



## **INCOME TAX EXEMPTION GRANTED TO INVESTMENT INCOME OF INDIVIDUALS THAT ESTABLISH DOMICILE IN PUERTO RICO**

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**T**he Act to Promote the Transfer of Investors to Puerto Rico, Act 22 of January 17, 2012 (the “**Act**”), is Puerto Rico’s latest effort to foster the Island’s economic development through tax incentives. The Act aims to achieve its economic growth objective with a novel approach. Instead of offering tax incentives to particular types of businesses, the Act offers tax incentives to nonresident individuals to entice them to move to the Island, acquire real estate and make other investments to spur the economy. In this newsletter we will summarize the income tax exemption on interest, dividends and certain long term capital gains (the “**Investment Income**”) granted by the Act to lure the nonresidents move to Puerto Rico, and will identify some of the individuals that could benefit from the Act’s tax benefits.

### **Investment Income Exemption**

A. Eligible Individuals. Nonresident United States citizens and nonresident aliens that establish their domicile in Puerto Rico qualify for the income tax exemption provided by the Act, so long as they have not been domiciled in Puerto Rico at any time during the 15 year period ending on January 17, 2012.

B. Investment Income. The Act’s income tax exemption is applicable to interest and dividend income and certain long term capital gains derived from the sale or exchange of securities.

1. Interest and Dividend Income. Interest and dividend income from all sources is exempt from Puerto Rico income tax (including the alternative basic tax) during the Exemption Period (as defined below). Notably, the interest and dividend income will also be exempt from United States federal income tax, but only if it constitutes Puerto Rico source income pursuant to section 937 of the United States Internal Revenue Code (the “US-IRC”) and the individuals also qualify as bona fide residents of Puerto Rico for purposes of section 933 of the US-IRC. Generally, interest and dividends paid by corporations organized under the laws of Puerto Rico constitutes income from sources within Puerto Rico under the US-IRC and thus will be exempt from Puerto Rico and United States federal income tax. Conversely, interest and dividends from corporations organized in the United States and elsewhere outside of Puerto Rico will enjoy exemption from Puerto Rico income tax, but will be subject to income tax under the US-IRC.

2. Capital Gains. The income tax exemption is also applicable to long term capital gains attributable to the increase in value of securities after the date that the individual establishes domicile in Puerto Rico. Thus, the gains recognized during the Exemption Period, derived from securities acquired after establishing domicile in Puerto Rico will be exempt, whereas gains derived from securities acquired prior to establishing domicile in Puerto Rico generally will be exempt only to the extent that the gain is attributable to the increase in value of the securities after the individual is domiciled in Puerto Rico.

The portion of the gain attributable to the increase in value of securities prior to establishing domicile in Puerto Rico (the “**Pre-Domicile Gain**”) will be subject to the Puerto Rico regular or capital gains tax rate, as applicable; except that a reduced 5% Puerto Rico capital gains tax will be applicable, if the Pre-Domicile Gain is recognized during the Exemption Period and after 10 years from the date that the individual is domiciled in Puerto Rico.

Significantly, pursuant to the interplay between sections 933 and 937 of the US-IRC, the long term capital gains exempt from Puerto Rico income tax, generally will also be exempt from United States federal income tax.

C. Exemption Period. The income tax exemption is applicable to the Investment Income recognized during the period that commences on the date that the individual is domiciled in Puerto Rico and ends on December 31, 2035 (the “**Exemption Period**”).

#### **Potential Beneficiaries of the Act’s Exemptions**

A wide array of individuals may benefit from the income tax exemption granted by the Act and the United States federal income tax exemption that results from the interplay between sections 933 and 937 of the US-IRC.

High net worth individuals with significant capital gains from trading in securities, may be lured by the Puerto Rico and United States exemption on such gains. For these individuals, the domicile in Puerto Rico generally will result in an income tax savings of 15% of the long term capital gains attributable to the increase in value of the securities after the individual establishes domicile in Puerto Rico.

Establishing domicile in Puerto Rico could also be attractive to owners of financial businesses, such as hedge funds and money management operations. These individuals may be able to maximize the Puerto Rico and United States federal income tax exemption by organizing a Puerto Rico corporation to render services to their non-Puerto Rico clients and structure a compensation package consisting of taxable salaries and tax free dividends.

Lastly, the Act could be very attractive to high net worth aliens that reside in countries where their capital is subject to significant sovereign risk. If these individuals establish their domicile in Puerto Rico and become United States citizens through residence and naturalization in Puerto Rico, they will enjoy the income tax benefits of the Act, while continuing to be treated as nonresidential aliens for United States federal estate tax purposes. Consequently, so long as they do not own property located in the United States (excluding Puerto Rico), their estate will not be subject to estate tax under the US-IRC and may be exempt from estate taxes in Puerto Rico.

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Should you have any questions with respect to the above, please contact Fernando Goyco-Covas, Esq. at (787) 281-1802 .

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