

Act 20

Export Services › Puerto Rico Tax Incentives

On January 17, 2012 Puerto Rico, enacted **Act No. 20 of 2012**, as amended, known as the “**Export Services Act**” (the “Act”), to offer the necessary elements for the creation of a World Class International Service Center. The Act provides tax exemptions and tax credits to businesses engaged in eligible activities in Puerto Rico. To avail from such benefits, a business needs to become an exempt business by applying for a tax concession and obtaining a tax exemption decree.

Eligibility

The Act provides benefits for services provided from Puerto Rico to outside markets. Eligible activities to receive benefits under the Act are services in the following areas:

- Research and development;
- Advertising and public relations;
- Economic, scientific, environmental, technological, managerial, marketing, human resources, engineering, information systems, 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 such as legal, tax and accounting services;
- Centralized managerial services, including, but not limited to, strategic direction, planning and budgeting, provided by regional headquarters or a headquarters company engaged in the business of providing such services;
- Services performed by electronic data processing centers;
- Development of licensee computer software;
- Telecommunications voice and data between persons located outside of Puerto Rico;
- Call centers;
- Shared service centers;

- Medical, hospital and 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; and
- Any other service designated by the Secretary of the Department of Economic Development and Commerce of Puerto Rico.

No Nexus with Puerto Rico

The eligible activity must not have a nexus with Puerto Rico. In other words, the service must not be related to the conduct of a trade, business or other activity in Puerto Rico to qualify for the benefits of the Act. Promoter Services are excepted from this general rule, as further explained below under Promoter Services.

The following services will be considered to have a nexus with Puerto Rico, and will not be eligible services:

- Business or income producing activities that are or have been performed in Puerto Rico by the applying business;
- The sale of any property for the use, consumption or disposition in Puerto Rico;
- Counseling on the laws, regulations and administrative determinations of the Government of Puerto Rico and its instrumentalities;
- Lobbying on the laws, regulations and administrative determinations of the Government of Puerto Rico and its instrumentalities; and
- Any other activity designated by the Secretary of the Department of Economic Development and Commerce of Puerto Rico.

Promoter Services

Services considered non-eligible for having a nexus with Puerto Rico can be considered Promoter Services, thus becoming eligible services, when rendered to non-resident individuals and/or foreign entities, if they are related to the establishment of a new business (as defined in the Act) in Puerto Rico. Only net income derived from Promoter Services performed within the 12-month period ending on the day preceding the day the new business takes the earliest of

the following actions will be considered exempt service income: (1) executes a contract to acquire or lease facilities in Puerto Rico; (2) begins construction of the facilities to be used in Puerto Rico; or (3) commences operations in Puerto Rico.

Tax Exemptions

At its core, the Act essentially extends to a broad spectrum of service industries the benefits that have made Puerto Rico one of the world's manufacturing leaders. Manufacturing accounts for 44% of Puerto Rico's GDP, compared with a U.S. average of less than 10%. Now, services enterprises ranging from advertising to accounting to legal services, as well as hedge fund managers and a wide range of other consulting firms are eligible for the benefits of the Act. Eligible activities can benefit from the following benefits on income derived from customers located outside of Puerto Rico in relation to services rendered from **Puerto Rico**:

- 4% fixed income tax rate;
- 3% fixed income tax rate in the case of services considered strategic;
- 100% tax exemption on distributions from earnings and profits;
- 90% tax exemption from personal property taxes for certain types of businesses (100% tax exemption for the first five years of operation). The taxable portion will be subject to the regular tax rate, that currently can be up to 8.83%; therefore, after considering the 90% exemption, the effective tax rate would be up to 0.883%;
- 90% tax exemption from real property taxes for certain types of businesses (100% tax exemption for the first five years of operation). The taxable portion will be subject to the regular tax rate, that currently can be up to 10.83%; therefore, after considering the 90% exemption, the effective tax rate would be up to 1.083%; and
- 60% tax exemption on municipal taxes (90% tax exemption if business operates in the industrial development zone constituted by the municipalities of Vieques and Culebra).

Any taxable portion will be subject to the regular tax rate, that currently can be up to 0.5%; therefore, after considering the 60% exemption, the effective tax rate would be up to 0.02%;

Tax Exemption Decree

To benefit from the Act, the service provider needs to submit an application with the Office of Industrial Tax Exemption of Puerto Rico to obtain a tax exemption decree, which will provide full detail of tax rates and conditions mandated by the Act and will be considered a contract

between the Government of Puerto Rico and the service provider. Once the service provider obtains the tax exemption decree, the benefits granted will be secured during the term of the decree, irrespective of any changes in the applicable Puerto Rico tax laws. The decree shall have a term of 20 years, with a possible 10-year extension.

Puerto Rico Income Taxes

An exempt business operating in Puerto Rico under the Act by means of a Puerto Rico entity should not be subject to any taxes (such as a dividend tax, tollgate tax or other similar taxes) on its income from its eligible activities in Puerto Rico, other than the Puerto Rico fixed income tax rate established in the tax decree, regardless if said income is distributed or retained by the entity. Upon repatriation, the distributed income would be subject to the tax imposed by the jurisdiction in which the owners of the Puerto Rico entity reside, if any.

Act 22

Individual Investors Act

Puerto Rico Tax Incentives

On January 17, 2012, Puerto Rico enacted **Act No. 22 of 2012**, as amended, known as the “**Individual Investors Act**” (the “Act”). The Act may have profound implications for the continued economic recovery of Puerto Rico. The Act provides tax exemptions to eligible individuals residing in Puerto Rico. To avail from such benefits, an individual needs to become a resident of Puerto Rico and apply for a tax exemption decree.

Eligibility

The benefits of Act No. 22, are only available to **bona-fide** residents of Puerto Rico that were not bona-fide residents of Puerto Rico for the 6-year period preceding the enactment of the Act on January 12, 2012 (“Eligible Individuals”). Generally, a bona-fide resident of Puerto Rico is 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.

Although Puerto Rico is a U.S. territory, pursuant to Section 933 of the U.S. Internal Revenue Code of 1986, as amended, bona-fide residents of Puerto Rico are not subject to U.S. federal income taxes on income derived from sources within Puerto Rico.

Therefore, U.S. citizens that are bona-fide residents of Puerto Rico benefiting from the Act will only be subject to federal income taxation on income derived from sources outside of Puerto Rico.

Tax Exemptions

The Act is designed to primarily attract to Puerto Rico high net worth individuals, empty nesters, retirees who currently relocate to other States and investors from U.S. and other countries. The Act provides the following benefits to new Puerto Rico bona-fide residents on qualified investments:

- 100% tax exemption from Puerto Rico income taxes on all dividends;
- 100% tax exemption from Puerto Rico income taxes on all interest; and

- 100% tax exemption from Puerto Rico income taxes on all short-term and long-term capital gains accrued after the individual becomes a bona-fide resident of Puerto Rico (“Puerto Rico Gain”).

Built-in Capital Gains

Also, capital gains realized by an Eligible Individual, but accrued before the individual became a bona-fide resident of Puerto Rico (“Non-PR Built-in Gains”), will be subject to preferential Puerto Rico income tax rates. If such gain is realized and recognized within 10 years after the date residence is established in Puerto Rico, it will be taxed at the income tax rate for capital gains applicable for the tax year in which the gain is realized (currently the capital tax rate is 10%) and at a 5% income tax rate if such gain is realized and recognized after said 10-year period. Pursuant to U.S. income tax regulations, U.S. residents moving to Puerto Rico will be subject to federal income taxes on any Non-PR Built-in Gains realized within 10 years after moving.

However, Puerto Rico income taxes may be creditable against such federal income tax, and therefore, U.S. residents moving to Puerto Rico and realizing Non-PR Built-in Gains within a 10-year period after moving may only be subject to the excess of U.S. taxes over Puerto Rico taxes on such Non-PR Built-in Gains. In

other words, under current law and tax rates, such individuals may only pay income taxes for the Non-PR Built-in Gains in an amount equal to the federal income tax rate imposed on such Non-PR Built-in Gains.

Example 1

For example, if stock from a publicly traded company is acquired by a U.S. resident in 2006 for \$40 and is worth \$100 just before moving to Puerto Rico in 2012, and then it is sold by the Puerto Rico resident on 2018 for \$200, the individual will be subject to income taxes for the gain realized on the sale as follows:

COST \$40	U.S. TAX	P.R. TAX	U.S. TAX AFTER P.R. CREDIT	NOT TAX U.S. & P.R.
NON-PR BUILT-IN GAINS \$60	\$9 (15% CURRENT RATE)	\$6 (10% CURRENT RATE)	\$3 (\$9-6)	\$3 (\$9+6)

After 10 years of moving from the U.S. to Puerto Rico, the income tax on the Non-PR Built-in Gains will not apply and bona-fide residents of Puerto Rico will only be subject to a 5% Puerto

Rico income tax on any portion of the Non-PR Built-in Gain realized after 10 years from moving to Puerto Rico.

PUERTO RICO GAIN \$100	\$0	\$0	\$0	\$0
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Example 2

If the stock acquired by the U.S. resident in Example 1 is sold by the Puerto Rico resident on 2023 for \$200, the individual will be subject to income taxes for the gain realized on the sale as follows:

COST \$40	U.S. TAX	P.R. TAX	U.S. TAX AFTER P.R. CREDIT	NOT TAX U.S. & P.R.
NON-PR BUILT-IN GAINS \$60	\$0	\$3	\$0	\$3
PUERTO RICO GAIN \$100	\$0	\$0	\$0	\$0

Tax Exemption Decree

To benefit from the Act, the individual investor needs to apply with the Office of Industrial Tax Exemption of Puerto Rico to obtain a tax exemption decree, which will provide full detail of tax rates and conditions mandated by the Act and will be considered a contract between the Government of Puerto Rico and the individual investor.

Once the individual investor obtains the tax exemption decree, the benefits granted will be secured during the term of the decree, irrespective of any changes in the applicable Puerto Rico tax laws. The term of the decree will be until **December 31, 2035**.

Act 73

Economic Incentives for the Development of Puerto Rico

One of the most effective programs in promoting the economic development of Puerto Rico has been the industrial development incentives laws. **Act No. 73 of 2008**, as amended, known as the “Economic Incentives for the Development of Puerto Rico Act” (the “Act”), is the current industrial development incentives law in effect.

The Act provides economic incentives, tax exemptions and tax credits to businesses engaged in eligible activities in Puerto Rico. To avail from such benefits, a business needs to become an exempt business by applying for a tax concession and obtaining a tax exemption decree.

Eligibility

Eligible activities that may qualify for the benefits of the Act include the following:

- Industrial units dedicated to the manufacture on a commercial scale;
- Subcontracted services rendered in Puerto Rico that are essential to a manufacturing unit that belongs to “a high economic impact cluster,” as designated by the Puerto Rico Industrial Development Company’s Executive Director in consultation with the Puerto Rico Planning Board;
- Services rendered in Puerto Rico by key suppliers of exempt businesses;
- Owners of property, real or personal, used by an exempt business in its exempt operations, such as a lessor of real estate used in operations of an exempt business; • Operations engaged in the breeding of animals for experimental use in laboratories for scientific and medical research, and other similar uses;
- Recycling activities that involve: (i) a transformation of recyclable materials into raw material or ingredients used for the elaboration of a product (partial recycling), (ii) the preparation of such recycled raw material for local sale or use or for exportation, or (iii) the transformation of recycled materials mainly collected in Puerto Rico into commercial articles (total recycling);
- Operations engaged in the planting and cultivation through the process of hydroponics;
- The development of licensed or patented software that may be reproduced on a commercial scale;
- Operation of certain specified strategic projects;

- The licensing of intangible property, whether developed or acquired by the exempted business that has a decree under the Act;
- An industrial unit that produces bottled purified water;
- The construction of social interest housing and planning and development of self-sustainable or partially sustainable communities; and
- Certain research and development activities conducted in laboratories.

Tax Exemptions

The Act provides the following tax exemptions:

- 4% fixed income tax rate;
- 1% fixed income tax rate for innovative firms introducing “pioneer” activities or operations in Puerto Rico;
- A reduction of 0.5% in the fixed income tax rate, when the business is located in an industrial area of low or intermediate development (as determined by the Office of Industrial Tax Exemption);
- 12% fixed income tax rate, withheld at source, on royalties paid to foreign entities with respect to intangible property used in the exempt business;
- 100% tax exemption on dividend distributions;
- 4% fixed income tax rate on gains derived from the sale of ownership interests or substantially all the assets of the exempt business, in lieu of any other Puerto Rico income tax imposed on such gains;
- 90% tax exemption from personal property taxes. The taxable portion will be subject to the regular tax rate, that currently can be up to 8.83%; therefore, after considering the 90% exemption, the effective tax rate would be up to 0.883%;
- 90% tax exemption from real property taxes. The taxable portion will be subject to the regular tax rate, that currently can be up to 10.83%; therefore, after considering the 90% exemption, the effective tax rate would be up to 1.083%;
- 60% tax exemption on municipal license taxes, with the first 3 semesters being 100% exempt. Any taxable portion will be subject to the regular tax rate, that currently can be up to 0.5%; therefore, after considering the 60% exemption, the effective tax rate would be up to 0.02%; Economic Incentives ACT 73 for the Development of Puerto Rico;

- 100% tax exemption on municipal construction taxes;
- 100% tax exemption on excise taxes and sales and use tax on raw material and certain machinery and equipment used in the production process; and
- Accelerated depreciation – 100% first-year bonus depreciation, with ability to carry over to subsequent tax years until exhausted.

Tax Credits

The Act provides various tax credits, including:

- 25% tax credit on purchases of products manufactured in Puerto Rico;
- 35% tax credit on purchases of products manufactured in Puerto Rico made from recycled materials;
- Tax credit for job creation during the first year of operations that ranges from \$1,000 per job created in an industrial area of intermediate development (as determined by the Office of Industrial Tax Exemption) to \$2,500 for jobs created in an industrial area of low development. In the case of businesses established in the municipalities of Vieques and Culebra, this tax credit is \$5,000 per job;
- 50% tax credit on eligible research and development activity costs; and
- 12% tax credit for royalties paid to foreign entities with respect to intangible property used in the exempt business.

Puerto Rico Income Taxes

An exempt business operating in Puerto Rico under the Act by means of a Puerto Rico entity should not be subject to any taxes (such as a dividend tax, tollgate tax or other similar taxes) on its income from its eligible activities in Puerto Rico, other than the Puerto Rico fixed income tax rate established in the tax decree, regardless if said income is distributed or retained by the entity.

Upon repatriation, the distributed income would be subject to the tax imposed by the jurisdiction in which the owners of the Puerto Rico entity reside, if any.