

Global REIT Survey 2016

AMERICAS



Puerto Rico – REIT



1 General introduction

	Enacted year	Citation	REIT type	REIT market
REIT	<ul style="list-style-type: none"> - Enacted in 1972 - Amended in 2000, 2006, 2011 and 2014 	<p>Internal Revenue Code for a New Puerto Rico, as amended (IRCNP¹)</p> <p>IRCNP §1082.01 to §1082.03 and §1101.01(a)(8)(F) (previously PRIRC of 1994 1500 to §1502 and §1101(18))</p>	In principle, corporate type (election for tax status)	<p>Significant improvements were expected from the 2006 changes in the PRIRC. However, no statistics are available which evidence such improvement. Amendments made during 2014 change certain requirements to increase investment in REITs and the creation of new REITs.</p>

The law that established Real Estate Investment Trusts (“REITs”) in Puerto Rico was enacted in 1972 and amended in 2000, 2006, 2011 and 2014. The REIT provisions are found in the Internal Revenue Code for a New Puerto Rico (IRCNP¹), Sections 1082.01 to 1082.03, and Section 1101.01(a)(8)(F) (previously PRIRC of 1994, Sections 1500 to 1502, and Section 1101(18)).

REIT legislation prior to the 2006 amendments was very restrictive and did not result in the expected investment and development that was contemplated when originally enacted. The 2006 amendments liberalised certain requirements to promote REIT market activity in Puerto Rico. However, the Puerto Rico Commissioner of Financial Institutions does not maintain separate statistics for REITs in Puerto Rico. Therefore, there is no public data available to assess any changes to REIT market activity as a result of the 2006 amendments.

During 2014, the REIT legislation was further amended to liberalise certain requirements and include, as an eligible activity, the income from the purchase of real property to be remodeled and rented. The intention for this amendment is to promote the purchase of redeveloped properties by the REITs and help to reduce large inventories held by local banks. In addition, during 2014 the IRCNP was amended to defer the gain realized on certain assets when the total proceeds from the sale of such assets are invested in a REIT. The purpose of this amendment is to promote the investment of local capital into REITs.

The REIT regime is principally a tax regime; corporations, trusts, certain partnerships and associations can elect for REIT status. However, the entity must be created or organized in the Commonwealth of Puerto Rico. In this survey, we refer to the corporate REIT type.

¹ On January 31, 2011, the Governor of the Commonwealth of Puerto Rico signed into law a new Puerto Rico internal revenue code, to be known as the “Internal Revenue Code for a New Puerto Rico” (hereinafter referred to as the “IRCNP” or the “2011 Code”). The 2011 Code repealed almost in its entirety the Puerto Rico Internal Revenue Code of 1994, as amended. However, the new code incorporates many of the provisions of the 1994 PR Code, including the REITs provisions. There are no substantive changes to such provisions in the 2011 PR Code. The 2011 Code also provides further guidance to US REITs that may qualify for tax exemption.

2 Requirements

2.1 Formalities / procedure

Key requirements
<ul style="list-style-type: none"> - Election with the income tax return - REITs are regulated by the Puerto Rico Commissioner of Financial Institutions - Managed by one or more trustees or directors

Once the legal structure is created, in order to operate as a REIT for tax purposes, an election is required. The election is made together with the filing of the income tax return for the year in which the tax regime is intended to be effective.

The Commissioner of Financial Institutions will oversee the operations of the REIT as regulator. Pursuant to the Puerto Rico Uniform Securities Act, all stocks or shares in a REIT will be considered "Securities".

In order to comply with federal laws:

1. Investor must register issuance of securities as part of the "full and fair disclosure" policy stated by the Securities Act of 1933
2. Sales could be regulated by the Securities Exchange Act of 1934
3. The REIT must also comply with the Uniform Securities Act of Puerto Rico².

The guidelines established by the North American Securities Administration Association (NASAA) will apply until otherwise modified by the Commissioner of Financial Institutions of Puerto Rico via regulations.

REITs shall present audited financial statements together with the corporate income tax return if their gross income for the year is in excess of \$3,000,000.

The REIT must be managed by one or more trustees or directors.

2.2 Legal form / minimum share capital

Legal form	Minimum share capital
Corporation, partnership, trust or association	No minimum capital

Legal form

REITs may be organized as corporations, certain types of partnerships, trusts, or associations. These entities must be domestic entities, organised or created under the laws of the Commonwealth of Puerto Rico. The entity must be one that would be taxable as a domestic corporation if it were not for the tax exemption provided for by the Puerto Rican REIT legislation. As a grandfathering provision, any partnerships in existence as of January 01, 2011, the effective date of the 2011 Code, can remain in the REIT regime to the extent they have filed an election to be treated as a corporation. Partnerships created on or after January 01, 2011 cannot be REITs.

² Act 20 of 2014 clarifies that REITs must comply with the provisions established by the Uniform Securities Act of Puerto Rico.

The REIT cannot be a financial institution as defined under Section 1033.17(f) of the IRCNPR (previously Section 1024(f) of the 1994 PRIRC) or an insurance company subject to taxation under Subchapter A of Chapter 11 of the IRCNPR.

Minimum share capital

There are no minimum capital requirements in Puerto Rico. Transferable capital must be represented by stocks or participation certificates.

All of its stocks, shares or interests must be transferable and issued exclusively in exchange for cash.

2.3 Shareholders requirements / listing requirements

Shareholder requirements	Listing mandatory
At least 20 ³ (50 shareholders prior to January 24, 2014) shareholders or partners	No

Shareholder requirements

A REIT has to be composed of at least 20³ shareholders or partners (50 shareholders prior to January 24, 2014). For this purposes, the shareholder of an exempt investment trust⁴ shall be classed as shareholders of the REIT.

At no time during the last half of its taxable year should more than 50% of the total value of outstanding shares be owned by less than six individuals, based on the attribution rules of Section 1033.17(b)(2) of the IRCNPR (previously Section 1024(b)(2) of the 1994 PRIRC). In order to comply with these provisions, the REIT must maintain records that demonstrate the actual ownership of its outstanding shares or interests.

At present there are no distinctions between resident and non-resident shareholders.

Listing requirements

Listing of a REIT is not mandatory.

2.4 Asset level / activity test

Restrictions on activities / investments
<ul style="list-style-type: none"> - At least 95% of gross income must be qualifying investment income. - At least 75% of gross income must be qualifying real estate investment income. - At least 75% of the value of total assets must be represented by real estate assets, cash or equivalents, and securities and obligations of Puerto Rico. - Not more than 25% of the value of total assets is represented by securities other than those mentioned above.

At least 95% of gross income must be derived from dividends, interest, rents from real property, gain from the sale of stocks, securities, real property and rights to real property, net gain from the sale of certain real estate assets and payments received or accrued for entering into agreements to execute loans guaranteed with mortgages on real property, or acquire or lease real property.

At least 75% of gross income must be derived from (i) rents derived from real property located in Puerto Rico, (ii) interest on obligations secured by mortgage on real property or rights to real property located in Puerto Rico, (iii) gain from the sale or other disposition of real property that is not of the type of property that qualifies as inventory, (iv) dividends or other distributions and gains

³ Act 20 of 2014 reduced the amount of shareholders from 50 to 20 effective after January 24, 2014.

⁴ An exempt investment trust is an entity that avails to the tax treatment under Section 1112.02 of the IRCNPR.

derived from the sale or other disposition of shares of transferable stock, certificates, or participation in another REIT, (v) income from the purchase of real property to be redeveloped and rented, (vi) 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.

At the end of each quarter of each taxable year, at least 75% of the value of total assets must be represented by real estate assets, cash or equivalents, and securities and obligations of Puerto Rico and/or of the US (and whichever instrumentality or political subdivision thereof); and not more than 25% of the value of total assets must be represented by securities other than those mentioned above. For the purpose of these sections, real property means land located in Puerto Rico or improvements thereon used as: hospitals, schools, universities, public or private housing, transportation facilities and/or public or private roads, office buildings, governmental facilities, facilities of the manufacturing industry, recreational centers, parking facilities, residential properties, shopping centers, hotels and buildings or structures acquired from the government of Puerto Rico, its agencies, and instrumentalities.

Subsidiaries of a REIT will not be treated as a separate entity, and all its assets, liabilities, income items, deductions and credits will be considered as belonging to the REIT. Subsidiary means a corporation, company, or partnership wholly owned, directly or indirectly, by a REIT.

Starting January 01, 2007 the acquisition of real property must be made through the purchase of assets, stocks or participations in a transaction that generates Puerto Rican source income subject to tax in Puerto Rico, except for assets bought from the government of Puerto Rico. This acquisition of real property can be either directly or through related companies.

2.5 Leverage

Leverage
No restrictions.

There are no leverage restrictions. Only for purposes of determining the compliance with the 95% qualifying gross income requirement, the IRCNPR provides a special rule for the income (interest and gain) generated by the REIT with respect to certain hedging instruments.

2.6 Profit distribution obligations

Operative income	Capital gains	Timing
90% of net taxable income must be distributed as taxable dividend and 90% of its exempt income must be distributed as an exempt dividend.	Included in net income.	Annually

Operative income

At least 90% of the net taxable income and exempt net income of a REIT must be distributed annually as taxable and exempt dividends, respectively. If the REIT does not distribute such net income, it will be taxable as a regular corporation at a maximum tax rate of 39%⁵.

⁵ Act 40 of 2013 increased the maximum corporate tax rate from 30% to 39%, effective for taxable years commencing after December 31, 2012.

Capital gains

Gains from sale of capital assets are part of a REITs gross income computation and therefore part of its net income determination. Also, certain net gains from sale or disposition of real property that does not constitute a prohibited transaction are part of the net income determination of the REIT.

2.7 Sanctions

Penalties / Loss of status rules
<ul style="list-style-type: none"> - Loss of REIT tax exemption. - Loss of REIT status.

The election to operate as a REIT could be terminated if the provisions and requirements under the IRCNPR are not satisfied for the taxable year for which the election is made or for any succeeding taxable year. The loss of REIT status requires a five-year waiting period to re-elect unless waived by the Puerto Rico Secretary of Treasury for reasonable cause.

A REIT that fails the gross income tests above, one or both, may be treated as satisfying those tests to maintain its election if: (1) certain disclosures are made with the income tax return for such taxable year, (2) the inclusion of any incorrect information on those disclosures is not due to fraud with the intent to evade taxes, and (3) the failure to meet the test or tests is due to reasonable cause and not to gross negligence⁶.

However, if a REIT fails to comply with the gross income tests above to operate as such during the taxable year but its election is not deemed terminated, the imposition of taxes will be applicable. The penalty is calculated as a tax charge of 100% on the greater of:

- i. the excess of:
 - a. 95% of the gross income (excluding gross income from prohibited transactions) of the REIT, less
 - b. the amount of such gross income derived from the dividends, interest, rents from rental property and other qualified income, or
- ii. the excess of:
 - a. 75% of the gross income (excluding the gross income from prohibited transactions) of the REIT, less
 - b. the amount of such gross income derived from qualified domestic income; multiplied by a fraction the numerator of which is the taxable income of the REIT for the taxable year (without taking into account any deduction for net operating loss) and the denominator of which is the gross income for the taxable year (excluding gross income from prohibited transactions).

In addition, the REIT is subject to a 100% tax on prohibited transactions, as discussed below.

3 Tax treatment at the level of REIT

3.1 Corporate tax / Withholding tax

Current Income	Capital gains	Withholding tax
Eligible income is tax-exempt.	Eligible capital gains are tax-	Eligible income received by the REIT

⁶ Act 20 of 2014 substituted the term "willful neglect" for "gross negligence" effective January 24, 2014.

	exempt.	is not subject to withholding tax.
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Current income

The eligible income is not taxed at the level of the REIT to the extent that the distribution requirements are met.

Income from prohibited transactions is subject to tax at a rate of 100%. This tax is levied upon the net income from prohibited transactions, excluding prohibited transactions for which there was a loss. A prohibited transaction is the sale or disposition of property primarily held for sale to customers in the ordinary course of a trade or business (inventory). The sale of certain real property shall not be treated as a prohibited transaction if certain requirements are met and the property is held for 1 year or more.

In the case that the REIT is not in compliance with distribution requirements it will be taxable as a regular corporation.

Capital gains

Eligible capital gains are not taxed at the level of the REIT.

Withholding tax

No withholding tax is levied on eligible income received by the REIT. As an otherwise taxable corporation, it would be subject to any other income tax withholding rules on income from prohibited transactions and other related income.

Other taxes

The REIT is subject to other taxes like municipal license taxes (similar to a gross receipt tax) and real and personal property taxes. For property tax purposes, the REIT may avail to other tax exemptions which might be available under the Municipal Property Tax Act depending on the type of activity or industry in which the property is used.

Accounting rules

There are no special accounting rules existing for a REIT. Generally, the REIT will follow US GAAP.

3.2 Transition regulations

Conversion into REIT status
No regulations.

3.3 Registration duties

Registration duties
Stamp duties and register fees.

The acquisition of real estate by the REIT will be subject to various kinds of stamp duties and registration and notary fees. These stamp duties and notary fees depend on the value of the property and vary from transaction to transaction.

4 Tax treatment at the shareholder's level

4.1 Domestic shareholder

Corporate shareholder	Individual shareholder	Withholding tax
<ul style="list-style-type: none"> - Final withholding tax on distributions. - Capital gains are taxable. 	<ul style="list-style-type: none"> - Final withholding tax on distributions. - Capital gains are taxable. 	Withholding tax of 10% on distributions.

Corporate shareholder

Dividends are subject to a final withholding tax of 10%.

If the shareholder is a resident entity, gain from the sale of the shares in a REIT would be taxable at special rates if considered long-term capital gains (corporations will be taxed at 15% or 20% for transactions after June 30, 2014⁷ rather than at a maximum tax rate of 39%).

Individual shareholder

Dividends are subject to a final withholding tax of 10%.

Residents of Puerto Rico would be subject to taxation on capital gains from the sale of the shares in a REIT. Special rate is available if the gain is considered a long-term capital gain (individuals and trusts will be taxed at 10%, or 15% for transactions after June 30, 2014⁸, rather than at a maximum tax rate of 33%).

Withholding tax

Taxable distributions are subject to withholding tax at the rate of 10%, as defined in Section 1082.02 of the IRCNPR (previously Section 1501 of the 1994 PRIRC). The trustees or directors to whom the management of the REIT has been delegated are responsible for deducting and withholding the required tax rate on the taxable distributions.

4.2 Foreign shareholder

Corporate shareholder	Individual shareholder	Withholding tax
<ul style="list-style-type: none"> - Withholding tax on distributions. - Potentially withholding tax on capital gains. 	<ul style="list-style-type: none"> - Withholding tax on distributions. - Potentially withholding tax on capital gains. 	<ul style="list-style-type: none"> - Withholding tax of 10% on distributions. - Puerto Rico has not entered into any Tax Treaties.

Corporate shareholder

Dividends will be subject to a 10% withholding tax.

Taxation of capital gain income in the case of a foreign shareholder will depend on the source of the gain and the residency status of the shareholder. If the shareholder is a non-resident entity, income tax withholding at source would be applicable only if the gain is considered from sources within Puerto Rico. Generally, the rule to determine the source of the gain in the case of personal property (shares) is the residence of the seller, with the exception of property that constitutes inventories, depreciable property, and intangible property, each of which are subject to specific rules.

⁷ Act 77 of 2014 increased the special tax rate on long term capital gains applicable to corporations from 15% to 20% for transactions executed after June 30, 2014.

⁸ Act 77 of 2014 increased the special tax rate on long term capital gains applicable to individuals from 10% to 15% for transactions executed after June 30, 2014.

Individual shareholder

The foreign individual shareholder is subject to a 10% withholding tax.

Taxation of capital gain income in the case of a foreign shareholder will depend on the source of the gain and the residency status of the shareholder. The rules to determine the source are the same that we indicated above under corporate shareholder.

Withholding tax

Taxable dividends, as defined in Section 1082.02 of the IRCNPR (previously Section 1501 of the 1994 PRIRC), are subject to withholding tax at the rate of 10% as provided by Sections 1062.08 and 1062.11 of the IRCNPR (previously Sections 1147 and 1150 of the 1994 PRIRC) related to income tax withholding at source on payments to non-resident persons. Treaty relief is not available.

5 Treatment of foreign REIT and its domestic shareholder

Foreign REIT	Corporate shareholder	Individual shareholder
Foreign REIT cannot qualify for REIT status. US REIT may qualify as a tax exempt organisation.	No specific tax privilege for corporate shareholders of foreign REIT.	No specific tax privilege for individual shareholders of foreign REIT.

Foreign REIT

A foreign REIT will not qualify as a REIT in Puerto Rico since the entity must be created or organized under the laws of Puerto Rico. However, an entity organised or created under the laws of any state of the United States of America qualifying during the taxable year as a real estate investment trust under the United States Internal Revenue Code of 1986, as amended, may qualify as a tax exempt organisation in Puerto Rico to the extent that certain investment requirements are met. This exemption may be extended to related persons of the US REIT.

Corporate shareholder

No specific tax privilege. Distributions from a foreign REIT to a Puerto Rican corporate shareholder will be subject to tax as any other income at the regular rates.

Individual shareholder

No specific tax privilege. Distributions from a foreign REIT to a Puerto Rican individual shareholder will be generally subject to tax as any other income at the regular rates. ■

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