GUIDE

Puerto Rico Act 22

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PUERTO RICO ACT 22
INCENTIVE FOR BUSINESS OWNERS AND RELOCATION OF INDIVIDUAL INVESTORS

Lowering Taxes Without Leaving the USA

Americans are in the uniquely unfavorable position of living under the world's most comprehensive tax regime and suffering a government that can effectively enforce that regime anywhere in the world. For many, US tax rules are a tight and choking leash. It's no wonder that record numbers of Americans are giving up their citizenship to seek freedom elsewhere. American can move to a zero-tax jurisdiction but still pays a full US Tax bill.

There is a current misconception that USA extraterritorial strategy consists of evading taxes and hiding money from the government. There are 100% legitimate ways to structure your taxes in Puerto Rico and obtain significant benefits from asset protection and taxes.

Puerto Rico is a territorial possession of the US. Under the US Internal Revenue Code, an American who becomes a resident of Puerto Rico begins a new tax life: all the income the person earns from Puerto Rican sources is subject to Puerto Rican income tax only, not to US income tax, you can not find similar benefits anywhere else in the world.

Puerto Rico is part of the US. Take any domestic flight, just a boarding pass and driver's license (or other accepted ID) will get you there. You also can buy real estate, register to vote, or get a driver's license.

Under the US Internal Revenue Code, an American who becomes a resident of Puerto Rico begins a new tax rule, all the income the person earns from Puerto Rican sources is subject to Puerto Rican income tax only, not to US income tax. A Puerto Rico corporation is a resident and citizen of Puerto Rico, no a US resident or citizen.
Under the US Internal Revenue Code Section 933 and Section 861, if the person performing the service (whether an individual or a corporation) is a Puerto Rican resident working in Puerto Rico, the income is exempt from US tax.

Section 933, a tool no other jurisdiction can match, enables the government of Puerto Rico to offer any benefit on locally generated income. The Puerto Rican government has adopted ultra-low tax rates for newly arriving investors and companies that perform services locally for customers located outside of Puerto Rico. Exercising the 936 section benefits, the passage of Acts 22 and 20, reduced taxes for incoming investors and businesses respectively.

PUERTO RICO TAX INCENTIVES ACT 22

Act 22 completely exempts new residents from Puerto Rican taxation on dividends, interest, and capital gains that accrue after becoming a resident of Puerto Rico. Given that Puerto Rican residents are also exempt from US income tax on Puerto Rican sourced income, Act 22 means tax freedom for individual Americans who can arrange for their investment income to arise from Puerto Rican sources.

0% Taxes on Dividends and Interest: A qualified individual's income from dividends and interest are exempt from Puerto Rico income taxes during the exemption period.

0% - 10% Taxes on Capital Gains: A qualified person's income from long-term capital gains is exempt from Puerto Rico income taxes during the tax exemption period after the individual becomes a resident of Puerto Rico. A qualified individual's long-term capital gains before becoming a resident of Puerto Rico are subject to a 10% tax rate if realized within ten years of residency of 5% if realized after ten years of residency.

0% Federal Taxes on Puerto Rico source Income: Under the US Internal Revenue Code, income derived from sources within Puerto Rico by individuals qualified as bona fide residents are exempt from federal income taxation.

Capital Gains

Capital gains are the primary benefit of Act 22.

The source for capital gains on the sale of securities and other personal property is your place of residence, so gains on stocks, bonds, or other personal property, like precious metals, that you recognize while a resident of Puerto Rico is treated as Puerto Rican-sourced income and thus eligible for exemption under Act 22.

Even if you keep your US brokerage account, while you are a bona fide Puerto Rican resident, capital gains earned in those accounts count as Puerto Rico-sourced income and can qualify for Act 22 treatment.

Previous appreciation Capital Gains

Moving to Puerto Rico does nothing to shelter previous appreciation capital gains.
Determining how to split a capital gain between appreciation that happened before you moved to Puerto Rico and appreciation that occurred while you were there depends on the type of property.

For investments that are trading in a public market, such as listed stocks and precious metals, you start by establishing the investment's price on the day of your move to the island. All profit up to that price is considered to have been earned before your move (and is taxable by Puerto Rico and the US). The rest of the profit is deemed to have accrued while you were in Puerto Rico (and is taxed by no one).

For example, a mainland US investor purchased stock for $100 on January 1, 2016. Then he moves to Puerto Rico on January 1, 2017, on which day the stock is worth $200. On January 1, 2018, sells the stock for $400, for a capital gain of $300 ($100 of which accrued before moving to Puerto Rico and $200 of which accumulated after moving).

Puerto Rico will tax the $100 accrued before moving at 10% and by the US (under current rules, at 20%). The US will allow a credit for the Puerto Rican tax; the effective total tax rate is still 20%, just if you had stayed on the mainland.

The $200 accrued after moving will be exempt from US tax since you are a Puerto Rican resident for all of that period, also will be exempt from Puerto Rican taxes under Act 22.

For non-marketable stocks and other interests in private companies, there is no clear and straightforward way to establish the value as of the day you become a Puerto Rican resident. The rules pretend that appreciation in private security you took with you to Puerto Rico happened evenly day by day from the time you bought it while living on the mainland to the time you sold it while living in Puerto Rico.

If you bought stock in a corporation for $100, 100 days before you moved and sold it for $300, 200 days after you arrived in Puerto Rico, one-third ($100) of the gain would treat as having accrued while you were still on the mainland (fully taxable), and two-thirds ($200) would treat as having accumulated while you were a Puerto Rican resident (tax free).

Puerto Rico will tax the $100 accrued before moving at 10% and by the US (under current rules, at 20%). The US will allow a credit for the Puerto Rican tax; the effective total tax rate is still 20%, just had stayed on the mainland.

The $200 accrued after moving will be exempt from US tax since you are a Puerto Rican resident for all of that period, also will be exempt from Puerto Rican taxes under Act 22.

PUERTO RICO RESIDENT ELEGIBILITY

Individuals who become residents of Puerto Rico are considered eligible under Act 22 unless the individual was a resident of Puerto Rico at any time beginning on January 16, 1997, and ending on January 16, 2012.

An individual that becomes domiciled in Puerto Rico establishes a presumption of residency as a Puerto Rico resident with a 183-day physical presence in Puerto Rico.

TAX EXEMPTION DECREE

An eligible individual is required of obtain a Tax Exemption Decree that will endure for a term the Government decrees valid until 2036. The Tax Exemption Decree constitutes a contract between the service provider and the Government of Puerto Rico and will be unaffected by any future legislation.

REQUIREMENTS

An individual that becomes domiciled in Puerto Rico is considered a Puerto Rico resident.

- First, an individual's 183-day physical presence in Puerto Rico establishes a presumption of residency under the Puerto Rico Tax Code.
- Second, the individual must not have a tax home outside of Puerto Rico during the year. A tax home is determined to be located near a person's principal place of business.
- Third, the individual must have a closer connection to Puerto Rico than to the US or another country. This is determined by a variety of factors including but not limited to the location of the individual's home, family, personal belongings, and voting district.

The tax exemption period begins on that date an individual becomes a resident of Puerto Rico. For more details, see our white paper "Becoming a Puerto Rico Resident.

TAXATION AND SOURCING OF INCOME RULES

A U.S. citizen is subject to worldwide taxation on income from all sources. However, a Puerto Rico residents is subject to U.S. tax only on their income from sources within the U.S. or world wide (other foreign countries), with minor exceptions.

When the Internal Revenue Code (IRC) speaks of sourcing of income, it is referring to the origin of the income as being earned in the U.S., world wide or in Puerto Rico. The taxpayer must first determine whether the gross income in each category is from U.S. sources, world wide or Puerto Rico sources, then the taxpayer can figure the taxable income in each category sources.

The source rules are designed to determine whether the U.S., world wide or Puerto Rico has a closer connection or "nexus" to the income. If income is Puerto Rico source income, Puerto Rico has the primary right to tax the income. Puerto Rico also has the primary right to tax eligible activities at 4%, ACT 20 o 100% exempt, Act 22.

Sourcing of Compensation Income

The general rule for sourcing wages and personal services income is controlled by where the service is performing. The residence of the recipient of the service, the place of contracting, and the time and place of payment are irrelevant.

Salaries, wages, and other compensation for labor or personal services are taxable were labor or services is performed, perform in PR are subject to PR taxes, perform in the USA, subject to Federal Taxes.

The general rule for employees: Source is determining on a time basis except for fringe benefits.

The general rule for non-employee Individuals: Source is determining on the basis that most correctly reflects the proper source of that income under the facts and circumstances of that particular case.

If services are performed both within, and without the U.S., the compensation for the services is allocated on the basis that most correctly reflects the proper source of income under the facts and circumstances. In many cases, it may be that an apportionment on a time basis may be acceptable.

However, compensation for services performed by a Puerto Rico resident in the U.S. is Puerto Rico source if all of the following are met:

The services are performed on temporarily in the U.S.,
Presence in the U.S. during the taxable year does not exceed 90 days and
Compensation for services does not exceed $3,000.

Example: Taxpayer A, a citizen, and resident of Puerto Rico were engaged by a U.S. firm to develop a new product for worldwide sales. In developing this product, taxpayer A was present in the U.S. for 56 days (8 weeks) to work out actual production problems. The entire project took twenty weeks for which he was paid $60,000.

Taxpayer A performed service as a temporarily in the U.S. for 56 days. He was paid more than $3,000. Therefore, the income cannot be solely Puerto Rico sourced and needed to be allocated as follows:

8 weeks in U.S. / 20 weeks' total project x $60,000 paid = $24,000 sourced U.S.

Puerto Ricans participate in (US) Social Security and Medicare and thus are subject to payroll taxes. However, no resident of Puerto Rico is subject to US income tax on what he earns from Puerto Rican sources. Instead, a resident of Puerto Rico is subject to Puerto Rican income tax, which generally is tax at rates similar to US federal income tax rates but with certain critical exceptions that are the focus of this report.

Personal income tax rates in effect:

Net taxable income (USD)

Not over 9,000, 0%
Over $9,000, but not over $25,000, 7% of the excess over $9,000
Over $25,000, but not over $41,500, $1,120 plus 14% of the excess over $25,000
Over $41,500, but not over $61,500, $3,430 plus 25% of the excess over $41,500
Over $61,500, $8,430 plus 33% of the excess over $61,500

If the individual's net taxable income exceeds $500,000, they will have to pay an additional tax (i.e., progressive adjustment tax). This tax is 5% of the excess of the total net taxable income over $500,000, limited to 33% of their personal and dependents' exemption plus USD 8,895.

In addition to the regular income tax, individuals are required to compute an ABT assessed by a previously established table. The ABT taxable income computing by adding back specific income items exempt from regular income tax. All individuals with an ABT net taxable income of USD 150,000 or more will need to calculate the ABT.

DIVIDENDS AND INTEREST

Interest

The residence of the payer determines interest income source. Interest income includes earnings from bank accounts, bonds, and notes. The interest that arises from sources within the 50 states and the District of Columbia is income from sources within the U.S.

However, interest on deposit with a Puerto Rico domestic corporation or partnership is Puerto Rico source income if the deposits are with a Puerto Rico branch of the corporation or partnership and the Puerto Rico branch is engage in the commercial banking business.

Interest paid by a U.S. trade or business (U.S. branch) corporation is deem paid by a domestic corporation and, therefore, from sources within the U.S.

Example 1: Taxpayer A, a U.S. taxpayer, receives interest income from a personal loan made to taxpayer B, a U.S. citizen but resident of Puerto Rico since taxpayer B is a resident of Puerto Rico, although a U.S. citizen, the income is Puerto Rico sourced income.

Example 2: Taxpayer C, a Puerto Rico corporation doing business in the U.S., receives interest income from taxpayer D, a U.S. citizen, and resident. The income is U.S. sourced because the payer is a resident of the U.S.

Example 3: Using the same facts as Example 2, except that taxpayer D makes the payment from a Swiss bank account to taxpayer C's bank in the Cayman Islands. The income is U.S. sourced because the payer is a resident of the U.S.

Dividends

The payer's country of incorporation determines dividend income. Dividends from US domestic corporations are U.S. source income. Dividends from Puerto Rico corporations are Puerto Rico source.

The source of interest and dividends is the tax residence of the payer. So the way to benefit from Act 22 concerning interest or dividends is that the payer's tax residence is Puerto Rico source (at least 80%) entity, which would make the income's source Puerto Rico.

If you hold US bank CDs as part of your portfolio, you could replace them with CDs of Puerto Rican banks (whose deposits are covered by FDIC insurance) to produce income that is entirely free of tax.

However, a dividend from a Puerto Rico corporation may be U.S. source income, if at least 50 percent of the corporation's gross income for the preceding three years was effectively connected income (ECI).

A dividend may also be U.S. source income if that dividend was from a Puerto Rico corporation which distributed it from earnings and profits that the corporation inherited from a domestic corporation, but only to extend the dividend qualifies for a dividends-received deduction.

Example 1: Taxpayer A, a U.S. person, received dividends from a Puerto Rico corporation with no U.S. ECI. The dividend is Puerto Rico source income.

Example 2: Taxpayer B, a citizen of Puerto Rico and residing in the U.S., receives dividends from Puerto Rico with no U.S. Effectively Connected Income (ECI, sales were made with in USA even the entity was not doing trade or business in USA) and deposits them in her U.S. bank account. The dividend is Puerto Rico source income.

Example 3: Taxpayer C, a citizen of the USA, residing in Puerto Rico, receives $800 in dividends in 2006 from a Puerto Rico corporation, which has the following income that is ECI.

Year	Total Gross Income	Puerto Rico Source Income Qualified Div	ECI/USA US Source
2003	$15,000	$6,100	$8,900
2004	$25,000	$15,500	$9,500
2005	$10,000	$3,200	$6,800
Totals	$50,000	$24,800	$25,200

Since the Puerto Rico corporation had more than 50% of ECI gross income for the preceding three years and 25 percent of its gross income is ECI, some or all of the dividend becomes Qualified U.S. sourced.

Effectively connected income for testing period / All gross income for testing period:

$25,200 / $50,000 x 800 = $403.

This is the U.S. source portion of the $800 qualified dividend.

RETIREMENT INCOME

Withdrawals from an IRA, 401(k), or other US tax-deferred retirement account would not be covered by Act 22. So moving to the island won't lessen the tax on withdrawals. The situation is the same with Social Security and other pension income.

Puerto Rico has its own IRA system, with both traditional and Roth plans, but it is distinct from the US IRA system. Income from employment in Puerto Rico cannot contribute to a US IRA and vice versa.

For a resident of Puerto Rico, a distribution from a US Roth IRA would be taxable by the Puerto Rican government. That is unless the US Roth IRA liquidates and the proceeds are used to contribute to a Puerto Rican Roth IRA (subject to contribution limits, which are similar to the US). The opposite is true as well.

A distribution from a US traditional IRA to a Puerto Rico resident would be taxable by both the US and the Puerto Rican government, unless it is liquidated, and the proceeds are used to contribute (subject to contribution limits) to a Puerto Rican traditional IRA, in which case the distribution would only be taxable by the Puerto Rican government. Again, the opposite scenario is true as well.

For taxable distributions, the availability of credit from either government for tax paid to the other prevents double taxation, and you end up effectively only paying the higher rate.

For purposes of sourcing pension income, there are two components: contributions to the pension plan, and the earnings accrued from investing those contributions.

The contribution portion is source according to where services is performed that earned the pension. The investment earnings portion is source according to the location of the pension trust. U.S. social security benefits are considered to be from U.S. sources.

Example: A U.S. citizen worked in Puerto Rico for a U.S. company. All services were performed in Puerto Rico. Upon retirement, taxpayer remained in Puerto Rico and began receiving a pension from the U.S. pension trust of their employer. Distributions from the U.S. pension trust must be allocated between (1) contributions, which are Puerto Rico source income and (2) investment earnings, which are U.S. source income.

Sourcing of Sales of Property

Sale of real property	= Where the property location
Sale of personal property	= Resident of receiver payment
Sale of inventory purchased	= Where transfer title/sold
Sale of inventory produced	= Where the inventory is produce

Sourcing of Rent and Royalty Income

Gross income from sources within the U.S. includes rents or royalties from property located in the U.S. or from any interest in such property, including rents or royalties for the use, or the privilege of using, in the U.S., patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises and other like property.

The income arising from the rental of property, whether tangible or intangible, located within the U.S., or from the use of property, whether tangible or intangible, within the U.S., is from sources within the U.S.

Rental income or compensation for the use of the tangible property is sourced to the place where the rental property is located.

Rents and royalties received from a controlled foreign corporation (CFC) by its U.S. shareholders are treated as income in a separate limitation basket (category) to the extent they are derived from the income of the CFC in the same basket. This look-through rule characterizes a U.S. shareholder's income received from a CFC as having the same character as that of the income from of the CFC. To illustrate, royalties from a wholly owned foreign subsidiary that earns only operating business profits are general limitation income (and not passive income) for its U.S. parent corporation.

Flow-Through Information from Schedule K-1s

The source and character in the hands of a partner or S corporation shareholder of any item of income, expense and so on, shall be determined as if such item were realized directly from the source from which recognized by the partnership or S corporation.

The flow-through entity generally provides information concerning the source of distributive amounts. One exception is that gain from the sale by a partnership of personal property is sourced based on partner's residence (with exceptions).

However, partnership income generally retains its character where it flows through to the individual.

Example: A partnership has 60 percent US source ordinary income. Therefore, 60 percent of the distribution would be US source.

Example: A partnership is formed in the U.S. with two equal partners who are both U.S. citizens and earns $20,000 from the sale of personal property that is not inventory. Partner A's tax home in the U.S. and partner B's tax home is in Puerto Rico. Partner A would have $10,000 U.S. source income, and partner B would have $10,000 Puerto Rico source income, exempt under Act 22.

Summary of Most Common Types of Income and Rules for Sourcing within the U.S.

Item of Income	Factor in Determining Source
Interest	Residence of payer
Dividends	Whether a U.S. or foreign corporation
Rent	Location of property
Royalties: Natural resources Patents, copyrights,	Where property is use
Sale of real estate	Location of property
Sale of personal property	Location of seller's tax home
Salaries, wages, other compensation	Where services performed
Business Income:	Where permanent establishment
Personal service	Where services performed
Sale of inventory – purchased	Where sold
Sale of inventory – produced	Where produced
Pension distribution attributable to contributions	Where services performed that earned
to investment earnings	Where Trust location