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Private equity funds after the approval of the Incentives Code

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Before the enactment of the Incentives Code the legal regime that Puerto Rico had was Act 185, approved on November 12, 2014. The financial industry was greatly benefited with the integration of the private equity funds into the Puerto Rico Incentives Code.

While this act was well intended with an effort to promote this type of alternative investment, the truth of the matter is that the lack of regulations and express approval process from the governmental agencies provided a grey and uncertain scenario for potential investors. By inserting the private equity funds in the Incentives Code, specifically in Chapter 4 "Finance, Investment and Insurance", some of that uncertainty has been vanished provided that funds may now obtain a 15 year-term period tax exemption decree, validating the status and incentives available for the investors and the fund general manager.

The main attributes and requirements of Act 185 were transferred to the Incentives Code without major changes under the new guidelines. The fund must raise a minimum capital of $10 million within its first 2 years. Under Act 185, the fund should have diversified its investments maintaining not more than 20% in a single business (considering related and affiliated entities as a "single business") after 4 years. Now with the Incentives Code, a significant change was made by modifying the diversification requirement to 50%, allowing more flexibility in managing the fund investments.

Benefits to investors remain the same by permitting them to deduct 60% of their initial investment from taxable income within a 15-year term period given that the maximum annual deduction shall not exceed 30% of their net income. Such 60% is reduced to 30% when the fund does not meet the requirement of investing at least 60% of its capital in businesses with an active trade in Puerto Rico. In such case, the time period to use the deduction is also reduced to 10 years with the same annual limit of 30% of the investor's net income. Important to note that in this second option, there is a minimum of 15% of the fund's capital that should be invested in Puerto Rico active trade or businesses.
In terms of preferential tax rates, investors continue to have an income tax rate of 10% for the dividend and interest income that flows from the fund. Capital gains are 100% exempt, except for the capital gain when the investor sells its proprietary interest in the fund which is subject to a 5% income tax rate. On the other hand, the general partner has a rate of 5% for interest and dividends, and a 2.5% on capital gains, except when selling its proprietary interest in the fund, which is subject to the same 5% income tax rate as the investors.

Tax incentives have historically resulted in one of the best allies to attract investment to Puerto Rico. The new Incentives Code was approved with high hopes that it will assist in boosting again the so desired economic development of the island. It is expected that private equity funds will play an active role in achieving this by financing, managing and investing in new ventures, among others.

We will continue with our commitment to keep you up to date with these tax-related developments. Please contact our Tax Department should you require additional information regarding this or any other tax issue. We will be glad to assist you.




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