

Becoming Puerto Rican - The Tax Benefits of Puerto Rican Residency for U.S. High Net Worth Taxpayers

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by

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Overview

My last article focused on the attractiveness of Puerto Rico for hedge fund managers. Poor John Paulsen cannot make a move without the financial press reporting on the story. If he bought a Big Gulp at Seven-Eleven, the Press would declare it as being tax motivated! First, it's the Bermuda reinsurance company and next it's his possible relocation to Puerto Rico. The news of this information did not uncover a heretofore unknown love of Salsa music but instead focused on the brilliant legislation adopted by the Puerto Rican government in 2012 to attract

These tax changes offer the potential to make Puerto Rico the new Florida. Access to Puerto Rico is extremely easy. A recent check counted in excess of fifty daily flights to the PR from the East Coast daily. Hence, the wealthy retiree could conclude that it is easier to get to the PR than Jackson Hole, Wyoming. The next important ingredient - check; golf course - plenty (check); rum - check. Additionally, a quick review showed three synagogues in San Juan and plenty of churches.

This article will focus on the tax benefits for high net worth investors. The potential tax benefits for U.S. high net worth investors are too great to ignore. This article will present the basic tax provisions of the new Puerto Rican tax incentives. Two pieces of legislation Act 20 of 2012 and Act 2012 have put Puerto Rico on the map in a major way at a time when the compliance requirements for offshore planning has become a dangerous game. The compliance requirements and penalties for failing to meet these requirements is extremely confiscatory for taxpayers including a possible short trip to the Big House.

Why bother, just have your client move to Puerto Rico and become a Puerto Rican.

Puerto Rican Tax Basics

Puerto Rico (“the PR”) is an unincorporated territory of the U.S. and is subject to most federal laws unless “locally inapplicable”. The currency of the PR is the U.S. currency. No passport is required for travel to the PR for U.S. citizens. The banks in the PR are regulated by the U.S. Federal Deposit Insurance Corporation.

The definition of a U.S. person under IRC Sec 7701(a) (3) does not include Puerto Rican entities. As a result, Puerto Rican entities are not subject to U.S. income taxation unless the business is engaged in a trade or business within the U.S.- effectively connected income (ECI); or investment income that would be subject to a withholding tax under IRC Sec 871(a) with an exemption for portfolio interest.

Under IRC Sec 933, bona fide residents of the PR that have PR-sourced income are exempt from U.S. taxation. IRC Sec 937 defines a bona fide resident for tax purposes. A person is a PR resident for tax purposes if present in the PR for at least 183 days during the taxable years and does not have a tax home outside of the PR and does not have a closer connection to the U.S. or a foreign country than the PR.

Export Services Act (Act 20 of 2012)

Businesses that relocate to the PR can significantly reduce their taxable income providing the PR entity is not engaged in a U.S. trade or business. The top federal corporate tax rate is 35 -40 percent for most corporations assuming a federal rate of 35 percent and a state rate of 5 percent.

Under the Export Services Act (Act 20 of 2012), the tax rate is 4 percent. Additionally, shareholders that relocate to the PR will have a 100 percent exemption on corporate distributions. Under the Export Services Act, services that are directed to foreign markets may qualify as services under the Export Act. Services for foreign markets include services performed for non-resident individuals and businesses. In order to qualify as “promoter services” under the Export Act, the net income must be earned and service performed within the 12-month period ending on the day preceding the day the business commenced operations within the PR.

A business (service provider) must request and obtain a tax exemption decree on or before December 31, 2020. The decree has a 20 year term and may be renewed for an additional 10 years providing

certain conditions are met. During the period of the exemption, the business will enjoy a 4 percent tax rate on its export services income and a 100 percent exemption on the distributions of earning and profits from the services income. The business is also eligible for a 100 percent property tax exemption during the first five years of operation and 90 percent after the fifth year.

Existing businesses that become eligible for benefits under the Export Services Act only receive the special tax rate (4%) on the portion of net income that exceeds the average net income for the three years preceding the request for a tax exemption decree. This aspect of the law is designed to prevent existing businesses from becoming tax exempt without a corresponding increase in economic activity in the PR.

The Individual Investors Act

The Puerto Rican government passed The Individual Investors Act on January 17, 2012 (Act 22). Under IRC Sec 933, interest and dividends that qualify as PR-sourced income are excluded from the income of a “resident individual investor (an individual who has not been a resident of the PR for the past years before his first year of residence in the PR). The new legislation exempts passive income from taxation - capital gains, interest and dividends.

Long term capital gains derived by the “resident individual investor” that were deemed to have accrued before the individual became a PR resident and are recognized within the first ten years after the date the individual becomes a PR resident, will be taxed at a 10 percent rate. If the gains are recognized after the ten year period but before, January 1, 2036, the gains will be taxed at a 5 percent rate. Gains considered to have accrued after the investor becomes a U.S. resident will receive a 100 percent exemption. Dividend and portfolio interest income are exempt from PR taxation under the new law.

Unlike states without a state income like Florida or Nevada, the PR solution provides an opportunity to completely avoid federal taxation on passive income as well as Puerto Rican taxation on the same income. The high net worth investor enjoys these benefits without the headache and legal consequences of FBAR requirements, Form 8938 and Form 3520 and Form 3520-A. The absence of not having these filing requirements is a very good thing.

The Strategy

Facts

Dan Jones operated a successful plumbing contractor business in the New York tri-state area for 30 years. He would like to retire and has an offer to purchase his business for \$30 million. The offer is an "all cash" offer. In the year preceding the sale and in anticipation of his retirement, Dan and his wife purchase a home in Puerto Rico. They also agree to meet the Closer Connection Test – they will register to vote in Puerto Rico, and obtain a Puerto Rican Driver's license. The Jones will purchase a home in Puerto Rico and reside in Puerto Rico at least 183 days per year.

Solution

Dan creates a Puerto Rican corporation that serves as the general partner to his family limited partnership which was formed in Delaware. The management fee for the general partner provides for a two percent annual management fee and a 20 percent profits interest. His management fee will be taxed at a 4 percent rate. This fund structure will allow Dan to convert some of his income that is treated as fixed and determinable or periodic income and effectively connected income to a U.S. trade business (his real estate investments) in service income taxed at four percent.

Dan assigns his ownership in his company stock to the FLP. As a Puerto Rican residence, Dan will be taxed at a 10 percent capital gains rate as the gain is within ten years of his declaration of residency in the PR.

Dan's investment portfolio will be structured in a private bank in Puerto Rico. Dan's banker is a Rutgers alumnus and fan just like Dan. The investment income will be completely income tax-free for both federal and Puerto Rican purposes. The projected investment income is \$2 million per year.

Dan is still subject to U.S. federal estate taxes and will implement domestic tax planning options in Nevada and South Dakota. The trust income will not be subject to income taxation in those states.

Summary

The PR is the real deal! The tax benefits, weather, accessibility and accommodations make it the New Florida. One could argue that more English is spoken in San Juan than Miami. In effect has become an onshore jurisdiction with offshore attributes without all of the red tape and compliance and reporting requirements of being offshore. Forget Mexico, Panama (it hurts me to say that) and all of the foreign ports that are calling you. The provisions of Export Services Act and Individual Investors Act create a new and unprecedented opportunity for U.S. high net worth taxpayers.