

Puerto Rico Export Services and New Resident Tax Incentives

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Executive Summary – Part 1

Act 20 – Export Services Act was signed into law on January 17, 2012

Incentives for Export Services Businesses in Puerto Rico:

- ✓ **4%** corporate tax rate
- ✓ **100%** tax exemption on dividends from export services businesses
- ✓ Decree of **20 years**, guaranteeing these rates
- ✓ **No federal taxes**



Sample Export Services

- Research and Development
- Advertising and Public Relations
- Consulting
- Commercial Arts and Graphics
- Architecture and Engineering
- Legal, Tax and Accounting
- Education and Training
- Hospitals and Laboratories
- Investment Banking
- Asset Management



Executive Summary – Part 2

Act 22 – Individual Investors Act was signed into law on January 17, 2012

Individual Investors Act

Move to Puerto Rico and pay ZERO TAXES on passive income.

**NO TAXES
on
DIVIDENDS**

**NO TAXES
on
INTEREST**

**NO TAXES
on
CAPITAL GAINS**



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Puerto Rico at a Glance

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Act to Promote the Exportation of Services of 2012

3

Act to Promote the Relocation of Individual Investors of 2012



A new framework for the development of the export services industry in Puerto Rico

Act No. 20 of 2012 to Promote the Exportation of Services

Act 20
of 2012

- **Objective:** To provide the appropriate environment and opportunities to make Puerto Rico a center of international services, focusing on:
 - encouraging local service providers to expand their business by offering their services to clients who are located outside of Puerto Rico, and
 - convincing foreign service providers to move their businesses to Puerto Rico
- **Public policy:** The development of a local service industry that is directed to the export of all kinds of services is declared as the public policy of the Government of Puerto Rico



Incentives

For Puerto Rico Export Services Businesses

4% Corporate Tax Rate

- Puerto Rican businesses providing services for exportation will enjoy a 4% flat income tax rate on income related to such services.
- This rate may be reduced to 3% when more than 90% of the eligible business's gross income is derived from export services and such services are considered "strategic services" as set forth under the Act.

100% Tax-Exempt Dividends

- Distributions from earnings and profits derived from the export services income of eligible businesses are 100% tax exempt for Puerto Rico residents.

100% Exemption on Property Taxes

- Eligible businesses providing services in the categories of corporate headquarters, call centers and shared services centers will enjoy a 100% exemption from property taxes during the first five years of operations.
- After said 5-year period, a 90% exemption will apply during the term remaining under the Tax Exemption Decree.



Eligible Services

The following are the services that are eligible for the new tax incentives

- **Research and development**
- **Advertising and public relations**
- **Consulting**
- **Advise on matters relating to any trade or business**
- **Commercial arts and graphic services**
- **Production of construction drawings, architectural and engineering services and project management**
- **Professional services, such as legal, tax and accounting**
- **Centralized management services**
- **Centers for electronic data processing**
- **Development of computer programs**
- **Telecommunications voice and data between persons located outside of Puerto Rico**
- **Call centers**
- **Shared services centers**
- **Storage and distribution centers**
- **Educational and training services**
- **Hospitals and laboratories**
- **Investment banking and other financial services**
- **Any other service that is later decided to be treated as an eligible service because it is in the best interest of Puerto Rico**



Requirements for Incentives

Puerto Rican companies providing services abroad about non-Puerto Rican matters

Puerto Rico Businesses

- The Act applies with respect to any entity with a bona fide office or establishment located in Puerto Rico that is or may be engaged in an eligible service.

Services for Exportation

- Services must be performed for non-resident individuals and/or foreign entities that have no nexus with Puerto Rico.

No Nexus to Puerto Rico

- The Eligible Service provided must not, and will not be, related to the conduct of a trade, business or other activity in Puerto Rico.



Rules and Incentives for Promoters and Existing Local Businesses

Law provides special rules for promoters and for existing P.R. businesses

Promoters

- **Special Incentive to Promoters:** The Act provides for incentives to local service providers that are engaged in Promotional Services.
- **Promotional Services** are eligible services rendered to non-Puerto Rico resident individuals and/or foreign entities related to the establishment of a New Business in Puerto Rico, as defined in the Act.
- **Tax incentives:** Businesses engaged in qualifying promotional services will receive the same tax incentives under the Act, but only with respect to the net income derived within the 12-month period prior to the New Business taking any of the following actions:
 - Beginning construction of the facilities to be used in Puerto Rico;
 - Commencing operations in Puerto Rico; or
 - Executing a contract to acquire or lease facilities in Puerto Rico.

Existing Puerto Rico Businesses

- **Existing Puerto Rico Businesses** are encouraged to apply for the incentives under the Act if they engage or intend to engage in exporting any of the eligible services described or in Promotional Services.
- **Base Period:** For those existing Puerto Rico businesses, the tax incentives will only apply to that portion of net income derived from an eligible service that exceeds the average net income generated by such business during the three taxable years preceding the date a request for a Tax Exemption Decree is filed by such business ("Base Period").



Tax Exemption Decree

Providing certainty for eligible businesses

- **Tax Exemption Decree:** To enjoy the benefits granted under the Export Services Act the services provider must request and obtain a tax exemption decree under the Act, which will be signed by the Secretary of the Department of Economic Development and Commerce of Puerto Rico.
- **20 Years:** Such decree will have term of 20 years, renewable for 10 additional years, provided certain conditions are satisfied.
- **Certainty:** The Tax Exemption Decree will constitute a contract with the Puerto Rico Government not subject to subsequent legislative changes.



Obtaining a Tax Exemption Decree

A fast and predictable process

- **Application:**
 - Interested persons may obtain a Tax Incentive Application from the Office of Industrial Tax Exemption.
 - The application is available on their website <http://www.oeci.pr.gov> .
 - Applicants must ensure that their initial application is complete and correct in all respects in order to avoid delays in the review process and the granting of the Tax Exemption Decree.
- **Interagency Review:**
 - The completed application will be reviewed by the relevant governmental departments and agencies.
 - They will ensure compliance with the applicable eligibility criteria, as set forth in the application and the Act.
- **Signed Decrees:**
 - The Secretary of Economic Development and Commerce will sign the Tax Exemption Decree for approved applications.
 - Applicants who submit a complete application should expect to have their Tax Exemption Decree in approximately **45 to 60 days**.



Lower Tax Rates than in the U.S.

Compare the Puerto Rico Tax Rates to those in the U.S.

Average U.S. Company

- Average State Corporate Tax Rate: 7%
- Federal Corporate Tax Rate: 35%

Export Services Company in P.R.

- Puerto Rico Corporate Tax Rate: 4%¹
- Federal Corporate Tax Rate: 0%²

Average U.S. Shareholder

- Average State Dividend Tax Rate: 6%
- Federal Qualified Dividend Tax Rate: 15%⁴

P.R. Shareholder

- Puerto Rico Dividend Tax Rate: 0%³
- Federal Dividend Tax Rate: 0%²



Potential Increase in Rates with the Upcoming Expiration of Bush Tax Cuts



Certainty in Rates for 20 Years with Tax Exemption Decree

¹ Municipalities in Puerto Rico may levy a gross receipts tax of up to 0.5% (1.5% for financial services), which applies in addition to the applicable corporate tax rate.

² Puerto Rico companies and individual residents do not pay federal taxes on Puerto Rico source income.

³ Rate applies to shareholders of export services companies exempted under Act 20 who are residents of Puerto Rico.

⁴ This preferential rate is set to increase to as much as 39.6% after December 31, 2012.



Incredible Corporate Tax Savings

Sample savings

- **Assumptions:** Company X is a service provider that qualifies under the Act with \$10MM in gross revenues and \$2.5MM net income before taxes. Its current corporate state tax rate is 7% and its federal rate is 35%.
- **See the Savings:**

| Company X in the U.S. | |
|--------------------------|------------------|
| • State Corporate Tax: | \$175,000 |
| • Federal Corporate Tax: | <u>\$875,000</u> |
| • Total Tax: | \$1,050,000 |

| Company X in Puerto Rico | |
|------------------------------|------------------------|
| • Puerto Rico Corporate Tax: | \$100,000 ¹ |
| • Federal Corporate Tax: | <u>\$0²</u> |
| • Total Tax: | \$100,000 |

Total Annual Savings: \$950,000

¹ Assumes no gross receipt tax from Puerto Rico municipalities.

² Puerto Rico companies do not pay federal taxes on Puerto Rico source income.



Savings on Dividends Too

100% tax-exempt profit distributions to Puerto Rico residents under Act 20

- **Assumptions:** Company X is the same as in the previous slide. It has a policy of distributing all of its net earnings to its shareholders, who are in the U.S., but can all move to Puerto Rico. Shareholders of Company X currently have a state income tax rate of 6% and a federal rate of 35% applicable to dividends.¹
- **See the Savings if Company X and all of its Shareholders are in Puerto Rico**

| Company X in the U.S. and Shareholders in the U.S. | | Company X in Puerto Rico and all Shareholders in Puerto Rico | |
|--|--------------------|--|------------------------------|
| • Net Income Before Taxes: | \$2,500,000 | • Net Income Before Taxes: | \$2,500,000 |
| • State and Federal Taxes: | <u>\$1,050,000</u> | • State and Federal Taxes: | <u>\$100,000²</u> |
| • Net Earnings: | \$1,450,000 | • Net Earnings: | \$2,400,000 |
| • Dividend to Shareholders: | \$1,450,000 | • Dividend to Shareholders: | \$2,400,000 |
| • State Tax on Dividend: | \$87,000 | • State Tax on Dividend: | \$0 |
| • Federal Tax on Dividend: | <u>\$507,500</u> | • Federal Tax on Dividend: | <u>\$0³</u> |
| • Net Dividend to Shareholder: | \$855,500 | • Net Dividend to Shareholder: | \$2,400,000 |

Total Annual Savings to Shareholders: \$1,544,500

¹ Assumes that dividends payable by Company X do not qualify for the reduced federal rate of 15% because they either do not meet the requirements as Qualified Dividends under the U.S. Internal Revenue Code or are paid after December 31, 2012, which is the last date for which dividends qualify for the reduced rate.

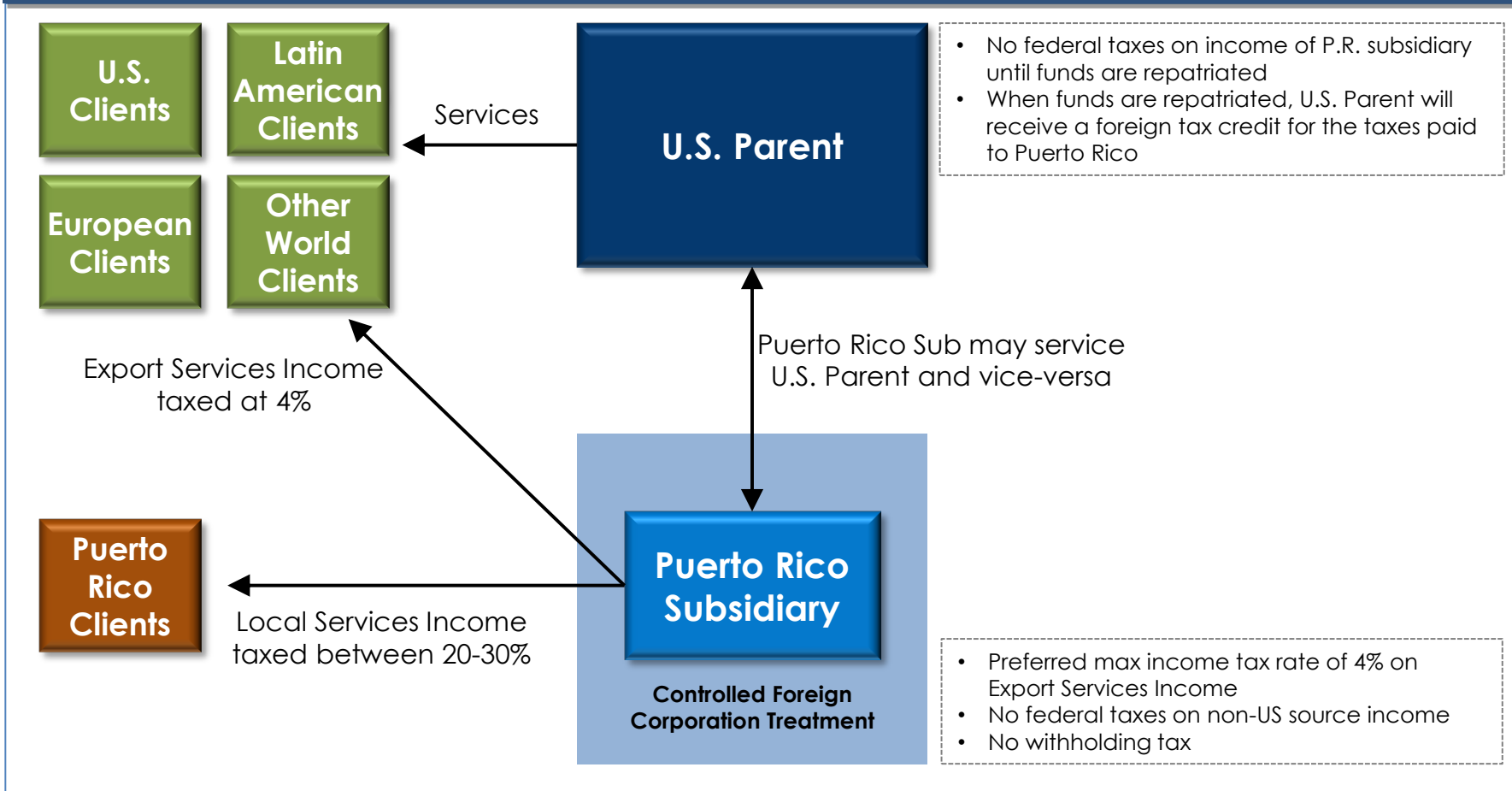
² Assumes no gross receipt tax from Puerto Rico municipalities. Puerto Rico companies do not pay federal taxes on Puerto Rico source income.

³ Puerto Rico residents pay no federal income taxes on Puerto Rico source income.



Controlled Foreign Corporation (CFC)

Subsidiary in Puerto Rico will be treated as a CFC for tax purposes

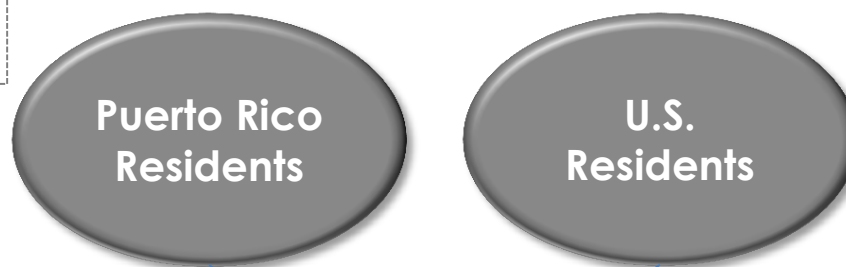




Shareholders in the U.S. and in Puerto Rico

Export services company may have shareholders in multiple jurisdictions

P.R. Residents are **100% exempt** from taxes on dividends



U.S. Residents must pay **15%*** federal tax when dividends are distributed

**Export Services
Company
(Puerto Rico)**

- Preferred max income tax rate of 4% on Export Services Income
- No federal taxes on non-US source income
- No withholding tax

* Qualified Dividend federal tax rate applicable until December 31, 2012, after which date dividends might be taxed as high as 39.6%



1 Puerto Rico at a Glance

2 Act to Promote the Exportation of Services of 2012

3 Act to Promote the Relocation of Individual Investors of 2012



A new framework for development and attracting capital to Puerto Rico

Act No. 22 of 2012 to Promote the Relocation of Individual Investors

Act 22 of 2012

- **Objective:** To attract new residents to Puerto Rico by providing a total exemption from Puerto Rico income taxes on all passive income realized or accrued after such individuals become bona fide residents of Puerto Rico
- **Goal:** New local investments in real estate, services and other consumption products, and capital injections to the Puerto Rico banking sector, all of which will accelerate the economy of Puerto Rico
- **Duration:** The incentives will expire on December 31, 2035



Incentives under Act 22

No taxes on passive income for New Residents of Puerto Rico until 2035

100% Tax Exemption on Dividends and Interest

- New Residents will enjoy a **100% tax exemption** from Puerto Rico income taxes on all dividend and interest income.
- Interest and dividends that qualify as Puerto Rico source income will not be subject to federal income taxation under Section 933 of the IRS Tax Code. New Resident investors may be able to reduce the tax rate applied on interest and dividend income coming from sources outside of Puerto Rico (including the source country taxation) to 0% or 10%, respectively, by investing through certain Puerto Rico investment vehicles.

100% Tax Exemption on Long-Term Capital Gains

- New Capital Gains: All long-term capital gains accrued after becoming a New Resident will be **100% exempt** from Puerto Rico taxes. **These gains will not be subject to federal taxes.**
- Prior Unrealized Capital Gains: All capital gains accrued and unrealized prior to becoming a New Resident will be subject to a tax of (i) 10%, if such gain is recognized within 10 years of new residence in P.R., and (ii) 5%, if such gain is recognized after said 10-year period. Such taxes paid may be used as a credit in another jurisdiction that taxes such gains. The U.S. will not tax any prior unrealized gains if recognized after 10 years of residence in Puerto Rico.
- To qualify for the Act 22 incentives, all gains must be recognized prior to January 1, 2036.



Requirements for the Incentives

New Residents that had not lived in Puerto Rico for the last 15 years

New Bona Fide Resident

- A Puerto Rico resident is an individual who is domiciled in Puerto Rico. Physical presence in Puerto Rico for a period of 183 days during the taxable year will create a presumption of residence in Puerto Rico for tax purposes.
- Section 937 of the U.S. Internal Revenue Service Code provides additional guidance as to what is generally considered a bona fide resident: (a) no tax home outside Puerto Rico during the tax year, and (b) no closer connection to the U.S. or a foreign country.

Non-Resident for Last 15 Years

- The New Resident must not have been a resident of Puerto Rico at any time during the 15-year period preceding the effective date of Act 22, which period would be from January 16, 1997 through January 16, 2012.



Lower Tax Rates than in the U.S.

Compare the Puerto Rico tax rates for New Residents to those in the U.S.

Average U.S. Resident

- Average State Dividend Tax Rate: 6%
- Federal Qualified Dividend Tax Rate: 15%¹

- Average State Interest Tax Rate: 7%
- Federal Interest Tax Rate: 35%

- Avg. State Long-Term Cap Gains Tax Rate: 5%
- Federal Long-Term Cap Gains Tax Rate: 15%³



Potential Increase in Rates with the Upcoming Expiration of Bush Tax Cuts

New Puerto Rico Resident

- Puerto Rico Dividend Tax Rate: 0%
- Federal Dividend Tax Rate: 0%²

- Puerto Rico Interest Tax Rate: 0%
- Federal Interest Tax Rate: 0%²

- Puerto Rico Long-Term Cap Gains Tax Rate: 0%
- Federal Long-Term Cap Gains Tax Rate: 0%



Zero taxes in Puerto Rico until 2035

¹ This preferential rate is set to increase to 39.6% after December 31, 2012 with the expiration of the Bush Tax Cuts.

² Puerto Rico residents do not pay federal taxes on Puerto Rico source income. With respect to dividend and interest income from sources outside Puerto Rico, New Puerto Rico Residents may reduce the federal tax rate applicable to 0% and 10%, respectively, when investing through certain Puerto Rico investment vehicles.

³ This preferential rate is set to increase to 20% after December 31, 2012 with the expiration of the Bush Tax Cuts.



Savings Example

100% tax exemption on all dividend and interest income

- **Assumptions:** John Smith has a portfolio with a market value of \$1MM with an average annual return of \$50,000 in interest and \$50,000 in dividends.
- **See the Savings**

| John in the U.S. | |
|---------------------------------------|-----------------|
| • Annual Dividend Income: | \$50,000 |
| • Annual Interest Income: | <u>\$50,000</u> |
| • Total Dividend and Interest Income: | \$100,000 |
| • State and Federal Dividend Taxes: | \$10,500 |
| • State and Federal Interest Taxes: | <u>\$21,000</u> |
| • Total Taxes: | \$31,500 |
| • Net Income After Taxes: | \$68,500 |

| John in Puerto Rico | |
|--|------------------------|
| • Annual Dividend Income: | \$50,000 |
| • Annual Interest Income: | <u>\$50,000</u> |
| • Annual Dividend and Interest Income: | \$100,000 |
| • State and Federal Dividend Taxes: | \$0 ¹ |
| • State and Federal Interest Taxes: | <u>\$0¹</u> |
| • Total Taxes: | \$0 |
| • Net Income After Taxes: | \$100,000 |

Total Annual Savings: \$31,500 or 31.5%

¹ Puerto Rico residents pay no federal income taxes on Puerto Rico source income. With respect to dividend and interest income from sources outside Puerto Rico, New Puerto Rico Residents may reduce the federal tax rate applicable to 0% and 10%, respectively, when investing through certain Puerto Rico investment vehicles.



Savings on Capital Gains

100% tax exemption on new long term capital gains

- Assumptions:** John Smith has a portfolio with a market value of \$1MM with an unrealized capital gain of \$500,000. It appreciates \$100,000 annually.

| John in the U.S. | |
|---|------------------|
| <u>TODAY</u> | |
| • Today's Portfolio Market Value: | \$1,000,000 |
| • Portfolio's Tax Basis: | \$500,000 |
| • Portfolio's Unrealized Capital Gains: | \$500,000 |
| <u>SALE IN 6 YEARS</u> | |
| • Portfolio Market Value: | \$1,600,000 |
| • Old Capital Gain: | \$500,000 |
| • New Capital Gain: | \$600,000 |
| • Taxes on Old Capital Gain: | \$100,000 |
| • Taxes on New Capital Gain: | \$120,000 |
| • Total Taxes: | \$220,000 |
| <u>SALE IN 11 YEARS</u> | |
| • Portfolio Market Value: | \$2,100,000 |
| • Old Capital Gain: | \$500,000 |
| • New Capital Gain: | \$1,100,000 |
| • Taxes on Old Capital Gain: | \$100,000 |
| • Taxes on New Capital Gain: | \$220,000 |
| • Total Taxes: | \$320,000 |

| John in Puerto Rico | |
|--|-----------------------|
| <u>TODAY</u> | |
| • Today's Portfolio Market Value: | \$1,000,000 |
| • Portfolio's Tax Basis: | \$500,000 |
| • Non-PR Unrealized Capital Gains: | \$500,000 |
| <u>SALE IN 6 YEARS</u> | |
| • Portfolio Market Value: | \$1,600,000 |
| • Non-PR Capital Gain: | \$500,000 |
| • New PR Capital Gain: | \$600,000 |
| • Taxes on Non-PR Capital Gain: | \$100,000 |
| • Taxes on New Capital Gain: | \$0 |
| • Total Taxes: | \$100,000 |
| <u>SALE IN 11 YEARS¹</u> | |
| • Portfolio Market Value: | \$2,100,000 |
| • Non-PR Capital Gain: | \$500,000 |
| • New PR Capital Gain: | \$1,100,000 |
| • Taxes on Non-PR Capital Gain: | \$25,000 ¹ |
| • Taxes on New Capital Gain: | \$0 |
| • Total Taxes: | \$25,000 |

¹ The U.S. will not tax any prior unrealized capital gains if recognized after 10 years of residence in Puerto Rico. Puerto Rico will tax such gain at 5%.