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New Tax Incentives Legislations in Puerto Rico

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I. Overview

On January 17, 2012, the Legislative Assembly of Puerto Rico approved new legislation to promote the economic development of Puerto Rico: (i) Act No. 22, also known as the Act to Promote the Relocation of Individual Investors to Puerto Rico (the “Individual Investors Act”) and (ii) Act No. 20, also known as the Act to Promote the Exportation of Services (the “Export Services Act”).

The Individual Investors Act seeks to attract new residents to Puerto Rico by providing a total exemption from Puerto Rico income taxes on all passive income realized or accrued after such individuals become bona fide residents of Puerto Rico. This relocation should result in new local investments in real estate, services and other consumption products, and in capital injections to the Puerto Rico banking sector, all of which will accelerate the economy of Puerto Rico.

The purpose of the Export Services Act is to establish and develop in Puerto Rico an international export services center. This act seeks 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 foreign service providers to Puerto Rico. The act also creates a special fund for the continuous development of new tax incentives that will promote export

services and the establishment of new businesses in Puerto Rico.

II. Individual Investors Act

A. Applicability

The Individual Investors Act applies to any individual investor that becomes a *Puerto Rico resident* on or before the taxable year ending on December 31, 2035 (hereinafter referred to as “Resident Individual Investor”), provided that such individual was not a resident of Puerto Rico at any time during the 15-year period preceding the effective date of the Individual Investors Act.

A *Puerto Rico resident* is an individual who is domiciled in Puerto Rico. Physical presence in Puerto Rico for a period of 183 days during the taxable year will create a presumption of residence in Puerto Rico for tax purposes.

B. Special Tax Rule under the US Code for Puerto Rico Bona Fide Residents

Pursuant to Section 933 of the Internal Revenue Code of the United States of 1986 (the “US Code”), income derived from **sources** within Puerto Rico by individuals who are a *bona fide residents of Puerto Rico* during the entire taxable year is not included in gross income and is exempt from taxation under the US Code. (the “Section 933 Exclusion”).

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.

C. Tax Exemption on Interest and Dividend Income

Under the Individual Investors Act, Resident Individual Investors will enjoy a 100% tax exemption **from Puerto Rico income taxes** on interest and dividend income derived during the Tax Exemption Period (as defined below).

Pursuant to the Section 933 Exclusion, interests and dividends received by Resident Individual Investors that qualify as **Puerto Rico source income** will not be subject to federal income taxation under the US Code.

Resident Individual Investors may be able to reduce the tax rate applied on interest and dividend income coming from sources **outside of Puerto Rico** (including the source country taxation) to 0% or 10%, respectively, by investing through certain Puerto Rico investment vehicles.

D. Tax Exemption on Capital Gains

Long-term capital gains (“**LTCG**”) derived by Resident Individual Investors for investment appreciation accruing after becoming a Puerto Rico resident will be 100% exempted from Puerto Rico income taxes, if such gain is recognized prior to January 1, 2036.

On the other hand, LTCG derived by Resident Individual Investors will be subject to preferential income tax rates in certain circumstances, as follows:

- 1) LTCG for investment appreciation that accrued prior to becoming a

Puerto Rico resident (the “**Non-PR Gain**”) will be taxed at: (i) 10%, if such gain is recognized within 10 years after the date residence is established in Puerto Rico and prior to January 1, 2036, and (ii) 5%, if such gain is recognized after said 10-year period but prior to January 1, 2036.

- 2) A similar rule applies under the US Code with respect to *United States Investors*, regardless of the Section 933 Exclusion, since any Non-PR Gain recognized within said 10-year period by investors formerly subject to the United States taxing jurisdiction (the “**United States Investor**”) will be taxed in accordance to the applicable provisions of the US Code. The *United States Investor* may elect to apportion to Puerto Rico any part of the LTCG related to investment appreciation that accrued after becoming a Puerto Rico resident and, therefore, be entitled to the Section 933 Exclusion for such portion.
- 3) The United State Investor qualifying as a Resident Individual Investor which recognizes a Non-PR Gain after 10 years of becoming a *bona fide* Puerto Rico resident would not be subject to federal income taxation on any portion of the Non-PR Gain and to a 5% tax in Puerto Rico. As stated before, any part of a LTCG attributable to the period of Puerto Rico residence would qualify for 0% United States federal income taxation and 0% Puerto Rico income taxation, if recognized prior to January 1, 2036.

Any LTCG for investment appreciation not described above will be taxed in accordance with the applicable provisions of the Puerto

Rico Internal Revenue Code of 2011, under which LTCG derived by Puerto Rico residents is subject to a 10% preferential income tax rate.

In light of the above, Resident Individual Investors may be able to reduce the tax rate applied on LTCG in their former domicile to 0%, 5% or a maximum 10%.

E. Tax Exemption Period

The tax exemption granted under the Individuals Investors Act will expire on December 31, 2035 (the "Tax Exemption Period").

III. Export Services Act

A. Applicability

The Export Services Act applies with respect to any entity with a *bona fide* office or establishment located in Puerto Rico that is or may be engaged in an eligible service (the "Eligible Business").

The term eligible service includes: (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) production of construction drawings, architectural and engineering services and project management; (vii) professional services such as legal, tax and accounting; (viii) corporate headquarters; (ix) electronic data processing centers; (x) development of computer programs; (xi) voice and data telecommunications between persons located outside of Puerto Rico; (xii) call centers; (xiii) 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 that must be treated as an eligible service (collectively, the "Eligible Service").

An Eligible Service must also qualify as either a *service for exportation* or a *promoter service*. *Services for exportation* are services performed for non-resident individuals and/or foreign entities that have no nexus with Puerto Rico (that is the Eligible Service is not, and will not be, related to the conduct of a trade, business or other activity in Puerto Rico).

Promoter services are services rendered to non-residents individuals and/or foreign entities related to the establishment of a new business in Puerto Rico, as defined by the Export Services Act.

B. Tax Exemption Decree

To enjoy the benefits granted under the Export Services Act the services provider must request and obtain a tax exemption decree under said act (the "Tax Exemption Decree"). Such decree will have 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.

C. Tax Incentives

Service providers operating under a Tax Exemption Decree will enjoy the following tax incentives during the term of such decree:

- 1) 4% flat income tax rate on Export Services Income (as defined below).

This rate may be reduced to 3% when more than 90% of the Eligible Business's gross income is derived from export services and such services are considered strategic services, according to the criteria established in the Export Services Act.

- 2) 100% tax-exempt distributions from earnings and profits derived from the Export Services Income.
- 3) 100% exemption from property taxes during the first five years of operations in the case of eligible services described in items (viii), (xii) and (xiii) of Section III.A above. After said 5-year period, a 90% exemption will apply during the term remaining under the Tax Exemption Decree.

D. Export Services Income

The term Export Services Income means net income derived by an Eligible Business subject to the following:

- 1) In the case of **new Puerto Rico businesses**, all net income derived from an Eligible Service.
- 2) In the case of **existing Puerto Rico businesses**, only that portion of net income derived from an Eligible Service that exceeds the average net income generated by such business during the three taxable years preceding the date a request for a Tax Exemption Decree is filed by such business.
- 3) In the case of **service promoters**, only the net income derived from Eligible Services performed within the 12-month period ending on the day preceding the day the new

business takes any of the following actions:

- a. Begins construction of the facilities to be used in Puerto Rico;
- b. Commences operations in Puerto Rico; or
- c. Executes a contract to acquire or lease facilities in Puerto Rico.