



Daily Tax Report®

Source: Daily Tax Report: News Archive > 2012 > July > 07/17/2012 > BNA Insights > Puerto Rico Offers New Tax Incentives to Lure Business and Individual Investment

136 DTR J-1

U.S. Possessions

Puerto Rico enacted two statutes that provide dramatic new tax incentives for businesses and individual investors. In this report, Jeanelle Alemar-Escabi and Edgar Rios-Mendez discuss the nuances and details of both acts that essentially allow service industries relocating to the island to benefit from lower tax rates on income derived from customers outside Puerto Rico, while giving new residents a 100 percent exemption from taxes on interest and dividends, and on long-term capital gains accrued after the individual becomes a resident of Puerto Rico.

Puerto Rico Offers New Tax Incentives to Lure Business and Individual Investment



**By Jeanelle Alemar-Escabi
and Edgar Rios-Mendez**

Jeanelle Alemar-Escabi is an associate at Pietrantonio, Mendez & Alvarez LLC and can be reached at [REDACTED]. She specializes in federal and local taxation.

Edgar Rios-Mendez is a capital member at Pietrantonio, Mendez & Alvarez LLC, with practice areas in international, federal, and local taxation, energy, and investment companies.

Taxpayers are urged to consult their tax advisers regarding specific questions as to U.S. federal or Puerto Rico taxes or as to the consequences of doing business in Puerto Rico and the application of these laws to their particular circumstances. The content of this article has been prepared for educational purposes. Its intention is not, and it does not constitute, legal advice. It is recommended to everyone who reads this article to seek advice from his or her lawyer and/or financial adviser before carrying out any transaction described here.

This article was not written to be used, is not intended to be used and cannot be used by any taxpayer for purposes of avoiding United States federal income tax penalties that may be imposed. This material is written not to support the promotion or marketing of any transaction. We are providing the foregoing disclaimer to satisfy obligations we have under Circular 230, governing standards of practice before the Internal Revenue Service.

Puerto Rico as a Business Location

Puerto Rico, as an unincorporated territory of the United States, is subject to most federal laws of the United States, unless "locally inapplicable."

Investors considering Puerto Rico as their principal place of business may look to benefit from the use of the U.S. currency in Puerto Rico, from intellectual property protection under U.S. laws, and from access to federal funds for infrastructure, social programs, education, and research. Moreover, no U.S. passport is required for U.S. citizens, and the Puerto Rico banking system is regulated by the U.S.

Federal Deposit Insurance Corporation.

In the context of income tax laws, the U.S. Internal Revenue Code of 1986, as amended, does not include Puerto Rico entities in the definition of "United States" persons.¹ Therefore, Puerto Rico entities, as well as entities organized outside of the United States doing business in Puerto Rico, are not subject to U.S. income tax, unless they:

- are engaged in trade or business within the United States, in which case they would be taxed on the "effectively connected" income, including gain from the disposition of interests in U.S. real property²; or
- derive investment income from U.S. sources, which would be subject to withholding tax, with an exemption for "portfolio" interest.³

¹ I.R.C. Section 7701(a)(30).

² I.R.C. Sections 882(a) and 897.

³ I.R.C. Section 881(a).

Also, pursuant to I.R.C. Section 933, income derived from sources within Puerto Rico by individuals who are bona fide residents of Puerto Rico during the entire taxable year is not included in gross income and is exempt from U.S. taxation. The term bona fide resident of Puerto Rico means a person who:

- is present for at least 183 days during the taxable year in Puerto Rico;
- does not have a tax home outside of Puerto Rico during the taxable year; and
- does not have a closer connection to the United States or a foreign country than to Puerto Rico.⁴

⁴ I.R.C. Section 937.

Thus, despite Puerto Rico's legal status as a U.S. territory, entities organized outside of the United States operating in Puerto Rico and bona fide residents of Puerto Rico will generally not be subject to U.S. income tax on Puerto Rico source income. Therefore, the local tax treatment of the income derived from Puerto Rico sources may be the only relevant tax at issue for such persons.

Extending to a broad range of service industries, the Export Services Act provides reduced tax rates for income derived from customers outside of Puerto Rico.

Consequently, local Puerto Rico incentives lowering or eliminating Puerto Rico local taxes are of key importance when deciding whether to choose Puerto Rico as a place in which to do business and reside.

Main Incentives Laws in Puerto Rico

Puerto Rico already offers significant tax incentives and some tax credits for certain manufacturing industries, hotel and tourism-related operations, agricultural activities, the film industry, international banking operations, green energy projects, and certain hospital facilities. It also has various foreign trade zones that offer tax benefits to distribution centers and certain other types of businesses established in those areas.

In search of new and creative ways to incentivize the economic development of the island, the government of Puerto Rico Jan. 17 approved two new laws, one intended to promote export of services to foreign markets, the other to attract high net-worth individuals to become residents of Puerto Rico.

Under the first law, Act No. 20-2012, also known as the Act to Promote the Exportation of Services (the "Export Services Act"), Puerto Rico seeks to establish itself as an international center for the export of services by encouraging local service providers to expand their services to persons outside of Puerto Rico in aid of promoting the development of new businesses in Puerto Rico and stimulating the inbound transfer of service providers to Puerto Rico.

The second law, Act No. 22-2012, the Act to Promote the Relocation of Individual Investors to Puerto

Rico (the "Individual Investors Act"), is designed to encourage investors to become residents of Puerto Rico by providing an exemption from Puerto Rico income taxes on interest, dividends, and capital gains realized or deemed accrued after such individuals become bona fide residents of Puerto Rico. This relocation should result in new local investments in real estate, services, and consumer products, as well as capital injections to the Puerto Rico banking sector, all of which will accelerate the economy of Puerto Rico.

Export Services Act

The Export Services Act allows business enterprises, ranging from advertising to accounting and legal services, to benefit from special tax rates applicable to income derived from services rendered to customers from outside Puerto Rico. The act is based on the Economic Development Incentives Act of Puerto Rico (Act No. 73-2008), and applies with respect to any entity with a bona fide office or establishment located in Puerto Rico, which is engaged in an "eligible business," defined as a business providing "eligible services" that, in turn, are considered to constitute either "services for foreign markets" or "promoter services."⁵

⁵ Act 20-2012, article 3(f).

The term "eligible services" encompasses:

- research and development;
- advertising and public relations;
- economic, environmental, technological, scientific, management, marketing, human resources, information, and audit consulting;
- advisory services on matters relating to any trade or business;
- commercial arts and graphic services;
- the production of construction drawings, architectural and engineering services, and project management;
- professional services, such as legal, tax, and accounting services;
- corporate headquarters;
- electronic data processing centers;
- the development of computer programs;
- voice and data telecommunications between persons located outside of Puerto Rico;
- call centers;
- services provided by shared services centers ("shared services"), including but not limited to accounting, finance, taxes, auditing, marketing, engineering, quality control, human resources, communications, electronic data processing, and other centralized management services;
- storage and distributions centers ("hubs");
- educational and training services;
- hospital and laboratory services;
- investment banking and other financial services; and
- any other service that the government of Puerto Rico later determines should be treated as an eligible service.

Eligible services must also qualify as either "services for foreign markets" or "promoter services." Services for foreign markets are services performed for nonresident individuals or foreign entities that have no nexus with Puerto Rico. Services provided for a U.S., non-Puerto Rico client would qualify. In other words, the eligible service is not, and will not be, related to the conduct of a trade, business, or other activity in Puerto Rico.

For example, warehousing and distribution services for products manufactured outside of Puerto Rico and to be distributed to markets outside of Puerto Rico will be considered eligible services.

Service industries can benefit from income tax rates of 4 percent, a 100 percent exemption from tax for distributions from earnings and profits, and generous property tax exemptions.

Promoter services is a new concept introduced by the Export Services Act. Promoter services rendered to nonresident individuals and/or foreign entities for the purpose of establishing a new business in Puerto Rico, as defined by the Export Services Act, are to be considered eligible services, notwithstanding the fact that the services will have

a nexus with Puerto Rico.

In the case of promoter services, only the net income derived from eligible services (see list above) performed within the 12-month period ending on the day preceding the new business taking any of the following actions—(1) beginning to construct the facilities to be used in Puerto Rico; (2) commencing operations in Puerto Rico; or (3) executing a contract to acquire or lease facilities in Puerto Rico—will be considered export services income eligible for benefits under the Export Services Act.

To enjoy the benefits granted under the Export Services Act, the service provider must request and obtain a tax exemption decree on or before Dec. 31, 2020. Such a decree will have a term of 20 years, renewable for 10 additional years, provided certain conditions are satisfied. The tax exemption decree will constitute a contract with the Puerto Rico government not subject to subsequent legislative changes.

During the term of the decree, the service provider will enjoy:

- a 4 percent flat income tax rate on export services income;
- 100 percent tax exemption for distributions from earnings and profits derived from the export services income; and
- 90 percent exemption from property taxes (100 percent exemption during the first five years of operations, in the case of certain eligible services).

In the case of a business that is already providing eligible services when it applies for the benefits under the Export Services Act, only that portion of net income derived from eligible services that exceeds the average net income (limited to eligible service activity) generated by the business during the three taxable years preceding the date on which the tax exemption decree is requested will be considered export services income subject to the preferential tax rate. This rule intends to prevent existing taxable businesses from becoming tax-exempt under the Export Services Act without a corresponding increase in economic activity for Puerto Rico.

The Export Services Act also creates a special fund that will be partially funded by one-tenth of the collections made with respect to taxes paid by businesses that obtain a tax exemption decree. This special fund will provide grants for certain activities, such as training, education, and other related activities with respect to the establishment of new businesses in Puerto Rico.

Individual Investors Act

The tax benefits granted under the Individual Investors Act will be available until Dec. 31, 2035 (the "Tax Exemption Period"). During this period, interest and dividends that qualify as Puerto Rico source income received by a "resident individual investor" (i.e., an individual who has not been a resident of Puerto Rico for the past 15 years before his first year of residence in Puerto Rico) will be 100 percent tax exempt from Puerto Rico income taxes.

Since I.R.C. Section 933 also does not subject this interest and dividends to federal taxation, the income will be totally exempt.

Long-term capital gains derived by a resident individual investor during the Tax Exemption Period will be subject to preferential income tax rates. If such gains were deemed to have accrued before the

individual investor becomes a Puerto Rico resident and are recognized within 10 years after the date the investor established residence in Puerto Rico, the gains will be taxed at a 10 percent income tax rate. If such gains are recognized after the 10-year period, but prior to Jan. 1, 2036, a 5 percent income tax rate will apply.

Gains related to investment appreciation considered accrued after the investor becomes a Puerto Rico resident will be 100 percent exempted from Puerto Rico income taxes.

The 10-year rule is intended to work in conjunction with U.S. Treasury Regulations providing that gains from the disposition of certain property of former U.S. residents will be considered to be from sources outside of the U.S. possession and subject to U.S. taxation for the 10 years following the change in residency.⁶ Under the regulations, such former U.S. residents may elect to apportion to Puerto Rico any part of the long-term capital gains related to investment appreciation that accrued after becoming a Puerto Rico resident and, therefore, would entitle the investor to the I.R.C. Section 933 exclusion for such portion.

⁶ Any tax paid or accrued with respect to a Puerto Rico income tax on any gain deemed from sources outside of the U.S. possession may be credited against U.S. taxes payable on such gain, subject to the limitations prescribed in I.R.C. Sections 901 and 904, related to foreign tax credits.

After 10 years of being bona fide residents of Puerto Rico, such former U.S. residents would not be subject to federal income taxation on any portion of the gain accrued while they were resident in the United States and would only be subject to a 5 percent income tax rate in Puerto Rico. As stated before, any part of the long-term capital gains attributable to the period of Puerto Rico residence would qualify for zero percent U.S. federal income taxation and zero percent Puerto Rico income taxation, if recognized prior to Jan. 1, 2036.

Any long-term capital gains related to investment appreciation not described above will be taxed in accordance with the applicable provisions of the Puerto Rico Internal Revenue Code of 2011, as amended, under which long-term capital gains derived by Puerto Rico residents are currently subject to a 10 percent preferential income tax rate.

Business Opportunities

Under the Export Services Act and the Individual Investors Act,⁷ service providers looking to expand to foreign markets may significantly reduce their tax liability by establishing their business in Puerto Rico, since a Puerto Rico entity not engaged in U.S. trade or business will generally not be subject to U.S. federal taxation and will benefit from a reduced income tax rate in Puerto Rico, in addition to complete tax exemption on distributions and an exemption from Puerto Rico property taxes.

⁷ Proposed House Bill 3968, currently being considered by the Puerto Rico Legislature, intends to amend the Export Services Act to include an exemption from municipal license taxes and amend the Individuals Investors Act to extend the capital gains tax treatment to short term capital gains, among other amendments.

For example, service providers rendering investment and financial services for markets outside of Puerto Rico, such as asset management, management of investment alternatives, management of activities related to private capital investment, management of coverage funds or high-risk funds, management of pools of capital, trust management that serves to convert different groups of assets into securities, and escrow accounts management services, may relocate to Puerto Rico to provide such services from Puerto Rico and be subject to a 4 percent Puerto Rico income tax rate, instead of the current maximum 35 percent U.S. federal income tax rate applicable to corporations.

Also, employees and/or owners of an eligible business relocating to Puerto Rico and becoming bona fide residents of Puerto Rico may benefit from the provisions of the Individual Investors Act providing exemptions with respect to certain Puerto Rico source income.⁸

⁸ Also, new residents of Puerto Rico may benefit from Act-216-2011, Housing Impulse Benefits Act, which provides various exemptions to buyers of residential property in Puerto Rico, acquired on or before Dec. 31, 2012.

The Export Services Act and the Individual Investors Act have the promise of revitalizing the Puerto

Rico economy in promoting the service industry and attracting new capital to the island by providing attractive tax benefits.

Contact us at <http://www.bna.com/contact/index.html> or call 1-800-372-1033

ISSN 1522-8800

Copyright © 2012, The Bureau of National Affairs, Inc.. Reproduction or redistribution, in whole or in part, and in any form, without express written permission, is prohibited except as permitted by the BNA Copyright Policy. <http://www.bna.com/corp/index.html#V>