Tax

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5 Tax matters you should consider before relocating to Puerto Rico

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For the past decades, the Government of Puerto Rico has been offering different tax benefits and incentives to local and foreign business entities that either established new operations in Puerto Rico or relocated them to the island. On January 12, 2012, the Government of Puerto Rico (1) enacted Act 20 in an effort to turn the island into an international hub of export services and, (2) enacted Act 22 to promote that individuals relocate to the island by providing certain exemptions from local income taxes.

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Overview

As a result of the enactment of Acts 20 and 22, now Chapters 2 and 3 of the Puerto Rico Incentives Code ("Incentives Code"), many individuals and businesses have re-examined their long-term tax plans and structures and are considering a relocation to Puerto Rico to take advantage of the tax benefits. In general, the Incentives Code provides standard tax benefits to certain businesses with eligible activities that obtain a grant of tax exemption ("Grant"), such as:

- 4% income tax rate on eligible income;
- 75% exemption on property taxes;
- 50% exemption on municipal taxes; and
- benefits for a period of 15 years, with an extension of 15 additional years available.

In the case of individuals with a Grant under Chapter 2 of the Incentives Code, the general benefits are 100% exemption from income tax on interest, dividends, and certain capital gains accrued after becoming a resident of Puerto Rico until taxable year 2035.

Regardless of how attractive the Puerto Rico tax incentives may be, they are not for everyone; there is no "one size fits all" formula. Therefore, prior to relocating to Puerto Rico, below you will find 5 tax questions you should answer prior to committing into making Puerto Rico your permanent domicile:

1. **Are you and your family committed to moving permanently to Puerto Rico?**
   As a citizen of the United States, you are subject to federal income taxes on your worldwide income, regardless of your place of principal residence or domicile. As such, you are required to file a federal income tax return, and report and pay taxes to the federal government on all sources of income, including income from Puerto Rico. Although Puerto Rico is a foreign jurisdiction for federal income tax purposes, it still is a Territory/Possession of the United States, and as such, the United States Internal Revenue Code allows for an exception from federal taxation for citizens of the United States that are bona fide residents of Puerto Rico.

   Puerto Rico bona fide residents can exclude Puerto Rico-source income for federal income tax purposes, provided they are subject to federal income tax on income from sources that are not Puerto Rico. The exclusion does not apply to the salary received by a federal government employee working in Puerto Rico, who must include federal income from work done in Puerto Rico as part of local and federal income taxes.

   For tax residency purposes, the Puerto Rico Internal Revenue Code defines "resident individual" as someone who is domiciled in Puerto Rico. It is presumed that you are a resident of Puerto Rico if you have been present in the island for a period of at least 183 days during the calendar year. Based on local case law, to qualify as a resident of Puerto Rico for local income tax purposes, you must have:

   - at least one-year of residency in Puerto Rico (actual physical presence); and
   - the intent to reside in Puerto Rico for an indefinite amount of time.

   For federal income tax purposes, the federal tax law has its own rules to determine whether you are considered a bona fide resident of Puerto Rico or not. Namely, you must meet three requirements:

   - comply with one of the five conditions for physical presence in Puerto Rico set forth in the United States Treasury Regulations (**presence test**);
   - not have a tax home outside Puerto Rico during any part of the taxable year (**tax home test**); and
   - not have a closer connection to the United States or a foreign country, than to Puerto Rico during any part of the taxable year (**closer connection test**).

   Proper determination of residency is essential since a bona fide resident of Puerto Rico is taxed in the island on their worldwide income and have the exclusion from federal taxation discussed above. It is important to keep in mind that compliance with the bona fide residency rules herein included must be made on an annual basis, and mere physical presence is not enough for the local and federal tax authorities.

   Therefore, becoming a bona fide resident of Puerto Rico will require compromises from you and your family, including successfully completing and documenting a permanent move to Puerto Rico. This can be a deal-breaker for many interested individuals and families.

2. Do you currently own investments that generate interest, dividends or capital gains?

From a federal income tax perspective, there are special sourcing rules for certain investment assets you own before the move to Puerto Rico, that you must keep in mind. Before you pack your bags and move to the island, you should know that federal income tax rules will tag along, including federal income sourcing rules. In connection to income that is exempted from Puerto Rico tax under a Grant, sourcing is determined as follows:

- **dividends** are sourced at the payer's country of incorporation;
- **interest** is sourced at the residence of the payor; and
- **sale of personal property** (i.e., stock), are generally sourced at the residence of the seller. However, gains from the sale or exchange of certain investment property owned by citizens of the United States prior to becoming bona fide residents of Puerto Rico, are considered from sources within the United States (including stock, bonds, and debt instruments sold within 10 years of the move to Puerto Rico). Nevertheless, you may choose to treat a portion of the gains related to the Puerto Rico holding period as from sources within Puerto Rico based on certain rules set forth in §937-2 of the Unites States Treasury Regulations.

In addition to potential continuous federal taxation of certain passive income regardless of your move to Puerto Rico, as a condition for granting the tax benefits in Puerto Rico, the Incentives Code requires, among others, that you:

- make a $10,000 annual contribution to a non-for-profit entity authorized by the Puerto Rico Department of Treasury;
- acquire by purchase from an unrelated person, residential real property within 2 years after the effectiveness of the Grant; and
- file an annual compliance report, which has a filing fee of $5,000.

Therefore, a relocation to Puerto Rico will not necessarily mean tax savings for you. As previously stated, there is no "one size fits all" formula.

3. What is your current business structure and what are the tax implications of modifying it?

United States international tax rules are complex and in constant change. One of the benefits associated with the use of corporations, for example, is the deferral of current federal taxes on income. Usually, earnings of a foreign corporation (not organized under United States law) is not federally taxed until the foreign corporation repatriates its earnings (i.e., dividends). To avoid this tax deferral, the federal government has enacted "safety measures" known as anti-deferral tax regimes. For example:

- if as a citizen of the United States, you own stock in a foreign corporation (including corporations formed under Puerto Rico law), you are not subject to taxation on income earned by the foreign corporation until the income is distributed (i.e., dividends), unless the corporation is a Controlled Foreign Corporation ("CFC"). CFC status is triggered when:
    - more than 50% of the foreign corporation's total combined value of shares or voting power is owned directly, indirectly or constructively by other United States Shareholders (including citizens of the United States); and
    - those United States Shareholders own directly, indirectly, or constructively, 10% or more of the total combined value of shares or voting power of the foreign corporation.

- there are special rules for foreign corporations owned by bona fide residents of Puerto Rico. However, other federal constructive ownership rules seem to complicate the planning for these types of corporate vehicles, when the individual has other United States-based entities, and/or another United States citizen as a shareholder, owner, partner, or member of the Puerto Rico corporation.

What does a "CFC status" means? In general terms, it means the United States Shareholder will not be able to use the tax deferral rule, and for federal income tax purposes, the earnings of the foreign corporation may be deemed as distributed and taxed at the federal level even though they were not. Moreover, the Tax Cuts and Jobs Act of 2017, made significant.

Therefore, if as part of your relocation to Puerto Rico you plan to set up a legal entity under Puerto Rico law, and have a United States citizen as a shareholder, owner, partner, or member of the Puerto Rico corporation, you should work with a knowledgeable international tax expert to determine the local and federal tax consequences of the proposed tax structures and select the most efficient one.

4. Will you continue to conduct business within the United States?

If you have built your personal and professional life in the United States, suddenly cutting ties when relocating to Puerto Rico seems nearly impossible. As such, each situation needs to be reviewed and analyzed on a case-by-case basis. For instance, an individual relocating to Puerto Rico whose income is solely from interest, dividends and/or capital gains will have a different situation than an individual who is materially participating in their United States-based business. Consequently, if as part of your business model you need to maintain a connection with the United States (i.e., business travel periodically to the Mainland), you need to be cognizant of certain important tax provisions, including source of income and engaged in trade or business federal tax rules.

For tax purposes, for example, the key factor in determining the source of income from salaries, wages or compensation for labor or services rendered, is where the services were performed. Therefore, services performed in the United States are generally taxed in the United States.

In addition, if the activities you perform in the United States constitute a trade or business in the United States of a Puerto Rico-based business, the activities conducted by the Puerto Rico business (or you by representation) in the United States may trigger federal tax implications for the Puerto Rico business. Conversely, if a United States business is deemed engaged in a trade or business in Puerto Rico, the United States business will have Puerto Rico tax consequences.

Engaged in trade or business determination is done in a case-by-case basis, and generally requires that the business' activities in the jurisdiction are closely and directly related to the derivation of profit, rather than being incidental, ministerial or clerical.

If you plan to conduct business between Puerto Rico and the United States, it is of critical importance that you plan ahead to avoid future unexpected tax implications in the United States or in Puerto Rico.

5. **Lastly, and perhaps most importantly, have you visited the island and validated move is a good fit for you and your family?**
   Although the year-long excellent weather and potential tax savings may be good reasons for some people to relocate and become bona fide residents of Puerto Rico, time has told that it is not convenient for everybody. When making your research about Puerto Rico and contemplating the pros and cons of relocating to the island, we encourage you to visit the island prior to making the final decision and see for yourself if permanently moving your domicile to Puerto Rico is an adequate and plausible decision based on your personal circumstances. Moving to a new country may be daunting to some, and international tax rules are complex and dynamic, so the move will only be worth if it fits your business, lifestyle, and family in the long run.

We are committed to keeping you up to date with all tax-related developments. Please contact our Tax Department should additional information be required regarding this or any other tax issue. We will be glad to assist you.

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