

#38: Puerto Rico Tax Incentives

Puerto Ricans are U.S. citizens but don't have the right to vote in federal elections and have no representation in Congress. Because they lack representation, Puerto Ricans pay no U.S. tax. Instead Puerto Rico has its own tax code for residents and companies operating there. This has enabled it to offer unique tax incentives, particularly Act 20 (Promotion of Export Services Act) and Act 22 (Act to Promote the Relocation of Individual Investors to Puerto Rico).

Act 20

Act 20 provides tax incentives for companies that establish export services that are rendered from Puerto Rico for the benefit of non-resident individuals or foreign entities. This export services income (EIS) is taxed at a 4% corporate rate. Moreover, dividends distributed out of EIS are 100% exempt from Puerto Rican tax. The Act also provides for a 60% exemption on municipal taxes and certain businesses receive a 100% exemption on property tax for the first five years and a 90% exemption thereafter. The business owner and employees must receive a reasonable salary based on the services provided, however, which is taxed at ordinary Puerto Rican income tax rates (as high as 33%).

Example 1. T owns a Puerto Rican export company that makes \$300,000/year. T receives a reasonable salary of \$100,000 and pays the full Puerto Rican personal income tax on this amount. The remaining \$200,000 of income is taxed at a 4% rate and the rest can be taken out of the company as a dividend that is 100% exempt from tax.

Eligible business types include:

1. Research and development
2. Advertising and public relations
3. Consulting services, including, but not limited to, economic, scientific, environmental, technological, managerial, marketing, human resources, computer, and auditing consulting services
4. Advice services on matters related to any trade or business
5. Creative industries
6. Production of blueprints, engineering, and architectural services, and project management
7. Professional services such as legal, tax, and accounting services
8. Centralized managerial services, including, but not limited to, strategic direction, planning, and budgeting, provided by regional headquarters or a company engaged in the business of providing such services
9. Electronic data processing centers
10. Development of licensable computer software
11. Telecommunications voice and data between persons located outside of Puerto Rico
12. Call centers
13. Shared service centers
14. Storage and distribution centers

15. Educational and training services
16. Hospital and laboratory services, including telemedicine facilities and medical tourism services
17. Investment banking and other financial services, including, but not limited to, 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 account management services
18. Commercial and mercantile distribution of products manufactured in Puerto Rico for jurisdictions outside Puerto Rico
19. Assembly, bottling, and packaging operations of products for export
20. Trading companies

Requirements

To qualify for the tax benefits, taxpayers must meet the following requirements:

1. The operation of the business must be in Puerto Rico. This means that the work output or value created must be accomplished in Puerto Rico.
2. The work must be performed for clients outside Puerto Rico. The following services will be considered to have Puerto Rican clients and won't be eligible services:
 - (a) Business or income-producing activities that are or have been performed in Puerto Rico by the applying business
 - (b) The sale of any property for the use, consumption, or disposition in Puerto Rico
 - (c) Counseling on the laws, regulations, and administrative determinations of the government of Puerto Rico and its instrumentalities
 - (d) Lobbying on the laws, regulations, and administrative determinations of the government of Puerto Rico and its instrumentalities
 - (e) Any other activity designated by the Secretary of the Department of Economic Development and Commerce of Puerto Rico
3. The business must submit an application with the Office of Industrial Tax Exemption (OITE) of Puerto Rico to obtain a tax exemption decree.
4. Prior to July 11, 2017, businesses were required to hire at least five Puerto Ricans to work in the business. Changes to the law on that date generally removed this requirement. However, there may be minimum employment requirements for a very limited number of businesses under regulations that have yet to be drafted (probably for call centers and telemedicine). It is anticipated that there will be no employment requirements for service and tech businesses.
5. To take advantage of the tax benefits, the taxpayer must become a resident of Puerto Rico. U.S. citizens are generally taxed on all income from whatever source derived. However, IRC § 933 provides an exception. Bona fide residents of Puerto Rico can exclude all Puerto Rico source income from U.S. income taxation, assuming that they aren't federal employees. Note that a resident of Puerto Rico is still subject to U.S. tax on income from sources outside of Puerto Rico.

Act 22

This Act gives new Puerto Rico residents the following benefits for income accrued after moving to Puerto Rico:

1. 100% tax exemption from Puerto Rico income taxes on all dividends
2. 100% tax exemption from Puerto Rico income taxes on all interest
3. 100% tax exemption from Puerto Rico income taxes on all short-term and long-term capital gains

To be a resident of Puerto Rico and qualify for the tax benefits, a taxpayer must satisfy three tests:

1. **Presence test:** The individual must generally be present in Puerto Rico for at least 183 days during the taxable year.
2. **Tax home test:** The individual doesn't have a tax home outside of Puerto Rico during the taxable year.
3. **Closer connection test:** The individual doesn't have a closer connection to the United States or a foreign country than to Puerto Rico.

Pre-Move Gains

Capital gains accrued before the individual established residency in Puerto Rico are subject to preferential Puerto Rican income tax rates. If gain is recognized within 10 years after moving to Puerto Rico, it is taxed only at the U.S. federal income tax rate for capital gains. If gain is recognized more than 10 years after establishing residency in Puerto Rico, it will be taxed at a flat Puerto Rico tax of 5%, and there will be no U.S. capital gains tax.

Example 2 (sale within 10 years). T, a U.S. resident acquires stock in 2011 for \$100. The stock is worth \$200 when T moves to Puerto Rico in 2015. The stock is sold by the now Puerto Rican resident in 2024 for \$300. T has \$100 of U.S. income and pays tax of \$23.80 on \$100 of long-term capital gain (.238 x \$100). The second \$100 of gain is Puerto Rico gain subject to a 0% tax rate. Thus, the total tax paid on the \$200 of gain is \$23.80.

Example 3 (sale after 10 years). Assume the same facts as in Example 2 except that the stock is sold in 2026 (more than ten years after T moved to Puerto Rico). T pays tax on the \$100 of pre-Puerto Rico gain at the special 5% Puerto Rico rate (\$5). T pays no tax on the gain that accrued after T moved to Puerto Rico. Thus, the total tax paid on the \$200 of gain is \$5.

Bottom Line

A U.S. citizen might wish to consider the benefits of Acts 20 and 22 if (1) the taxpayer is willing to become a bona fide resident of Puerto Rico, and (2) the amount of income the individual can generate from sources within Puerto Rico is enough to justify the move.

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