Global Watch

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Income tax exemption granted to non-residents who establish domicile within a specified timeframe

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This article is intended to highlight general issues and is not a comprehensive statement of the topic or the laws of that country.

In brief

During 2012, Acts 22-2012 and 138-2012 were approved by the Legislative Assembly of Puerto Rico. The purpose of these measures is to provide incentives to individuals who have NOT been residents of Puerto Rico during the past 15 years, to become residents of Puerto Rico. In order to encourage the transfer of such individuals to Puerto Rico, the Acts completely exempt from Puerto Rico income tax their passive income, which may consist of interest, dividends, and capital gains.

What does the Act aim to do?

Act No. 22-2012 (also known as The Individual Investors Act) and its subsequent amendment seek to attract new residents to Puerto Rico by providing an exemption on certain investment income. The Puerto Rico government hopes that by establishing residence in Puerto Rico, new residents will positively impact the local economy by investing in real estate, buying local products/services, and transferring assets to local banks. This represents an additional initiative to attract foreign capital, fuel economic growth, and promote the socioeconomic development of the island.

To whom does the Act apply?

The Act applies to all individual investors who become 'Puerto Rico Residents' on or before December 31, 2035, provided that such individuals were not residents of PR at any time during the 15 year period preceding the effective date of the Act (i.e., January 17, 2012, even though it was subsequently amended in 2012).

Generally, a PR resident is an individual who is domiciled in PR. Although there is a presumption that any individual present in PR for more than 183 days is a resident, facts and circumstances should be closely evaluated since this may not always be the case. Some key factors that may impact residency include: location of home, family, bank accounts, dependents' school, driver license, medical insurance, and voting registration.

Both US and non-US citizens may qualify under the Act. PR residents who are temporarily outside of PR (e.g., students or government officials working temporarily outside of Puerto Rico and other individuals with similar facts and circumstances) would not qualify as they would still be deemed to be PR residents.

What are the procedures for qualification?

To qualify for the exemptions granted under the Act, every so-called Resident Individual Investor (i.e., a tax resident qualifying under the Act) must request a tax exemption decree from the Secretary of Economic Development and Commerce (Secretary). The tax exemption decree will provide details of the tax treatment and shall be considered a contract between the Resident Individual Investor and the Puerto Rico government.

The effective period should be stated in the tax exemption decree, but may not go beyond December 31, 2035.

The decree may be revoked by the Secretary if any of the following events occur:

- the Resident Individual Investor fails to comply with any of the obligations imposed by this Act or its regulations, or by the terms of the decree
- the Resident Individual Investor ceases to comply with his or her tax responsibilities under the PR Internal Revenue Code (PR Code) and other laws of Puerto Rico
- the decree was obtained based on false or fraudulent representations of any facts or circumstances which, in whole or in part, motivated the issuance of the decree.

What is the exemption period?

The income tax exemption will apply only to investment income recognized during the period that starts on the date the individual is domiciled in PR and ends on December 31, 2035 (Exemption Period). After this date, those residents who took advantage of the exemptions granted will be taxed as any other PR resident and as stated in the PR Code.

What investment income is exempt?

Interest and dividend income received by Resident Individual Investors during the Exemption Period will be fully exempt from PR income taxation. The exemption applies to all sources of such income, i.e., PR, United States, and foreign.

In the case of long-term capital gains, the Act provides for either a full PR income tax exemption or a reduced tax rate of 5%, depending on certain requirements described below.

The portion of long-term capital gains attributable to the increase in value of securities ***after*** a Resident Individual Investor establishes domicile in PR will be exempt from PR taxation, if the securities are disposed before January 1, 2036. This exemption would apply to securities acquired before or during the Exemption Period.

However, for capital gains recognized after December 31, 2035, the entire net gain would be subject to income tax under the PR Code. This means that the increase in value attributable to the Exemption Period would be fully taxable if the securities are disposed after the Exemption Period expires.

The portion of long-term capital gains attributable to the increase in value of securities ***prior*** to establishing domicile in PR will be subject to the PR capital gain tax rate of 10%. However, if this 'pre-domicile' gain is recognized during the Exemption Period ***and*** after 10 years from the date the individual establishes domicile in PR, a reduced 5% tax will apply.

Bottom line

This new PR tax exemption may serve as an attractive incentive for employees to work on a longer-term basis in Puerto Rico -- either as a permanent transfer or equalized employee. US citizens, in particular, may be drawn to this new law. Bona fide residents of Puerto Rico under US income tax law generally have their PR source income exempted from US income taxation. As a result, US citizens who qualify as bona fide residents of Puerto Rico under US tax law could possibly avoid US income taxation as well as enjoy the PR tax benefits provided by the Act.

Companies with employees who qualify under the Act may also benefit, depending upon the terms of their equalization policy. If the policy serves to equalize the employee's passive income, with any tax liability decrease accruing to the company's benefit, this exemption could reduce overall mobility costs. Global mobility program managers should identify any affected individuals and quantify potential savings.

This new exemption should also be considered by companies who are evaluating jurisdictions in which to continue or set up new operations. While its success remains to be seen, the Act is intended to attract more residents, which may or may not have an impact on PR's future talent pool.

For more information, please do not hesitate to contact:

Jorge Morazzani	*(703) 918-3684*	*jorge.morazzani@us.pwc.com*
Jose Osorio	*(787) 772-8057*	*jose.osorio@us.pwc.com*

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