

DOING BUSINESS IN PUERTO RICO

This document describes some of the key commercial and taxation factors that are relevant on setting up a business in Puerto Rico.

1. BACKGROUND

From a business risk standpoint, the Commonwealth of Puerto Rico falls under the jurisdiction of the U.S. federal court system, which provides for all of the rights afforded by the U.S. Constitution and the same rule of law which makes the United States the safest jurisdiction to do business, including due process, intellectual property protections, and the all-important enforceability of contracts. Virtually every industry falls under the purview of federal regulations or oversight, including the FDA, FAA and EPA, just to name a few.

And Puerto Rico's business infrastructure is well developed, with world-class attorneys, accountants, bankers, engineers, technologists, academics, and virtually every discipline necessary to conduct the most complex of transactions.

1.1. Country overview

Puerto Rico is strategically located between the Caribbean Sea and Atlantic Ocean, midway between North and South America. Is the fourth largest island in the Caribbean after Cuba, Hispaniola (which comprises the Dominican Republic and Haiti), and Jamaica. Also, the Puerto Rican territory includes other three small islands, Vieques, Culebra and Mona, as well as numerous islets. It has a total area of 5,324.5 square miles, 100 miles long and 35 miles wide.

Puerto Rico has a total population of 3.726 million people, according to the 2010 US Census. Its population derive from a mix of cultures and ethnic backgrounds (Taíno, African and Spanish). The major component of the ethnic and racial mix on the island is the Spanish population.

Puerto Rico came under United States sovereignty pursuant on December 10, 1898, and Puerto Ricans have been citizens of the United States since 1917.

Spanish and English are the official languages. The U.S. Dollar is the official currency.

Puerto Rico also have full presence of international banks and offers a sophisticated logistics capabilities with major couriers including UPS, FedEx, Crowley and Horizon.

The climate of Puerto Rico range from 74 °F (23 °C) in the winter and 85 °F (29 °C) in the summer, making it an ideal paradise all year long.

Puerto Rico's time is the same as Eastern Standard Time in the United Sates, with no changes from Daylight Saving Time.

As a territory of the United States, Puerto Rico falls within the U.S federal system and is subject to both US federal and local law. Also share a common defence, market and currency. Specifically, U.S constitutional law and, in fact, most federal laws and regulations, apply in Puerto Rico, and the island also has its own constitution, laws and regulations. Puerto Rico's local government includes an executive, legislative and judicial branch.

Puerto Rico has a republican system of government, elected every four years. The executive branch comprises the governor, elected by the people, and cabinet members who are in turn appointed by the governor. The legislative branch is composed of two cabinets: The Senate and House Representatives, also elected by the people. The judicial branch comprises four main bodies: the Supreme Court, the Court of Appeals, the Court of First Instance and a lower-level system of municipal courts throughout the island.

1.2. Economic overview

Puerto Rico enjoys a highly diversified economy and has become a formidable player in high-value added manufacturing industries, which include pharmaceuticals, electronics, textiles, petrochemicals, processed foods, clothing and texture. Also the service sector has experience a particular growth, particularly in educational and health services, professional and business services, and financial and insurance services, among others.

The Gross Domestic Product (GDP) in Puerto Rico was worth 101 billion US dollars in 2012. The GDP value of Puerto Rico represents 0.16 percent of the world economy. GDP in Puerto Rico averaged 34.65 USD Billion from 1960 until 2012, reaching an all time high of 101 USD Billion in 2012 and a record low of 1.69 USD Billion in 1960. GDP in Puerto Rico is reported by the World Bank Group.

A prime allure of Puerto Rico is its highly educated and bilingual workforce. Employers have access to a large pool of qualified job candidates. According to the Puerto Rico Labor and Human Resources Department, as of December 2011, the labor force was about 1.3 million strong, of which 1.1 million were employed. The service sector employs the largest percentage of the workforce.

1.3. Transport infrastructure

Puerto Rico is an international destination with world-class air service. The Island has eleven airports servicing residents and visitors. The San Juan Luis Muñoz Marín International Airport (SJU) serves as the regional hub, receiving upwards of 8 million passengers a year. It handles 4,300 cargo flights per month and over 1,800 weekly flights from more than 20 airlines connecting Puerto Rico to worldwide destinations. It provides direct service to more than 20 domestic cities and many international destinations in the Caribbean, North America, South America, and Europe. Typical flight time from Miami to San Juan is under three hours, while it takes approximately four hours to fly direct from New York City.

Puerto Rico's two other international airports are Mercedita Airport (PSE), located on the south side of the Island in Ponce, and Rafael Hernández Airport (BQN), which is located on the west side of the Island in Aguadilla and serves as an air cargo hub.

A hub for transshipment between the Americas and Europe, Puerto Rico has nine modern maritime ports. The main seaport is located in San Juan, which has the largest cruise ship harbor in the Eastern Caribbean and it stands as the main harbor for several cruise ship companies, and another major seaport is located in Ponce. The Port of the Americas in Ponce is a transshipment seaport for value-added cargo with post-Panamax vessel capability.

The Island is connected through a modern transportation network of more than 24,000 miles of highway make all points on Puerto Rico no more than two hours from any airport or seaport on the island. Puerto Rico has an extensive road system with a main freeway crossing the north side from San Juan to Arecibo, and another one linking San Juan to Ponce that crosses the central east side from the north to the south coasts. Another important freeway goes from San Juan to Canóvanas in the northeast.

In addition, an efficient mass transit system, known as "Tren Urbano" (Urban Train), interconnects the San Juan metro area. Also, has the bus rapid transit (BRT) system that aims to extend the Urban Train line through connections to island suburbs.

2. CHOICE OF LEGAL FORM

2.1. Limited Liability Company

Limited Liability Companies (LLC) are more flexible operationally than corporations but can still provide legal protection for their managers and members. The management of an LLC is typically governed by an LLC agreement.

A foreign LLC may register in Puerto Rico by petition signed by an authorized person following the procedures specified in the General Corporation Law. LLCs must maintain a registered office and resident agent for service of process in Puerto Rico.

LLCs are generally taxed as corporations, and subject to tax at both the business entity and shareholder levels. Notwithstanding, LLCs may elect to be treated as partnership for tax purposes, receiving pass-through tax treatment under the partnership rules.

2.2. General Partnership

A partnership is an organization of two or more natural persons or juridical entities to carry on a business for profit pursuant to a partnership agreement. Partnerships may be organized under the Civil Code, Commercial Code or Limited Liability Partnership Law. The Civil Code treats a partnership as a juridical entity separate from its owners.

Under the New Internal Revenue Code for a New Puerto Rico, Puerto Rico partnerships automatically provide pass-through tax treatment. Partnerships are not subject to tax based on their distributable share of the partnership's income items, at their applicable rate, even though the income was not distributed. However, partnerships existing on January 1, 2011 may elect to continue to be treated as corporation. In that case partnerships and their partners are subject to tax at the partnership level and again at the partner level to the extent the partnership makes any distributions.

2.3. Limited Liability Partnership

Two or more natural persons, including those rendering professional services, can form a limited liability partnership under the provisions of the Limited Liability Partnership Law.

Generally, a partner in a limited liability partnership is not personally liable for the debts and obligations of the partnership or for negligent or unlawful acts of another partner or employee not supervised by the partner, provided he or she had no prior knowledge of such acts. However, the partner may be held personally liable for partnership debts and obligations that arise out of an error, omission, negligence, incompetence or illegal act committed by the partner or in which that partner was involved, directly or through any person under his or her control or supervision or which that partner had notice or knowledge.

Foreign limited liability partnerships are permitted, but permission from the secretary of State is required to operate both a foreign LLP and domestic LLP.

2.4. Limited Partnership

The formation of a limited partnership under the laws of Puerto Rico is very similar to that of a general partnership. The social contract is identical to that of the general partnership except that it must identify the regular partners from the limited partners. The limited partners are only required to make capital contributions and are shielded from liability. However, the limited partner must indemnify the limited partnership from any harm resulting from an abuse of the partner's position or negligence.

2.5. Sole proprietorship

A sole proprietorship is a business owned by a single individual who chooses not to form partnership, corporation or limited liability company. There are no special legal requirements for creating a sole proprietorship.

Sole proprietorships are not juridical entities and cannot enter into contracts, sue or be sued in their own name. Accordingly, a sole proprietorship provides no liability shield for its owner and generally terminates upon the death of its owner. Likewise, is not taxed separately, and all income is passed through to the owner.

2.6. Joint Venture

A joint venture is formed between two or more parties who agree to undertake economic activity together and share in the revenue, expenses, and control of the enterprise. For tax purposes, it is treated as a partnership.

2.7. Corporation

A corporation is an entity separate and distinct from its shareholders, directors and officers. It has the power to enter into contracts, hold property, and sue and be sued in its own name; it also has continuity of life and free transferability of ownership interest. Any person or juridical entity can form a corporation.

A typical corporation's structure consists of three major groups: directors, officers and shareholders. The liability of directors and officers may be indemnified by the corporation. The liability of corporate shareholders for the acts of the corporation is limited to their investment in its stock.

Corporations must file an annual report, which must be file electronically by an officer of the corporation, and in case of Puerto Rico corporation whose annual volume of business exceeds \$3 million, must be accompanied by the corporation's balance sheet at the close of the preceding fiscal year and audited by a certified public account licensed in Puerto Rico.

Puerto Rico corporations must maintain a designated principal office and agent in Puerto Rico for service purposes.

2.8. Trust

The Puerto Rico Civil Code essentially incorporates the common law of trusts while attempting to harmonize common law and civil concepts. The Civil Code defines a trust as "an irrevocable mandate whereby certain property is transferred to a person, named the trustee, so he or she may disposed of it as directed by the party who transfers the property, named constituent, for his or her own benefit or the benefit of a third party, named the beneficiary."

3. AUDIT REQUIREMENT

3.1. Requirement

Every person engaged in a trade or business in Puerto Rico whose volume of business exceeds \$3,000,000 must file financial statements, certified by a certified public accountant (CPA) licensed in Puerto Rico, along with their income tax, property tax, and volume of business returns. All foreign corporations must also file a balance sheet of their Puerto Rico operations, certified by a CPA licensed in Puerto Rico, together with the Annual Corporation Report.

4. TAXATION

4.1. Corporation Tax

Every domestic corporation and foreign corporation (including a branch) engaged in business in Puerto Rico or with effectively connected income is required to file a corporation income tax return on or before the fifteenth day of the fourth month following the close of its taxable year. The tax rates applicable to domestic corporations and foreign corporations engaged in a trade or business in Puerto Rico or with effectively connected income graduates from 20% to 39% .

4.2. Branch Profits Tax

The branch profit tax" (BPT), is imposed to tax the P.R. Branch's operations as if it was a foreign subsidiary. The purpose of a branch profit tax is to treat as dividends the remittances of funds to the home office as a foreign parent. The BPT generally represents a 10% tax upon the "dividend equivalent amount". Broadly speaking, the BPT would be imposed if the earnings and profits derived by the Branch were not reinvested in Puerto Rico as of the end of the taxable year.

4.3. Personal Income Tax

A person's liability for Puerto Rican tax is determined by residence status. A person can be a resident or a non-resident for Puerto Rican tax purposes. The general rule is that a person who is a resident of Puerto Rico is taxed on the individual's worldwide income. Non-residents are generally taxed on income derived directly or indirectly from sources within Puerto Rico.

Net taxable income is taxed at graduated rates, depending on the filing status. The tax rates range from 7% up to 33%. Non-residents are subject to the same graduated tax rates on compensation income.

4.4. Capital Gains Tax - Preferred Tax Rate

If for any taxable year the long term capital gain of any corporation or individual exceeds the short term capital loss, a tax will be imposed based on the following tax rates:

- Corporations = 20%
- Individuals = 15%

Such corporation or individual still has the option to pay taxes on the capital gain based on normal tax rates, if those rates are more beneficial.

4.5. Sales Taxes

Sale and use taxes (SUT) apply to taxable items: tangible personal property, taxable services, admissions rights and combined transactions, subject to certain exclusions and exemptions. The SUT rate is 7%.

4.6. Local Taxes

Municipal Local Tax - A corporation engaged in trade or business in Puerto Rico is normally subject to the payment of municipal license taxes (similar to a gross receipt tax). For non-financial businesses, the tax may be as high as .5% of the volume of business (defined as gross receipts) the company received or accrued during the year. The municipal volume of business declarations must be filed on or before the fifth day following April 15 of each year, reflecting the volume of business realized by the corporation during the accounting year preceding the filing of the return.

Personal Property Tax - The tax is computed on the net book value of taxable property, however, if the book value of the personal property does not reasonable reflects the fair market value then such property must be adjusted based on their minimum residual values as provided by the Municipal Revenue Collection Center. The minimum residual value is a percentage of the asset cost and ranges from 10% to 20% depending on the useful life of the asset. The maximum tax rate is 8.83% and varies depending on the municipality in which the taxable property is located. Taxable property normally includes cash on hand, inventories, materials and supplies, furniture and fixtures, and machinery and equipment used in the trade or business. The property tax must be paid on or before May 15 of each year. If payment is made in full by that time, a 5% discount is allowed.

5. TAX INCENTIVES

5.1. Investment Incentives

In order to bolster a diversified economy, the local government has created an aggressive economic and tax incentives program with the purpose of helping operations on the island become more profitable to those companies who establish themselves here.

Act No. 73, known as the Economic Incentives Act for the Development of Puerto Rico, was established to provide the adequate environment and opportunities to continue developing a local industry, offer an attractive tax proposal, attract direct foreign investment and promote economic development and social betterment in Puerto Rico. The tax benefits are as follows:

- 4% income tax on industrial development income
- 0% tax on dividends or profit distributions
- 0% to 1% tax rate on income for pioneer or novel products manufactured in PR
- Up to 50% tax credit on purchases of products manufactured or recycled locally
- Up to \$5,000 for each job created during 1st year of operation
- Up to 50% tax credit on Research and Development activities
- 60% tax exemption on municipal taxes
- 90% tax exemption on property taxes
- Special deductions on investments from structures, machinery and equipment
- Marketing incentives program available to qualified companies whose sales are greater than \$100,000 per year

Act No. 273, known as The International Financial Center Regulatory Act, was enacted with the objective of making Puerto Rico an international banking and financial center by providing tax incentives for new banking and financial activity in Puerto Rico that is done for clients outside of Puerto Rico. The tax incentive offer is mainly a four 4% income tax rate for new banking and financial businesses established in Puerto Rico under qualifying circumstances.

5.2. Acts 20/22

Act No. 20, known as the Act to Promote the Exportation of Services, provides attractive tax incentives for companies that establish and expand their export services businesses in the island. The tax benefits are as follows:

- 4% corporate tax rate, which may be reduced to 3%
- 0% tax on dividends or profit distributions from export services businesses
- 90% tax exemption on property taxes for certain property used in export service businesses
- 60% tax exemption on municipal taxes

- Decree of 20 years, renewable for an additional 10 years, guaranteeing these rates

Act No. 22, known as the Individual Investors Act, seeks to attract new residents to Puerto Rico by providing a total exemption from Puerto Rico income taxes on all passive income realized or accrued after such individuals become bona fide residents of Puerto Rico. This relocation should result in new local investments in real estate, services and other consumption products, and in capital injections to the Puerto Rico banking sector, all of which will accelerate the economy of the island. The tax benefits are as follows:

- 0% tax on dividends and interests for new Puerto Rico residents
- 0% tax on short-and-long term capital gains for new Puerto Rico residents
- 0% federal taxes on Puerto Rico source income
- Decree of 20 years, renewable for an additional 10 years, guaranteeing these rates

6. EMPLOYMENT

6.1. Social Security/Unemployment Taxes

Employers in Puerto Rico are subject to the taxes imposed by the Federal Insurance Contribution Act (FICA) (Social Security and Medicare taxes) and the Federal Unemployment Tax Act (FUTA). An employer is a person or organization for whom a worker performs services as an employee. As an employer you are required to withhold, report and pay employment taxes on wages paid.

FICA taxes are used to finance the Social Security and Medicare systems. FICA taxes consist of two components: the social security tax and the Medicare tax. You must withhold the employee portion of FICA taxes from your employees' wages and contribute the employer portion of FICA tax. The current tax rate for social security is 6.2% for the employer and 6.2% for the employee, or 12.4% total. The current rate for Medicare is 1.45% for the employer and 1.45% for the employee, or 2.9% total.

6.2. Payroll Taxes

Other labor related expenses of a company operating in Puerto Rico are the state unemployment and disability taxes, chauffeur's social security, and the Puerto Rico workmen's compensation insurance.

State Unemployment - Each employer must pay the tax on the first \$7,000 of annual wages paid. In addition, every employer must pay a special tax of 1% of all taxable wages. The special tax, together with the experience-based tax, will not exceed 5.4%.

Disability Taxes - Disability insurance provides indemnification to workers for loss of salaries resulting from disability caused by sickness or accident not related with their employment. The current rate is 0.60%. Both employer and employee share the tax burden evenly. The disability insurance tax is imposed on the first \$9,000 of wages and salaries paid during the calendar year by an employer to an employee.

Chauffeur Insurance - If the employer hires non-executive employees who are required or permitted to operate motor vehicles as an integral and regular part of their jobs, chauffeur's social security must be paid instead of Puerto Rico Disability Insurance Tax. Every employer must pay a tax of 30 cents weekly for each covered employee.

Workmen's compensation - Provides indemnification for accidents incidental to or as a consequence of employment. This is a compulsory insurance that is obtained from the State Insurance Fund Corporation. All the employees of a business, including executive officers, are

required to be covered by this insurance. The rate varies according to the type of labor performed by the employees.

Income Tax Withheld - An employer is required to withhold income tax at source upon the salaries and wages paid to its employees performing services in Puerto Rico. The Treasury Department publishes tables for the determination of the tax to be withheld together with an instruction manual. The tax is determined by one two methods: the percentage method or the wage bracket method.

7. WITHHOLDING TAXES

7.1. Royalties

Royalty payments are subject to a 29% withholding tax. However, royalties paid by corporations or partnerships that are grantees of tax exemption under the Puerto Rico tax incentives acts are generally subject to a 12% withholding tax rate.

7.2. Dividends

Dividend distributions to resident individuals or nonresident U.S. Citizens from domestic corporations and certain resident foreign corporations and partnerships are subject to a preferential tax rate of 15%.

8. MISCELLANEOUS

"So there you have it. Puerto Rico is a U.S. territory, part of the biggest economy in the world, with amazing people, world-class infrastructure, and a privileged location smack in the middle of the Hemisphere." Nicholas Prouty - founder and president of Putnam BridgeFunding LLC

This document is provided as a general overview of matters to be considered when setting up an overseas business in Puerto Rico. It is essential to take advice on specific issues. No liability can be accepted for any action taken or not taken arising from the information provided.

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