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## PUERTO RICO—THE PERFECT U.S. TAX RESORT



THE PERFECT U.S. TAX RESORT  
 PUERTO RICO - SUN, SAND, SURF  
 & 4% TAX  
 PLUS  
 ASSET PROTECTION POSSIBILITIES

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### INSIDE

#### Puerto Rico

The Perfect U.S. Tax  
 Resort—Sun, Sand,  
 Surf & 4% Tax

Pages 1, 2, 3 & 4

This article focuses on both certain tax incentives that Puerto Rico has successfully used to spur economic development and job creation, and those asset protection tools that can be deployed to protect the assets of those individuals who may chose to conduct business and/or reside in Puerto Rico.<sup>1</sup>

#### Exportation of Services Incentives Act of 2012 (Act 20)

On January 17, 2012, Puerto Rico enacted Act No. 20 of 2012, also known as the Act to Promote the Exportation of Services (“Act 20”). Act 20 provides tax exemptions to businesses engaged in certain eligible activities in Puerto Rico. To take advantage of such benefits, a business needs to become an exempt business by obtaining a tax exemption decree through the Department of Economic Development and Commerce (“DEDC”).

#### Eligibility of Qualified Services Under Act 20

Act 20 provides benefits for certain qualified services provided from Puerto Rico to outside markets, that is, to the U. S. and other foreign countries. Eligible activities to receive benefits under Act 20 are services in the following areas:

- research and development;
- advertising and public relations;
- economic, scientific, environmental, technological, managerial, marketing, human resources, engineering, information systems technological auditing and consulting services;
- commercial art and graphic services; consulting services for any trade or business;
- production of engineering and architectural plans and designs and related services;
- professional services such as legal, tax and accounting services;
- centralized managerial services, including, but not limited to, strategic direction, planning and budgeting, provided by regional headquarters or a headquarters company engaged in the business of providing such services;
- services performed by electronic data processing centers;
- development of licensable computer software;
- telecommunications voice and data between persons located outside of Puerto Rico;
- call centers;
- shared service centers;
- medical, hospital and laboratory services;
- investment banking and other financial services, including, but not limited to, asset management, management of investment alternatives, management of activities related to private capital investment, management of coverage funds or high risk funds, management of pools of capital, trust management that serves to convert different groups of assets into securities and escrow accounts management services;
- any income derived from the investment of funds earned from providing an eligible service, so long as such investment is reinvested in the entity that conducts the eligible service, is made in a business with its principal place of business in Puerto Rico, or is held in a financial institution in Puerto Rico; and

(Continued on page 2)

- any other service designated by the DEDC Secretary.

**Requirements Established Under Act 20**

In order to qualify as an eligible activity under Act 20, the following requirements must be met:

- Establish a “bona fide” office in Puerto Rico;
- As per recent amendments to the law, at least five (5) employees are required to work in Puerto Rico (Act No. 187 of 2015);
- The export service that is provided cannot have a nexus with Puerto Rico, and, as a general rule, the service itself must not be related to the conduct of a trade, business or other activity in Puerto Rico. Services considered to have a nexus with Puerto Rico, and thus, are not considered to be eligible services under Act 20 include:
  - services provided to business or regarding income-producing activities that are or have been performed in Puerto Rico by the applying business;
  - services regarding the sale of any property located in or for use, consumption or disposition in Puerto Rico; or
  - services rendered to a resident of Puerto Rico.
- Professional services such as legal, tax or accounting are eligible services under Act 20 as long as the same are being rendered to non-residents of Puerto Rico and the services do not have a nexus to Puerto Rico.

**Promoter Services**

Promoter Services represent a non-eligible service that nevertheless will be eligible by law of exception to the no nexus rule described above. Promoter Services are services provided to nonresident individuals and/or foreign entities that are related to the establishment of a new business in Puerto Rico as defined in Act 20 and its regulations. Only net income derived from Promoter Services provided to a new business that performed within the twelve (12) month period ending on the day preceding the earliest of the following actions will be considered exempt service income regardless of its nexus to Puerto Rico:

- The new business executes a contract to acquire or lease facilities in Puerto Rico;
- The new business begins construction of the facilities to be used in Puerto Rico; or
- The new business commences operations in Puerto Rico.

**Tax Exemptions Under Act 20**

Qualified eligible activities can benefit from the following benefits on income derived from customers located outside of Puerto Rico in relation to services rendered from Puerto Rico:

- four-percent (4%) fixed corporate income tax rate;
- certain investment income also qualifies for four percent (4%) tax rate;
- one hundred percent (100%) tax exemption for Puerto Rico residents on distributions from earnings and profits;<sup>2</sup>
- one hundred percent (100%) tax exemption for the first five years of operation from personal property taxes for certain types of businesses, and ninety percent (90%) tax exemption thereafter for the term of the tax exemption decree. The taxable portion will be subject to the regular tax rate, which currently can be up to eight and 83/100 percent (8.83%). Tax is imposed on the fair market value of the personal property. In general, book value is accepted to be equal to fair market value;
- one hundred percent (100%) tax exemption for the first five years of operation from real property taxes for certain types of businesses and ninety percent (90%) tax exemption thereafter for the term of

the tax exemption decree. Tax is imposed on the value of the property as assessed by the Municipal Revenue Collection Center. The taxable portion will be subject to the regular tax rate, which currently can be up to ten and 83/100 percent (10.83%); and

- sixty percent (60%) tax exemption on municipal taxes (ninety percent (90%) tax exemption if the business operates in the industrial development zone constituted by the municipalities of Vieques and Culebra). Any taxable portion will be subject to the regular tax rate, which currently can be up to zero point five percent (0.5%).

**Act 20 Tax Exemption Decree**

To benefit from Act 20, the Act 20 entity needs to submit an application with DEDC to obtain a tax exemption decree signed by the Secretary, which will provide full detail of tax rates and conditions mandated by Act 20 and which will be considered a contract between the Government of Puerto Rico and the Act 20 entity. Once the service provider obtains the tax exemption decree, the benefits granted will be secured during the term of the tax exemption decree, irrespective of any changes in the applicable Puerto Rico tax laws. The tax exemption decree shall have a term of twenty (20) years, renewable for a possible ten (10) year extension. Upon repatriation, the distributed income would be subject to the tax imposed by the jurisdiction in which the owners of the Puerto Rico entity reside, if any.

**Individual Investors Incentives Act of 2012 (Act 22)**

On January 17, 2012, Puerto Rico enacted Act No. 22 of 2012, also known as the Act To Promote The Relocation of Individual Investors (“Act 22”). Act 22 provides tax exemptions to eligible individual investors who need to become bona fide residents of Puerto Rico and apply for a tax exemption decree with DEDC.

**Requirements Established Under Act 22**

The benefits of Act 22 are only available to *bona fide* residents of Puerto Rico that were not *bona fide* residents of Puerto Rico for the six (6) year period preceding the enactment of Act 22 on January 17, 2012 (“Eligible Individuals”). Generally, a *bona fide* resident of Puerto Rico is a person who:

- is present in Puerto Rico for at least 183 days during the tax year;
- does not have a tax home outside of Puerto Rico during the tax year; and
- does not have closer connections to the United States or to a foreign country than to Puerto Rico.
- a person to become a bona fide resident will be required to purchase real property in Puerto Rico (Act 187 of 2015).

Pursuant to Sec. 933 of the U. S. Internal Revenue Code, *bona fide* residents of Puerto Rico are not subject to U. S. federal income taxes on income derived from sources within Puerto Rico. Therefore, U. S. citizens that are *bona fide* residents of Puerto Rico benefiting from Act 22 will only be subject to federal income taxation on income derived from sources outside of Puerto Rico.

**Tax Exemptions Under Act 22**

Act 22 is designated to primarily attract high net-worth individuals to Puerto Rico, who currently relocate to other states and individuals investors from the United States and other countries. Act 22 provides the following benefits to new Puerto Rico *bona fide* residents on qualified investments:

- one hundred percent (100%) tax exemption from Puerto Rico income taxes on all dividends;
- one hundred percent (100%) tax exemption from Puerto Rico income taxes on all interest; and

- one hundred percent (100%) tax exemption from Puerto Rico income taxes on all short-term and long-term capital gains accrued after the individual becomes a *bona fide* resident of Puerto Rico.

### Act 22 Tax Exemption Decree

To benefit from Act 22, the individual investor needs to submit an application with DEDC to obtain a tax exemption decree signed by the Secretary, which will provide full detail of tax rates and conditions mandated by Act 22 and will be considered a contract between the Government of Puerto Rico and the individual investor. Once the individual investor obtains the tax exemption decree, the benefits granted will be secured during the term of the tax exemption decree, irrespective of any changes in the applicable Puerto Rico tax laws. The term of the tax exemption decree will be until December 31, 2035.

### Asset Protection Possibilities<sup>3</sup>

An individual utilizing the Act 20 and Act 22 Puerto Rico tax incentives may hold assets in an offshore asset protected trust (“APT”) which can own the Puerto Rico operating entity and other Puerto Rico assets. The APT is a disregarded grantor trust. In the event the APT owns offshore based holding companies which in turn own Puerto Rico based assets, those holding companies will also be disregarded entities.

An APT is a trust established outside the jurisdiction of the United States and Puerto Rico. The Trust is normally tax neutral. The APT is not a tax avoidance device rather, as the APT is structured as a grantor trust, it is merely disregarded.

All income and assets of the APT structure of course are reported in both Puerto Rico and the United States. The Grantor must comply with Puerto Rico and U.S. Treasury reporting and compliance requirements.

APTs must be a discretionary trust wherein the Trustee has the discretion to take various actions vis-à-vis the trust without the interference or control of the Grantor. A United States court cannot force the Trustee to exercise its discretion nor is the Trustee obligated to recognize an instruction from the Grantor which would require the Trustee to pay assets of the Trust over to a creditor of the Grantor. Such actions abrogate the discretionary provisions of the Trust. This is the basics for assets protection.

Trustees are prohibited from acting under duress (i.e. forcibly by U.S. court order) and/or making payments to “excluded persons” such as creditors. A U.S. person cannot however avoid contempt citations for non-payment of alimony and child support by placing assets into an APT. Practitioners must be careful of such attempts to avoid payment of alimony and child support.

A properly drafted and established APT is designed to take advantage of the laws of the offshore jurisdiction which do not recognize U.S. Debtor/Creditor laws or judgments rendered by U.S. courts. Unless a creditor is willing to go through an expensive court process in the offshore jurisdiction in order to attempt to obtain information about an APT, the Trustee may remain silent. Additionally, there is no guarantee that the Creditor will prevail.

APTs provide additional safety features which protect assets from Creditors’ attack. These include, but are not limited to, “flee”, “anti-duress” and “spend thrift” provisions. The flee provisions authorize the Trustee to change the location of the APT to another offshore jurisdiction and to automatically change the Trustee in the event a U.S. Judgment Creditor attempts to bring actions against the APT. The Trustee is under the no duty to disclose to any Creditor that the “flee” provisions have been implemented.

Obviously, these provisions have a chilling effect on a Creditor’s collection efforts as the Creditor has no idea in the world where the new trust is located. The “anti-duress” provisions normally prohibit the Trustee from making any distributions directly or indirectly from the Trust to any Creditor of the Grantor. “Spend-thrift” provisions further prohibit the Trustee from making distributions from the Trust for the benefit of any Creditor of any beneficiary of the Trust including beneficiaries who are the spouse or children of the Grantor.

The APT also incorporates an estate plan which distributes assets to certain named beneficiaries of the Grantor upon death. If at the time of the death of the Grantor there are no outstanding claims against the Grantor, the Trust can provide that the assets that are to be brought onshore to be administered by a U.S. based Trust Company or distribute them directly to beneficiaries.

By having an APT own an offshore holding company which in turn owns a Puerto Rico based LLC additional asset protection may also be achieved as the ownership interest in the Puerto Rico LLC is beyond the jurisdiction of Puerto Rico and U.S. courts. The holding company structure is not controlled by the Grantor/Ultimate Beneficial Owner it is rather controlled by the Trust Company.

When coupled with the Puerto Rico tax incentives a well founded APT structure provides the comfort of flexibility and wealth preservation.

Working in conjunction with a Puerto Rico tax expert such as my colleague Robert Feiger, our clients have found that the combination of an asset protection plan wrapped around Puerto Rico incentive qualifying entities is a hard to beat combination.



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This Article does not constitute legal and/or tax advice. Anyone considering utilizing the techniques described herein is cautioned to consult with legal and tax advisors before doing so. Each client’s potential structure is conditioned upon facts and circumstances unique to that client and the client’s planning needs.



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<sup>2</sup>Administration Determination No. 15-22, made effective October 3, 2015, imputes, under certain conditions, the salaries paid to stockbrokers or partners, who at the same time are employees of companies that perform services under tax incentive decrees issued under Acts 20 and 22. The facts of each case should be studied to determine the applicability of this Administrative ruling.

<sup>3</sup>Practitioners and clients need to take into consideration a multitude of issues before rendering asset protection advice including but not limited to, solvency, tax compliance, litigation history, fraudulent transfers, etc .

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