

## Puerto Rico Tax Incentives – Can Puerto Rico Have Nice Things?

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**Did you hear about the crypto conference in Las Vegas? During a break, the audience all got up, walked outside ... and moved to Puerto Rico!**

As the Puerto Rico business and investor incentives of Act 60 approach their 10th anniversary, they are having their best year ever at achieving the goal of attracting wealth and innovation to the island. Originally titled Act 20 (business incentive) and Act 22 (investor incentive), these provisions have attracted growing attention from the media, lawmakers, and more recently the IRS.

The focus of this attention has been based on a perception that U.S. persons pop in and out of the island primarily to take advantage of unique tax benefits. In fact, up to this point the results of the incentives have been underwhelming – a few thousand people have relocated over the past nine years. That’s around five people per U.S. state per year. The designers of the program must have wondered if it was worth the effort.

However, something more is happening. In recent years, the program has seen a swell of crypto investors, defi innovators, and blockchain entrepreneurs. They have created a community of young futurists that others want to be a part of. For some, it’s as simple as choosing between staying in mom and dad’s basement or moving to an apartment or condo near the beach where you can be surrounded by others who share your passion.





### **The Incentives in a Nutshell**

Legacy Act 20 generally provides for a 4% tax rate on income from specified export activity. A bona-fide resident of Puerto Rico can avoid including all or part of the income (or dividends from the company) in U.S. taxable income. Typically, the company engages in providing services to customers outside of Puerto Rico, with the owner being the only employee. This common arrangement aligns with remote work incentives that are becoming more common around the world. However, many Act 20 businesses hire local employees and make use of local contract services and provide other benefits to the Puerto Rico economy.

Legacy Act 22 is an investor incentive favored by crypto investors. Essentially, the provision provides an exemption for certain island-sourced investment income – notably capital gains of either a short-term or long-term variety. A special rule allocates gains to the period before and after taking up residency in Puerto Rico. The cost of obtaining and maintaining Act 22 benefits can be around \$20,000 per year (plus the eventual purchase and occupation of a Puerto Rico residence) so there is a material annuity benefit to the Puerto Rico economy.

### **The U.S. Rules that Support the Effectiveness of Incentive Regime**

Puerto Rico is a commonwealth and a territory of the United States. The government of Puerto Rico has the right to collect taxes from its residents of bona-fide status on their island-source income. Despite generally taxing its citizens on their worldwide income, under Section 933 of U.S. tax law, the U.S. government effectively agrees that island-source income is exempt from U.S. federal tax. The

exemption applies to the approximately 3.3 million residents of Puerto Rico. So conceptually, you can pay one place or the other – but not both.

What happens if Puerto Rico decides not to tax income it otherwise has the primary right to tax? The Section 933 exemption can still apply—preventing the U.S. from soaking up the income and taxing it. So, in the case of a U.S. citizen that qualifies as a bona-fide resident of Puerto Rico and earns island-source income, the final tax liability can be 4% or zero.

### **What is the Current Enforcement Landscape?**

Under some implied pressure from lawmakers, the IRS is now purportedly on the scene in force in Puerto Rico. They have a formal campaign to review Act 22 claims and in 2020 they arrested and indicted the head of one of the accounting firms in an Act 20 sting operation. The IRS does not conduct multi-year criminal sting operations over \$100k so it is reasonable to expect more activity in both areas. Furthermore, the implication is that the IRS is encouraging the Puerto Rico government to be more diligent in enforcing the conditions of the local incentives. Controversy can be expected similar to what happened starting in 2005 in the U.S. Virgin Islands (and in some cases is still ongoing).

### **Can Puerto Rico Have Nice Things?**

The legacy Act 20 and Act 22 incentives are not the only tax incentives available in Puerto Rico. In fact, Puerto Rico offers a morphine drip of other financial incentives. Around 4,000 doctors are taking advantage of a 4% tax rate to encourage them to remain in Puerto Rico and provide





critical health care services. Assuming they are bona-fide residents providing these services in Puerto Rico, they can pocket the benefit despite being U.S. citizens. To the extent the U.S. were to eliminate the rule, some of these doctors might relocate to Orlando or New York and the U.S. could collect more taxes. But critical medical services in Puerto Rico could be negatively impacted.

On the business side, the IRS has reported that large U.S. companies have taken advantage of Puerto Rico tax incentives to create 70,000 jobs in Puerto Rico. Smaller businesses have undoubtedly created this many or more jobs relying on similar incentives (other than Act 20). Janet Yellen and other officials decry the global “race to the bottom.” But Puerto Rico was winning the race and securing badly needed local employment. Now the world has called off the race – and changes proposed by the Biden administration would further erode the tax benefits of Puerto Rico employment.

### The Outlook

What can be said for sure at this time is that the Puerto Rican incentives have accomplished what every other country in the world is trying to do – create a hub of crypto, defi, and blockchain innovation and talent. What is more remarkable is that such a center involving virtual activity has flourished in a country that at times has intermittent wifi.

One strategy would be to recognize and harness the nascent metaversal industry. Refocus incentives and investment in this area to encourage its continued growth. After ten years, hit the refresh button on the Act 20 and Act 22 incentives to better align them to an increasingly

remote workforce and virtual business environment. Provide greater clarity (from both the Puerto Rico and U.S. IRS standpoint) about the way the rules work. There are valid concerns about the efficiency of the Puerto Rico tax incentives of Act 20 and Act 22. However, they have inadvertently nurtured a powerful economic force that could not have been contemplated at the time the incentives were enacted. It’s a nice thing.

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