimis and special rules apply to make this determination.

Individuals are deemed residents when they are domiciled in Puerto Rico. An individual is presumed to be a resident of Puerto Rico if he or she has been present in Puerto Rico for a period of 183 days during the calendar year.

1.4 Tax Rates
In general, entities treated as corporations for Puerto Rico income tax purposes are subject to a progressive tax rate structure, which consist of a flat tax of 20% (18.5% for taxable years commenced after 31 December 2018) on the normal tax net income and surtax ranging from 5% to 19% on the surtax net taxable income. Certain types of income (eg, dividends, and long-term capital gains) may be subject to preferential income tax rates. Corporations may also be subject to an alternative minimum tax if it exceeds the regular tax. The alternative minimum tax is 30% on the alternative minimum net income. For taxable years commenced after 31 December 2018, the alternative minimum tax on corporations would be the higher of USD500 or 18.5% of alternative minimum net income (23% for entities with volume of business exceeding USD3,000,000).

Individuals are also generally subject to a progressive tax rate structure of up to 33%. For taxable years commenced after 31 December 2018, all individuals receive a 5% reduction in the otherwise applicable income taxes. Certain types of income (eg, dividends, and long-term capital gains) may be subject to preferential income tax rates. Individuals may also be subject to an alternative basic tax ranging from 10% to 24% on their alternative minimum net taxable income of USD150,000 or more, when it exceeds the regular tax. For taxable years commenced after 31 December 2018, the alternative minimum tax ranges between 1% and 24% for alternative minimum net income exceeding USD25,000. Also, for taxable years commenced after 31 December 2018 the computation of alternative minimum net income for individuals and corporations is restrictive in connection with the allowance of deductions.

Self-employed individuals who receive substantially all their income from their trade or business and corporations dedicated to the rendering of services are able to, subject to certain conditions, opt to pay a fixed income tax on their gross income at rates that range between 6% and 20%, for taxable years commenced after 31 December 2018.

Corporations or individuals investing through entities treated as partnerships for Puerto Rico income tax purposes are subject to quarterly estimated income tax payments of 30% on their distributive share (or lower applicable tax on preferential items), are withheld at source by the partnership and creditable against the income tax liability of the owners.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits
The taxable income of a corporation is comprised of its gross income for the taxable year minus allowable tax deductions. Gross income includes all income earned or received by the corporation, such as receipts from sales, dividends received, interest collected, income from rents and royalty payments, condonation (remission) of debt and capital gains. There are certain items of income that are excluded from the definition of gross income. Allowable deductions include all "ordinary and necessary" expenses of the business, which generally may include: payroll expenses, repairs and maintenance

expenses, taxes paid, licence fees paid, interest payments, depreciation and depletion, advertising and marketing, and deductible amounts paid to provide employee benefits.

A corporation's taxable income and its income for purposes of financial reporting are calculated in a similar manner, but have certain differences resulting from required tax adjustments. Income for financial reporting is computed under "Generally Accepted Accounting Principles" (which are similar but not identical to International Accounting Standards). The differences between book and taxable income result from temporary or permanent differences in the book reporting such as unrealised gains or losses, prepaid expenses, amortisation or depreciation, to name a few. Corporations are generally required to calculate gross income on an accrual basis, but certain smaller businesses can account for gross income using a cash or modified cash accounting method.

2.2 Special Incentives for Technology Investments

The Economic Incentives for the Development of Puerto Rico Act (Act 73-2008) provides certain tax and economic incentives to eligible activities in Puerto Rico. One of the benefits provided under Act 73-2008 is a research and development (R&D) tax credit equal to 50% of certain qualified R&D expenses incurred in Puerto Rico. This credit may be sold or can be used against the corporation's corporate income tax.

Research and development is also an eligible business activity pursuant to the Economic Incentives for the Development of Puerto Rico Act (Act 73-2008). The term "research and development" is defined as any activity for the improvement of knowledge or abilities in science or technology. Benefits under Act 73-2008 are granted for a 15-year period and include 4% or 8% flat income tax rate, 2% or 12% withholding tax on royalty payments, 90% exemption from real and personal property taxes, 60% exemption from municipal licence taxes on gross receipts and 100% exemption on sales and use tax imposed on raw materials used on the exempt manufacturing operations.

2.3 Other Special Incentives

There are several laws in Puerto Rico that provide tax and other economic incentives to particular industries and activities conducted in Puerto Rico. Among the various incentives laws are the following:

- the Economic Incentives for the Development of Puerto Rico Act (Act 73-2008), which provides incentives and tax credits to activities such as manufacturing, recycling, software development, and scientific research and development, among others;
- the International Financial Entities Act (Act 273-2012), which provides incentives to international financial entities providing financial services to entities outside of Puerto Rico;
- the International Insurer and Reinsurer Act (Act 399-2004), which provides incentives to international insurance, reinsurance and holding companies that cover risks outside of Puerto Rico;
- the Export Services Act (Act 20-2012), which provides incentives to business conducting services in Puerto Rico for entities outside of Puerto Rico – eligible activities include certain professional services, data processing centres, trading companies, telemedicine facilities, call centres, shared services centres, headquarters among other eligible services;
- the Tourism Development Act of Puerto Rico (Act 74-2010), which provides incentives and tax credits to owners, operators and lessors of eligible tourism activities in Puerto Rico;
- the Puerto Rico Film Industry Incentives Act (Act 27-2011), which provides incentives and tax credits to film productions undertaken in Puerto Rico;
- the Private Equity Funds Act (Act 185-2014), which provides incentives to any legal entity that invests in different securities that are not publicly traded – the fund needs to comply with certain requirements;
- the Act to Promote the Relocation of Individual Investors (Act 22-2012), which provides incentives to individuals that relocate to Puerto Rico.

Other incentivised activities include: public private partnerships, cruise ship industry, agriculture, workforce education and training, small and medium-sized businesses, and renewable energy.

Note that there is a proposed legislation that would adopt a New Incentives Code in Puerto Rico. The new legislation may impact the benefits granted under the current tax incentive laws mentioned above. Also, the Government of Puerto Rico has informally stated that it is working towards creating a strong legal framework (including local tax incentives) to promote Qualified Opportunity Zone investments in Puerto Rico, capitalising on the fact that most of the island has been designated as an "opportunity zone".

2.4 Basic Rules on Loss Relief

When a corporation operates for tax purposes at a net loss for a given taxable year, it incurs a net operating loss (commonly referred to as an "NOL"), which can be used to offset taxable income in other tax years. In general, a corporation can use an NOL incurred in taxable years commenced after 31 December 2012 to offset taxable income for the following ten years. In the case of a NOL incurred for taxable years commenced after 31 December 2012 and before 1 January 2015, the NOL that may be used in a taxable year is limited to 90% of the net income of said taxable year and for taxable years commenced after 31 December 2014 the NOL that may be used in a taxable year is limited to 80% of the net income of said taxable year and is back to 90% for taxable years commenced after 31 December 2018.

The use of a NOL may be limited in the case of reorganisations, liquidations, changes in corporate ownership and changes in control.

Capital gains and losses are characterised as long term (underlying asset held for more than one year) or short term (underlying asset held for one year or less). Short-term capital losses are first applied to offset short-term capital gains. Long-term capital losses are then applied to offset long-term capital gains. If there is a net short-term capital loss, it would then be applied to offset the net long-term capital gain. If a long-term net capital gain results at the end of this netting process, tax rates lower than the normal tax rates applicable to ordinary income may apply upon election of the taxpayer. The preferential tax rate available for a long-term net capital gain for sales or exchanges occurring after 30 June 2014 generated by a corporation is 20%. If the end result is a net short-term capital gain, instead of a long-term net capital gain computed as described above, that gain would be subject to the same graduated tax rates as ordinary income. In the case of corporations there is no deduction against income for capital losses that exceed capital gains. Capital losses incurred in a taxable year will be admitted only up to the amount of the capital gains generated during said taxable year.

As mentioned above, for taxable years commenced after 31 December 2014, capital losses may be carried over to subsequent taxable years as a capital loss up to 80% of the net capital gain generated in the taxable year in which the capital loss is carried over. For this purpose, the net capital gain will be computed without considering said net capital loss or any net capital loss that is generated in any of the intermediate taxable years. Effective for taxable years commenced after 31 December 2018, the carryover limitation is increased to 90% of the net income.

2.5 Imposed Limits on Deduction of Interest

In general, there is no limitation on the interest expense deduction by corporations, provided the interest is on bona fide debt. However, interest expense related to tax exempt income is not deductible.

Interest paid to non-resident related parties is subject to a 29% tax withholding at source. No deduction is allowed for this interest if the required withholding is not made.

2.6 Basic Rules on Consolidated Tax Grouping

There are no consolidated income tax returns in Puerto Rico. Losses of separate companies are generally not allowed to be offset against income of other companies in the affiliated group.

In some cases, pass-through entities or reorganisations may be used to achieve use of separate company losses.

2.7 Capital Gains Taxation

The preferential tax rate available for a long-term net capital gain for sales or exchanges occurring after 30 June 2014 generated by a corporation is 20%. Capital gains and losses are characterised as long term (asset held for more than one year) or short term (asset held for one year or less). Short-term capital losses are first applied to offset short-term capital gains. Long-term capital losses are then applied to offset long-term capital gains. If there is a net short-term capital loss, it would then be applied to offset the net long-term capital gain. If a long-term net capital gain results at the end of this netting process, tax rates lower than the normal tax rates applicable to ordinary income may apply upon election of the taxpayer. If the end result is a net short-term capital gain, instead of a long-term net capital gain computed as described above, that gain would be subject to the same graduated tax rates as ordinary income. In the case corporations there is no deduction against income for capital losses that exceed capital gains. Capital losses incurred in a taxable year will be admitted only up to the amount of the capital gains generated during said taxable year.

For taxable years commenced after 31 December 2014, capital losses may be carried over to subsequent taxable years as a capital loss up to 80% of the net capital gain generated in the taxable year in which the capital loss is carried over. For this purpose, the net capital gain will be computed without considering said net capital loss or any net capital loss that is generated in any of the intermediate taxable years. For taxable years commenced after 31 December 2018, the carryover limitation is increased to 90% of the net income.

There are certain tax incentives acts that provide exemptions from capital gain income tax rates such as the Economic Incentives for the Development of Puerto Rico Act (Act 73-2008) and the Tourism Development Act of 2010 (Act 74-2010) that provide a special reduced tax rate on the sale of stock in the exempt business.

2.8 Other Taxes Payable by an Incorporated Business

Other taxes that may be payable by an incorporated business on a transaction are sales and use taxes, municipal licence tax on gross receipts and real estate transaction fees and taxes.

2.9 Incorporated Businesses and Notable Taxes

Other taxes to which an incorporation business may be subject to are real and personal property taxes (in general, the real property tax rates range from 7.8% to 10.83% and the personal property tax rates range from 5.8% to 8.83%), municipal licence tax on gross receipts (in general, the tax is equal to 0.5% on the gross income for non-financial businesses), excise taxes and sales and use taxes (in general, the tax is equal to 11.5% on importation or acquisition of taxable items and 4% on taxable business to business services).

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Businesses activities in Puerto Rico may be conducted in corporate or non-corporate form, with the preferred path depending on factors such as taxation, governance requirements, filing requirements and limited liability protections. Closely held businesses generally prefer an entity form that allows them a single level of taxation, the lower statutory tax rate applicable to individuals, and limited liability. This is possible for operations conducted through limited liability companies (LLCs) that elect partnership status and corporations that elect corporations of individuals (Subchapter N) status. On the other hand, a business may be organised in corporate form, or elect to be taxed as a corporation for tax purposes to prevent its owners from becoming subject to reporting and tax payment obligations in Puerto Rico, or to prevent operations in Puerto Rico from becoming subject to current taxation in the owners' jurisdictions of residency.

From a tax perspective, non-corporate or pass-through treatment may be available for operations conducted in the following forms: sole proprietorship, partnership, corporation of individuals, or a LLC that elects to be treated as a partnership. Also, certain eligible entities that may have made pre-2011 special partnership are still treated as pass-through entities. LLCs are generally treated as corporations but may elect partnership treatment regardless of the number of members. Except for LLCs operating under certain incentives laws prior to 2011, LLCs that are treated as pass-through or disregarded entities in other relevant jurisdictions are automatically treated as partnerships for Puerto Rico income tax purposes (this default treatment would apply only to non-Puerto Rico entities effective commencing 10 December 2018). Before taxable year 2011, partnerships were taxed as corporations, and partnerships that existed before that taxable year may elect to continue being taxed as corporations. For taxable years starting with 2011, partnerships are treated as pass-through entities.

Individuals are taxed at graduated rates up to 33% (a 5% discount applies with respect to taxable years commenced after 31 December 2018) and are also subject to alternative minimum taxes ranging between 10% and 24% for alternative minimum tax income of USD150,000 or more. For taxable years commenced after 31 December 2018, the alternative minimum tax ranges between 1% and 24% for alternative minimum tax income exceeding USD25,000. On the other hand, corporations are subject to income tax of 20% (regular tax, which is reduced to 18.5% for taxable years commenced after 31 December 2018) plus additional taxes determined on the basis of graduated rates ranging from 5% to 19%. In addition, actual or deemed dividend distributions are generally taxed at 15% for individuals and 10% for non-resident corporations. Therefore, taxes on corporate distributions subject business income to two levels of taxation (at the entity level and upon actual or deemed distribution). The analysis of whether a business operation will be subject to a higher rate if it is conducted in corporate or non-corporate form will also depend on the deductions that may be available to the business and how any differences in the deductions allowed may impact the effective tax rate ultimately imposed on the operation.

Partnerships, special partnerships and corporations of individuals are not subject to tax, with the exception of certain items relevant only to corporations of individuals. The partners, members or stockholders are subject to Puerto Rico income taxes on their distributive share in the items of income, gain, loss, expenses or credits of the pass-through entity, as if they had conducted the business directly (ie, pass-through treatment). The income of the business reflected in the income tax return of the partners will be taxed at the rates applicable to the individual or corporate partner as if such partner had derived the income directly. Distributions by pass-through entities are generally not subject to additional Puerto Rico income taxes, therefore, a single level of taxation applies with respect to the business operations of a pass-through entity.

The partners or members of a partnership or LLC treated as a partnership are treated as if they are engaged in the trade or business of the entity in Puerto Rico, which subjects non-Puerto Rico partners or members to Puerto Rico filing and tax payment obligations that they may not otherwise have if it not were for their investment in such entities. On the other hand, partners or stockholders of special partnerships and corporations of individuals are not considered engaged in a trade or business in Puerto Rico solely by reason of their investment in the special partnership or corporation of individuals.

In addition, since Puerto Rico does not allow consolidated returns, closely-held businesses that operate in multi-entity structures may prefer pass-through treatment in order to have the opportunity to offset income from one entity with losses from another entity. This offset ability is limited. On the other hand, a corporation that generates a loss may apply such loss to offset income generated by the same legal entity in subsequent years, up to ten years from the year of loss (in the case of losses incurred after 2012). The amount of net operating loss deduction that may be claimed in a particular year is limited to 80% of the net taxable income for that year, with respect to losses incurred in taxable years commenced after 31 December 2014 (90% for losses incurred in taxable years commenced after 31 December 2013 and before 1 January 2015 and for taxable years commenced after 31 December 2018).

Finally, certain activities may qualify for tax exemption grants or concessions that provide a single level of taxation at preferential income tax rates, regardless of whether the activity is conducted in corporate or non-corporate form, whether it is owned by individuals or corporations, or the place of residence or organisation of such owners. In such cases, the decision between corporate or non-corporate form is based mostly on non-Puerto Rico tax considerations, governance, filing requirements (including avoiding the application of additional filing requirements in Puerto Rico to non-Puerto Rico owners), and limited liability.

For taxable years after 31 December 2018 the computation of alternative minimum taxes for both individuals and corporations, is modified to establish more strict documentation and filing standards as a requirement to allow certain deductions, and an optional fixed rate is established in specific circumstances on the gross income of individual and corporate taxpayers that render services subject to withholding. Also, for taxable years commenced after 31 December 2018, under certain circumstances, the gain on the sale of the interests in a partnership that is engaged in a trade or business in Puerto Rico is treated as Puerto Rico source income, and thus is subject to Puerto Rico income taxes.

3.2 Individual Rates and Corporate Rates

Regular corporate income tax rates are generally higher than regular individual income tax rates (33% less a 5% discount compared to 37.5% at the maximum rates for taxable years commencing 31 December 2018, but see below for the tax rates for prior taxable years). Also, operations conducted in corporate form are subject to income taxes on actual or deemed dividend distributions, therefore establishing a second level of taxation. On the other hand, there is generally no second level of taxation in the context of sole proprietorships or pass-through entities. Therefore, individual professionals usually prefer to operate as sole proprietorships or through entities that allow pass-through treatment from a tax perspective.

Moreover, certain professions (such as lawyers, certified public accountants, and engineers) are highly regulated and not allowed to operate in corporate form due to non-tax considerations. In some cases, a professional services corporation may be organised, and such entity is generally taxed as a corporation unless the owners qualify for and make an election for the entity to be treated as a corporation of individuals. Limited liability companies may also be used to provide professional services and elect to be treated as a corporation of individuals or as a pass-through entity for Puerto Rico tax purposes.

For taxable years commencing on or before after 31 December 2018, the maximum regular income tax rate applicable to all individuals was 33% and the maximum regular income tax rate on corporations was 39%; see above, **3.1 Closely Held Local Businesses** for full details.

3.3 Accumulating Earnings for Investment Purposes

A 50% tax applies on the net income of an entity treated as a corporation (computed with certain adjustments) if the entity is considered created or used with an intent to impede the imposition of Puerto Rico income taxes on its stockholders. This motive is presumed if earnings and profits are accumulated in excess of the reasonable needs of the business or if the entity is a mere holding company with respect to stock or investments.

In addition, a 10% branch profit tax applies on the reduction in the net Puerto Rico equity of a non-Puerto Rico entity operating through a branch in Puerto Rico, unless the branch generates 80% or more of its gross income from a Puerto Rico trade or business. Finally, a 10% tax is imposed on implicit dividend amounts of entities taxed as corporations that are owned by "foreign owners".

3.4 Sales of Shares by Individuals in Closely Held Corporations

Individuals (residents and non-residents of Puerto Rico) are subject to a 15% withholding tax on distributions by Puerto Rico corporations or foreign corporations that derive at least 80% of their gross income from Puerto Rico sources or that is effectively connected with a Puerto Rico trade or business during a three-year look-back period (eligible distributions). Resident individuals may opt out of the 15% withholding tax and report the eligible distribution as ordinary income subject to the graduated rates. Resident individuals who receive dividends from non-eligible corporations are subject to Puerto Rico income taxes on such dividends at the regular graduated rates, up to 33% (a 5% discount applies to taxable years commenced after 31 December 2018).

Non-resident individuals are subject to a 15% withholding tax on dividends that constitute Puerto Rico source income. Dividends are considered Puerto Rico source income if distributed by a corporation organised in Puerto Rico as long as 20% or more of such corporation's gross income is from sources within Puerto Rico during a three-year look-back period. If the 20% threshold is met, the full amount of the dividend is considered income from Puerto Rico sources. On the other hand, dividends distributed by a non-Puerto Rico corporation that is engaged in a trade or business in Puerto Rico are considered Puerto Rico source income if the corporation derives 20% or more of its gross income as income from Puerto Rico sources or as income effectively connected with a Puerto Rico trade or business. In the case of the non-Puerto Rico distributing corporation, dividends will be treated as Puerto Rico source income only in the proportion of income from Puerto Rico sources or effectively

connected with a Puerto Rico trade or business to the entity's total income from all sources.

Individuals who are residents of Puerto Rico are subject to Puerto Rico income taxes on net long-term capital gains (including the sale of shares in closely-held corporations) at a 15% rate. Non-resident individuals are not subject to Puerto Rico income taxes on the sale of shares in closely-held corporations because income from the sale of personal property (other than inventory) by a non-resident individual is generally not considered income from sources within Puerto Rico.

Full exemption or preferential tax treatment applies to dividends distributed from earnings and profits that were derived from certain strategic activities if a grant of tax exemption or concession is obtained under applicable incentives statutes. Preferential rates apply with respect to the gain on the sale of the stock or substantially all the assets of a business that operates under a grant of tax exemption issued pursuant to certain incentives statutes.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends and gains on the sale of shares in publicly traded corporations derived by individuals are taxed in the same way as if such income was derived in connection with closely held corporations. Individuals (residents and non-residents of Puerto Rico) are subject to a 15% withholding tax on distributions by Puerto Rico corporations or foreign corporations that derive at least 80% of their gross income from Puerto Rico sources or that is effectively connected with a Puerto Rico trade or business during a three-year look-back period (eligible distributions). Resident individuals may opt out of the 15% withholding tax and report the eligible distribution as ordinary income subject to the graduated rates. Resident individuals who receive dividends from non-eligible corporations are subject to Puerto Rico income taxes on such dividends at the regular graduated rates, up to 33% (a 5% discount applies effective for taxable years commencing after 31 December 2018).

See also **3.4 Sales of Shares in Closely held Corporations**, above.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The Government of Puerto Rico generally does not have the legal authority to enter into tax treaties with foreign countries and is not covered by treaties to which the USA is a party.

Non-Puerto Rico corporations and non-resident individuals may be subject to two different Puerto Rico income tax regimes. If the entity or individual are engaged in a trade or business in Puerto, Puerto Rico income taxes will apply on their income effectively connected with the Puerto Rico trade or business, which includes income from sources within Puerto Rico.

On the other hand, non-resident individuals and non-Puerto Rico corporations that are not engaged in a trade or business in Puerto Rico are subject to withholding taxes on interest, dividends and royalties, to the extent such payments constitute fixed or determinable income from Puerto Rico sources.

Puerto Rico withholding taxes will apply on the gross amounts received as interest, dividends and royalties to the extent such payments constitute Puerto Rico source income. Interest payments are subject to a 29% withholding tax if made to a related party that is a non-Puerto Rico resident individual or a non-Puerto Rico entity not engaged in a trade or business in Puerto Rico. Dividends are subject to a 10% withholding tax if paid to corporate stockholders, while a 15% withholding tax will apply to individual stockholders. Royalty payments will be subject to a 29% withholding tax.

Specific sourcing rules apply for each type of income. Generally, interest is Puerto Rico source income if it is paid with respect to obligations of individual residents of Puerto Rico, Puerto Rico entities or non-Puerto Rico entities that are engaged in a trade or business in Puerto Rico. However, there are several exceptions to this rule, including interest received by US citizens, which is not considered Puerto Rico source income.

Dividends are considered Puerto Rico source income if distributed by a corporation organised in Puerto Rico as long as 20% or more of such corporation's gross income is from sources within Puerto Rico during a three-year look-back period. Dividends distributed by a non-Puerto Rico corporation that is engaged in a trade or business in Puerto Rico may be considered Puerto Rico source income if the corporation derives 20% or more of its gross income as income from Puerto Rico sources or as income effectively connected with a Puerto Rico trade or business. In the case of the non-Puerto Rico distributing corporation, dividends will be treated as Puerto Rico source income only in the proportion of income from Puerto Rico sources or effectively connected with a Puerto Rico trade or business to the entity's total income from all sources.

Royalties are Puerto Rico source income if paid for the use of intellectual property in Puerto Rico.

The 29% withholding tax may be reduced or eliminated pursuant to a provision of Puerto Rico tax law in case it can be demonstrated the withholding would cause undue hardship

because the amounts withheld would have to be reimbursed to the person or the withholding would be excessive. Certain taxpayers with tax incentives grants issued by the Government of Puerto Rico qualify for reduced rates of withholding or no taxation on dividends and/or royalties.

4.2 Primary Tax Treaty Countries

The Government of Puerto Rico does not have the legal authority to enter into treaties – thus, it is not a party to income tax treaties, nor is it included as part of the treaties in which the USA is a party.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

See above **4.2 Primary Tax Treaty Countries**.

4.4 Transfer Pricing Issues

In general, the Secretary of Treasury is authorised to distribute, apportion, or allocate gross income, deductions, credits or allowances between or among organisations or businesses owned or controlled directly or indirectly by the same interests. The Secretary of Treasury is also authorised to impute income by reason of interest, dividends, compensation or for any other concept or nature in transactions when it is necessary to avoid tax evasion or to clearly reflect the income of any of such organisations or businesses. The purpose of this is to prevent the manipulation of or improper shifting of gross income and deductions between two or more organisations or businesses.

However, the biggest transfer pricing issues for inbound investors are generally not related to the Secretary of Treasury's allocations, but to specific tax provisions that impose taxes or disallow deductions on certain related party transactions. These types of special provisions include the imposition of a 29% withholding tax on interest paid to a foreign-related party that is not engaged in a trade or business in Puerto Rico, the imposition of a 4% excise tax on certain purchases by a foreign-related party of products manufactured in Puerto Rico, and the 51% disallowance of deduction of payments made to a related party for services rendered if such payments were not subject to Puerto Rico income taxes, as would be the case of services rendered outside Puerto Rico. For taxable years commenced after 31 December 2018, in the case of the 51% disallowance, the full deduction is allowed if a transfer study is submitted with the income tax return.

4.5 Related Party Limited Risks Distribution Arrangements

The Secretary of Treasury has the authority to challenge such type of arrangements, but in practice we have not seen such type of challenges.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Puerto Rico has limited transfer pricing rules and regulations, but as under the OECD standards an arm's-length principle generally applies.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims are Settled

The Puerto Rico Treasury Department entered into a Tax Coordination Agreement with the US Internal Revenue Service and has established administrative guidance and for a Mutual Agreement Procedure, pursuant to which taxpayers may seek Competent Authority assistance, make protective refund claims, extend statute of limitations periods if necessary, and eventually settle any necessary adjustments to Puerto Rico income taxes to avoid double taxation. These procedures are usually applied in the context of transfer pricing adjustments and Advance Pricing Agreements.

5.2 Taxing Differences

Non-Puerto Rico corporate entities may operate in the USA either through a subsidiary structure or through a branch.

In a subsidiary structure, the non-Puerto Rico parent entity incorporates a wholly owned corporate subsidiary under the laws of Puerto Rico, making it a separate corporate Puerto Rico legal entity distinct from the non-Puerto Rico parent. The Puerto Rico subsidiary is liable for Puerto Rico income tax on all net income earned by the Puerto Rico subsidiary, at up to a 39% regular corporate income tax rate (the highest regular corporate income tax rate is reduced to 37.5% for taxable years commenced after 31 December 2018). The Puerto Rico subsidiary may be subject to an alternative minimum income tax of 30% on the alternative minimum net income (the alternative minimum income tax rate is 18.5% or 23%, depending on the taxpayer for taxable years commenced after 31 December 2018). Further, the repatriation of profits (a dividend distribution) by the Puerto Rico subsidiary to the foreign parent is generally subject to a Puerto Rico withholding tax of 10%, unless previously subject to the implicit dividend tax mentioned herein. Generally, the Puerto Rico subsidiary will have to withhold 10% on the amount invested by the subsidiary in certain assets outside of Puerto Rico, up to the amount of the accumulated Puerto Rico earnings and profits as an implicit dividend made to the non-Puerto Rico parent. Other taxes such as real and personal property taxes, municipal licence tax on gross receipts, excise taxes and sales and use taxes may be applicable to the local subsidiary.

On the other hand, a non-Puerto Rico entity may operate in Puerto Rico through a branch. Because a branch is not a

Puerto Rico corporation, it would report and be subject to Puerto Rico income tax on the net income that is "effectively connected" to the Puerto Rico business at normal Puerto Rico regular corporate income tax rates up to 39% (the maximum regular corporate income tax rate is reduced to 37.5% for taxable years commenced after 31 December 2018). The non-Puerto Rico entity operating through a branch of which less than 80% of its gross income is considered to be effectively connected to its Puerto Rico trade or business during a certain period of time may also be subject to a branch-level tax of 10% of the Puerto Rico effectively connected earning and profits not reinvested in Puerto Rico. The branch profits tax is imposed on the repatriation of the earnings from a Puerto Rico branch to its non-Puerto Rico home office. Thus, the intent behind the branch profit tax provisions is to put the earnings and profits of a branch of a non-Puerto Rico corporation deemed remitted to its home office on equal footing with the earnings and profits of a Puerto Rico subsidiary that has paid out dividends to its non-Puerto Rico parent. Instead, if the branch has 80% or more of its gross income considered to be effectively connected to its Puerto Rico trade or business during a certain period of time, it will have to withhold 10% on the amount invested by the branch in certain assets outside of Puerto Rico, up to the amount of the accumulated Puerto Rico earnings and profits as an implicit dividend made to the non-Puerto Rico parent. Actual dividend distributions made by the non-Puerto Rico corporate entity will be subject to Puerto Rico income tax to the extent they are considered to be Puerto Rico sourced (generally in proportion to the amount of the gross income generated from the Puerto Rico business) and reduced by the amount of Puerto Rico branch profits tax or implicit dividend tax already paid on the earnings and profits actually distributed through the dividend by the non-Puerto Rico corporate entity. Other taxes, such as real and personal property taxes, municipal licence tax on gross receipts, excise taxes and sales and use taxes may apply to the branch in the same form that they apply to the local subsidiary.

5.3 Capital Gains of Non-Residents

In general, the sale of personal property (not inventory) by a non-resident individual, including stock, is not considered income from sources within Puerto Rico, and therefore is not subject to Puerto Rico income taxes. However, effective taxable years commenced after 31 December 2018, under certain circumstances, the gain on the sale of partnership interests is treated as Puerto Rico source income if the partnership was engaged in business in Puerto Rico.

5.4 Change of Control Provisions

As a general rule, there are no change of control provisions that could apply to trigger tax or duty charges on the disposal of an indirect holding much higher up the overseas group. However, any transaction should comply with the economic substance doctrine and be part of a business plan that does not have the purpose of avoiding Puerto Rico income taxes; otherwise, it could be challenged as a sham transaction under judicially developed doctrines.

Notwithstanding the foregoing, there are multiple statutes in Puerto Rico which require the notification and/or authorisation in the event of a direct and/or indirect change of control of an entity conducting business in Puerto Rico. Tax exempt entities under the Economic Incentives Act for the Development of Puerto Rico (Act 73-2008), the International Financial Entities Act (Act 273-2012), and the Tourism Development Act of Puerto Rico (Act 74-2010), among other statutes, require the notification or authorisation upon a change of control. Financial entities regulated by the Office of the Commissioner of Financial Institutions have similar requirements.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

In 2010, the circumstances when a foreign entity may be treated as engaged in a trade or business in Puerto Rico and deriving income effectively connected with a Puerto Rico trade or business were expanded to include foreign entities that purchase personal property manufactured in Puerto Rico or manufacturing services rendered in Puerto Rico from a related company (defined as more than 50% common ownership within the group), if certain tests are met. In such cases, the foreign affiliated buyer is treated as deriving income effectively connected with a Puerto Rico trade or business and subject to Puerto Rico income taxes at regular graduated corporate rates. The amount of the income of the foreign affiliated buyer that is considered effectively connected with a Puerto Rico trade or business is generally determined on the basis of an apportionment formula that looks at four factors (property in Puerto Rico, payroll for Puerto Rico employees, sales from Puerto Rico and purchases from Puerto Rico over worldwide property, payroll, sales and purchases). Proper documentation is required to support the application of such apportionment formula and the absence of proper documentation may cause the assumption that 50% of the income of the foreign buyer is effectively connected with a Puerto Rico trade or business. A different apportionment formula may be applied, subject to the approval of the Secretary of the Treasury, if the apportionment formula described above would produce unreasonable results.

An excise tax of 4% of the purchase price of the personal property or services acquired is imposed, and collected through withholding, in lieu of the income tax described above, if the person from which the personal property or services are acquired has had gross receipts in excess of USD75 million for any of the three preceding taxable years. Certain credits are allowed to reduce the amount of the excise tax but if such credits bring the excise tax to zero, then the foreign affiliated buyer will be subject to income

taxes under the apportionment formula (or approved alternate formula) described above.

5.6 Deductions for Payments by Local Affiliates

Where a non-Puerto Rico affiliate charges a related Puerto Rico entity for management and administrative expenses incurred by it, the costs charged will be measured against the "arm's-length" standard. As a general rule, if the affiliates are related entities under the Puerto Rico tax laws, 51% of the deduction for said expense is disallowed if the fee is not otherwise subject to Puerto Rico income tax. For taxable years commenced after 31 December 2018, such disallowance would be waived if a transfer pricing study is submitted with the return. Finally, in order for transactions involving non-local affiliates to be respected by the Puerto Rico Treasury Department, the transaction must have substance applying the rules of the tax doctrine "substance over form".

5.7 Constraints on Related Party Borrowing

Interest paid by a local affiliate to a non-Puerto Rico related entity is subject to a 29% Puerto Rico income tax withholding at source. In addition, the interest paid by the local affiliate to a non-local affiliate must be arm's length. Furthermore, the "substance over form" doctrine applies in Puerto Rico in order to determine if the debt is a bona fide debt.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of domestic corporations is not exempt from Puerto Rico corporate tax. Domestic corporations are taxed on their worldwide income at the regular or preferential corporate tax rates. However, subject to certain limitations and restrictions, a domestic corporation may take a credit against its Puerto Rico income tax for the amount of income and excess-profit taxes imposed on income from sources outside Puerto Rico by the authorities of the USA, any possession of the USA or any foreign country. The foreign tax credit is subject to a per-country limitation and an overall limitation. The per-country limitation is based on the ratio that the normal tax net income from sources within the particular country (or foreign jurisdiction) bears to the total normal tax net income for that year. The overall limitation is based on the ratio that the corporation's normal tax net income from sources outside Puerto Rico bears to its entire normal tax net income for the same tax year.

Instead of the foreign tax credit, a domestic corporation can elect to take a deduction against gross income for the income tax paid or accrued during the year to the USA, any possession thereof or a foreign country.

6.2 Non-Deductible Local Expenses

Foreign income of domestic corporations is not exempt in Puerto Rico. As a general rule, ordinary and necessary expenses may be deducted, but certain deductions allowed are limited for purposes of the computation of alternative minimum tax income.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are taxed at the regular corporate tax rates. However, for a deduction or credit for the taxes paid or accrued during the year to the USA, any possession thereof or a foreign country may be claimed.

6.4 Use of Intangibles

Intangibles developed by local corporations may be used by non-local subsidiaries. However, the local subsidiary must charge an arm's-length royalty fee for such use (ie, a fee that the local corporation would charge if the related entity were a separate unrelated company operating at arm's length). Royalties earned by the local entity from the licensing arrangement are generally subject to Puerto Rico income tax at ordinary income tax rates. Note, however, that under the Economic Incentives for the Development of Puerto Rico Act (Act 73-2008) the licensing of intangible property developed or acquired by the exempt entity is an exempt activity under Act 73-2008 and the income generated from such activities is eligible for the benefits under such act and generally subject to a flat 4% income tax rate in Puerto Rico.

Note that under the Economic Incentives for the Development of Puerto Rico Act (Act 73-2008) and the Tourism Development Act of 2010 (Act 74-2010), there are certain reduced income tax withholding rates applicable to royalties paid to non-resident entities for the use in Puerto Rico of an intangible in the exempt activities.

6.5 Taxation of Income of Non-Local Subsidiaries Under CFC-Type Rules

Under the Puerto Rico tax rules, there are no CFC-type rules under which local corporations are taxed on the income of their non-Puerto Rico subsidiaries or non-Puerto Rico branches.

6.6 Rules Related to the Substance of Non-Local Affiliates

In order for transactions involving non-Puerto Rico affiliates to be respected, the non-Puerto Rico affiliate and the transaction must have substance. The Puerto Rico Treasury Department may challenge transactions by analysing the substance of the non-Puerto Rico affiliate operations. The substance is what will generally control the Puerto Rico tax treatment, rather than the form; see also **7.1 Overarching Anti-Avoidance Provisions**, below.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Corporations created under the laws of Puerto Rico are taxed on their worldwide income, including the gain derived from the sale of shares in non-local affiliates. If the shares have been held for more than one year, any gain or loss is long term. Long-term capital gain may be subject to the preferential capital gain rate of 20%. Capital gains not qualifying as long-term capital gains are subject to ordinary corporate income tax rates. Capital losses may be netted against capital gains.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The Puerto Rico Treasury Department has broad authority to re-characterise items of income or deduction or make re-allocations of income and expenses so that the income of a taxpayer is properly reflected for purposes of the computation of that taxpayer's income tax obligation. In general, an arm's-length standard applies. In addition, our statutes follow closely the statutory language of the US Internal Revenue Code of 1986, and its predecessors, and certain principles established through administrative guidance or case law under such code have been adopted in Puerto Rico. Such principles include an acknowledgement that while a taxpayer is entitled to plan its transactions or operations in such a way that applicable taxes are minimised, such planning must be consistent with the intent of the law. If the planning is not consistent with the intent of the law, then it will be ignored and the substance of the transaction will determine applicable taxes. The burden of proof to establish that what has been done is consistent with the intent of the law falls on the taxpayer.

It is a basic principle that income must be taxed to the person who earns it. A transaction that does not alter the economic relationships of the parties involved will be evaluated so that tax consequences will follow the substance of the transaction, rather than its form. If a transaction is entered into only to obtain a tax benefit and lacks economic substance, that transaction will be treated as a sham and will not be recognised for tax purposes. A transaction must follow a business objective.

In addition, several provisions disallow deductions or impose special income taxes in the context of transactions between related parties. For instance, a 51% deduction disallowance applies with respect to payments to related parties for services rendered in connection with a Puerto Rico business if such payments are not subject to Puerto Rico income taxes. For taxable years commenced after 31 December 2018, this disallowance may be waived if a transfer pricing study is included with the income tax return.

In addition, the purchase from a member of the same controlled group of corporations of tangible property manufactured in Puerto Rico or of manufacturing services rendered in Puerto Rico may subject the buying affiliate to Puerto Rico income taxes as if that buying affiliate were engaged in a trade or business in Puerto Rico. Alternatively, under certain circumstances income taxes imposed on the buying affiliate may be substituted by a 4% excise tax on the purchase price of the tangible property or the service.

8. Other

8.1 Regular Routine Audit Cycle

There are no regular routine audits conducted by the Puerto Rico Treasury Department. Note that there is a proposed tax reform under consideration that would establish a routine audit cycle of five years to certain taxpayers that fall under the definition of large taxpayers as established under applicable law.

9. BEPS

9.1 Recommended Changes

Action 1: Digital Economy

In 2013, Puerto Rico expanded the criteria under which a remote seller is required to collect sales taxes. In 2017, certain notifications and reporting documentation requirements were imposed on non-collecting retailers or remote sellers ("non-withholding agent merchant"). As an alternative to providing notice and reports, the remote seller may elect to collect and remit the sales and use tax to Puerto Rico. In addition, in order to place withholding agent merchants on the same footing as remote seller non-withholding agent merchants, the Puerto Rico Treasury Department started collecting the 1% municipal use tax on imports on behalf of municipalities, so these imports will be subject to a combined sales and use tax of 11.5%, rather than only to the 10.5% commonwealth sales and use tax. Further developments in the law may be expected as a result of a recent US Supreme Court decision.

Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements

Generally, Puerto Rico does not allow hybrid entities. With certain exceptions, a limited liability company taxable as a conduit in another jurisdiction must be treated similarly in Puerto Rico (effective 10 December 2018 this restriction applies only to non-Puerto Rico LLCs). As to financial instruments, general tax principles consistent with the rules applied in the USA are used to classify instruments as debt or equity. Certain specific rules have been adopted targeting cases where in respect of a payment there is a deduction but no corresponding tax obligation. These include the 51% disallowance of deduction of payments made to a non-resident

related party for services rendered outside Puerto Rico that were not subject to Puerto Rico income taxes.

In addition, Puerto Rico applies certain anti-avoidance rules to attack mismatch arrangements such as the doctrines of economic substance, business purpose and step transaction.

Action 3: CFC

Puerto Rico has not formally adopted the OECD recommendation regarding BEPS Action 3. However, US CFC Rules may be applicable to Puerto Rico subsidiaries of US corporations. Puerto Rico has no independent CFC provisions.

Action 4: Interest Deduction

Puerto Rico has not formally adopted the OECD recommendation regarding BEPS Action 4. However, Puerto Rico has rules in place limiting the deduction of interest. Interest expense is generally deductible without limitation. However, interest expense related to exempt income is not deductible. If interest is paid to a foreign entity (ie, non-Puerto Rico entity) related party, a mandatory 29% withholding at source is applicable.

Action 5: Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Puerto Rico provides various preferential tax regimes, but they are generally linked to employment level and capital invested in Puerto Rico. To prevent evasion and shifting of income, Puerto Rico and the USA are parties of a Tax CoordinationAgreement for the exchange of information and mutual assistance. Taxpayers in both jurisdictions may also submit a request for competent authority assistance for issues related to Advance Pricing Agreements.

Action 6: Treaty Abuse

The Government of Puerto Rico generally does not have the legal authority to enter into tax treaties with foreign countries and is not covered by tax treaties to which the USA is a party.

Action 7: Permanent Establishment

Puerto Rico has not formally adopted the OECD recommendation regarding BEPS Action 7. However, Puerto Rico has certain rules for when a foreign corporation will be considered engaged in trade or business in Puerto Rico.

As a general rule, a foreign entity (including a US entity) would be considered to be engaged in a trade or business in Puerto Rico through the acts of its employees or dependent agents in the territory. Generally, the actions of independent agents in Puerto Rico are not attributed to the foreign entity.

Also, in general, continuous, considerable for-profit activities are required in Puerto Rico for a foreign entity to be considered engaged in a trade or business in the territory. As a general rule, rendering services in Puerto Rico makes a foreign entity engaged in a trade or business in Puerto Rico, except if either of the following two exceptions apply:

- if non-residents of Puerto Rico render the service in Puerto Rico for a term of less than 90 days of the taxable year in the aggregate (counting each individual separately);
- the services rendered in Puerto Rico are de minimis taking into account certain factors included in the Regulations under the Puerto Rico Internal Revenue Code of 2011, as amended, even if rendered by residents of Puerto Rico – as a general rule, de minimis services are those that that do not represent a substantial activity compared with the total activities of the foreign entity and that require a minimum of resources of the foreign entity taking into consideration all facts and circumstances.

Actions 8-10: Transfer Pricing (Intangibles, Risks & Capital, and Other High-Risk Transactions)

In general, the Secretary of Treasury may distribute, apportion, or allocate grossincome and deductions, credits, or allowances between or among organisations, trades, or businesses, or impute income when it is necessary to avoid tax evasion or to clearly reflect the income of any entity.

The regulations provide that the intervention of the Secretary of Treasury is not restricted to the case of improper accounting, to the case of a fraudulent, colourable or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his and her affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

With respect to intangible assets, the regulations generally require an arm's length consideration for the transfer or use of intangible property. This would be generally measured by comparable transactions with unrelated parties, prevailing rates in the particular industry for similar property, competitor's offers and/or other factors that would be considered by unrelated persons in determining the consideration for transfer or use of the intangible.

In 2016, the Puerto Rico Treasury Department circulated a draft regulation with transfer pricing rules that would generally adopt guidelines from US Treasury Regulations and the Organization of Economic Co-operation and Development (OECD) Transfer Pricing Guidelines. Although the draft of regulation has not been promulgated as a proposed regulation, it is plausible that in the near future similar rules will be implemented. The taxpayer may be able to submit a transfer pricing study pursuant to the requirements under Section

482 of the US Internal Revenue Code of 1986, as amended, to avoid the 51% disallowance of deduction of payments made to a related party for services rendered that were not subject to Puerto Rico income taxes effective for taxable years commenced after 31 December 2018.

Finally, to prevent shifting of income and evasion, Puerto Rico and the USA are parties of a Tax Coordination Agreementfor the exchange of information and mutual assistance with respect to taxes. Taxpayers in bothjurisdictions may also submit a request for competent authority assistance for issues related to Advance Pricing Agreements.

Action 11: Measuring and Monitoring BEPS
At present, the Puerto Rico Treasury Department has not adopted specific rules related to BEPS Action 11.

Action 12: Disclosure of Aggressive Tax Planning
No laws or regulations similar to the Model Mandatory Disclosure Rules have been adopted in Puerto Rico. However, there are certain informative return filing requirements that purport to provide local taxing authorities with visibility of local and outbound transactions that may be abusive. Such informative return requirements apply in contexts such as reports required to be made by financial institutions in connection with cash transactions exceeding USD10,000, reports of payment of receipt of interest, reports of dividend distributions, and reports regarding extension of credit facilities of USD250,000 or more. Finally, entities that are required to submit audited financial statements under current law (generally, entities with volume of business of USD3 million or more) are obliged to include with their Puerto Rico income tax returns an attachment disclosing their Uncertain Tax Positions, as such term is defined under US GAAP.

Action 13: Transfer Pricing Documentation and Country-by-Country Reporting
At present, the Puerto Rico Treasury Department has not adopted specific rules related to BEPS Action 13 or specific requirements for documentation pertaining to transfer pricing.

The 2016 draft regulation of transfer pricing includes a general record retention requirement with respect to supporting materials, including documentation of the efforts undertaken to comply with the arm's length standard, for production if the Secretary of Treasury requests such information and documentation when determining the true taxable income of a controlled organisation.

Action 14: Dispute Resolution Mechanisms
At present, the Puerto Rico Treasury Department has not adopted specific rules related to BEPS Action 14.

Action 15: a Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS
The Government of Puerto Rico generally does not have the legal authority to enter into tax treaties with foreign countries and is not covered by tax treaties to which the USA is a party.

9.2 Government Attitudes
The Government of Puerto Rico's attitude toward BEPS is positive, but Puerto Rico has not implemented many of the BEPS measures. The Government of Puerto Rico wants to increase tax collection by preventing profit-shifting to other jurisdictions, especially in the case of affiliated groups, and has tried, accordingly, to improve its transfer pricing rules, but it is still in the process of adopting more specific transfer pricing rules.

9.3 Profile of International Tax
Given the presence of multinational companies in Puerto Rico, international tax has a high profile in the territory. However, because Puerto Rico is an unincorporated territory of the USA, the Secretary of the Treasury of Puerto Rico does not have the authority to participate in the OECD's BEPS initiative or working committees. Furthermore, for the same reason, Puerto Rico does not have sovereign authority to enter into tax treaties with other countries and the tax treaties of the USA generally do not include Puerto Rico.

Usually, Puerto Rico follows US tax initiatives in the international tax area, but it may take a long time to catch up.

9.4 Competitive Tax Policy Objective
Puerto Rico has a long-standing policy of granting tax incentives (ie, preferential tax rates, full or partial exemptions from local taxes, and targeted tax credits) to strategic activities, such as manufacturing, export services and international trading, R&D, renewable energy generation, international insurance, and international financing activities. However, such benefits are applicable only if the specific eligible activity is rendered in Puerto Rico and conditions are established to ensure that the tax benefits are provided to substantial activities. Such conditions include, for example, the existence of a bona fide Puerto Rico office from which the core activity is operated, minimum employment commitments, minimum capital requirements, and licensing requirements. Certain individuals who relocate to Puerto Rico may also enjoy Puerto Rico income tax exemptions with respect to interest, dividends and certain capital gains.

For taxable years commenced after 31 December 2018, the Government reduced individual income taxes by providing a 5% discount and reduced the maximum regular income tax rate for corporations from 39% to 37.5%. On the other hand, for purposes of the alternative minimum tax income determination the availability of the deductions was substantially affected by requiring, for example, full compliance

with informative return filings for the corresponding deduction to be allowed. The intent of these changes is to ensure that Puerto Rico continues to be attractive for local businesses and for potential new international investors, while expanding the base by controlling the perceived abuse in the claiming of deductions not specifically supported by proper documentation.

While not necessarily inconsistent with BEPS principles, some structures with owners subject to the taxing jurisdiction of other countries may find that their jurisdictions of origin may impose minimum tax requirements or special taxes (such as the recently enacted tax on Global Intangible Low Tax Income applicable under the US Internal Revenue Code), which may cause double taxation or reduce the impact of the preferential rates offered by Puerto Rico to targeted activities.

9.5 Features of the Competitive Tax System

The effectiveness of the tax incentives programmes in the attraction of foreign direct investment may be reduced by BEPS initiatives applied by jurisdictions of origin of potential investors.

9.6 Proposals for Dealing with Hybrid Instruments

Currently, there is no proposal addressing specific aspects of hybrid instruments. Issues regarding characterisation of financial instruments or arrangements are handled by application of general tax doctrines such as debt versus equity and economic substance.

9.7 Territorial Tax Regime

Puerto Rico has a worldwide tax regime. Interest expense is generally deductible without limitation. However, interest expense related to exempt income is not deductible. If interest is paid to a related party that is a foreign entity (ie, a non-Puerto Rico entity) a mandatory 29% withholding at source is applicable.

9.8 CFC Proposals

Puerto Rico does not have a territorial regime. Instead Puerto Rico has a worldwide income regime. In general, we do not agree with the idea of having a sweeper CFC rule that may make offshore subsidiaries whose profits are taxed at a "low rate" vulnerable to CFC apportionment.

9.9 Anti-Avoidance Rules

Puerto Rico does not have legal authority to enter into treaties and, even though it is an unincorporated territory of the USA, the provisions of treaties in which the USA is a party do not include Puerto Rico.

However, Puerto Rico has established anti-avoidance principles. In general, an arm's length standard applies. In addition, our statutes follow closely the statutory language of the US Internal Revenue Code of 1986, and its predecessors, and certain principles established through administrative guidance or case law under such code have been adopted in Puerto Rico. Such principles include an acknowledgement that while a taxpayer is entitled to plan its transactions or operations in such a way that applicable taxes are minimised, such planning must be consistent with the intent of the law. If the planning is not consistent with the intent of the law, then it will be ignored and the substance of the transaction will determine applicable taxes. The burden of proof to establish that what has been done is consistent with the intent of the law falls on the taxpayer. It is a basic principle that income must be taxed to the person that earns it. A transaction that does not alter the economic relationships of the parties involved will be evaluated so that tax consequences will follow the substance of the transaction, rather than its form. If a transaction is entered into only to obtain a tax benefit and lacks economic substance, such transaction will be treated as a sham and will not be recognised for tax purposes. A transaction must follow a business objective.

The Puerto Rico Treasury Department has broad authority to re-characterise items of income or deduction or make re-allocations of income and expenses so that the income of a taxpayer is properly reflected for purposes of the computation of that taxpayer's income tax obligation. In addition, several provisions disallow deductions or impose special income taxes in the context of transactions between related parties. For instance, a 51% deduction disallowance applies with respect to payments to related parties for services rendered in connection with a Puerto Rico business if such payments are not subject to Puerto Rico income taxes; however, effective for taxable years commenced after 31 December 2018, this disallowance may be avoided if a transfer pricing study is included with the return. This disallowance would be waived under a proposed tax reform bill being considered by the Puerto Rico Legislature if a transfer pricing study supporting the arms'-length nature of the payment is submitted to the Secretary of the Treasury.

In addition, the purchase from a member of the same controlled group of corporations of tangible property manufactured in Puerto Rico or of manufacturing services rendered in Puerto Rico may subject the buying affiliate to Puerto Rico income taxes as if such buying affiliate were engaged in a trade or business in Puerto Rico. Alternatively, under certain circumstances income taxes imposed on the buying affiliate may be substituted by a 4% excise tax on the purchase price of the tangible property or the service.

9.10 Transfer Pricing Changes

Generally, issues of transfer pricing are handled in Puerto Rico by application of the arm's length principle enunciated in the regulations, but there is not much specific guidance. If approved, the draft of proposed regulation presented by Puerto Rico Treasury Department in 2016 would incorpo-

rate detailed rules that should have an impact on related party transactions.

Taxation of profits from intellectual property is an important issue since many companies transfer such property to Puerto Rico for use in their operations. However, since most intellectual property is not developed in Puerto Rico, most controversies have centred on correlative adjustments effected by the Internal Revenue Service pursuant to the Tax Coordination Agreement between the USA and Puerto Rico.

9.11 Transparency and Country-by-Country Reporting

Transparency and fairness in the imposition of taxes to international operations or transactions are objectives that any jurisdiction should support, but it is important that mechanisms be established to ensure that international commerce is not affected by onerous documentary and information requirements, potential breaches in confidentiality, and the application of conflicting rules. The Puerto Rico Treasury has informally expressed their general support to such objectives.

O'Neill & Borges LLC
250 Ave. Muñoz Rivera, Ste. 800
San Juan, P.R. 00918-1813

Tel: +1 787 764 8181
Fax: +1 787 753 8944
Email: info@oneillborges.com
Web: www.oneillborges.com

O'NEILL & BORGES LLC

9.12 Taxation of Digital Economy Businesses

In connection with the sales tax, changes have been made to try to impose the obligation of collecting sales taxes on transactions generated by the digital economy business operating largely from outside Puerto Rico. In particular, the Government of Puerto Rico has tried to impose to online merchants that sell to domestic customers the obligation of either collecting the sales tax or reporting said sales to the Government of Puerto Rico.

In relation to the digital economy, recent changes have not been made or discussed in the context of income taxes or other types of taxes.