Investment Destination: Puerto Rico

Edgar Ríos-Méndez
Jeanelle Aleman-Escabi
U.S. Taxes in Puerto Rico - Individuals

- Bona fide Residents of Puerto Rico (U.S. citizens or not) are subject to U.S. federal income taxes on a worldwide basis, pursuant to IRC Regs. 1.1-1(b).
- Section 933 of U.S. Code, however, excludes from US taxation all income derived from Puerto Rico sources by a “bona fide” resident of Puerto Rico.
- A bona fide resident of Puerto Rico is one that meets the physical presence, tax home and closer connection tests prescribed in the IRC Regs. 1.937-1.
- Generally the relevant sourcing rules are:
  - Service income – sourced based on the place where the services are rendered;
  - Capital gains – based on residence of seller;
  - SWAPS – based on residence of recipient of income;
  - Dividends – based on residence of payor; and
  - Interest – based on residence of payor.
U.S. Taxes in Puerto Rico - Entities

- U.S. Internal Revenue Code of 1986, as amended ("U.S. Code"), excludes Puerto Rico from the definition of "United States".
- Therefore, Puerto Rico entities, like other entities organized outside of the U.S. are not taxed in the U.S., unless:
  - engaged in a U.S. trade or business (actually or constructively), in which case they are taxed on income from U.S. sources which is effectively connected to their U.S. trade or business; or
  - derive investment income from U.S. sources.
Entities organized outside of the U.S. operating in Puerto Rico and bona fide residents of Puerto Rico may legally avoid paying U.S. income taxes despite Puerto Rico’s legal status as a U.S. territory.

Consequently, the local tax treatment of the income derived from Puerto Rico sources may be the only relevant tax consequences to these persons.

Local Puerto Rico tax incentives lowering or eliminating PR local taxes are of key importance when deciding to choose PR as a place to reside and do business.
Puerto Rico Taxes - Individuals

- Income Taxes – maximum rate 33%
- Alternative Minimum Tax – 24%
- Sales and Use Tax – 7%
- Property Taxes:
  - Real Estate – varies by municipality- approximately 10% based on 1957 values.
  - Estate and Gift Taxes – 10% on non-Puerto Rico property and tax credit for estate taxes paid to U.S.
Puerto Rico Taxes – Individuals (cont.)

- **Estate Taxes**
  - The gross estate of individuals residing in Puerto Rico at the time of their death is composed of all property regardless of its location. Nonetheless, US citizens need only to include property located in Puerto Rico at the time of their death in the Puerto Rico estate tax return.
  - The gross estate will be reduced by various deductions and credits permitted by the PR Code in arriving at the taxable estate upon which the estate tax will be computed. The PR Code imposes a 10% flat rate for purposes of the estate tax.

- **Gift Taxes**
  - Generally, a gift tax is applicable to all transfers of property made by Puerto Rico resident individuals. The PR IRC imposes a 10% flat rate for purposes of the gift tax.
Puerto Rico Taxes - Entities

- Income Taxes – maximum rate 39%
- Alternative Minimum Tax – 30%
- Sales and Use Tax – 7%
- Municipal License Taxes – 0.5% on gross income for non-financial businesses.

Property Taxes:
- Real Estate – varies by municipality - approximately 10% based on 1957 values.
- Personal Property – varies by municipality – approximately 8%.
Certain Puerto Rico Incentives Laws

- Act 20-2012 - Export Services; and
- Act 22-2012 - Resident Individual Investors.
Act 20-2012 Export Services

- Benefits provided under a 20 year decree;
- 4% income tax rate;
- 100% exempt distributions;
- 60% exemption from municipal license taxes (90% if located in development zones of Vieques or Culebra); and
- 90% Exemption from Real and Personal Property Taxes.

- Tax benefits available to “eligible businesses”, defined as entities which provide (i) “eligible services”, (ii) for foreign markets (no nexus with Puerto Rico) or promotion services.
Act 20-2012 Export Services (cont.)

- “Eligible services”:
  - Research and Development;
  - Advertising and Public Relations;
  - Economic, environmental, technological, scientific, managerial, marketing, human resources, information systems, engineering, auditing and consulting services;
  - Consulting services for any trade or business;
  - Commercial art and graphic services;
  - Production of engineering and architectural plans and designs, and related services;
  - Professional services as legal, tax and accounting services;
  - Centralized managerial services, including, but not limited to, strategic direction, planning and budgeting, that are performed by a headquarters company or regional headquarters that is engaged in the business of providing such services.
Act 20-2012 Export Services (cont.)

- “Eligible services”:
  - Services performed by electronic data processing centers;
  - Development of licensable computer software;
  - Telecommunications voice and data between persons located outside of Puerto Rico;
  - Call centers;
  - Shared service centers;
  - Medical and hospital services, including reference laboratories services;
  - 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 accounts management services.
Act 20-2012 Export Services (cont.)

- “No Nexus with Puerto Rico”:
  - The eligible service provided must not be related to the conduct of a trade, business or other activity in Puerto Rico.
Case Study - Export Services
Incentives for local companies

- Company A currently does business exclusively in Puerto Rico.
- Company A may expand its business locally or export to the Caribbean Basin.
- **What is the right move?**
Act 20 benefits at work:

### Puerto Rico Growth

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in PR Income</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>PR Corporate Taxes (39%)</td>
<td>-$ 390,000</td>
</tr>
<tr>
<td>Revenue After Corp. Taxes</td>
<td>$ 610,000</td>
</tr>
</tbody>
</table>

### Caribbean Basin Expansion

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Net CB Income</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>PR Tax Exports (4%)</td>
<td>-$ 40,000</td>
</tr>
<tr>
<td>Net CB Distribution</td>
<td>$ 960,000</td>
</tr>
</tbody>
</table>

**Tax Benefit of $411,000 per each $1,000,000 of additional net income**
Act 22-2012 - Individual Resident Investors

- Benefits provided under a decree:
  - 100% income tax exemption (including alternative minimum tax) on interest and dividends received.
  - 100% exemption for capital gain accrued after becoming a resident of PR and realized before January 1st, 2036.
  - 10% tax on capital gain accrued before PR residency and realized within 10 years of becoming a PR resident (5% after 10 years, but before January 1st, 2036 on gain accrued before becoming a PR resident).

- Individual Resident Investor (IRI) - individual investor that becomes a Puerto Rico resident on or before the taxable year ending on December 31st, 2035 and has not been a resident of Puerto Rico for the past 15 years preceding the effective date of Act 22 (January 16th, 1997 to January 16th, 2012)

- Sunset: December 31, 2035.
Case Study - Relocation of Individual Investor

- Joe is considering moving to a lower tax jurisdiction. A significant percentage of his income comes from fixed income securities.
- PR Mutual Fund may prove to be an attractive investment tool for Joe:
  - Invests 80% of its assets in US fixed income securities; and
  - 20% in local taxable PR.
- What is the right move?
### Act 22 - Tax incentives at work:

<table>
<thead>
<tr>
<th><strong>US Residency</strong></th>
<th><strong>PR Residency</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>US Resident</strong></td>
<td><strong>PR Resident</strong></td>
</tr>
<tr>
<td>Interest from Taxable US Fixed Income &amp; Investments made by PR Fund</td>
<td>Interest from US fixed income and Investments made by PR Fund</td>
</tr>
<tr>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th><strong>USA Income Taxes (39.6%)*:</strong></th>
<th><strong>USA &amp; PR Income Taxes on distributions (0%):</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Compensation after Taxes:</strong></td>
<td>$604,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

*396,000 Tax Benefit for Individual Investor*

* The 39.6% is the maximum rate applicable, assuming the taxpayer has other income and it is subject to such maximum rate. A **net investment income tax of 3.8%** on the lower of modified adjusted gross income or net investment income may be applicable. Institutional Investors will be subject to a **5.85% income tax** after the dividend deduction.
Edgar Ríos-Méndez  
Member

Mr. Ríos-Méndez is one of PMA’s tax partners and his practice focuses on international tax matters, inbound and outbound corporate reorganizations, registered investment companies, structured investment vehicles and other complex federal, international and Puerto Rico tax law matters. Mr. Ríos-Méndez has been active in some of the major Puerto Rico tourism related projects with respect to the negotiation of tax incentive grants and the sale of tourism investment tax credits. In the Puerto Rico industrial tax incentive area, Mr. Ríos-Méndez has assisted clients in the industrial and service sectors and in recent times has actively participated in the negotiation of tax incentives for clients in the financial services industry. He has requested private letter rulings and negotiated closing agreements with the Puerto Rico Treasury Department for the Firm’s clients. Mr. Ríos-Méndez has acted as tax counsel in the structuring of financing transactions with borrowers located in Puerto Rico, the Baltic region, Eastern Europe and Asia.

Education:
- New York University School of Law, New York, NY 1999 L.L.M. in Taxation
- University of Puerto Rico School of Law, San Juan, PR 1997 J.D. Magna Cum Laude
- Xavier University, Cincinnati, OH 1993 B.A. Cum Laude

Bar Admissions:
- Commonwealth of Puerto Rico, 1998
- U.S. Court of Appeals for the First Circuit, 1998
- U.S. Tax Court, 2002
Jeanelle Alemar-Escabí  
Limited Member

Ms. Alemar-Escabí joined PMA in 2006, and is a limited member of the tax practice group. Before joining the Firm, Jeanelle served as tax advisor for the Secretary of the Puerto Rico Treasury Department from 2001 to 2004. Jeanelle’s practice includes advising clients on federal and state income tax issues, corporate taxation, and the design and implementation of corporate reorganizations. Also, she advises clients as to local taxation issues such as property, municipal license, excise, and sales and use taxes. She has experience negotiating tax exemption grants and tax credits under the Puerto Rico Tax Incentives Act and the Puerto Rico Tourism Development Act. In addition, Jeanelle has participated in the design, execution and amendment of tax qualified and non-qualified benefits plans, and has assisted clients in complying with the filing requirements established by the Puerto Rico and Federal governmental agencies. Jeanelle is also a Certified Public Accountant and a Notary Public.

Education:

• Georgetown University Law Center, Washington, DC 2008 L.L.M. Taxation

• University of Puerto Rico Law School, San Juan, PR 2006 J.D.

• University of Puerto Rico Mayaguez Campus, Mayaguez, PR, 2001 B.S.B.A., Accounting and Finance Honors: Magna Cum Laude

Bar Admissions:

• Commonwealth of Puerto Rico, 2007

Publications:


This presentation is protected under the copyright laws of the United States and is the property of Pietrantoni Méndez & Álvarez LLC. It may not be reproduced or otherwise distributed without the express consent of Pietrantoni Méndez & Álvarez LLC.

The content of this presentation 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 presentation to seek advice from his/her lawyer and/or financial advisor before carrying out any transaction described here.

Circular 230: This presentation 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 IRS.