GOVERNMENT OF PUERTO RICO
DEPARTMENT OF ECONOMIC DEVELOPMENT AND COMMERCE

February 22, 2023

CIRCULAR LETTER NO. 2023 -002

ATTENTION: APPLICANTS, GRANTEES AND REPRESENTATIVES OF APPLICANTS AND GRANTEES UNDER ACT NO. 60-2019, AS AMENDED, KNOWN AS THE PUERTO RICO INCENTIVES CODE

SUBJECT: DEVELOPMENT OF DIGITAL ASSETS FROM BLOCKCHAIN TECHNOLOGY UNDER ACT NO. 60-2019, AS AMENDED, KNOWN AS THE PUERTO RICO INCENTIVES CODE

The Department of Economic Development and Commerce of Puerto Rico ("DDEC", for its Spanish acronym) is currently promoting the development of digital assets based on blockchain technologies as part of DDEC's efforts to position Puerto Rico as a competitive international technology hub and a key destination for business activities. Pursuant to Reorganization Plan No. 4 of June 22, 1994, as amended, DDEC is responsible for implementing and supervising the execution of Puerto Rico's public policy on economic development in the various entrepreneurial sectors of manufacture, commerce, tourism, services, and digital asset development through the export of services, among others. DDEC is also responsible for coordinating, supervising, regulating, and administering the promotion of the programs and incentives offered by Act No. 60-2019, as amended, also known as the "Puerto Rico Incentives Code" ("Incentives Code"). In view of the growth this industry is showing in Puerto Rico and around the world, the DDEC has received numerous inquiries regarding the scope of the blockchain-related activities and digital assets under the Incentives Code.

Considering the above, DDEC issues this Circular Letter with the purpose of clarifying the scope of the terms "blockchain technology", "digital assets based on blockchain technology" and "blockchain validation" under the Incentives Code, to their applicability under Sections 1020.02(a)(12), and 2031.01(a)(11) of the Incentives Code, in the context of businesses activities related to the generation or development of digital assets based on blockchain networks or technologies or other similar technologies, or investments in these types of digital assets.

I. BACKGROUND

For more than 60 years, Puerto Rico has built its economic landscape through its historic incentives program which has been made possible through the enactment of many incentives' acts conferring preferential tax treatment to businesses engaged in specific business activities. This process has required a dynamic ecosystem to maintain Puerto Rico's competitiveness with other jurisdictions at par, for which Puerto Rico has, at different times, adopted dynamic tax incentives as part of its efforts to effectively respond to the everchanging global business environment, without losing the competitive edge it has always offered as a preferred place for

investment and business. In line with this objective, the Incentives Code was enacted to combine different tax benefits that were dispersed through various tax incentives acts that had been enacted at the time, into one comprehensive incentives framework that would serve as a tool for addressing the upcoming opportunities and challenges.

Again, Puerto Rico has an opportunity to step up and take advantage of certain emerging industries in the technological sector by welcoming businesses engaged in blockchain development, blockchain validation, and related activities, including digital assets. By providing a framework that promotes the development of these technologies, Puerto Rico will become a pioneer in blockchain technology, promoting the socioeconomic development of the Island.

a. Blockchain Technologies & Digital Assets

A blockchain is a digital ledger of transactions that is duplicated and distributed across a network of computer systems. These transactions are grouped into lists called blocks and are securely linked using cryptography. The network participants use software to verify the integrity of the blocks and thus the transactions and associated data. This technology allows users to unequivocally verify that the record of transactions is both complete and unaltered.

A digital asset can be explained as anything that exists in binary data that is self-contained, uniquely identifiable, and has a value or usage. Therefore, with such technology, a person or entity can provide/support ownership, authenticity, transaction history, and location without third parties.

The Government of Puerto Rico wishes to collaborate in the development and expansion of blockchain technologies and digital assets in the Island, by providing guidance on the scope of the activities or assets that can enjoy the tax benefits provided under the Incentives Code in connection to the investment, development and/or export of such technology in and from Puerto Rico.

b. Eligible Export and Investment Activities

Chapter 3 -Export of Services and Goods- of Subtitle B of the Incentives Code, was adopted to include export activities as the cornerstone for the economic and sustainable development of Puerto Rico. Since its enactment, the public policy of the Government of Puerto Rico has been to foster an even more diversified and knowledge-driven economy to enhance and develop further business opportunities in Puerto Rico. During the more than 25 years in which the export services incentives have been available, many business opportunities have flourished, including, most recently, the production of digital assets based on blockchain networks or other similar technologies, or investments in these types of digital assets.

Likewise, in recognition of this industry at a global level, the Incentives Code considers digital assets based on blockchain technology, as eligible for the preferential capital gain treatment provided to resident investor individuals, under the Chapter 2 -Individuals- of Subtitle B of the Incentives Code.

Considering the high-paced development of blockchain technology in the global workplace, this presents an opportunity for economic development in Puerto Rico, for which we should define the scope of the terms "blockchain technology", "digital assets based on blockchain technology" and "blockchain validation", which shall be construed to be included as eligible activities or assets within the Incentives Code, subject to the conditions established to enjoy the tax benefits in each corresponding Subchapter, as applicable, and as explained in this Circular Letter.

Given the decentralized nature of blockchain, the DDEC recognizes that in many cases the direct beneficiary is the network in itself, with the indirect beneficiaries being the users of the network across the globe.

Many blockchain validation protocols are moving to a "proof of stake" model whereby blockchain Miners are replaced with Stakers to produce and validate blockchain records so people and companies can write software applications on decentralized, neutral databases. Stakers lock up a security guarantee denominated in the blockchain native token (i.e. ETH). This guarantee is held within the protocol and is used in order to ensure good behavior by the Stakers. Good behavior means, correctly processing blockchain transactions and obey the rules of the protocol. Correctly processing blockchain transactions requires correctly running validating software that processes transactions on the blockchain. Incorrectly processing blockchain transactions can result in penalties being applied to the staked blockchain native token. Successful validating earns a reward, not a return on investment.

When using "proof of stake" as a validation mechanism, rewards are calculated in frequent periods, which require high intensity accounting practices since the rewards or commissions will vary in their value depending on the FMV of the token received as a reward. While sometimes staking rewards are referred to in percentages (%), these rewards are not paid based on the value of the assets staked, but rather based on the quantity of software put to use in the network. In some cases tokens are committed to the network for a given period of time.

Providers of staking services need to be cognizant of these periods in order to elect to stake, unstake, or restake tokens. The activities performed to initiate the act of staking, as well as the labor of the persons conducting the staking activities are active in character and sourced to the location where the actions that initiate the activity are performed.

II. PRINCIPLES GOVERNING THE INTERPRETATION OF TAX INCENTIVES ACTS

It is a cardinal principle that tax-imposing laws in Puerto Rico will not be interpreted extensively, but they will be rather fairly interpreted, and according to their own and express terms. *Pepsi-Cola v. Mun. Cidra*, 186 D.P.R. 713 (2012); *IFCO Recycling v. Aut. Desperdicios Sólidos*, 184 D.P.R. 712 (2012); *Yiyi Motors v. E.L.A.*, 177 D.P.R.230, 250 (2009); *Café Rico v. Mun. De Mayagüez*, 155 D.P.R. 548, 559 (2001); *Talcott Inter-Amer. Corp. v. Registrar*, 104 D.P.R. 254, 262 (1975). Nonetheless, this strict interpretation rule must be harmonized with another rule that provides that tax laws should receive a reasonable interpretation that will render the legislator's purpose and

intention into effect. *Yiyi Motors v. E.L.A., supra*; Bernier y Cuevas Segarra, Aprobación e interpretación de las leyes en Puerto Rico, San Juan, Pubs. J.T.S., 1987, pág. 466.

In the context of the interpretation of tax incentives acts that grant exemptions, in *Orsini García v. Srio. de Hacienda*, 177 D.P.R. 596, 616 (2009), the Puerto Rico Supreme Court ("PRSC") expressed that "tax exemptions will not be interpreted restrictively if the legislative intention of granting them is clear and unequivocal, because doing so would defeat the purpose of the statute". See also *Pepsi-Cola v. Mun. Cidra, supra*; *Pfizer v. Mun. of Vega Baja*, supra; *Textile Dye Works, Inc.* and *General Processors, Inc. v. Secretary of the Treasury*, 95 D.P.R. 708, 713 (1963). In this context, tax incentives acts should not be construed like old tax exemptions that were privileges, and for which it was beneficial to the public interest to interpret them restrictively. Instead, they should be interpreted in a manner consistent with their creative purpose of encouraging industry and productive investment. *Textile Dye Works, Inc. y General Processors, Inc. v. Secretario de Hacienda*, *supra*. The courts have recognized that tax incentives grants are the essential instrument for promoting Puerto Rico's incentives program and economic development. *Pepsi-Cola v. Mun. Cidra, supra; Pfizer v. Mun. de Vega Baja, supra; Textile Dye Works, Inc. y General Processors, Inc. v. Secretario de Hacienda, supra.*

III. LEGAL BASIS

Among the different business activities eligible for tax benefits, Section 2031.01(a)(11) of the Incentives Code provides that, businesses engaged in the distribution in physical form, through the web, cloud-computing, or as part of a blockchain network, and the income generated from the licensing, program subscription or service charges, will be considered an eligible export service eligible for certain tax incentives under Chapter 3 of Subchapter B of the Incentives Code.

In terms of the preferential capital gain treatment provided to resident investor individuals under Chapter 2 of Subchapter B of the Incentives Code, Section 2022.02 considers the sale of "other assets," as eligible for such tax benefits, subject to the conditions established in such provision. "Other assets" is defined by Section 1020.02(a)(12) of the Incentives Code as merchandise (commodities), coins, and any other digital asset based on blockchain technology.

Understanding that the development of blockchain networks and digital assets from such or other networks provide many business opportunities for the continued economic development of Puerto Rico, the following shall be the scope of the terms "blockchain technology", "digital assets based on blockchain technology," and "blockchain validation" under the Incentive Code, including but not limited to Sections 1020.02(a)(12) and 2031.01(a)(11) of the Incentives Code, in the context of businesses activities related to the generation or development of digital assets based on blockchain network technologies or other similar technologies, or investments in such digital assets.

On the other hand, Section 2031.01(d) of the Incentives Code states that the DDEC may establish any other criteria, requirement, or condition for a service to be considered a service for export, taking into consideration the nature of the services rendered, the direct or indirect beneficiaries and any other factor that may be relevant to achieve the objectives of this Chapter.

As stated previously, given the decentralized nature of blockchain, the DDEC recognizes that in many cases the direct beneficiary is the network in itself, with the indirect beneficiaries being the users of the network across the globe.

IV. SCOPE OF DIGITAL ASSETS BASED ON BLOCKCHAIN TECHNOLOGIES OR OTHER SIMILAR TECHNOLOGIES

For purposes of this Circular Letter, and pursuant to Chapters 2 and 3 and Subtitle B of the Incentives Code, the following shall be the scope of the terms "blockchain technology," "digital assets based on blockchain technology," and "blockchain validation", in order to assist tax incentives applicants with understanding the context of the tax incentives under the Incentives Code for eligible activities related to blockchain technology networks or similar technologies, digital assets and investment in such assets or technology.

(a) *Blockchain Technology* – An electronic method for storing cryptographically secure data in a database or distributed ledger technology that is decentralized, consensus-based, mathematically verified, and distributed across multiple locations, including mining, staking and other similar activities. This term shall also include blockchain networks.

(b) Blockchain Validation - the activity undertaken by decentralized, distributed participants in order to come to consensus on the valid transactions and current state of a blockchain. This requires the deployment and ongoing maintenance of software, hardware and connectivity infrastructure implementing the specific "consensus mechanism" for a given blockchain protocol. Validators (also known as Miners on Proof of Work blockchains) receive compensation in the form of consensus rewards created directly by the blockchain protocol and transaction fees from users of the blockchain. Validation broadly comprises of two main activities:

i. Selecting and attesting as to the current, valid last block of the blockchain, thus agreeing to the contents of the preceding blocks and the contained transactions.
ii. Proposing new blocks comprised of valid transactions to be appended to the blockchain.

Common examples of consensus mechanisms used on blockchains, and thus by Validators, include Proof of Work and Proof of Stake.

1) *Proof of Stake (POS) consensus mechanism* – A blockchain validation software activity that requires Validators to lock (stake) digital assets as a good behavior guarantee. This is a prerequisite for the Validator to be able to process and validate transactions on the blockchain network. A proportion of this guarantee is irrevocably lost if a Validator does not correctly process transactions in line with the defined protocol rules whenever they are selected to do so and in a short time window. The process of block building carried out by Proof of Stake Validators can be further broken down into four specialist activities, each of which may be

carried out by separate entities including the following:

i. Searchers - Collect blockchain transactions from users and create bundles to be included as a part of a block, these bundles are then passed to specialist block builders
ii. Builders - Collect both transactions and bundles of transactions in order to construct a full block. These blocks are then passed to Relays which are connected to a large number of block proposers (Validators)
iii. Relays - Receive blocks from multiple builders and offer these blocks to the block Proposer
iv. Proposers - Keep track of the current status of the blockchain, validate the correctness of blocks proposed by other Validators and when randomly selected to propose a block, selects one offered by their chosen relays

A Validator is ultimately responsible for ensuring that the blocks they propose (whether from a relay or built themselves) are correctly formed and follow the latest version of the blockchain protocol. However all of the these different activities involve continuous research, deployment, and maintenance of software, hardware and accounting systems.

2) *Proof of Work (POW) consensus mechanism* – a blockchain validation software activity that secures and protects the blockchain on the basis of one's 'work,' or computational power, dedicated to the network.

i. *Mining* – means the competitive process that verifies and adds new transactions to the blockchain for a virtual currency that uses the POW method.

(c) *Covered Digital Instrument* – Shall mean a Digital Asset that has formally been declared to be an investment contract or a security under the Securities Act of 1933, as amended, by the SEC or by a federal court of the United States with competent jurisdiction in a case whose holding is final and unappealable.

(d) *Cryptocurrency* – means a digital or virtual currency in which transactions are verified and records maintained by a decentralized system using cryptography, rather than by a centralized authority.

(e) *Digital Asset* – means anything with the right to use that is stored digitally and is uniquely identifiable that organizations can use to realize value, including but not limited to virtual or digital currencies, cryptocurrency, stablecoins and digital tokens, covered digital instruments, and initial coin offerings (ICOs), including those generated from farming, mining, staking and other similar activities or technologies.

(f) *Federal Securities Acts* – means the Securities Act of 1933, as amended, the Securities Exchange Act of 1934, as amended, the Investment Advisers Act of 1940, as amended, the Investment https://www.msn.com/en-us/feed Company Act of 1940, as amended, the

Trust Indenture Act of 1939, as amended, and any other act adopted by the U.S. Congress regulating the issuance, transfer and market of securities in the United States.

(g) Stablecoin- any cryptocurrency designed to have a relatively stable price, typically through being pegged to a commodity or currency. This does not include cryptocurrencies that are pegged to another cryptocurrency as means to maintain stability.

(h) *Virtual Currency* – means a digital representation of value that is intended to be used as a medium of exchange, unit of account, or store of value, and is not legal tender, including digital currency. Virtual currency does not exist in a physical form, it is intangible and exists only on the blockchain or distributed ledger associated with a particular virtual currency. It does not include values received as part of rewards programs, values issued solely for use within an online game, a native digital token used in a proprietary blockchain service platform, or gift certificates.

The above terms shall apply for purposes of determining the type of eligible activity undertaken by the exempt business in Puerto Rico under Sections 2031.01(a)(11) of the Incentives Code, and the eligible digital asset under of the Section 1020.02(a)(12) of the Incentives Code. In order for the above activities or assets to qualify as eligible activities or assets under the corresponding provisions of the Incentives Code, the exempt business shall comply with the provisions contained in of Chapters 2 and 3 of Subchapter B of the Incentives Code and the Regulation, among others, as applicable.

V. DETERMINATION

Therefore, in accordance with the provisions of the Incentives Code and the public policy of the Government of Puerto Rico, the Secretary of the DDEC, in consultation with the Secretary of the PRDT, determines that it is in the best interest and for the social and economic wellbeing of Puerto Rico that "blockchain technology," "digital assets based on blockchain technology," "blockchain validation" are considered as part of the eligible activities undertaken by the exempt business in Puerto Rico under Section 2031.01(a)(11) of the Incentives Code, and the digital asset under Section 1020.02(a)(12) of the Incentives Code.

As for "proof of stake" to be performed at a commercially reasonable scale, it will require the setup of analysis and control systems as well as a robust accounting system. In addition, to be eligible users shall remain active throughout the staking process as there are constant matters to deal with to successfully and profitably operate staking as a business. Examples of tasks being performed by a person staking tokens is for one electing to stake tokens in each network. The provider will need to analyze and elect in which network they would prefer to stake tokens in exchange for rewards.

VI. EFFECTIVENESS

The provisions of this Circular Letter shall take effect immediately.

For more information regarding the provisions of this Circular Letter, please contact the DDEC at (787) 764-6363, or via email at Applications@ddec.pr.gov .

Iris E. Santos Díaz
Acting Secretary