

(H.B. 3038)
(Conference)

(No. 289)

(Approved December 26, 2006)

AN ACT

To amend clause (18) of Section 1101; renumber clause (6) and clause (7) of subsection (c) as clauses (7) and (8), respectively; add a clause (6) to subsection (c); amend subclauses (B) and (D) of clause (6), subsection (c); paragraphs (v), (viii) and (x) of subclause (D) of clause (6), subsection (c); add paragraphs (xi) and (xii) of subclause (D) of clause (6), subsection (c); eliminate subclause (E) of clause (6), subsection (c); rename subclause (F) as subclause (E) of clause (6), subsection (c) and amend said clause; rename subclause (G) as subclause (F) of clause (6), subsection (c) and amend its paragraph (ii), eliminate subclause (F) of clause (6), subsection (c); add subclause (G) to clause (6) of subsection (c); amend subclause (C) of clause (7), subsection (c); subclause (B) of clause (2), subsection (e); and clause (4) of subsection (f) of Section 1500; amend subsection (a); subsection (b); clause (1) of subsection (d); subclause (B) of clause (1), subsection (d); clause (2) of subsection (d); eliminate clause (3) of subsection (d); renumber clause (4) as clause (3) of subsection (d) and amend the same and its subclause (A), respectively; renumber clause (5) as clause (4) of subsection (d); add a new clause (5) to subsection (d); eliminate clause (6) of subsection (e); and add a new subsection (f) to Section 1501 of Act No. 120 of October 31, 1994, as amended, known as the “Puerto Rico Internal Revenue Code of 1994,” in order to require that in relation to the taxation on real estate investment trusts, every acquisition of property by the real estate investment trusts be conducted after the effective date of this Act and that it be conducted by means of transactions for the purchase of assets, stock or shares in partnerships that generate income from sources in the Commonwealth of Puerto Rico and that are subject to the payment of income tax under the Code; to broaden the definition of the term “real property,” eliminate the requirement that states that only investments in real property built after June 30,

1999 or subjected to substantial renovation if built after that date are eligible; to include shopping centers and hotels under the definition of real property; define the meaning of a subsidiary; establish that the tax rate imposed on taxable distributions shall be of ten percent (10%); clarify certain terms; and make certain technical amendments.

STATEMENT OF MOTIVES

The “Puerto Rico Internal Revenue Code of 1994” (“the Code”) was amended by Act No. 25 of January 13, 2000, for the purpose of providing taxation rules for real estate investment trusts organized in and outside of Puerto Rico. Even though a similar provision had been in effect since 1972, and notwithstanding the apparent benefits it granted to real estate investment trusts organized in Puerto Rico, said investment vehicle had not been used in Puerto Rico. Sadly, the amendments made in the year 2000 were completely inoperative since they exclude the main property classifications that are traditionally possessed through these investment vehicles, such as hotels and shopping centers. Furthermore, that Act excluded anything built prior to July 1999 (except properties privatized by the government), thus limiting the type of property that could avail itself of this provision to those that the Government would privatize. The Act included as eligible real properties those that were object of substantial renovation but also set a limit as to those properties (still excluding hotels and shopping centers) that were built after June 30, 1999. The alternative of changing said date and eliminating the exclusion, so that the Act would be available to renovated properties, seriously upsets the real property market and discriminates between: (i) properties that are well administered and maintained in good condition by their owners, favoring the owners of properties in poor condition and susceptible to renovation; (ii) old properties as against new properties; and (iii) properties built recently against those in the process of being built or

being planned. Should these inequalities be established, a pattern of inequity would be implemented in Puerto Rico between real properties and the taxpayers who possess them.

These restrictions contrast with the federal provisions (known as “Real Estate Investment Trusts” or “REITs”), which have been very well received. In the United States the use of REITs has exponentially increased to such a degree that they presently constitute the main investment vehicle for channeling public capital market investments to real estate investments, such as residential, rental, commercial and hotel properties.

The purpose of the amendments proposed under this Act is to foster the creation of real estate investment trusts in Puerto Rico and thus promote economic activity and the economic development these generate through their investments as well as to encourage the development of capital markets in Puerto Rico.

On the other hand, what was approved in the year 2000 establishes a tax rate of seventeen percent (17%) on the distribution of local REITs for a limited term of ten (10) years, while no local taxation whatsoever is imposed on the REITs organized in the United States. It must be pointed out that this differential in the tax rate would negatively affect the competitive position of the local investor and would lead to allowing that United States entities not subject to taxation take over the control of the real properties that could be owned by the local REITs. Finally, the tax treatment of seventeen percent (17%) is not equal to that of the local investment companies (investment vehicles similar to the REITs because they reflect a passive investment and require the annual distribution of ninety percent (90%) of the profits) since the tax rate applicable to the distributions of said investment companies is of

ten percent (10%) in the case of individuals and five point seventy-five percent (5.75%) in the case of corporations.

Pursuant to the preceding, this Legislature deems it necessary to amend “the Code” in order to broaden the definition of the term “real property,” eliminate the requirement that states that only investments in real property built after June 30, 1999 or subjected to substantial renovation if built after that date are eligible and include the shopping centers and hotels in the definition of real property; eliminate language established in a subsection (c) duplicated in subsection (b) of Section 1501 and which inexplicably deprives the trust of the deduction for net losses of Section 1023(g); define the meaning of a subsidiary; and establish as ten percent (10%) the tax rate to be imposed on the taxable distributions of the local REITs.

For the purpose of preventing reductions in the collections of the Department of the Treasury by allowing that existing entities choose to be REITs or that the REITs acquire real property through transactions free from taxation, these amendments establish, as an indispensable condition for the local REITs and those organized in the United States to qualify under the benefits provided to the REITs by “the Code,” the requirement that every acquisition of property made by a REIT be carried out after the effective date of this Act and that it be done through transactions for the purchase of assets, stock or shares in partnerships that generate income from sources in the Commonwealth of Puerto Rico and that, with the exception of assets purchased from the government, are subject to income taxes under “the Code.”

Lastly, this Act clarifies certain terms and makes certain suitable technical amendments to best encourage said investment instrument.

BE IT ENACTED BY THE LEGISLATURE OF PUERTO RICO:

Section 1.-Clause (18) of Section 1101 of Act No. 120 of October 31, 1994, as amended, is hereby amended to read as follows:

“Section 1101.—Exemptions from Tax on Corporations.—

Except as provided for in Subchapter O, the following organizations shall be exempt from taxation under this Subtitle:

...

(18) any entity created or organized under the Laws of the United States of America or of any State of the United States of America and which during the tax year qualifies as a registered investment company or real estate investment trust under the United States Internal Revenue Code of 1986. In the case of these real estate investment trusts, including their subsidiaries, the exemption on all income from sources outside and inside Puerto Rico shall be granted only if all real property assets owned by the trust and its subsidiaries constitute real property, as this term is defined in Section 1500(c)(7)(D) and the acquisition of said real property by the trust and/or its subsidiaries (as this term is defined in Section 1500(c)(7)(G)), or the interest of the trust on the subsidiaries, is conducted after the effective date of this Act and through transactions for the purchase of assets, stock or shares in partnerships that generate income from sources in the Commonwealth of Puerto Rico and that are subject (with the exception of assets purchased from the Government of Puerto Rico), to income taxes under this Act.

...”

Section 2.-Clause (6) and clause (7) of subsection (c) are hereby renumbered as clauses (7) and (8) respectively; a clause (6) is added to subsection (c); subclauses (B) and (D) of clause (6), subsection (c) are

amended; paragraphs (v), (viii) and (x) of subclause (D) of clause (6), subsection (c) are amended; paragraphs (xi) and (xii) of subclause (D) of clause (6), subsection (c) are added; subclause (E) of clause (6), subsection (c) is eliminated; subclause (F) is renamed as subclause (E) of clause (6), subsection (c) and said clause are amended; subclause (G) is renamed as subclause (F) of clause (6), subsection (c) and its paragraph (ii) are amended, subclause (F) of clause (6), subsection (c) is eliminated; subclause (G) is added to clause (6) of subsection (c); subclause (C) of clause (7), subsection (c) is amended; subclause (B) of clause (2), subsection (e) is amended; and clause (4) of subsection (f) is amended in Section 1500 of Act No. 120 of October 31, 1994, as amended, to read as follows:

“Section 1500.-Definition of real estate investment trust.

(a) ...

(9) makes an election according to subsection (c)(1).

(c) Limitations.-A corporation, company, partnership, trust or association shall not be deemed a real estate investment trust for a specific tax year unless:

(1) ...

(6) the acquisition of the real property by the trust and/or its subsidiaries (as this term is defined in Section 1500(c)(7)(G)), or the interest of the trust on the subsidiaries, is conducted after the effective date of this Act, and through transactions for the purchase of assets, stock or shares in partnerships that generate income from sources in the Commonwealth of Puerto Rico and that are subject (with the exception of assets purchased from the Government of Puerto Rico, its agencies and instrumentalities), to income taxes under this Act.

(7) For the purposes of this Subchapter:

(A) ...

(B) The term “real property assets” means real property (including real property rights and rights on mortgages secured by real property) and shares (or transferable stock certificates) in other real estate investment trusts that are exempt from the payment of income taxes by virtue of the provisions of this Subchapter. Said term also includes any property (other than a real property asset) attributable to a temporary investment of new capital, but only if said property consists of stock or of a debt instrument and only for the period of one year as of the date in which the real estate investment trust receives said capital.

(C) ...

(D) The term “real property” means land located in Puerto Rico or the improvements made in these that are used as:

(i) ...

(v) office or housing buildings;

(viii) recreational centers;

(x) commercial facilities and shopping centers;

(xi) buildings or structures purchased from the

Government of Puerto Rico, its agencies and instrumentalities; and

(xii) hotels

(E) The term “temporary qualified investments” means income that:

(i) is attributable to stock or debt instruments;

(ii) ...

(iii) ...

For the purpose of this subclause (E), the term “new capital” means the amounts received by a real estate investment trust in exchange for shares or stock certificates in said trust (not including

the amounts received according to a dividends reinvestment plan) or in a public offer of debt instruments of said trust with a due date of at least five (5) years.

(F) Treatment of certain exchange risk coverage instruments. Except as provided in the regulations promulgated by the Secretary, any:

(i) ...

(ii) profit from the sale or any other disposition of any of the investments mentioned in subclause (E)(i) of this subparagraph, shall be deemed as income qualified under subsection (c)(2) of this Section.

(G) The term “subsidiary” means a corporation, company, partnership or special partnership totally possessed directly or indirectly by a real estate investment trust. For the purpose of this subchapter, a corporation, partnership or special partnership that qualifies as a subsidiary, according to the aforementioned definition, shall not be treated as a separate entity and all its assets, debts and income items, deductions and credits shall be deemed to belong to the real estate investment trust.

(8) A corporation, company, partnership, trust or association that fails to comply with the requirements of either or both clauses (2) and (3) of subsection (c) of this Section, for any tax year, shall be deemed to have complied with said requirements for a tax year if:

(A) ...

(B) ...

(C) noncompliance with the requirements of either or both clauses (2) or (3) of subsection (c) of this Section is due to reasonable cause and not to intentional negligence.

(e) Interest.-

(1) ...

(2) Special rule. If –

(A) ...

(B) a portion which said debtor directly or indirectly receives or accrues from the lessees, consists of qualified rents as described in subsection (d)(6)(B) of this Section;

then the amounts received or accrued by said debtor shall not be excluded from the term “interest” for being based on the income or profits of said debtor in the degree that the amounts thus received are attributable to the qualified rents received or accrued by said debtor.

(f) Termination of the Election.-

(1) ...

(2) ...

(3) ...

(4) Exception. If the election of the corporation, company, partnership, trust or association is terminated under clause (1) because of noncompliance with the requirements of subsections (c)(2) or (c)(3) or both subsections, clause (3) of this subsection (f) shall not apply, if:

(A) ...

...”

Section 3.-Subsection (a); subsection (b); clause (1) of subsection (d); subclause (B) of clause (1), subsection (d); and clause (2) of subsection (d) are hereby amended; clause (3) of subsection (d) is eliminated; clause (4) is renumbered as clause (3) of subsection (d) and the same and its subclause (A), respectively, are amended; clause (5) is renumbered as clause (4) of subsection (d); a new clause (5) is added to subsection (d); clause (6) of

subsection (e) is eliminated; and a new subsection (f) is added to Section 1501 of Act No. 120 of October 31, 1994, as amended, to read as follows:

“Section 1501.-Taxation of a real estate investment trust and its beneficiaries.

(a) In general. Every real estate investment trust that complies with the provisions of Section 1500 shall be subject to the payment of taxes under subtitle A, except if during the tax year it distributes to its beneficiaries, as taxable dividends, an amount of not less than ninety percent (90%) of its net income (determined without considering the credits provided in Section 1026); and as exempted dividends, an amount of not less than ninety percent (90%) of its exempted net income as defined in subclause (c) of clause (4) of subsection (d).

(b) When computing the net income of a real estate investments trust:

(1) ...

(2) ...

(c) ...

(d) Taxation of stockholders or beneficiaries of a real estate investment trusts.

(1) Residents of Puerto Rico or citizen of the United States. Every individual resident of Puerto Rico or citizen of the United States, every corporation or domestic partnership subject to taxation-

(A) ...

(B) Shall include in its gross income and pay taxes at a tax rate of ten percent (10%), in lieu of any other tax imposed by this subtitle:

(i) ...

(2) Obligation to withhold.-The trustee(s) or director(s) who has/have been entrusted with the administration of the real estate investments trust, must deduct and withhold an amount equal to ten (10) percent of the taxable dividends distributed. The deduction, withholding and payment of said tax shall be governed by the provisions of subsections (e), (f), (g) and (h) of Section 1012.

(3) Foreign individuals and foreign corporations and partnerships.- Any real estate investment trust that pays dividends to a stockholder or beneficiary subject to taxation shall be subject to a tax rate of ten percent (10%) imposed by subsection (d)(1)(B) of this Section, and subject to the limitation of Section 1131, shall deduct and withhold said tax according to the provisions under Sections 1147 and 1150 and accredit said tax with the proportional part corresponding to said stockholder from the excessive income taxes and benefits paid to the United States, to any possession or any other part of the United States other than a State or any foreign country, by such a real estate investment trust on or with respect to the benefits from which it is considered that such dividends have been paid. For the purpose of determining the gross amount of the tax that must be deducted and withheld prior to said credit, the dividends paid during the tax year by the real estate investment trust to the beneficiary shall be considered:

(A) not to include the exempted dividends, as defined in subclause (A) of clause (4); and

(B) ...

(4) ...

(5) The credit provided in Section 1026 shall neither be available nor apply to the distributions of dividends made by a real estate investment trust subject to the provisions of this Subchapter.

(e) Taxation of the net income derived from prohibited transactions.-

(1) ...

(f) Imposition of taxes if certain requirements are not met:

“Should a real estate investment trust fail to comply with the requirements of subsections (c)(2) or (c)(3), or of both subsections, during any tax year, but its election under subsection (c)(1) is not deemed terminated by virtue of Section 1500(f)(4), then a tax of one hundred percent (100%) shall be imposed on said trust over the greater amount of

(i) the excess of-

(A) ninety-five percent (95%) of the gross income (excluding the gross income from prohibited transactions) of the real estate investment trust, less

(B) the amount of said income derived from the sources mentioned in Section 1500(c)(2); or

(ii) the excess of-

(A) seventy-five percent (75%) of the gross income (excluding the gross income from prohibited transactions) of the real estate investment trust, less

(B) the amount of said income derived from the sources mentioned in Section 1500(c)(3), multiplied by a fraction whose numerator is the taxable income of the real estate investment trust for the tax year (without considering any deduction for the net loss of operations) and whose denominator is the gross income of the tax year (excluding the gross income from prohibited transactions).

Section 4.-This Act shall take effect as of January 1, 2007.

CERTIFICATION

I hereby certify to the Secretary of State that the following Act No. 289 (H.B. 3038) (Conference) of the 4th Session of the 15th Legislature of Puerto Rico:

AN ACT to amend clause (18) of Section 1101; renumber clause (6) and clause (7) of subsection (c) as clauses (7) and (8), respectively; add a clause (6) to subsection (c); amend subclauses (B) and (D) of clause (6), subsection (c); paragraphs (v), (viii) and (x) of subclause (D) of clause (6), subsection (c); add paragraphs (xi) and xii) of subclause (D) of clause (6), subsection (c); eliminate subclause (E) of clause (6), subsection (c); rename subclause (F) as subclause (E) of clause (6), subsection (c) and amend said clause; etc.,

has been translated from Spanish to English and that the English version is correct.

In San Juan, Puerto Rico, today 31st of October of 2007.

Francisco J. Domenech
Director