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Revenue

The government of Puerto Rico passed two pieces of legislation that provide dramatic new tax incentives for businesses and individual investors. In this article 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 all interest and dividends, and long term capital gains accrued after the individual becomes a resident of Puerto Rico.

Investment Destination: Puerto Rico New Tax Incentives to Lure Business and Individual Investment

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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.” Therefore, 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 (“I.R.C.”), does not

include Puerto Rico entities in the definition of “United States” persons.¹ Therefore, Puerto Rico entities, as well as other entities organized outside of the United States doing business in Puerto Rico, are not subject to U.S. income tax, unless they: (i) 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 property;² or (ii) derive investment income from U.S. sources, which would be subject to withholding tax, with an exemption for “portfolio” interest.³

Also, pursuant to I.R.C. §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: (1) is present for at least 183 days during the taxable year in Puerto Rico, (2) does not have a tax home outside of Puerto Rico during the taxable year; and (3) does not have a closer connection to the United States or a foreign country than to Puerto Rico.⁴

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 Pu-

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¹ I.R.C. §7701(a)(30).

² I.R.C. §§882(a) and 897.

³ I.R.C. §881(a).

⁴ I.R.C. §937.

erto 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. Consequently, local Puerto Rico incentives lowering or eliminating Puerto Rico local taxes are of key importance when deciding 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.

On January 17, 2012, in search of new and creative ways to incentivize the economic development of the island, the government of Puerto Rico approved two new laws, one intended to promote export 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 export services center. The Export Services Act is intended to encourage local service providers to expand their services to persons outside of Puerto Rico, promote the development of new businesses in Puerto Rico and stimulate 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

The term “eligible services” encompasses: (i) research and development; (ii) advertising and public relations; (iii) economic, environmental, technological, scientific, management, marketing, human resources, information and audit consulting; (iv) advisory services

on matters relating to any trade or business; (v) commercial arts and graphic services; (vi) the production of construction drawings, architectural and engineering services, and project management; (vii) professional services, such as legal, tax and accounting services; (viii) corporate headquarters; (ix) electronic data processing centers; (x) the development of computer programs; (xi) voice and data telecommunications between persons located outside of Puerto Rico; (xii) call centers; (xiii) 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; (xiv) storage and distributions centers (“hubs”); (xv) educational and training services; (xvi) hospital and laboratory services; (xvii) investment banking and other financial services; and (xviii) any other service that the government of Puerto Rico later determines should be treated as an eligible service.

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.

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. 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.

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 December 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: (i) a 4 percent

⁵ Act 20-2012, article 3(f).

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

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 the eligible services that exceeds the average net income generated by the business during the three taxable years preceding the date on which the tax exemption decree is requested will be considered export service 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 a 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 December 31, 2035 (the "Tax Exemption Period"). Pursuant to the I.R.C. §933 exclusion, 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) during the Tax Exemption Period will not be subject to federal income taxation and, under the Individual Investors Act, will enjoy a 100 percent tax exemption from Puerto Rico income taxes.

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 January 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.

This 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. §933 exclusion for such portion. 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 0 percent U.S. federal income taxation and 0 percent Puerto Rico income taxation, if recognized prior to January 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.

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 exemp-

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. §§901 and 904, related to foreign tax credits.

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 gain tax treatment to short term capital gains, among other amendments.

tions with respect to certain Puerto Rico source income.⁸

With the Export Services Act and the Individuals Investors Act, the government of Puerto Rico seems to be concentrating its efforts to revitalize the Puerto Rican economy in promoting the service industry and attracting new capital to the island by providing attractive tax benefits.

Taxpayers are urged to consult their tax advisers regarding specific questions as to U.S. federal or Puerto

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 December 31, 2012.

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/her lawyer and/or financial advisor before carrying out any transaction described here.

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