

## Caribbean Tax Advantages

### *Puerto Rico Acts 20 and 22*

By Carlos G. Amador-Domenech

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Puerto Rico continues to gain visibility in economic headlines with news of a troublesome debt burden near \$70 billion and around \$40 billion in unfunded pension liabilities. In an ongoing effort to attract business, increase employment opportunities and generate revenue to meet its debt obligations, the island has legislated economic incentives for investors and businesses. In 2012, the Puerto Rican legislature passed Acts 20 and 22 to provide tax incentives for service-oriented businesses and wealthy investors. In spite of its recent economic challenges, Puerto Rico still offers modern infrastructure, low rent, highly educated human capital, ease of movement between the island and mainland U.S., excellent bilingual schools, and dollar currency. In this whitepaper, we explain Puerto Rico's often-misunderstood relationship with the United States, its current tax laws, and the specifics of Acts 20 and 22.

### **Puerto Rico and the United States**

The Commonwealth of Puerto Rico became an unincorporated territory of the United States under the terms of the Treaty of Paris. The treaty followed the end of the Spanish American War, when the United States defeated Spain and gained control of Cuba, Puerto Rico, parts of the Spanish West Indies, Guam and the Philippines. In 1917, the U.S. granted citizenship to the citizens of Puerto Rico through the Jones Act, which also created the Senate of Puerto Rico, established a bill of rights, authorized election of a resident commissioner in U.S. Congress and exempted Puerto Rican bonds from federal, state and local taxes regardless of where the bond holder resides. Puerto Rico residents are U.S. citizens but do not have the legal right to vote for the President of the United States. In addition, the Puerto Rican resident commissioner, an elected representative to the U.S. Congress, does not have

a vote in the legislative branch. The Commonwealth is governed by the Puerto Rico Constitution, which was enacted and ratified in 1952 after President Harry Truman signed Public Act 600 in 1950. Ultimate legal authority rests in the U.S. Constitution and Congress' ability to enact law concerning territories.

Puerto Rico is generally considered a foreign jurisdiction for federal income tax purposes. The government has often paired the advantages of this autonomous tax relationship with the U.S. with local tax and economic incentives to promote operations on the island and generate employment opportunities and economic activity. In addition, U.S. Internal Revenue Code Section 933 establishes that Puerto Rico source income for bona fide Puerto Rico residents is exempt from U.S. income taxes, which creates additional planning opportunities at the individual level.

### **Puerto Rico Tax Code**

Under the Puerto Rican Constitution, the island has its own tax code that applies to individuals of Puerto Rico and locally domiciled corporations (i.e., entities organized under the laws of the Commonwealth or engaged in a trade or business in Puerto Rico). In such cases, the code applies to worldwide income and its rates are similar to U.S. federal income taxes. Puerto Rico source income derived by non-Puerto Rico entities or non-resident individuals is also subject to income taxes under the code. The tax revenues go into the Puerto Rico Department of the Treasury and are used to fulfill budgetary mandates.

### **Tax Incentives: Acts 20 and 22**

There are two compelling tax incentives enacted in Puerto Rico that business owners, corporations and investors can leverage to develop tax minimization strategies and expand their bottom line. Act 20 of 2012 promotes the exportation of services through a low corporate income tax rate and exemptions on distributions. Act 22 of 2012 seeks to attract wealthy investors to the island by slashing tax rates on certain capital gains, dividends and interest income to 0% as further described below.

**Act 20** – The Law to Promote the Export of Services, better known as Act 20, was enacted into law in 2012 as a means to promote the creation of business operations in Puerto Rico and focuses on exporting services to jurisdictions outside of the island. Eligible services include:

- Research and development
- Advertising and public relations
- Economic consulting, environmental, technological, scientific, managerial, marketing, human resources, data and auditing
- Advice relating to any other matters relating to business
- Commercial arts and graphics services
- Production of construction drawings, engineering and architecture, and project management
- Professional services such as legal, tax and accounting
- Management centralized services that include, but are not limited to, services of strategic direction, planning and budgeting, which are carried by the central company (“headquarters”)

- Centers for electronic data processing
- Development of computer programs
- Voice and data telecommunication between persons located outside of Puerto Rico
- Call centers
- Shared services centers
- Storage and distribution centers for companies engaged in the business of product transportation belonging to a third party
- Educational and training services
- Hospital and laboratory services
- Investment banking and other financial services including, but not limited to:
  - Asset management
  - Management of alternative investments
  - Management of activities related to private equity investments
  - Management of covering funds or hedge funds

Investors and business owners who decide to relocate or establish operations in Puerto Rico and qualify for the 20-year tax exemption decree (with a possible 10-year extension) enjoy a 4% corporate income tax rate that is further reduced by 1% if more than 90% of all the gross income from the business entity is derived from the export of services and the services are considered strategic by the government of Puerto Rico. Furthermore, shareholders enjoy a 100% tax exemption on Puerto Rico income taxes on qualified distributions and dividends; a 60% exemption from municipal license taxes; and, in certain cases,

a temporary 90% exemption on property taxes.

**Act 22** – The Law to Encourage the Transfer of Investors to Puerto Rico, better known as Act 22, was enacted into law by the island’s government in 2012 to encourage investors to relocate and become residents of Puerto Rico. The Act, which extends until December 31, 2035, essentially eliminates income taxes on dividends and interest. A full exemption is granted on capital gains from the sale or exchange of securities with respect to the portion of the gain derived after becoming a Puerto Rico resident. However, there is a special 5% tax on capital gains accrued prior to becoming a bona fide Puerto Rico resident if these are realized after 10 years of relocation prior to January 1, 2036. To qualify, the new resident must not have been a resident of Puerto Rico in the last 15 years. Also, a grant of tax exemption must be requested by following the procedures established in Act 22.

### **Opportunities Under the U.S. Code**

As mentioned above, the U.S. code excludes from federal income taxation Puerto Rico source income derived by a bona fide Puerto Rico resident if certain conditions are complied with. To qualify as a bona fide Puerto Rico resident for purposes of Section 933 of the U.S. code, an investor must meet these three tests:

#### **1. Presence Test (any of the following):**

- a. The individual is present in Puerto Rico for at least 183 days during the taxable year.
- b. The individual is present in Puerto Rico for 549 days during the three-

year period that includes the current taxable year and the two preceding taxable years, as long as the individual is also present in Puerto Rico for a minimum of 60 days during each year of the three-year period.

c. The individual's presence in the U.S. does not exceed 90 days during the taxable year.

d. The individual generates no "earned income" from sources within the U.S. and is present in Puerto Rico for more days than in the U.S.

e. The individual has no significant connection to the U.S.

### **2. Tax Home Test:**

a. This test is met if the individual does not have his/her regular place of business outside of Puerto Rico at any time during the taxable year.

### **3. Closer Connection Test:**

a. This test is met if the individual has a closer connection with Puerto Rico than with the United States or foreign country. This is a facts-and-circumstances test.

The individual would need to file Form 8898, Statement for Individuals who Begin or End Bona Fide Residency in a U.S. Possession, to provide the IRS with the information requested above.

### **Planning Opportunities**

Acts 20 and 22 provide interesting and compelling planning opportunities for both investors and business owners. Broadly speaking, with Act 20 alone, a business owner can set up a corporate entity in Puerto Rico dedicated to the exportation of service – for example, a marketing and advertising or asset management business – and maintain

corporate profits within the company as earnings. The company would pay a Puerto Rico corporate income tax rate of 4% (which could be further reduced to 3% if the business is considered strategic). If the individual owner is also a bona fide resident of Puerto Rico, he or she may be able to receive distributions from the Act 20 business organized in Puerto Rico without imposition of federal income taxes or Puerto Rico income taxes. Regardless of the status of the individual owner, the distribution of earnings derived from the Act 20 activity would be exempt from Puerto Rico income taxes under the Act 20 grant. However, if the investor/business owner were not a bona fide Puerto Rico resident, then the distribution/dividend would be subject to federal income taxation once repatriated back to the U.S.

A Pennsylvania retiree couple, for example, considering a full or partial move to Florida, Arizona or Costa Rica, can add Puerto Rico to their list because of the attractive tax structures. If they choose to become bona fide residents of Puerto Rico, under Act 22 their portfolio will have a 0% Puerto Rico income tax rate on dividends, interest and capital gains derived from appreciation after the relocation (with a special 5% tax rate on gains related to appreciation prior to the relocation if realized after 10 years of relocating to the island). They will, however, be subject to federal income taxation on any non-Puerto Rico source income, including dividends and interest, at the then-applicable rates under the U.S. code (unless a separate exemption applies under the U.S. code).

Combining both Acts 20 and 22 with the bona fide Puerto Rico resident status under Section 933 of the U.S. code is the most powerful planning tool for business owners. This opportunity gained publicity and continues to be heavily searched on Google since speculation arose that John Paulson, the famous hedge fund manager, was considering moving to Puerto Rico. He has since denied any immediate plans to move. If he were to relocate to the island and become a bona fide resident, Paulson would eliminate taxation on certain capital gains, dividends and interest from the investments within the fund. The business, if incorporated in Puerto Rico, would be taxed at a 4% rate.

### **Tropical Financial Paradise**

Puerto Rico is a beautiful, tropical paradise that offers investors and business owners attractive tax incentives to relocate or establish businesses on the island. The Puerto Rico Industrial Development Company (PRIDCO), a government agency in charge of tax exemption decrees, helps identify cost-effective real estate from its vast holdings; offers human capital through its partnerships with local university systems; and provides information on navigating the process. In addition, The Foley Group has developed a network of tax attorneys, accountants and government agencies on the island to help you navigate the process and gain access to this unique tax-minimizing strategy.

### REFERENCES

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"Law to Promote the Export of Services: Law Num. 20-2012", 16th Legislative Assembly; 6th Ordinary Session. January 17, 2012.

"Law to Encourage the Transfer of Investors to Puerto Rico: Law Num. 22-2012", 16th legislative Assembly; 6th Ordinary Session. January 17, 2012.

I.R.C. § 933