



ENHANCED TAX BENEFITS FOR INDIVIDUAL INVESTORS THAT ESTABLISH RESIDENCE IN PUERTO RICO AFTER JANUARY 17, 2012

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Act Number 22 of January 17, 2012 (“**Act 22**”), which provides extraordinary tax benefits to “eligible individuals” that establish residence in Puerto Rico after January 17, 2012, has been amended¹ to: (i) provide that a grant of tax exemption (“**Tax Grant**”) will be issued to “eligible individuals”; and (ii) include short term capital gains derived from sales of securities among the types of income eligible for Puerto Rico (“**PR**”), and United States (“**US**”),² income tax exemption.

A Tax Grant is considered a contract between such individual and the Government of Puerto Rico, and it is designed to ensure to the “eligible individual” that receives the grant the continued availability of the tax benefits provided by Act 22 until the year 2035, as a contractual right, regardless of future changes in PR law. The benefits of Act 22 are only available to “eligible individuals” that request and obtain a Tax Grant from the Secretary of Economic Development and Commerce of Puerto Rico.

Short term capital gains derived by “eligible individuals” from the sale of securities will also enjoy exemption from US income taxes, as such gains are considered PR source income under the US Internal Revenue Code of 1986, as amended (“**US-IRC**”) and PR source income of a “bona fide” resident of PR (other than amounts received for services performed as an employee of the US or any agency thereof) is excluded from US income taxation.³ The combined US and PR exemptions represent

an extraordinary opportunity for those individuals that establish residence in PR and obtain a Tax Grant under Act 22, as short term capital gains from the sale or exchange of securities earned by all other US citizens and residents are subject to federal taxation as ordinary income. This additional tax benefit of Act 22 is mainly directed towards individual investors that derive substantial amounts of capital gains from the sale or exchange of securities, and more so to those whose investments generate ongoing short term capital gains.

The following is a summary of the tax benefits made available by Act 22 to any individual that:

- (i) did not reside in PR at any time during the 15 year period that ended on January 17, 2012;
- (ii) becomes a “resident” of PR after January 17, 2012 and prior to 2036; and
- (iii) requests and obtains a Tax Grant under Act 22 (“**Eligible Individual**”).⁴

US Taxes: An Eligible Individual must be certain that he qualifies as “bona fide resident of PR”, as defined in US-IRC §937. Otherwise, he will be fully subject to US income taxes on his worldwide income.⁵ All references herein to PR resident or PR residency refers solely to a “bona fide resi-

1. **Period of Act 22 PR Exemption:** The tax benefits of Act 22 start on the date of commencement of bona fide residency in PR (which must be after January 17, 2102), and end on December 31, 2035, or prior termination of such residency.

2. **PR Income Tax Exemption:** Dividends and interest from all sources are exempted by Act 22.

US Taxes: The US-IRC generally provides US income tax exemption on PR source dividends and interest earned by a “bona fide resident of PR”. However, dividend and interest income from Non PR sources (i.e., US or foreign sources) will be subject to US income taxation.

3. **PR Capital Gains (Long and Short Term) Tax Exemption on Appreciation of Securities after PR Residency:** Act 22 provides 100% exemption from PR capital gains taxes on gains attributable to the appreciation in value of securities after the “eligible individual” becomes a PR Resident.

US Taxes: These gains will not be subject to US income taxation if the securities were not owned prior to becoming a PR resident, and if so owned when sold after 10 years of PR residency; as these are considered PR source income under the US-IRC.

However, capital gains (long and short term) attributable to the appreciation in value of securities that are owned by such individual at the time he becomes a PR resident, and which are sold within the 10 years following commencement of PR residency, will not be considered PR source income under the US-IRC and are not entitled to US income tax exemption.⁷

4. **PR Tax Rate of 5% on Certain Long Term Capital Gains:** Long term capital gains that are attributable to the appreciation in value after commencement of PR residency, of securities that were owned before such

“eligible individual” became a PR resident, and that are realized after 10 years of PR residency, will be subject to a reduced 5% PR long term capital gains tax rate.

US Taxes: There will be no US tax on these gains, as they are considered PR source income under the US-IRC, and the US does not tax gains from appreciation of securities purchased prior to PR residency that are sold after 10 years of PR residency.

5. **PR Alternative Basic Tax Exemption:** All income exempted or subject to a reduced tax rate pursuant to Act 22 is also exempt from the PR alternative basic tax, or ABT.

6. **Exceptions to General Source of Income Rules Applicable to Interest and Dividends Received from PR Organized Corporation:** Eligible individuals must be aware that, while dividend and interest paid by a PR corporation (including legal entities treated as corporations for US income tax purposes) to a bona fide PR resident are generally exempt from US income tax as PR source income, there are exceptions to these rules under complex regulations issued pursuant to US-IRC §937 that were designed to prevent the treatment of income from US and foreign sources as PR source income when distributed by PR corporations. These regulations provide that under certain circumstances, and exceptions, a portion of the:

(a) dividends and/or interest paid by a PR corporation that derives income from sources outside PR to a PR resident individual who owns (directly or indirectly) at least 10% of the voting shares of the PR corporation may be treated as income from sources outside PR; and

(b) dividends and/or interest paid by a PR corporation that serves as a “conduit arrangement” for US source income being paid to a PR resident may be treated as income from US sources.

7. **US Resident Aliens and Foreigners:** For an alien,⁸ including an alien that is a current resident of the US (i.e., US resident alien), PR residency can be extra rewarding from a US estate tax perspective. If such individual is a PR resident at the time of his demise, he will only be subject to US estate taxes on “property located within the US”,⁹ instead of his worldwide assets.

8. **Possible Enhancements to Act 22:** In order to make Act 22 more attractive to a broader range of individual US investors, the Government of Puerto Rico should consider additional amendments to Act 22, such as: (i) granting PR income tax exemption to income from sources outside PR derived from annuities, pension plans

and royalties; (ii) reducing the number of prior years of non PR residency from 15 to 10 years; and (iii) eliminating the PR Civil Code forced heirship rules¹⁰ on testamentary successions, which will allow “eligible individuals” to freely dispose of their estates and utilize all means available under the US-IRC to defer, mitigate and/or even eliminate exposure to US estate taxes. This last amendment is very important, as married individuals, and those who contemplate devising most of their estates to public, charitable and religious uses, may be hesitant to move to PR if those wishes are not possible and/or if their exposure to US estate taxes is significantly greater than if they had not moved to PR.

¹ Act Number 138 of June 11, 2012.

² The US income tax exemption on capital gains is not a result of Act 22, but is attributable to the provisions of the US-IRC applicable to the sale of securities by a bona fide resident of PR.

³ US-IRC §933. Notice however that short term gains derived from the sale of securities owned prior to becoming a PR resident are not PR source income under the US-IRC.

⁴ These tax benefits remain in effect for as long as such individual maintains his PR residency, and up to the year 2035.

⁵ Even though all other US citizens and US residents are subject to US income tax on their worldwide income, those that are “bona fide residents of PR” are exempt from US income taxation on their PR source income, other than amounts received for services performed as an employee of the US or any agency thereof, pursuant to US-IRC §933.

⁶ See AMG Puerto Rico Business Law Notes, Article 2006-03, dated November 24, 2006, on the US-IRC regulatory requirements to qualify as a “bona fide resident of Puerto Rico”.

⁷ US-IRC Regulations §1.937-2(f)(1).

⁸ See AMG Puerto Rico Business Law Notes, Article 2012-LABR-01, dated June 4, 2012, on foreign investors (aliens) gaining US residency status (EB-5 Visa) by investing in the US (including investments in PR), as these foreigners can move to PR and enjoy the benefits of Act 22.

⁹ These individuals will be exposed to a maximum 10% estate tax on their holdings that are not property located within PR, but careful planning can result in no PR estate taxation on assets located outside the US and outside PR.

¹⁰ Generally, when the decedent has descendants, two thirds of the estate must go to descendants.

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