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Treasure Island: Puerto Rico Bids To Become New Age Tax Haven

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Morro Castle in Old San Juan. (Credit: Bryan Mullennix)

By Philip DeMuth and Lauren Gensler

As the U.S. Treasury Department continues to tighten its noose around offshore accounts, a new tax haven has sprung up under its nose in the Caribbean. Welcome to Puerto Rico–island of tropical breezes, and (for new arrivals only) a 0% tax rate on certain dividends, interest and capital gains.

Puerto Rico is about the same size as Connecticut but with more palm trees, twice the unemployment rate, a third the median household income and a tiny fraction of the hedge funds–a deficiency the financially teetering territory aims to correct by turning itself into a refuge for tax-oppressed millionaires and billionaires.

Yes, this is legal. While the U.S. asserts a sweeping right to tax citizens' income wherever they live and wherever it's earned, Section 933 of the tax code exempts residents of Puerto Rico from paying U.S. income tax on their Puerto Rico-sourced income. Instead, the Commonwealth of Puerto Rico has the exclusive right to tax local income as it sees fit.

"The way the U.S. tax code is written, I could be on Mars Mars and be taxed on intergalactic income but not if I'm sitting on this island in the Caribbean. It's kind of in a twilight zone," marvels Irvine, Calif. money manager Mohnish Pabrai.

To exploit this special status and help rescue its economy, Puerto Rico's Legislative Assembly adopted two laws in 2012 and expanded them last year. Act 20 entices hedge funds, family offices, professional service firms and even software developers to locate there by taxing their corporate profits from exported services at a flat 4% rate and allowing those profits to be paid out to the owners free of Puerto Rico income tax. So far the government has okayed 346 export companies, with 400 approvals expected this year.

Pabrai used Act 20 to set up a new private equity venture in Puerto Rico last year and figures he'll save as much as $10 million in tax a year, as well as half a million in operating costs. (There's an abundance of educated Puerto Ricans ready to work for less than their California counterparts. Office space is cheaper, too.)

Act 22 grants new Puerto Rico residents (including, after a recent amendment, returning Puerto Ricans who left before 2006) a 0% rate on locally sourced interest and dividends as well as all capital gains accrued after they become residents, a particular benefit for active traders. So far 509 tax refugees have been granted Act 22 status and another 600 will get it this year, Puerto Rico's Department of Economic Development & Commerce projects.

Puerto Rico? Really? When the property crime rate in the San Juan metropolitan area is six times that of the New York City area?

It depends on how you want your pocket picked. Since 2013, when rate hikes on the wealthy and a 3.8% ObamaCare tax on net investment income both kicked in, the top effective combined federal and state tax rate on long-term capital gains and qualified dividends has been 32.7% for New York City residents, 33% in California and 29% in Connecticut. On short-term gains and taxable interest it's now a hefty 52.3% in NYC, 52.6% in California and 48.6% in Connecticut.

Sadly, moving to Puerto Rico won't buy you a total dispensation from the Internal Revenue Service. Uncle Sam still wants his cut on dividends you receive from U.S. public companies, profits from mainland private businesses, pensions and deferred compensation earned in the states, and Social Security benefits.

Plus, any unrealized capital gain accrued before you moved to Puerto Rico–say, on that Apple Apple stock you bought for a split-adjusted $10 a share–is subject to U.S. tax if you sell within ten years after your move. During that period Puerto Rico will also impose a 10% tax on your pre-move gains, which gets credited against what you owe Uncle Sam. After ten years the U.S tax on preexisting gains disappears and the Puerto Rican bite drops to just 5%.

This is a much sweeter deal than you can get these days by renouncing U.S. citizenship. In 2008, after years of stories in FORBES and elsewhere about billionaire tax expatriates, including Campbell Soup Campbell Soup heir John Dorrance and Styrofoam cup heir Kenneth Dart, Congress decided that anyone worth more than $2 million would have to pay taxes on unrealized gains above a certain amount ($690,000 for 2015) when giving up citizenship–just as if they'd sold all their assets.

If you take up residence in Puerto Rico, you get to keep your citizenship and the dollars in your wallet and you don't have to ante up any U.S. gains tax unless you sell within the next ten years.

Make no mistake: To benefit from Act 22 you must become a bona fide Puerto Rico resident, which means being on the island at least 183 days a year. You can't just rent a post office box in San Juan and call it "home" while keeping a $5 million house and your ties back in the States. Your business, family, bank and brokerage accounts, driver's license and yacht should all move with you to the island.

But you don't really have to spend 183 full days in Puerto Rico. "If you arrive at 11:59 at night that is counted as a day in Puerto Rico," says San Juan tax attorney Edgar Rios-Mendez. Conveniently, San Juan is 3 1/2 hours or less by private jet from New York's LaGuardia Airport.

(Be careful. Remember, you must convince not only Puerto Rico's friendly officials that your residence is on the island but also the possibly hostile auditors from the high-tax jurisdiction you've just fled–and they, too, can count partial days to claim you as a resident.)

Pabrai considers the Act 22 personal tax deal so good that he's surprised thousands of rich Americans haven't already moved to Puerto Rico. Yet he himself has not for the sort of personal reason that could be holding others back, too: His wife, Harina Kapoor, started and runs a solar energy company and a yoga studio in California and understandably doesn't want to go.

Billionaire investor John Paulson hasn't moved, either, but is, if anything, even more bullish about what he has called "the Singapore of the Caribbean." While he declined to be interviewed for this story, island officials say Paulson's investment will reach $1.5 billion by year's end, a figure his aides don't dispute.

The pool at St. Regis Bahia Beach Resort. Courtesy of St. Regis.

So far Paulson has acquired three beachfront hotels, including the luxe five-diamond St. Regis Bahia Beach Resort and the historic Condado Vanderbilt, which was designed by the same architects as New York's Biltmore Hotel but lay dormant for 15 years until he came along. It reopened in December after a $200 million renovation.

Paulson has also snapped up office space and a parking lot in the financial district, and empty lots on the boutique-lined Ashford Avenue, primed for new high-rise condos.

Nicholas Prouty, who runs Putnam Bridge, a private equity firm that targets distressed assets, did call the moving vans. Putnam picked up two big Puerto Rico projects from bankruptcy court. Then, despite "some sense of guilt" about uprooting his 10-year-old daughter, Prouty moved Putnam Bridge and his family from Greenwich, Conn. to San Juan in 2013.


Nicholas Prouty in San Juan. (Credit: José Jiménez Tirado)

Putnam is sinking at least $100 million into revitalizing the Puerto del Rey Marina near the town of Fajardo and poured more than $200 million into Ciudadela, a mixed-use development in San Juan's Santurce district that has now sold all of its 312 condo units, primarily to Puerto Ricans. "Beachfront property located in a country with an American flag in the courtroom and a CVS on the corner is a good bet," Prouty opines, adding that the current government's policies are setting the stage for an island comeback.

While he moved for business and tax reasons, Prouty says his weekends are now "utterly epic," with his family cruising to "pristine beaches with funky beach bars" where they meet up with others from his daughter's private school.

What about the danger that either Puerto Rican voters or the U.S. Congress will decide the deals being handed out to the rich are so good they shouldn't be true?

Those already approved for Act 20 and 22 benefits have some protection from shifting island sentiment: contracts with the Puerto Rican government guaranteeing favorable tax treatment for 20 years. Meanwhile, government officials optimistically predict that, by 2017, Act 20 and 22 will together create 82,500 jobs, more than ten times what they've generated so far.

As for a change in the U.S. tax code, that seems unlikely for now, particularly if Republicans deem it a tax hike. And Washington presumably wants Puerto Rico to succeed. After all, if the territory can't pay its $71 billion in government debts (currently rated BB with a negative outlook by Standard & Poor's), U.S. investors will take part of the hit.

Still, it's worth remembering this: Some of Puerto Rico's economic problems can be traced to Congress' decision to end, as of 2006, a special tax break for drug and other manufacturers who produced in Puerto Rico and exported to the U.S.