

A large, blue, 3D geometric sphere composed of interconnected cubes and lines, resembling a molecular or network structure, is positioned in the upper right background. The sphere is partially cut off by the top and right edges of the page.

Puerto Rico

Taxation

FUNDS AND FUND MANAGEMENT 2010

3.1 Taxation of funds

Domestic mutual funds are better off operating as registered investment companies (RIC). This is so because a RIC operates as a flow through entity, if certain criteria are met, as we shall see.

As long as a RIC distributes to its shareholders as taxable dividend or as dividends from industrial development income at least 90 percent of its net income, the RIC will incur no Puerto Rico income tax. Only domestic and certain United States¹ RIC's are eligible for such treatment. RIC's that meet the annual distribution requirements are tax-free pass-through entities. RIC funds enable shareholders to have access to professional management, portfolio diversification, and economics of scale in their investing without exposing them to an added layer of taxation.

For purposes of the 90 percent distribution requirement, distributions made during the four-month period following the close of the RIC taxable year could be treated as having been paid during such taxable year if the RIC so elects. This option could be of advantage for individual shareholders, and others under the cash method of accounting, because income taxation could be deferred by one year by making such election.

For example, assume that certain RIC files its income tax return on a calendar year basis and on or before 30 April of its second year of operations distributes 90 percent of its first year net income to its shareholders and files the required election. Since the distribution is equivalent to 90 percent of its net income for its first year of operations, such RIC will not be subject to Puerto Rico income taxation during such year. Whereas, the individual shareholders, assuming that they filed their income tax returns on a calendar year basis and report income under the cash method, will include such distribution in their income tax returns corresponding to the second year of operations of the RIC. Therefore, taxation of such distribution would have been deferred one year.

¹ Refer to Section 3.8, Other tax-favored vehicles

Foreign RIC's do not qualify for the 90 percent distribution rule discussed above. Therefore, such RICs will be taxed as a regular corporation on its income from Puerto Rico sources and related to its business operations in Puerto Rico.

3.2 Taxation of resident shareholders/investors in a resident fund

Puerto Rico resident shareholders are taxed on the year they receive distributions from the RIC's. However, whether the distribution is taxable or not depends on the nature of the income being distributed. In general, dividend income of RIC's distributions are taxed to resident as follows:

Type of Income	Rate (%)
Exempt dividends	N/A
Dividends from industrial development income – (generally it might be subject to limitations)	N/A
Ordinary dividend from investments in Puerto Rico (PR) corporations	10
Ordinary income from foreign corporations with at least 80% of its gross income for the last previous years earned from PR sources	10
Other ordinary dividend	Up to 33
Capital gain dividends – from PR corporations	15
Capital gain dividends – from foreign corporations	15

In addition to the tax obligations triggered by fund distributions of income and realized gains, shareholders face potential tax liability when they redeem (that is, sell) their fund shares. A redeeming shareholder incurs a taxable gain or loss equal to the net proceeds of the redemption less the shareholder's adjusted basis in the shares redeemed. The shareholder's basis is generally equal to the acquisition cost of the shares redeemed adjusted for stock splits, stock dividends, and reinvested dividends. The gain or loss recognized upon redemption is treated as long-term or short-term, depending upon whether the shareholder's holding period for the shares redeemed is more or less than six months. A holding period of more than six months will result in long-term capital gain or loss.

The investments held in taxable accounts are eligible for limited step up in tax basis upon the death of the shareholder. If a shareholder dies owning RIC's shares, the heir of the deceased shareholder will have a tax basis in the shares equal to the deceased shareholder adjusted tax basis or the adjusted basis in the hands of the last preceding owner who did not acquire the shares by bequest, devise, or inheritance. Provided, nevertheless, that for purposes of computing gain in the sale or exchange a maximum increment of the basis of USD 400,000 shall be allowed. In any event, however, the allowable increment shall not exceed the value of the shares as of the date of the death or six month thereafter. The potential income tax liability for capital gains accrued during the life of the deceased shareholder may therefore be partially eliminated. Shareholders can also exit RIC's investments without paying taxes

or passing along the obligation to pay taxes on accrued capital gains by gifting the fund shares to a charitable institution or by using the fund shares to establish a charitable trust.

3.3 Taxation of resident shareholders/investors in a non-resident fund

If a resident of Puerto Rico is a shareholder of an RIC organized under the laws of the United States or any of its 50 states that qualifies as a RIC or real estate investment trust under the U.S. Internal Revenue Code, the income tax rules discussed above will apply to such shareholder in reference to dividends distributions received from such RIC. The shareholder will be able to take a tax credit for taxes paid to other jurisdictions as a result of their income from such investments.

3.4 Taxation of non-resident unitholders/investors in a resident fund

Nonresident shareholders are taxed in the year they receive distributions from the RIC's. Generally, the distributing RIC is required to withhold from the distribution, a percentage which varies depending on the circumstances.

- Non-resident shareholders receiving a distribution from a Puerto Rico resident fund (domestic RIC) shall be subject to a 10-percent withholding.
- Non-resident shareholders receiving a Puerto Rico-source distribution from a non-resident fund (U.S.-organized RIC exempt in Puerto Rico), shall be subject to withholding from the distribution in the following percentage:

Type	Percent of Withholding (%)
Non-resident individual	29
Non-resident individual who is citizen of the United States	20
Foreign corporations not engaged in trade or business in PR	29

Non-resident individuals are subject to Puerto Rico death taxes on the gross estate located in Puerto Rico.

3.5 Taxation of fund management/custodian companies

The fund manager or investment adviser is typically organized as a corporation, subject to the regular corporate tax rules.

3.6 Entitlement to income

There is no deemed distribution for undistributed income at year end. Income arises to the unitholder when it is distributed by the fund.

3.7 Double tax agreements

Not applicable

3.8 Other tax-favored vehicles

Other investment entities include a registered investment company or real estate investment trust company that is created or organized under the laws of the United States, or those of any state of the United States that, during the taxable year, qualifies as a registered investment company or real estate investment trust company under the U.S. Internal Revenue Code.

A registered investment company organized in the United States may qualify for exemption if certain requirements are met, including the distribution of 90 percent of its net income.

Certain registered real estate investment trust company (REIT) created or organized in the United States may qualify as an exempt REIT organization under the Puerto Rico Internal Revenue Code. To qualify for the exemption the following two conditions must be met:

- The REIT must qualify as such under the U.S. Internal Revenue Code during the taxable year.
- All the real estate assets owned by the REIT and its subsidiaries must be real property, such as but not limited to hospitals and related facilities, universities, public and private housing, and public and private roads. Also, the purchase of that real property by the REIT and/or subsidiaries, or the purchase of the REIT's interest in the subsidiaries must be made by means of a transaction that generates Puerto Rico-source income subject to tax under the Puerto Rico Internal Revenue Code, except with respect to assets purchased from the Puerto Rico government.

3.9 Real estate investment trusts

Real estate investment trusts (REIT), provided that certain conditions and requirements are satisfied, pay no Puerto Rico income tax. In order to qualify for this tax treatment a corporation, partnership, trust, or association electing to be taxed as a REIT must meet the following conditions and requirements:

- Must be managed by one or more trustees or directors.

- Must be beneficially owned by at least 50 persons, except during the first taxable year for which an election to be taxed as a REIT is applicable.
- It's ownership must be evidenced by transferable shares, or by transferable certificates of beneficial interest that were issued for cash.
- Must not be closely held, except during the first taxable year for which an election to be taxed as a REIT was filed. Generally, a REIT will be closely held if at any time during the last half of its taxable year it is more than 50 percent owned by five or fewer individuals.
- It is neither a financial institution, nor an insurance company.
- It would be otherwise taxed as a domestic corporation unless REIT tax treatment is elected.
- Must generate at least 95 percent of its gross income from certain forms of investment-type income.
- Must generate at least 75 percent of its gross income from certain forms of real estate-related investment income.
- At the close of each quarter of the taxable year at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash, or its equivalents, (including accounts and notes receivables), and securities and obligations of the Commonwealth of Puerto Rico and/or the United States government or any instrumentalities or political subdivisions thereof.
- Not more than 25 percent of the value of a REIT's total assets may consist of securities other than those that qualify under the 75-percent test.
- With respect to securities that qualify under the 75-percent test, no more than 5 percent of the value of a REIT's total assets may consist of securities of any issuer, and the REIT may not hold securities with more than 10 percent of the total voting power of the outstanding securities of any one issuer.
- Must comply with its withholding obligations with respect to dividends paid.

REIT status must be affirmatively elected with the return for the first taxable year for which the entity wants the election to be applicable. Once made, the election is valid for later years unless terminated or revoked.

As long as a REIT distributes to its shareholders as taxable dividend at least 90 percent of its taxable net income and as exempt dividends at least 90 percent of its exempt net income, the REIT will incur no Puerto Rico income tax.

A REIT with an election terminated or revoked would not be eligible to elect REIT's tax treatment prior to the fifth taxable year beginning after the first taxable year for which such termination or revocation is effective.

Taxation of resident shareholders of a REIT:

Taxable dividends received from a REIT by any individual resident of Puerto Rico or citizen of the United States, and any domestic corporation or partnership, are included in the shareholder's gross income and taxed at a tax rate of 10 percent, in lieu of any other tax. Exempt dividends distributed by the REIT are excluded from gross income.

Taxation of non-resident shareholders of a REIT:

A 10-percent income tax is imposed on taxable dividends by a REIT to a non-resident individual, a foreign corporation, or partnership. The REIT should credit against the withholding tax (subject to the certain limitations) the shareholder's or beneficiary's proportional share of any income taxes paid to the United States, any possession of the United States (excluding any state) or any foreign country, by the REIT or with respect to the benefits from which such dividends are considered to have been paid. The trustees or directors to whom the management of the REIT has been delegated is responsible of withholding and deposit the 10-percent tax on the dividend's distributions to resident and non-resident shareholders.

3.10 Transfer taxes, stamp duty, capital duty

Each investment company registered in Puerto Rico shall pay to the secretary a registration fee at the rate of 0.03 percent of the total USD value of the capital stock issued or proposed to be issued by the investment company. Such USD value shall be the par value or the subscription price of such stock, whichever is greater. In case of additional issues of stock, an additional registration fee computed at the same rate shall be paid in advance.

3.11 Miscellaneous

None

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