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Tax & Corporate Update

Puerto Rico Issues New Administrative Guidance for Private Equity Funds

On March 11, 2026, the Puerto Rico Department of Economic Development and Commerce (“DDEC”, for its Spanish acronym), through the Office of Incentives for Business in Puerto Rico (“OIN”), issued [Administrative Order No. DDEC 2026-002](#) (the “Order”). The Order provides detailed operational, investment, and compliance guidance applicable to Private Equity Funds and Puerto Rico Private Equity Funds operating under Act 60-2019, as amended (the “Incentives Code”).

The Order was issued in response to questions from fund sponsors, investors and advisors regarding eligible investments, investor deductions, capital structuring, and anti-abuse safeguards, and was developed in consultation with the Office of the Commissioner of Financial Institutions (OCIF).

1. Applicability and Purpose

The Order applies to all Private Equity Funds holding tax exemption grants issued under the Incentives Code.

Its principal objectives are to:

- Formalize rules governing the administration, investment, and operation of private equity funds;
- Establish classifications of portfolio entities;
- Establish parameters for eligible cash and in-kind contributions;
- Prevent abusive capital recycling practices; and



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- Define the timing and amount of investor contributions eligible for tax deductions.

2. Classification of Portfolio Entities

A central component of the Order is the clarification of three categories of entities for investment-qualification purposes:

I. **Actively Engaged Trade or Business Entity**

An entity qualifies as “active” if it conducts continuous and regular business operations in Puerto Rico, maintains personnel, facilities, or assets on the Island, and derives at least 80% of its gross income from active business activities in Puerto Rico. Limited passive income (up to 20%) is permitted.

The Order adopts a look-through approach for pass-through entities and certain subsidiary structures when determining whether investment requirements are satisfied.

II. **Passive Entity**

A passive entity is one that does not actively conduct business operations in Puerto Rico and derives income primarily from interest, dividends, rents, royalties, or capital gains. Investments in passive entities do not count toward the statutory investment thresholds applicable to private equity funds.

III. **Mixed Entity**

Entities engaged in both active and passive activities may qualify as active only if at least 80% of gross income is derived from active business operations.

3. In-Kind Contributions and Investment Retention Rules

The Order establishes rules governing in-kind contributions, including contributions of equity, securities, notes, and similar assets:

- In-kind assets must remain invested in the fund for a minimum period of 24 months.
- If the assets are sold before the end of that period, the proceeds (or an amount equal to the asset’s tax basis, adjusted for gain or loss) must remain invested until the 24-month requirement is met.

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- The investor's deduction is based on the tax basis of the contributed asset, not its fair market value, which seems to validate tax free status of such contributions.
- Real estate contributions are expressly excluded from qualifying as in-kind contributions.

The Order also clarifies that funds may temporarily hold cash or cash equivalents in excess of statutory limits, provided overall investment requirements are satisfied.

4. Restrictions on Capital Recycling and Related-Party Investments

To prevent transactions that merely recycle investor capital without generating meaningful economic activity in Puerto Rico, the Order imposes new safeguards:

- As a general rule, a private equity fund may not invest in an entity related to an investor owning 20% or more of the fund. An exception applies where the investment supports new business activity, operational expansion, or job creation in Puerto Rico.
- Any such related-party investment must be supported by documented economic impact analysis, available for review by OIN and OCIF.
- Immediate distributions or repayments to the related investor are discouraged, and a 24-month retention period is generally required.

5. Timing of Investments for Investor Deductions

For purposes of the investor deduction under Section 2042.03(d)(1) of the Incentives Code, an investment is considered made when:

- Contributed cash is specifically allocated and invested in qualifying projects or assets; or
- Non-cash property is contributed to the fund.

The Order emphasizes the importance of clear accounting records and documentation demonstrating tangible economic impact, such as job creation or operational growth.

6. Determination of an Investor's Net Contribution

The Order introduces a critical clarification regarding the "Net Contribution" eligible for deductions:

- If an investor contributes capital and receives a loan from the same fund within 120 days, the deductible amount is reduced by the loan amount.

- Only the net contribution (contribution minus loan) may be used to calculate the deduction.
- Full deductibility may still be available if the loan is made after 120 days or if a contemporaneous, documented investment plan exists and is retained for audit purposes.

7. Effective Date and Compliance Considerations

The Order is effective immediately, with certain provisions—particularly those governing in-kind contributions, capital recycling, and net contribution calculations—applying to contributions made after publication. Funds with existing grants may elect to apply these rules earlier.

Conclusion

Administrative Order DDEC 2026-002 represents a significant development in the regulatory framework governing private equity funds under The Incentives Code. Fund sponsors and investors should review existing fund structures, contribution mechanics, and related-party transactions to ensure compliance and preserve available tax benefits.

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