If you are looking for a slice of paradise, topped with a serving of healthy tax incentives, and have the strength to stomach a certain degree of risk, Puerto Rico might be the place for you.

The locals call it Boringquen, meaning “The Land of the Valiant Lord.” In Spanish, it is known as la isla del encanto - “The Island of Enchantment.”

For years, Puerto Rico has been seducing visitors as a tropical island getaway with it’s pristine, crystal-clear beaches, legendary surf, vibrant 17th and 18th century Spanish colonial architecture, and outdoor adventures in some of the most spectacular wonders of nature in the world.

Puerto Rico (officially the Commonwealth of Puerto Rico) is an unincorporated territory of the United States. It lies southeast of Florida in the Caribbean, next to the Dominican Republic and the US and British Virgin islands, and covers an area of approximately 9,100 square kilometers.
The total permanent population is estimated at 3.7 million. Puerto Rico also hosts approximately 4 million visitors each year. Since visitors from the United States do not need a visa or even a passport to enter Puerto Rico, Puerto Rico attracts many tourists from the mainland United States. Manufacturing is the mainstay of Puerto Rico’s economy, followed by the service industry.

Although English and Spanish are both official languages in Puerto Rico, Spanish is by far the most used language in everyday life, with over 95% of the population speaking it.

Puerto Rico is located just a few hours flight away from the mainland United States, and moving to the island is as easy as moving from California to Texas, or from New York to Florida—you don’t need a visa or work permit.

**Americans and the Long Arm of the IRS**

US citizens, along with citizens of the African country of Eritrea, are unique in that they are the only people in the world that are taxed no matter where they live. Everyone else in the world can simply pack their bags and move to a low tax jurisdiction like Singapore or the Cayman Islands and, for the most part, not worry about paying taxes to their home country. Not so for Americans.

**Americans have limited options when it comes to minimizing their tax burden. Those options include:**

1. **Move to a tax-friendly state**

   Untold Americans do this every year—moving from a tax-heavy state like California or New York to a no-tax state like Texas or Florida. Of course, this allows people to escape their state tax burden… but you still have to pay Federal taxes.

2. **Move abroad and claim the Foreign Earned Income Exclusion**

   Moving abroad to a tax friendly jurisdiction like Panama, and claiming the [Foreign Earned Exclusion](#) allows you to exclude roughly $100,000 of foreign earned income from your US Federal income tax. However, income earned above the exclusion would be subject to tax, and you would still have to pay taxes on investment income.

   There are also special deductions and allowances for foreign housing, so between the Foreign Earned Income Exclusion plus a Foreign Housing Allowance, you could live mostly tax free overseas on roughly $150,000 annually.
3. Renounce your US citizenship

Renouncing US citizenship is quite possibly the most serious and emotionally difficult option. It is also the most absolute option that ensures you truly sever your tax liabilities to the US government. Even though the tax burden in the US may not be favorable, most people have friends, family, and other significant connections to the US, so renouncing US citizenship is not a decision to be taken lightly.

4. Move to Puerto Rico

Up until recently, moving to Puerto Rico wasn’t a serious option for Americans looking to minimize their tax burden. But in recent years the Puerto Rican government has passed new laws, which provide very significant tax incentives.

Puerto Rico is now openly trying to woo productive people to come to the island. And because Puerto Rico has its own independent tax system, you could be exempted from most US federal taxes.

Puerto Rico’s Current Tax Law

The first thing to understand about Puerto Rico is that it is a US territory, so for most purposes, it is similar to any US state. In the same way that a resident of Texas can become a resident of New York, a resident of New York can become a resident of Puerto Rico.

But as a US territory, Puerto Rico has some unique characteristics. Most importantly, it has its own tax system (see section 734 of Title 48 of the US Code). This allows Puerto Rico to offer some unique tax incentives that none of the other 50 states can offer.

The US Internal Revenue Code states that anyone who is a bona fide resident of Puerto Rico for an entire year will not be taxed on income derived from Puerto Rico. (Note- this doesn't mean you have to spend the entire year in Puerto Rico—more on this later…)

**Simply put, residents of Puerto Rico are generally not required to pay US federal income tax, nor file most income tax returns to the IRS.**

Puerto Rico isn’t the only place that has a special tax agreement with the US. Other places include US possessions such as Guam, Palau, the US Virgin Islands, and American Samoa.

However, compared to all those other US territories, Puerto Rico is a much more attractive option because it is both the closest to the mainland United States and it is by far the most populated territory.

Palau is nice. Trust me, I’ve been several times. But you might go crazy spending all of your time on that tiny little island chain in the middle of nowhere in the Pacific.
Puerto Rico on the other hand is just a few hours away from major cities in the US. It’s only one-hour time difference from the East Coast, and even shares the same time with the East Coast during daylight savings.

And Puerto Rico itself isn’t just some small island with nothing to do. With about 2.5 million people living in the San Juan metropolitan area, you can find vibrant nightlife, museums, coffee shops, and many of the niceties and big box retailers that you are accustomed to seeing on the mainland.

So not only could you lower your tax liability far much more than you could in tax-friendly states like Florida or Texas, you could do so while still living a lifestyle that is not foreign to you.

**Puerto Rico’s Tax Incentives**

The Puerto Rican government has recently passed a number of tax-incentive laws specifically targeting US citizens from the mainland.

In general, as long as you haven't lived in Puerto Rico within the last 15 years, you can qualify.

The Puerto Rican tax law incentives state that if you move to Puerto Rico and become a new resident,
they’ll sign a contract with you that is good until 2035, guaranteeing that you will pay zero capital gains taxes, zero taxes on your dividend income, and if you set up a corporation, only a 4% corporate income tax.

Puerto Rico is basically borrowing from Singapore’s playbook. They are hoping that by lowering their taxes and incentivizing people to come to the island to work and start businesses, they can create jobs and grow their economy.

There are two big parts to the laws—the first is the business income portion, and the other is the investment income portion.

**Act 20 - The Export Services Act**

Act 20 reduces taxes on corporate profits for qualifying Puerto Rican service companies to just 4%.

Specifically, a US citizen can start a Puerto Rican company or move an existing company to Puerto Rico, which performs services within Puerto Rico on behalf of customers outside Puerto Rico. And in this case, if approved, the corporate tax rate would be just 4%.

Now, the Internal Revenue Service has a long series of rules about corporate income to determine where is the ‘source’ of the income.

For example, in this case, if you have a company which performs services in Puerto Rico, but your customers are in California, is the business income derived from Puerto Rico or California?

According to the IRS, the important factor in determining where service income is sourced for tax purposes is where the service is performed.

Generally, all income your business receives from services performed in Puerto Rico is considered to be from sources within Puerto Rico. The location of the customer can be anywhere in the world, even in the United States.

The key to Act 20 is that the Puerto Rican company must perform all of its services in Puerto Rico. If the company has any connections or branches in the United States that perform part of the service, the income would be subject to US tax.

For example, you cannot have a company in Puerto Rico performing services for US customers if the company maintains offices and sales staff (who are also performing services) in the United States. In this case, the company would be subject to US federal tax.

So in order to qualify, it’s imperative that the company be fully engaged in Puerto Rico, “exporting” services abroad.
The question to answer for any entrepreneur then becomes—can your business be in one place and provide a service to customers in another place? Candidly, there are numerous types of businesses which could qualify, many of which are specifically mentioned in the law:

- E-commerce businesses, particularly those which provide or publish digital products and services
- Consulting firms of any kind, particular those which do not require substantial travel to the customer in order to provide the service
- Investment management
- Graphic design
- Internet marketing and copywriting services
- Investment relations and PR
- Inbound and outbound call centers, especially bilingual (English / Spanish) call centers
- Remote tax and legal consultancy, including tax preparation work
- Software development
This list is obviously not exhaustive as there are nearly limitless options.

Income from these kinds of service businesses, as long as the service is performed entirely in Puerto Rico, would only be subject to a **4% Puerto Rican corporate tax**.

If a Puerto Rican corporation meets the requirements for Act 20 and pays out dividends, **resident shareholders would not pay Puerto Rican personal income tax on the dividends either**.

And thanks to Section 933, American citizens who are residents of Puerto Rico are also exempt from paying US income taxes.

(Note that American shareholders of a Puerto Rican company who live in the mainland US would still have to pay state and federal taxes on the dividend income.)

What this means is that if you are an official resident of Puerto Rico and have an approved business which exports services from the island, your total tax liability could be reduced to as low as just 4%.

A 4% corporate tax rate is one of the key benefits that attracted people like Peter Schiff and a number of other financial services entrepreneurs to Puerto Rico.

Peter’s company is performing financial services from Puerto Rico. But his customers are outside of Puerto Rico—many of them are on the US mainland.

Peter was originally operating his business in California, and moving his business from California to Puerto Rico effectively reduced his corporate tax burden from over 50% in California to just 4% in Puerto Rico.

**Act 22 - The Individual Investors Act**

Act 22 is the second major incentive. It eliminates taxes on investment income that an individual generates after becoming a resident in Puerto Rico.

This applies to capital gains, dividends, and interest income, though the rule does not fully apply to existing investments that you own prior to becoming a resident.

For example, if you purchased 500 ounces of gold at $250 (nice going!) more than a decade ago, and moved to Puerto Rico on a day that the gold price was $1,250, you would still owe tax on the $1,000 gain that you accrued prior to moving to Puerto Rico (assuming you sell).

However, if the gold price goes from $1,250 to $2,000 while you are living in Puerto Rico, you would not owe a penny on the additional $750 capital gain (again, assuming that you sell).
As another example, assume you buy shares of XYZ Corporation on the day after you move to Puerto Rico at $10. Five years later, XYZ is trading for $75. You can sell the stock and pocket the entire $65/share gain, tax-free... no taxes owed to Puerto Rico or to the US government.

Bear in mind, you cannot escape certain types of capital gains tax in Puerto Rico—most notably from US real estate.

So if you purchase a property in Florida after you move to Puerto Rico, for example, you cannot escape US tax liability on the capital gains when you sell the property.

The tax exemption can apply, however, to dividend income—provided that dividend income comes from Puerto Rican corporations.

If you buy shares of, say, AT&T, and AT&T pays a small dividend, you would still owe US tax on that income. The same rules apply to interest.

For example, if you hold a private mortgage in the United States for a US property, and the borrower pays you 8% per year, that money would be taxable in the US.

But if you opened a Certificate of Deposit in Puerto Rico, the interest income from that CD would be tax-free in both Puerto Rico and the US.

However, make sure you understand the risks associated with the Puerto Rican banking system and the Puerto Rican government.
In short, the Puerto Rican banking system is not sufficiently capitalized or liquid to withstand a financial shock.

Moreover, the Puerto Rican government is in a position where they have to borrow money just to pay interest on the money they have already borrowed.

This entire situation is covered in greater detail in the section *Caveat Emptor: Is Puerto Rico the Next Greece?*

### Qualifying for Residency in Puerto Rico

In order to reap most of the tax benefits of Puerto Rico's new laws, you have to be a bona fide resident.

According to the IRS, you qualify as a bona fide resident of Puerto Rico if you meet these three criteria:

1. **Physical Presence Test**
2. Do not have a tax home outside Puerto Rico
3. Do not have a closer connection to the United States or to a foreign country than to Puerto Rico.

#### 1. Physical Presence Test

The key number is 183. In order to qualify as a resident of Puerto Rico for tax purposes, Section 937 of the Internal Revenue Code says that you must spend 183 days within a year in Puerto Rico.

One important thing to note is that a day spent in both Puerto Rico and the US mainland counts as 1 day in Puerto Rico for residency. You can spend 1 hour of the day in Puerto Rico and spend 23 hours in the US, and that day counts as if you were in Puerto Rico the whole day.

For example, on day one you fly from San Juan to Atlanta and spend the night there. The following day you fly back to San Juan and both days count toward residency in Puerto Rico.

And again, there’s a lot going on in Puerto Rico, especially in the metropolis of San Juan. It’s not a small island in the middle of nowhere. Life is in full swing there.

As for corporate residency—80% of the work, as measured by the payroll, has to be performed in Puerto Rico to qualify for corporate residency. If you’re operating a business yourself, and you’re 100% of the payroll, and you spend five months in the US every year, you are disqualified because now 40% (5 of 12 months) of the payroll is assigned to the US.

So if you’re planning on spending more of your time in the US, you have to hire enough people who will live in Puerto Rico, and you have to pay them enough to qualify. It is important to remember that the Puerto Rican
government is trying to grow the economy. They’re trying to get businesses to create jobs and hire people. So you could hire people for clerical work, back office work, or operational work to meet the 80%.

2. Do not have a tax home outside Puerto Rico

What is a tax home? According to the IRS, your tax home is the general area of your main place of business or employment, regardless of where your family home is.

Your tax home is the place where you are permanently or indefinitely engaged to work as an employee or self-employed individual.

If you do not have a regular or main place of business because of the nature of your work, your tax home may be the place where you regularly live. If you have neither a regular or main place of business nor a place where you regularly live, your tax home is wherever you work.

In order to pass this test, you must establish Puerto Rico as your tax home and break any ties to any previous tax home you had before moving to Puerto Rico. Passing this test is simple in principle: live and work in Puerto Rico.

3. Do not have a closer connection to the United States or to a foreign country than to Puerto Rico.

To pass this test, you must be able to prove that you are indeed living and working in Puerto Rico and that you have more significant contacts and connections in Puerto Rico than in the mainland United States.

This is a subjective call, but here are some tips from experience:

• When traveling to the United States, you’ll need to fill out an entry form. You should indicate on this form that you live in Puerto Rico, and use your Puerto Rican address on any official government form.

• Change your address with different companies that you have a relationship, even if it’s something small. For example, change the address for your frequent flier accounts to Puerto Rico, even if you don’t actually receive any mail from them. And get a subscription to something (newspaper, anything) delivered regularly to your home in Puerto Rico.

• Avoid having an address in the US if at all possible. If you do, use a PO Box or commercial mail forwarding service—something that is clearly not a residential address.

• Try not to maintain a home in the US. If you do have a home, try to rent it out, and avoid spending any time there at all.

• Keep your family with you in Puerto Rico. If you do not home school, enroll your children in local public or private schools on the island.
• If you’re so inclined, join a gym, country club, church, or some other type of organization.

• Keep personal property in Puerto Rico. Don’t just rent a turnkey corporate apartment in San Juan while all of your stuff still ‘lives’ in the US, even if it’s all at a U-store it place.

• Have a family doctor or dentist in Puerto Rico. Go see him/her on occasion for checkups. Keep the receipt, or at least jot down the dates.

• Make friends! Don’t be a hermit and sit in your apartment all day. Go meet other people in Puerto Rico. Put down some roots and get to know the city.

• Learn a bit of Spanish… or at least be able to demonstrate that you are making efforts to learn a bit of Spanish.

**Who Can Benefit From These New Tax Incentives**

First, an important note: moving somewhere specifically for tax purposes is not necessarily the most prudent decision. You should move because you really like the place, and the tax benefits happen to be another advantage.

So if you find that you enjoy life in Puerto Rico, there are certain cases where it could be a good decision to move to Puerto Rico to reap the tax benefits.

**People Who Expect Capital Gains in the Near Future**

Puerto Rico may make sense if you have a temporary situation where you’re expecting massive capital gains in the next 18-36 months.

You can basically move to Puerto Rico, establish residency, earn your capital gains, pay no taxes on the income, and move back to the mainland US or wherever you please.

The 0% tax break is only for capital gains earned after you move to Puerto Rico. So any subsequent capital gains after you move to Puerto Rico are tax-free.

**People Who Earn Their Living Primarily From Capital Gains**

Similar to above, if you earn most of your income through capital gains and enjoy the idea of living on a tropical island with warm weather all year round, then Puerto Rico could be the place for you for the long term.
Again, Act 22 exempts residents of Puerto Rico from capital gains taxes. Section 933 of the US Internal Revenue code, exempts residents of Puerto Rico from US taxes.

With these two combined, you would pay no income taxes on your capital gains—none in Puerto Rico and none in the US.

**Internet Based / Telephone Based Businesses**

If you have a business or plan to start a business where you use the Internet or telephone to service your customers outside of Puerto Rico, then you can operate the business through a Puerto Rican corporation.

In this case, you wouldn’t necessarily have to move to Puerto Rico. As long as the business meets the requirements for Act 20, the company would only be taxed at a 4% corporate tax rate.

However, if you remain on the mainland US, you would still be subject to federal and state income taxes if the company pays you dividends.

If you become a resident of Puerto Rico, you could reap the benefits of both Act 20 and Act 22 by paying yourself in the form of dividends from the company. In this case, the company would only pay 4% corporate tax and your dividend income would be tax free in both the US and Puerto Rico.

See a case study of a well known financial entrepreneur Peter Schiff below for more details on moving and operating a service business in Puerto Rico.
Case Study—Peter Schiff

Rather than move yourself, it’s much easier to move a business or set up a business in Puerto Rico. In this case, the business is paying just a 4% corporate tax. A business structured in Puerto is also non-reportable, since it’s still a US jurisdiction.

If the business does not pay you a dividend personally, then you would have no individual income taxes due. As always, you can control when (and where) you pay out those dividends.

Peter Schiff is an outspoken financial entrepreneur, investment broker, author, and financial commentator. You’ve probably seen some of his appearances on CNBC, FOX News etc., which are always colorful.

Back in 2006 and 2007 Peter was giving out warnings on live TV that the US housing market and the US economy as a whole are about to crash… Back then everybody ridiculed him and actually laughed at his face on air.

Peter owns and operates several financial and investment businesses. One of them is an asset management firm that used to be based in California.

Peter reincorporated and moved his asset management business down to Puerto Rico. His company can perform those services in Puerto Rico for its customers on US mainland and around the world, and now the business only pays a 4% corporate tax on that income.
You do need to receive a salary from the company, and this salary would be subject to ordinary income taxes in Puerto Rico. Ordinary income tax rates on the island range from 0% to 33%. And just like US tax, there are a number of deductions that you can take.

For example, if you buy a house or a condo there, you can deduct your mortgage interest. You also have a personal deduction, so you’re paying income taxes on your wages at a lower bracket.

But compared to your salary, all of your higher income would be from dividends from the business. And as we’ve mentioned earlier, you don’t have to pay taxes on investment income, like dividends.

Peter has so far moved his business to Puerto Rico, and he plans to relocate and become a resident also personally.

Once he does that his situation will look like this:

Peter’s business pays a 4% corporate tax; he pays Puerto Rican income tax on some nominal salary, and 0% on the dividends that the business pays him—so 0% on the other 96% of the company’s income.

The income that Peter’s business used to earn was made in California, which means that it had to pay California tax, which goes up to 13%. It also has to pay roughly 40% US federal tax.
So Peter took his business that was based in Newport Beach, California with a marginal tax bracket of over 50% and lowered his tax burden to 4% by moving it down to San Juan.

There are other benefits to moving his business from California to Puerto Rico. Office rents are cheaper, and hiring people for clerical, back office work costs less as well.

So overall, moving his business from California to Puerto Rico made a lot of sense to Peter Schiff. Not only are the taxes lower, the overall costs of doing business are lower as well.

In general, take time to make these decisions. Don't rush in to a place just for the tax benefits, especially if major economic turmoil is looming in the horizon.

**Caveat Emptor: Is Puerto Rico the Next Greece?**

So is it time to pack your bags and move to Puerto Rico? The tax incentives are certainly very enticing. But there are some very serious issues the place is facing that should not be ignored.

**A Look at Puerto Rico's Perilous Banking System**

Puerto Rico’s commercial banking system is not in good shape.

At the time of this writing (Summer 2014), Puerto Rico’s banking system has enough cash / cash equivalents on hand to cover just 8.3% of customer deposits. This means that for every $100 in customer deposits, an average bank in Puerto Rico holds just $8.30.

Furthermore, the banking system’s net equity constitutes just 11.5% of their total asset base.

This number is very important because it represents the banking system’s ‘margin of safety.’

If bank assets in Puerto Rico declined by more than 11.5%, the entire banking system would be insolvent.

Now, ordinarily this would be a reasonable (not high, but not shockingly low) figure. Problem is, Puerto Rico is not an ordinary place.

As of December 2013, the banks already have a mortgage delinquency rate (90 days past due) of 16%. That’s substantial.

Moreover, Puerto Rican banks are primary owners of the Puerto Rican government’s debt. And boy is the Puerto Rican government under a mountain of debt.

By late June 2014, in fact, the government was already proposing that government-owned agencies should be able to negotiate with their bondholders and restructure. And a number of lawsuits have already started.
Doral Financial Corporation, for example, is suing the Puerto Rican government for voiding a 2012 agreement to pay a hefty $200+ million tax refund.

Bottom line, there’s a very low chance everyone gets out of this debt crisis whole. And if the Puerto Rican government defaults, then yet another large portion of Puerto Rican banks’ portfolios will lose tremendous amounts of value.

You have to look at the situation rationally—given the possibility of default and loan delinquencies, is 11.5% really an appropriate margin of safety? Is 8.3% an appropriate level of liquidity?

**The Puerto Rican Government’s Debilitating Debt**

Like Greece, the Puerto Rican government borrowed money in a currency it cannot print and debase. They spend far too much on programs they cannot afford. And all of this has been decades in the making.

In my view the Puerto Rican government has already passed the point of no return—they have to borrow money to pay back interest on the money that they have already borrowed.

And as we’ve seen throughout history, this is a lose-lose situation. There are only two options out of this situation—inflating their way out of debt, or simply defaulting.
Puerto Rico does not have the option of creating inflation, though, because they do not control their own money supply. Therefore some form of default or restructuring is likely.

Granted, Puerto Rico is poising itself as the Singapore or Hong Kong of the western hemisphere with its low tax rates. There are already people investing and moving businesses to Puerto Rico like John Paulson, who bought the St. Regis – a $500 million project – and another two $100 million resorts in San Juan.

Peter Schiff argues that there are a lot of people who have already moved or who are in the process of moving to Puerto Rico, and these businesses will employ people, rent space, and spend money that they’re bringing in Puerto Rico.

The big question is whether or not the Puerto Rican government will be able to last long enough for the economic benefits to kick in. And if they can’t, will they be in a position to honor their promises and keep the tax incentives for the next two decades?

Governments can and have made promises and subsequently break them. President Obama has promised to end income tax for seniors making less than $50,000. He also promised that the US wouldn’t spy on its citizens. Both promises were broken.

Unemployment

Puerto Rico’s economy is not in good shape either. Many have compared the situation to the economic crisis in Greece.
Their official unemployment rate is over 15% but their labor force participation rate is only around 43%.

For these reasons, the Puerto Rican government passed laws including Act 20 and Act 22 to improve the situation. They are hoping that these tax incentives will attract investors and people who start businesses and employ people in Puerto Rico.

The Puerto Rican government has seen the success of business friendly jurisdictions like Singapore and Hong Kong and they are hoping that they can successfully grow their economy like the other two islands did.

**Conclusion**

Until recently Americans didn’t have many options to minimize their tax burden. Puerto Rico, with its relatively new tax incentives, now gives Americans another opportunity to significantly reduce their tax liabilities.

For investors, those who are able to relocate a service business, and entrepreneurs who are willing to start up a new business to take advantage of these new tax incentives, Puerto Rico is a compelling option.

(Note: there are a number of other tax incentive laws that have been passed, ranging from tax credits for motion picture production to massive tax breaks for casino and hotel properties to subsidized wages for new hires. They are even proposing incentives to make Puerto Rico a global hub for startups.)

It is important to remember that the island is under severe financial strain, and the jury’s out on whether or not the Puerto Rican government will be able to honor their promises in these laws.

Unless you intend to just move a business to Puerto Rico, you would also have to commit to living in Puerto Rico in order to fully benefit from the new laws.

However, if you’ve calculated the risks and benefits and have decided that Puerto is the kind of place you would like to live, great. Just remember, there are many options, and Puerto Rico is just one of many. But it might just be the right one for you.