

January 14, 2015

## Corporate and Tax Update

### *Private Equity Funds Act*

Act 185 – 2014, known as the “Private Equity Funds Act” (“PEFA”), allows certain domestic or foreign investment vehicles to elect to be treated as a Private Equity Fund (“PEF”). Pursuant to PEFA, PEF investors may receive beneficial tax treatment under the Puerto Rico Internal Revenue Code of 2011, as amended (the “Code”). The PEF must be organized as a partnership or limited liability company to be engaged in the business of investing in securities of entities that are non-publicly traded at the time of investment (“Private Securities”).

The highlights of PEFA can be summarized as follows:

#### Eligibility

To be eligible, the partnership or limited liability company must comply with the following eligibility requirements during each year:

- have an office located in Puerto Rico;
- at least 80% paid-in capital must be invested in non-publicly traded securities and up to 20% in allowable short term investments, which include short term Puerto Rico or U.S. government securities, reselling agreements, certificates of deposit, deposit or checking account insured by the FDIC or the Credit Unions Supervision and Insurance Corporation, account for miscellaneous expenses and/or investment certificates issued by the Government Development Bank for Puerto Rico, an International Banking Entity or an International Financial Entity;
- within 4 years from inception and thereafter, a PEF shall maintain a minimum of 15% of paid-in capital invested in non-public securities issued by companies that derive (for the prior 3 year period) at least 80% of their gross income



For more information on the above, please contact any of the following attorneys in the corporate and tax practice:

#### **Juan Carlos Méndez**

[jcmendez@reichardescalera.com](mailto:jcmendez@reichardescalera.com)  
787.777.8834

#### **Carlos E. Serrano**

[cserrano@reichardescalera.com](mailto:cserrano@reichardescalera.com)  
787.777.8815

#### **Claudia Motta**

[cmotta@reichardescalera.com](mailto:cmotta@reichardescalera.com)  
787.777.8830

- from sources within Puerto Rico or from income effectively connected to Puerto Rico;
- within 4 years from inception and thereafter, if organized as a PR-PEF, the entity is required to maintain a minimum of 60% of paid-in capital invested in either (i) non-public securities issued by companies that derive (for the prior 3 year period) at least 80% of their gross income from sources within Puerto Rico or from income effectively connected to Puerto Rico, or (ii) in an exempt investment trust under Sec 1112.02 of the Code;
- all investors must qualify as “accredited investors” which are defined as:
  - a bank, insurance company, registered investment company, business development entity, small business investment company, GDB, EDB, IBE or IFE;
  - a Commonwealth of Puerto Rico employee benefits plan or any other employee benefits plan or trust as defined in the Employee Retirement Income Security Act of 1974, only if a bank, insurance company, or registered investment advisor makes the investment decisions, or if the plan’s total assets are greater than \$5,000,000;
  - a nonprofit organization, corporation, association whose total assets are greater than \$5,000,000;
  - a director, executive officer or general partner of the issuer of securities;
  - an individual person with a net worth exceeding \$1,000,000 at the time of the purchase, not including the value of the individual person’s main residence, either individually or jointly with his or her spouse;
  - an individual person that earned more than \$200,000 in each of the last 2 years prior to the purchase, or that earned a joint income of \$300,000 with his or her spouse and expects to reasonably maintain the same level of income throughout the year in course;
  - a trust with total assets of more than \$5,000,000 that was not organized or created to purchase publicly traded securities and where a sophisticated person makes the purchase; or
  - any business in which the owners of the capital are accredited investors;
- use a registered investment adviser that is engaged in a trade or business in PR with a

**Alba I. Joubert Pereira**

[ijoubert@reichardescalera.com](mailto:ijoubert@reichardescalera.com)

787.777.8825

**Ana Mercedes Faría**

[afaria@reichardescalera.com](mailto:afaria@reichardescalera.com)

787.777.8832

**Bibiana A. Cruz**

[bcruz@reichardescalera.com](mailto:bcruz@reichardescalera.com)

787.777.8813

- business office in Puerto Rico and duly registered with the relevant regulators;
- within 4 years from inception and thereafter, the PEF must operate as a diversified investment entity, and no more than 20% of its paid-in capital can be invested in the same business (a controlled group of corporations or a group of related entities will be considered a business);
- minimum capital of \$10 million within 24 months of issuance, and thereafter; and
- have an advisory board including at least one of its investors or limited partners.

### Election

An entity that meets the foregoing eligibility requirements may choose to be treated as a PEF only if it notifies said election to the Puerto Rico Secretary of Treasury on or before the last day of the third month after the inception date of the PEF. Failure to comply with any of the eligibility requirements will prevent the PEF from enjoying the tax benefits for that specific year. However, it may request treatment as a PEF in subsequent taxable years when all of the above-referenced requirements are met.

### Election Effects

The applicable provisions to partners of a partnership (Chapter 7 of the Code) shall apply to investors of a PEF.

For accredited investors, interest derived from interest and dividends will be taxed at a fixed rate of 10%. Capital gains are completely exempt from tax. Capital gains realized by investors of the PEF in the sale of proprietary interest will be taxed at a fixed rate of 5%, unless proceeds from the sale are reinvested in a PR-PEF, which in such case would be exempt from tax.

Investors who are Puerto Rico residents may, subject to certain limitations, take as a deduction in computing their net income the net capital losses incurred by the PEF.

Interest and dividend income received by general partners, registered investment advisors and private equity firms are taxed at a rate of 5%, while their capital gains are taxed a rate of 2.5%.

### Incentive Acts Coordination

PEFA does not limit any tax treatment that may be obtained by the accredited investors, general partners, or registered investment advisers under the provisions of any current or

future incentives' act, including, the Act to Promote the Exportation of Services (Act 20-2012), and the Individual Investors Act (Act 22-2012).

PEFA exempts PEFs from filing the volume of business declaration under the Municipal License Tax Act (Act 113-1974) and the personal property tax return under the Municipal Property Tax Act (Act 83-1991). PEFs are also exempt from the provisions of the Investment Company Act of Puerto Rico (Act 6-1954) and the Puerto Rico Investment Companies Act of 2013 (Act 93-2013).

### Compliance

PEFs must comply with all applicable provisions of federal and Puerto Rico securities laws, and with specific operational and disclosure requirements established by PEFA, including requirements for the extension of existence of the PEF.

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