



INTERNATIONAL FINANCIAL ENTITIES ACT OF PUERTO RICO

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Act Number 273 of September 25, 2012 (“Act 273”) provides tax incentives to international financial entities that set up operations in Puerto Rico (“PR”). Act 273 replaces, prospectively, the former International Banking Center Regulatory Act, Act Number 52 of 1989 (“Act 52”), with the objective of improving the conditions for conducting international financial transactions in PR, while simultaneously boosting the Island’s economy.

International financial entities (“IFEs”) are licensed by the PR Office of the Commissioner of Financial Institutions (“Commissioner” or “OCFI”), and authorized to conduct certain Act 273 specified financial transactions (“Eligible IFE Activities”). Once licensed, an IFE can request a grant of tax exemption (“Tax Grant”) from the PR Department of Economic Development and Commerce, which will enumerate and secure the following tax benefits provided by Act 273 as contractual rights (i.e., regardless of future changes in PR law) for a fifteen (15) year period:

(1) to the IFE:

- a fixed 4% PR income tax rate on the net income derived by the IFE from its Eligible IFE Activities; and
- full property and municipal license tax exemptions on such activities.

(2) to its shareholders:

- 6% income tax rate on distributions to PR resident shareholders of earnings and profits derived from the Eligible IFE Activities; and
- full PR income tax exemption on such distributions to non-PR resident shareholders.

The concept of IFEs was originally introduced in PR by Act 52. However, under Act 52, the entities were known as International Banking Entities (“IBE”) and received a different tax treatment than the one afforded to IFEs. IBEs, contrary to IFEs, were entitled to certain tax benefits by operation of law, which could be repealed or modified at any time by the PR legislature, inasmuch as there was no contractual protection pursuant to a grant in the nature of a contract between the Government of PR and the IBE.

The primary purpose of IFEs is to attract US and foreign investors to PR¹. Consequently, Act 273 authorizes them to engage in traditional banking and financial transactions, principally with non-residents of PR. Furthermore, the scope of Eligible IFE Activities encompasses a wider variety of transactions than those previously authorized to IBEs. An existing IBE can continue operating under Act 52, or it can voluntarily convert to an IFE, so that it may broaden its scope of Eligible IFE Activities transactions and obtain a Tax Grant under Act 273.

The following is a summary of the organization and licensing requirements, the Eligible IFE Activities and prohibited activities, and tax grant available under Act 273.

I. **Requirements for Organizing an IFE:** Any entity organized under the laws of PR, the United States, or any foreign country can request a license from the OCFI to be organized as an IFE.

a. **Personnel:** The IFE shall employ at least four (4) full-time employees in its offices in PR, unless a lesser amount is otherwise authorized by the Commissioner.

b. **Office Space:** An IFE must obtain acceptable office space in PR, where the IFE will conduct its business activities with its required personnel and will maintain the necessary records and documents.

c. **Capital:** The IFE must have authorized capital of at least \$5,000,000, and paid-in-capital of at least \$250,000. Such capital shall be fully paid before a license is issued, unless a lesser amount is authorized by OCFI. The IFE must also possess and maintain in PR \$300,000 in unencumbered assets or financial guarantees acceptable to OCFI, unless a lesser amount is otherwise authorized by the Commissioner.

II. **Request to Organize an IFE:** An entity that meets the above requirements for organization, can apply to the OCFI for authorization (“Permit”) to organize an IFE. The application procedure for such Permit entails:

a. **Completed Application:** Completion of the forms provided by OCFI for a permit to organize the IFE, including statements of personal history submitted by directors, managers and owners of a 10% or more interest in the IFE, and submission of the same to OCFI along with a non-refundable application fee of \$5,000.

b. **Investigation:** Investigation by the Commissioner of all data furnished in the application and other documentation and pertinent information submitted, such as the financial capacity and experience of the applicant and the character, integrity and experience in or knowledge of banking or international business of the applicant’s management. If such investigation costs exceed the \$5,000 deposit, they will have to be paid by the applicant before the Permit is issued.

c. **Department of State:** Once a Permit to organize the IFE has been granted by the Commissioner, the articles of incorporation, or any other written document which establishes the legal status of the entity, as well as a copy of the Permit, shall be filed with the Department of State of the Commonwealth of PR (the “Department of State”). The Department of State shall then issue, under its official seal, a certification indicating that the documents have been filed. Such certification must be submitted to the Commissioner.

III. **IFE License:** After the entity is organized, the Commissioner will issue or deny the IFE license, based upon his consideration of the following documents and evidence:

a. Certification from the Department of State that the appropriate documentation has been filed, after obtaining the Permit to organize the IFE;

b. Payment of the annual license fee of \$5,000 (check payable to the “PR Secretary of the Treasury”);

c. Certified copy of the articles of incorporation, or any other written document that establishes the legal status of the entity;

d. Copy of the bylaws or internal regulations adopted by the Board of Directors or governing body of the IFE or of the person of which such IFE will be a unit of, certified by the secretary or person who acts in a similar capacity, and authenticated by notary public;

e. Evidence that the capital of the IFE has been subscribed, issued, and paid, or assigned in the case of a unit, and that the IFE complies with the minimum requirement of unencumbered assets;

f. A statement or resolution authenticated by notary public in which the Board of Directors or governing body of the IFE, or of the person of which the IFE is a unit of, indicate that the IFE has complied with all terms and conditions of the Act 273 and its regulations and is ready to commence operations; and

g. A sworn statement signed by the chief executive officer of the IFE certifying that the IFE has adopted and implemented the necessary procedures to comply with the U.S. Bank Secrecy Act, the U.S. Patriot Act, and Office of Foreign Asset Control of the U.S. Department of the Treasury (“OFAC”), as applicable.

IV. **Tax Grant:** After an IFE license is issued, the IFE may submit a copy of the license to the Secretary of Economic Development and Commerce, who will issue a tax exemption grant after obtaining a favorable recommendation from the Secretary of Treasury.

a. **Term and Extensions:** The Tax Grant will have a duration term of 15 years, renewable for two additional 15-year terms (for a total of 45 years), depending on a favorable recommendation from the Secretary of Treasury. The extensions must be requested 6 to 24 months before the end of the

applicable 15-year term. The Tax Grant will become ineffective if the IFE license is revoked, suspended or not renewed. When a Tax Grant extension is requested, the IFE’s PR income tax rate may increase from 4% up to 10%, as determined by the Secretary of Treasury and the Secretary of Economic Development and Commerce.

b. **Contractual Nature:** The Tax Grant will constitute a contract with the PR Government, and is designed to ensure that the IFE receives the tax exemption until the Tax Grant expires, regardless of future changes in PR law.

V. **Eligible IFE Activities:** Pursuant to Act 273, IFEs are permitted to engage in the following activities:

(1) Accept deposits, including demand deposits, solely for commercial purposes and interbank deposits, or otherwise borrow money from other IFEs and from any non-resident of PR pursuant to regulations issued by the Commissioner;

(2) Accept properly collateralized deposits or otherwise borrow “duly secured money” from the PR Government Development Bank (“GDB”) and the PR Economic Development Bank (“EDB”);

(3) Make or place deposits in GDB, EDB, any IFE, or in any bank, including banks organized under the laws of PR, and branches in PR of banks that are foreign persons;

(4) Make, procure, place, guarantee, or service loans; provided that none of such loans may be granted to a domestic person², except as otherwise provided in Act 273, and provide financial guarantees for debt issuance transactions in PR;

(5) Issue, confirm, give notice, negotiate or refinance letters of credit, provided that the client and beneficiary requesting the letter of credit is not a domestic person; or issue, confirm, give notice, negotiate or refinance letters of credit for export financing transactions, even if the beneficiary is a domestic person;

(6) Discount, rediscount, deal or otherwise trade in money orders, bills of exchange, and similar instruments, provided that the drawer and the original debtor is not a domestic person;

(7) Invest in securities, stocks, notes, or bonds of the Government of PR that are exempt from taxes in PR;

(8) Carry out any banking transactions permitted by Act 273 in the currency of any country, or in gold or silver, and participate in foreign currency trade;

(9) Underwrite, distribute, and otherwise trade in securities, notes, debt instruments, drafts and bills of exchange issued by a foreign (i.e., non-PR) person for final purchase outside of PR;

(10) Engage in trade financing of import, export, barter, and exchange of raw materials and finished products activities with domestic persons, when the Commissioner has determined through regulations or order, that the international aspects of the underlying transaction override any involvement of the local financial and business community, and that such activities would be appropriate for the IFE; provided, that these transactions allowed by exception shall not enjoy the property and municipal license tax exemptions granted by Articles 21 and 22 of Act 273, or the preferential 4% income rate afforded by Article 6(a) of Act 273.

(11) Engage in any activity of a financial nature outside of PR which would be allowed to be done, directly or indirectly, by a bank holding company or by a foreign office or subsidiary of a U.S. bank under applicable U.S. law;

(12) After obtaining a special permit from the Commissioner, act as fiduciary, executor, administrator, registrar of stocks and bonds, property custodian, assignee, trustee, attorney-in-fact, agent or in any other fiduciary capacity; provided that such fiduciary service shall not be offered to, nor inure to the benefit of domestic persons;

(13) Acquire and lease personal property at the request of a lessee who is a foreign person, pursuant to a financial lease agreement which complies with the regulations of the Commissioner;

(14) Buy and sell securities outside PR, on the order of, or at its discretion, for foreign persons and provide investment advice in relation to such transactions or separate therefrom, to such persons;

(15) Act as a clearinghouse in relation to financial contracts or instruments of foreign persons, as authorized by regulations adopted by the Commissioner;

(16) Organize, manage, and provide management services to international financial entities such as investment companies and mutual funds, provided that the stock or participation in the capital of such companies is not distributed directly by an IFE to domestic persons;

(17) Engage in such other activities as are expressly authorized by the regulations or order of the Commissioner, or are incidental to the execution of the services authorized by Act 273 and the regulations of the Commissioner;

(18) Participate in the granting and/or guarantee of loans that originate and/or are guaranteed by GDB and EDB;

(19) With the Commissioner's prior approval, participate in the grant and/or guarantee of loans that originate and/or are guaranteed by any bank considered a domestic person, but without including transactions between any domestic bank and an affiliate entity. These transactions will be authorized only during the 5 years following approval of Act 273.

(20) With the Commissioner's prior approval, purchase substandard or non-performing loans from a PR bank, including foreclosure of collateral related to said loans and the sale of property that acted as collateral of said loans. The purchase of these loans will be authorized only during the 2 years following approval of Act 273.

(21) Finance, through loans or financing guarantees, projects in high priority areas for the Government of PR in cases designated as extraordinary by the Secretary of the Treasury and the Commissioner, (subject to regulations issued by the Commissioner and with prior approval from the Secretary of Treasury and the Commissioner);

(22) Establish, with the Commissioner's authorization, branches outside of PR, in the continental United States and its possessions or in other foreign countries. The Commissioner may authorize any IFE to establish a service unit or office within PR, in which specific transactions related to services provided by such IFE will be conducted, in a manner provided for by regulation, but such service unit or office will in no way constitute a branch of such IFE;

(23) With authorization from the Commissioner, provide to other IFEs or to other foreign persons outside of PR, those services of a financing nature, that are defined and generally accepted in the U.S. and PR

banking industry, and that are not enumerated in Act 273.

(24) Dedicate itself to provide the following services: (i) asset management; (ii) management of alternative investments; (iii) management of activities related to the investment of private capital; (iv) management of hedge funds and high-risk funds; (v) management of pools of capital; (vi) administration of trusts utilized for converting different types of assets into securities; and (vii) management of escrowed funds for foreign persons.

VI. Prohibited Activities: An IFE may not engage in the following activities:

(1) Accept deposits or borrow money from domestic persons, except from GDB, EDB, and other IFEs;

(2) Make, procure, place, secure or service any loan, unless all the loan proceeds would be used outside of PR, except in those instances described above, or as authorized by the Commissioner;

(3) Issue, confirm, or give notice of letters of credit, unless all the proceeds of the letter of credit would be used outside of PR, and both the issuer and the beneficiary must be foreign persons, except in export financing transactions for the benefit of a domestic person;

(4) Discount bills of exchange, unless all the proceeds of the bills of exchange would be used outside of PR, and both the drawer and the beneficiary must be foreign persons;

(5) Purchase or hold any of its own capital stock of or the interest in the capital of the person of which it is a unit, except when previously authorized by the Commissioner;

(6) Grant any kind of financing or credit to any of its directors, officers, employees or stockholders, except when previously authorized in writing by the Commissioner; and

(7) Directly or indirectly place, underwrite, insure or reinsure risk or objects that reside, are located or will be executed in PR, or participate in reciprocity or retrocession arrangements or agreements that cover or are related to such risks or objects, or assign insurance to, or assume reinsurance from any insurer authorized to be engaged or that is engaged in the insurance business in PR.

VII. Interaction of Act 273 and Act 22 benefits to individuals that established residence in PR after January 17, 2012:

As a further incentive to boost the Puerto Rican economy, Act 273 can interplay with the previously approved Act 22 of January 17, 2012 (“Act 22”) (see AMG Newsletter Article 2012-TAX-6, “Enhanced Tax Benefits for Individual Investors that Establish Residence in Puerto Rico After January 17, 2012”) so that dividends received by an Act 22 bona fide PR resident from Eligible EFI Activities would be fully exempt from PR income tax, and also from US income taxes to the extent it is PR source income pursuant to the source of income rules of the US Internal Revenue Code of 1986, as amended. Therefore, an individual that becomes a resident of PR under Act 22, and is a shareholder of a tax-exempt IFE, can benefit from full exemption from PR income taxes on distributions of earnings and profits derived from an IFE’s Eligible IFE Activities.

¹By exception, IFEs are also allowed to enter into transactions with the PR Government Development Bank, the PR Economic Development Bank, the PR Government, deposit funds in PR banks, participate in local loan syndications and purchase sub-standards or non-performing loan from PR entities.

²“Domestic Person” is an individual resident of PR, an entity incorporated or organized under PR law, any individual whose principal place of business is in PR, or (unless excluded by regulations) a non-PR entity with an office in PR that is deemed to be engaged in business in PR for purposes of the PR Internal Revenue Code.

If you need additional information or advice concerning IFEs, please contact Fernando Goyco-Covas at 787-281-1802, Nikos Buxeda at 787-281-1800 or Ricardo Muñiz at 787-281-1818.

The above summary is intended for information purposes only. It cannot be considered a legal opinion, and it does not intend to consider all the tax and legal considerations that could be relevant to any particular person or entity. It should also be noted that the changes discussed herein were recently enacted, and that the PR Treasury has not yet issued regulations, tax forms or interpretative announcements on such changes.

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