(S. B. 233)

(No. 20-2014)

(Approved January 24, 2014)

AN ACT

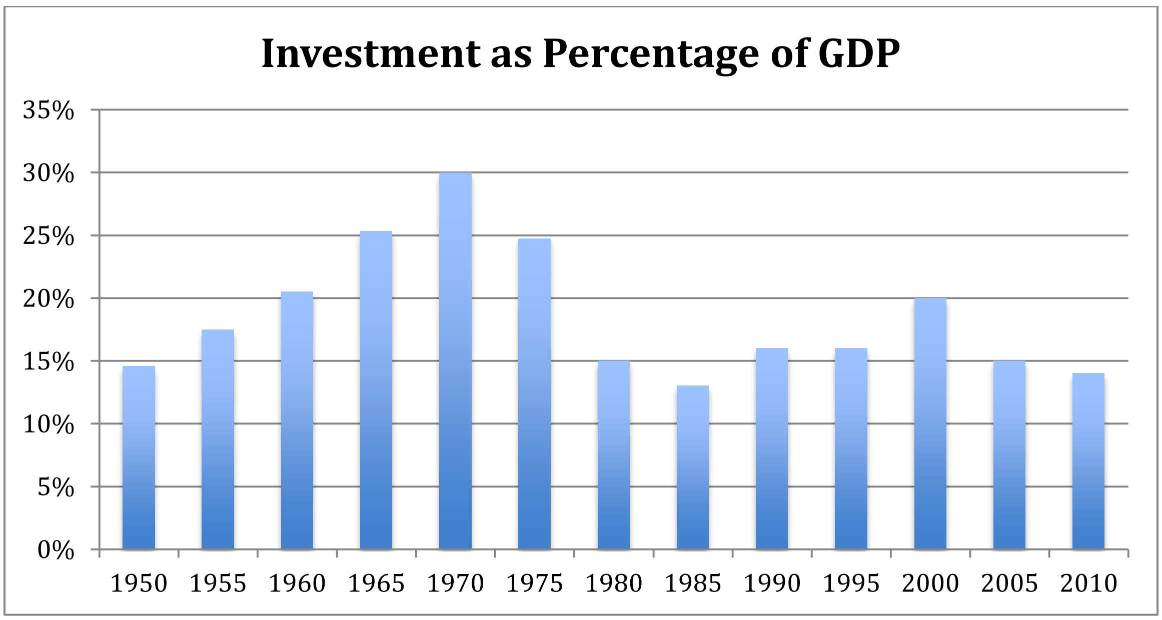
To create the "Puerto Rico Capital Reinvestment Act"; amend Sections 1034.10, 1082.01, and 1082.02 of Act No. 1-2011, as amended, known as the "Internal Revenue Code for a New Puerto Rico," in order to reform the tax treatment of Real Estate Investment Trusts and allow for the reorganization of businesses to free their capital so they may reinvest in certain types of economic activity; add the purchase of foreclosure property to make it rent-to-own property as an eligible activity for Real Estate Investment Trusts; delegate the responsibility of promoting Real Estate Investment Trusts to the Department of Economic Development and Commerce; and for other related purposes.

STATEMENT OF MOTIVES

Puerto Rico is facing a serious economic crisis. Unemployment rates are extremely high. Almost 180,000 jobs have been lost between 2007 and 2011. Each job lost is a tragedy for the Island, and we must stop this. To start creating jobs, we must encourage investments in Puerto Rico.

Due to historic and restrictive reasons, our current financial situation is unfavorable for new investments. Many times, investments must be made with retained earnings or directly from savings. Without access to financing, large-scale projects or investments that make a difference cannot be made. A hotel or a factory cannot be financed in absence of significant sources of capital. To get back on the path of economic progress, Puerto Rico needs to find sources of capital.

Our economy is one of those in the world with the highest consumption rate in proportion to size. Statistics show that 15% of our economy is devoted to investments, as opposed to 20% in the United States. Moreover, the U.S. economy has one of the lowest consumption rates in proportion to its Gross Domestic Product. The unemployment issue, which is of utmost concern for our people, can be addressed by encouraging private investment. The need for investment has been confirmed by the Government Accountability Office (GAO). Said agency stated that the main challenge for our economy would be to close the investment gap. In 2000, investment rates reached 20% of our GDP. We have never been able to reach such investment levels in our economy again. While investment in our economy remains stagnant (or even worse, decreases, as it has been the trend for the past four years) we will never be able to create the jobs that our People need.



Capital investment comes from different sources. One of such sources is capital raised in Puerto Rico that is invested outside the Island due to a lack of adequate investment opportunities for investors in the local market. Said capital is the result of the work of thousand of Puerto Ricans who have successfully been able to make their dreams come true by creating jobs and establishing productive businesses. Another source is foreign capital that could be invested in Puerto Rico if we had the incentives to attract it, as we once did under Section 936 of the U.S. Internal Revenue Code. If we could tap those two sources of capital, we could increase investment in Puerto Rico's economy.

The level of investment needed could be also achieved by encouraging the use of the equity of successful business to free the same and use it for new investment. If we had the appropriate means, those new investments could be financed through equity, thus eliminating the need for high-risk financing.

Real Estate Investment Trusts (REITs) are among the most important investment methods in the United States and the world. REITs are the preferred method of the U.S. financial industry to invest in real estate. As of June 30, 2012, investments by REITs in the U.S. were estimated to be $630 billion. However, legislation in Puerto Rico concerning REITs, which is contained in the Internal Revenue Code, is not attractive enough to foster its creation. For such reason, there are only 8 REITs in Puerto Rico operating several shopping malls, and all of their principal offices are located outside the Island.

This Act tempers the legislation on real estate trusts with the current situation of the Island's economy. In this manner, our Internal Revenue Code shall be capable of fully developing the concept of REITs. The number of people needed to form a REIT is also reduced so that this mechanism may be established more often.

The main purpose of this legislation is to free the earnings of successful business and allow them to reinvest such accumulated earnings in the economy of Puerto Rico. Real estate transferred to a REIT allows investors to free their investment and return. Deferring the payment of capital gains when a successful business invests in new ventures will also facilitate the freeing of their capital.

In this manner, the capital freed through REIT will become venture capital for new investments. All of this will boost the economic growth of and the investments in Puerto Rico to create jobs for our people.

Businesses where earnings may be invested are those that have proven to be particularly effective in creating jobs. This includes the development of urban centers, the purchase of the Government's public debt, the export of goods and services, tourist activity, and other real estate trusts that invest in Puerto Rico. If the earnings derived from such activities are not reinvested and remain invested, they would be subject to the tax laws currently in effect.

For example, a Puerto Rican business was created with a $30-million capital and a $60-million debt, for a total of $90 million. Over time, the enterprise value increased to $120 million, which constitutes a $30 million earning. Shareholders want to reinvest such earning through sales. Under our plan, if the $30-million earning is reinvested in new businesses, it will be exempt from taxation at that time. REITs allow them to attract capital to purchase the existing business, thus freeing the $30 million to be reinvested in new business without being subject to taxation. This $30-million reinvestment will create nearly 1,000 jobs. If, at any time, a business stops reinvesting its earnings in job creation activities in Puerto Rico, it would be subject to the applicable taxes under the law in effect. This will eliminate the Treasury's risk of loss. In other words, this measure has no long-term cost for the Government.

These REITs allow for the sale of shares in a large real estate portfolio, thus diversifying their investment without being the sole owner. The side effects of this legislation are both significant and positive, since they provide the middle-class with an opportunity to invest their savings in a diversified real estate portfolio. In this manner, the risks entailed by individual real estate investments are substantially reduced. Hence, the changes made under this legislation provide for the use of REITs to promote the development and reactivation of the construction industry by providing opportunities to a group of medium-size investors, thus creating a new asset class for local investors who have been adversely affected by the recent municipal bond price drop.

Moreover, this Act empowers real estate investment trusts to invest in the purchase of real estate owned by banks. These commercial and residential buildings are currently not in use and the real estate owned by banks for sale currently exceed 30,000 units in Puerto Rico, which limits such banks' lending capacity for new construction. However, investors could buy and renovate these properties and make them rent-to-own properties through the Real Estate Investment Trust mechanism. Tenants may have the opportunity to use a portion of their rent as down payment at the time of exercising their purchase option. The creation of a new rent-to-own market will help reducing the number of for sale-inventory of homes, meeting the need for housing of the people of Puerto Rico, and providing a new business opportunity for REITs.

In the United States, the Administration of President Barack Obama passed the Small Business Jobs Act of 2010, which sets forth provisions that are similar to the provisions of this Act.

This legislation sets forth as public policy the pressing need to reinvest capital in new ventures. It also allows for the reinvestment of established businesses' accumulated earnings that are not generating profit. This investment, geared toward sectors particularly effective in the creation of jobs and economic development, has a great potential for boosting the economy of Puerto Rico.

BE IT ENACTED BY THE LEGISLATIVE ASSEMBLY OF PUERTO RICO:

Section 1.- This Act shall be known as the "Puerto Rico Capital Reinvestment Act."

Section 2.- Section 1034.04 of Act No. 1-2011, as amended, is hereby amended to read as follows:

"Section 1034.04.- Recognition of Gain or Loss.-

(a) …

(b) …

(1) …

…

(10) Deferral of Gain or Loss from the Sale, Assignment, Exchange or Transfer of Eligible Securities.-

(A) No gain or loss shall be recognized on the sale, assignment, exchange or transfer of eligible property when the total proceeds from the transaction is invested in eligible securities within one (1) year after the sale assignment, exchange or transfer of eligible property.

(B) Securities.- For purposes of this paragraph (10) of subsection (b) of this Section, the term 'securities' means any:

(i) promissory notes, notes, common or preferred stock, treasury stock, security futures, bonds;

(ii) interest of any kind as owner, member, or partner in a limited liability company or any kind of partnership;

(iii) evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, investment contract, preorganization certificate or subscription;

(iv) privilege on any security or on any group or index of securities (including any interest therein or based on the value thereof); or

(v) any instrument commonly known as a 'security,' or any certificate of interest or participation in, or right to subscribe to or purchase, any of the foregoing.

(C) Eligible Securities.- For purposes of this paragraph (10) of subsection (b) of this Section, 'eligible securities' shall be:

(i) securities issued by a qualified real estate investment trust under the provisions of subsection (a) of Section 1082.01; or

(ii) securities issued by an exempt investment trust that complies with the provisions of Section 1112.02.

(D) Proceeds from the Transaction.- For purposes of this paragraph (10) of subsection (b) of this Section, proceeds from the sale, assignment, exchange, or transfer of eligible property shall be:

(i) the total amount of cash realized in such transaction; minus

(ii) the amount of the debt secured by the eligible property and paid within thirty (30) days following the transaction;

(iii) provided that such debt has been incurred prior to November 1, 2013.

(E) Eligible Property.- For purposes of this paragraph (10) of subsection (b) of this Section, 'eligible property' shall be:

(i) real property located in Puerto Rico; or

(ii) securities owned by Puerto Rico residents or United States citizens who are not Puerto Rico residents. However, in the case of stock issued by a corporation, eligible property shall only be the stock of a corporation engaged in trade or business in Puerto Rico and that derived more than fifty percent (50%) of its gross income for the three (3) taxable years immediately preceding the sale, assignment, or transfer, from the active conduct of its trade or business in Puerto Rico.

(F) Rules to Prevent Abuse.- The Secretary may impose through regulations, circular letter, or order the necessary rules to prevent the provisions of this Section from being used for the main purpose of evading taxes without making the corresponding investment in eligible securities of business actively involved in investments that comply with the provisions of Sections 1082.01 or 1112.02. However, such rules shall allow the sale and alienation of eligible securities in accordance with subparagraph (G) of paragraph (10) of subsection (b) of this Section, provided that such transactions are subject to taxation under this Code.

(G) Sale or Alienation of Eligible Securities.- The sale of eligible securities (including the sale to the issuer of such securities acquired in the transaction described in subparagraph (A) of paragraph (10) of subsection (b) of this Section) shall not render void an election of non-recognition of gain or loss made under such paragraph. A resale agreement between the taxpayer and the issuer of such securities entered into simultaneously with a transaction described in subparagraph (A) of paragraph (10) of subsection (b) of this Section shall not impair the application of the provisions of said subsection with respect to the recognition of gain or loss in the sale of eligible property. A gain or loss shall only be recognized for eligible securities that have been sold, assigned, alienated or transferred."

Section 3.- Section 1082.01 of Act No. 1-2011, as amended, is hereby amended to read as follows:

"Section 1082.01.- Definition of Real Estate Investment Trust.-

(a) In General.- For purposes of this Subchapter, the term 'real estate investment trust' means a corporation, partnership, trust, or association that meets the following requirements:

(1) …

…

(5) whose shares or certificates of beneficial interest are held by not less than twenty (20) persons and, for purposes of this paragraph, the shareholders or the holders of certificates of beneficial interest in an exempt investment trust that avail themselves of the provisions of Section 1112.02, shall be treated as shareholders of the real estate investment trust;

(6) at no time during the last half of its taxable year more than fifty percent (50%) of the total value of its shares issued and outstanding are owned (based on the tax assessment rules established by Section 1033.17(b)(2)) by or for not more than five (5) individuals; however, for purposes of this paragraph, the shareholders or holders of certificates of beneficial interest in an exempt investment trust that avail themselves of the provisions of Section 1112.02, shall be treated as shareholders of the real estate investment trust;

(b) …

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

(1) …

…

(3) …

(A) …

…

(F) net gain from the sale or other disposition of real estate which is not a prohibited transaction solely by reason of Section 1082.02(e)(3);

(G) qualified temporary investment income;

(H) income derived from the purchase of property to be renovated and leased;

(4) …

…

(8) A corporation, company, partnership, trust, or association that fails to meet the requirements of paragraphs (2) and (3) of this subsection (c), or both, for any taxable year shall nevertheless be considered to have satisfied such requirements for such taxable year if:

(A) …

…

(C) the failure to meet the requirements of paragraphs (2) or (3), or of both, is due to reasonable cause and not due to gross negligence.

(d) …

…

(f) Termination of Election.- …

(1) …

…

(4) Exception.- If the election of a corporation, company, partnership, trust, or association has been terminated under paragraph (1) by reason of its failure to meet the requirements of subsections (c)(2) or (c)(3), or of both subsections, paragraph (3) of this subsection (f) shall not apply, if:

(A) …

…

(C) the corporation, partnership, trust, or association establishes to the satisfaction of the Secretary that its failure to qualify as a real estate investment trust to which the provisions of this Section apply is due to reasonable cause and not due to gross negligence.

(g) Applicability of the Uniform Securities Act.- None of the provisions of this Code shall be construed as to exempt real estate investment trusts from complying with the provisions of Act No. 60 of June 18, 1963, as amended, known as the 'Puerto Rico Uniform Securities Act'."

Section 4.- Section 1082.02 of Act No. 1-2011, as amended, is hereby amended to read as follows:

"Section 1082.02.- Method of Taxation of Real Estate Investment Trusts and Beneficiaries.-

(a) In General.- Every real estate investment trust that complies with the provisions of Section 1082.01 shall be subject to taxation under Subtitle A, except if during the taxable year it distributes to its beneficiaries, as taxable dividends, an amount of not less than ninety percent (90%) of its net income (determined without regard to the credits provided in Section 1022.02(d) and 1033.19); and as exempt dividends, an amount of not less than ninety percent (90%) of its exempt net income as defined in subparagraph (C) of paragraph (4) of subsection (d).

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

(1) The deduction for net losses provided in Section 1033.14 shall not be taken into account; and

(2) the provisions of Section 1061.24(c) shall not be taken into account.

(c) …

(d) Taxation of Stockholders or Beneficiaries of a Real Estate Investment Trust.-

(1) …

…

(5) …

(e) Taxation of Net Income from Prohibited Transactions.-

(1) …

…

(3) Certain Sales Not to Constitute Prohibited Transactions.- For purposes of this Section, the term ‘prohibited transaction’ does not include the sale of property which is a real estate asset as defined in Section 1082.01(c)(7)(B), if:

(A) the trust has held the property for one (1) year or more; provided, that such term shall be computed taking into account the amount of time that such property was held by the juridical entity that made an election to file as a real estate investment trust, notwithstanding it has previously made an election to file as a real estate investment trust under Section 1081.01;

(B) aggregate expenditures made by the trust, or any partner, stockholder or beneficiary of the trust, during the one (1)-year period preceding the date of sale which are includible in the basis of the property do not exceed thirty percent (30%) of the net selling price of the property;

(i) during the taxable year the trust does not make more than fifty (50) sales of property; or

(ii) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property sold during the taxable year does not exceed ninety percent (90%) of the aggregate bases of all of the assets of the trust as of the beginning of the taxable year; and

(C) the trust has held the property for one (1) year or more for production of rental income in the case of property, which consists of land or improvements.

(D) …

…

(4) …

…

(6) Other Sales that are not a Prohibited Transaction.- Notwithstanding the provisions of this Section, the sale of a property that is a real estate asset, as defined in Section 1082.01(c)(6)(B), shall not be considered a ‘prohibited transaction’ for purposes of paragraph (1), if the total amount realized from such sale is used for the acquisition of other real property within a term not to exceed twenty-four (24) months, or for the construction of a real property, whose construction shall begin within a period not to exceed thirty-six (36) months and has been previously notified to the Department of the Treasury. Provided, that the trust must show to the satisfaction of the Secretary that:

(A) said construction shall be completed within a reasonable timeframe after it begins, taking into account the circumstances of the market and the nature of the project; and

(B) any delay in such construction is not due to gross negligence or to evade the restrictions of this Section.

(f) …”

Section 5.- Promotion of Investment Trusts.-

(a) The Department of Economic Development and Commerce (hereinafter, “the Department”) is hereby entrusted with the responsibility of promoting in the Commonwealth of Puerto Rico and abroad:

(1) the provisions of paragraph (10) of subsection (b) of Section 1034.10 of Act No. 1-2011, as amended, to the extent they allow business capital to be freed in order to be invested in activities that foster the economic development of Puerto Rico;

(2) the provisions of Sections 1082.01 and 108.2.02 of Act No. 1-2011, as amended, regarding real estate investment trusts, including the changes made in this Act;

(3) the provisions of Act No. 93-2013, as amended, regarding the exempt investment trusts created thereunder, specifically eligible exempt investment trusts set forth in Section 1112.01 of Act No. 1-2011, as amended.

(b) Annual Report to the Legislative Assembly.- The Department shall submit an annual report to the Legislative Assembly on or before March 31 of each calendar year about the efforts made by the Office and the attainment of the public policy objectives set forth in this Act.

Section 6.- If any provision of this Act were held to be unconstitutional, illegal, or null by a court with competent jurisdiction, such holding shall not affect or invalidate the remaining provisions of this Act and the effect of such holding shall be limited only to the Article, Section, Subsection, Paragraph, Subparagraph, Clause or Subclause held to be unconstitutional, illegal, or null.

Section 7.- The provisions of this Act shall supersede any law, or part thereof, joint resolution or administrative provision inconsistent therewith. Any legal or statutory rules that have not been specifically repealed or that are not in conflict with the provisions of this Act shall continue to be in effect.

Section 8.- This Act shall take effect immediately after its approval.

CERTIFICATION

I hereby certify to the Secretary of State that the following **Act No. 20-2014 (S. B. 233)** of the **3rd Session of the 17th Legislature** of Puerto Rico:

AN ACT to create the "Puerto Rico Capital Reinvestment Act"; amend Sections 1034.10, 1082.01, and 1082.02 of Act No. 1-2011, as amended, known as the "Internal Revenue Code for a New Puerto Rico," in order to reform the tax treatment of Real Estate Investment Trusts and allow for the reorganization of businesses to free their capital so they may reinvest in certain types of economic activity; add the purchase of foreclosure property to make it rent-to-own property as an eligible activity for Real Estate Investment Trusts; delegate the responsibility of promoting Real Estate Investment Trusts to the Department of Economic Development and Commerce; and for other related purposes.

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

In San Juan, Puerto Rico, on this 14th day of February, 2014.

Juan Luis Martínez Martínez
Acting Director