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Leaving Mainland America Yet Remaining in the United States — Puerto Rican Residency as an Alternative To Expatriation

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OVERVIEW

One of the news items that generates political fireworks each year is the number and names of famous Americans who renounce their U.S. citizenship. According to the *Wall Street Journal*, the United States is on track to have the largest number of expatriations in history. In the second quarter of 2013, 1,130 names appeared on the list of those Americans or permanent residents who renounced U.S. citizenship or residency. In the first quarter of 2013, 679 Americans renounced their citizenship or permanent residency. The number of those renouncing their citizenship in the second quarter of 2013 was more than in all of 2012.¹ Moreover, some observers and commentators have pointed out that these numbers may be incomplete; that to date, the IRS has failed (either by mistake or with purpose) fully to disclose all the expatriations.

¹ Plevin & Saunders, “Number of Americans Renouncing Citizenship Surges,” *Wall St. J.*, Aug. 9, 2013, <http://online.wsj.com/article/SB10001424127887323977304579002780562003814.html>.

Regardless of one’s political persuasion — liberal or conservative — the topic of expatriation generates a lot of conversation. For some, it is a reaction to the belief that the United States is headed in the wrong direction. For others, it is a negative reaction to what the United States stands for in the world.

What if I were to tell you that you can gain many of the tax benefits of expatriation without giving up your U.S. citizenship? How so? To borrow a line from the song in the Broadway musical *West Side Story*, “I want to live in America,” the goal of this planning strategy is to leave mainland America without leaving the United States for citizenship purposes.

What are the tax reasons for giving up U.S. citizenship? U.S. citizens and permanent residents are taxed in the United States on their worldwide income and assets. On the other hand, a nonresident alien is generally taxed only on income that is effectively connected to a U.S. trade or business, income that is fixed or determinable, and periodic income. In addition, for a nonresident alien, most interest income may be exempt under the portfolio interest exemption and dividend income is frequently taxed at lower rates if applicable tax treaties so provide. Further, the estate of a nonresident alien with no U.S.-situated assets should not be subject to U.S. federal estate tax.²

The exit price of expatriation has become increasingly confiscatory over the years. One of the more publicized stories was that of Ken Dart who gave up his U.S. citizenship to become a citizen of Belize with his personal residence in the United States becoming

² See §§2103–2105. Unless otherwise indicated, all Section or “§” references are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations thereunder.

the consulate for Belize.³ Denise Rich, whose ex-husband Marc Rich was officially pardoned by President Clinton, joined her ex-husband in giving up U.S. citizenship to become a Swiss Citizen.⁴ Then there was Tina Turner who had been living in Europe for many years, and finally gave up her U.S. citizenship.⁵

The author has personally known two U.S. citizens who gave up their U.S. citizenship. One of the two could have easily fared just as well under certain of the new Puerto Rican tax incentives, being a former investment professional living off of investment income and mostly short-term capital gain income from investments in hedge funds. The other taxpayer expatriated anticipating legal problems.

In 2012, Puerto Rico passed a series of sweeping new tax laws, making this U.S. Commonwealth highly desirable as a residence from an income tax standpoint. This article focuses on Puerto Rican (PR) tax incentives as an alternative to expatriation for those who become Puerto Rican residents for income tax purposes.

TAXATION OF AMERICANS WHO EXPATRIATE

Who Is a U.S. Citizen and Permanent Resident?

Aside from any political considerations, what is the tax problem associated with being a U.S. citizen? As stated above, U.S. citizens and residents are taxed on their worldwide income.⁶ Additionally, U.S. citizens and residents are subject to estate tax on their worldwide assets.⁷

The U.S. Constitution defines a U.S. citizen as one who is born or naturalized in the United States and is subject to its jurisdiction. The Tax Reform Act of 1984⁸ provided objective statutory authority to determine whether a nonresident alien is resident for income tax purposes and, thus, exposed to worldwide income taxation. The objective residence definition

provides that U.S. residency exists if either the “lawful permanent residence” test or “substantial presence” test is met.⁹ The lawful permanent residence test is outside the scope of this article. The substantial presence test is discussed below.

The substantial presence test is automatically satisfied if an individual who is not a U.S. citizen or permanent resident nonetheless is present in the United States for 183 days or more during the calendar year.¹⁰ The substantial presence test can also be met if the nonresident alien is present in the U.S. for less than 183 days during the current year by looking back over a period of years. A weighted formula adds the sum of the days in the current year plus one-third of the days in the preceding year and one-sixth of the days in the second preceding year.¹¹

The test for whether an individual is subject to U.S. estate and gift tax is different from the test for income tax residence. The test for estate and gift tax purposes looks to see if the decedent was a U.S. citizen or domiciliary. The treasury regulations define “domicile” as where one intends to remain indefinitely.¹²

Tax Law Basics of Expatriation

The initial tax legislation related to expatriation has its origin in 1966 and was enacted to address a concern that U.S. citizens might renounce citizenship to claim the tax benefits of foreign persons.¹³ The Foreign Investors Tax Act of 1966, introduced by the Johnson Administration, used a 10-year window and required a tax-avoidance motive but did not include a presumption of tax avoidance based on income or net worth. The U.S. tax expatriation law was significantly expanded in 1996.¹⁴ The 1996 legislation expanded treatment to long-term residents of the United States. The legislation also presumed tax avoidance as a primary motive if the taxpayer’s average annual net income tax liability over the preceding five-year period exceeded \$100,000 or his or her net-worth exceeded \$500,000.¹⁵ The 1996 legislation continued the 10-year window. The American Jobs Creation Act of 2004¹⁶ eliminated the subjective issue of tax motivation.

³ Wood, “Ten Facts About Expatriation,” *Forbes*, Mar. 23, 2010, <http://www.forbes.com/2010/03/23/expatriation-exit-tax-limbaugh-obamacare-personal-finance-robert-wood.html>.

⁴ Phillips, “IRS Releases List of Americans Hoping to Expatriate, The List Tops 1000,” *Forbes*, Aug. 11, 2013, <http://www.forbes.com/sites/kellyphillips/2013/08/11/irs-releases-list-of-americans-hoping-to-expatriate-number-tops-1000>.

⁵ Bachman, “Mr. Taxman, Why Some Americans Working Abroad Ditch Their Citizenship,” *Time*, Jan. 31, 2013, <http://world.time.com/2013/01/31/mister-taxman-why-some-americans-working-abroad-are-ditching-their-citizenships>.

⁶ See §1(a); see also §§11(a), 61(a).

⁷ See §2001(a).

⁸ P.L. 98-369.

⁹ See §7701(b).

¹⁰ See §7701(b)(1)(A)(ii).

¹¹ Regs. §1.7701(b)-1(e), *Ex. I*.

¹² Regs. §20.0-1(b).

¹³ S. Rep. No. 89-1707, at 27, 53–54, 57 (1966). See Foreign Investors Tax Act of 1966, P.L. 89-809.

¹⁴ See Health Insurance Portability and Accountability Act of 1996, P.L. 104-191.

¹⁵ See former §877(a)(2).

¹⁶ P.L. 108-357.

The Heroes Earnings Assistance and Relief Tax Act of 2008¹⁷ repealed the 10-year window and instead introduced a deemed taxable disposition of worldwide assets by reason of expatriation. The new rules, under §877A, are applicable to taxpayers who expatriate on or after June 17, 2008. IRS Notice 2009-85¹⁸ supplemented §877A with 58 pages of guidance for taxpayers. Gain on the deemed disposition of worldwide assets is taxed at capital gains rates, presumably without any of the exclusions that generally are available under §121 for gains on sale of a principal residence.¹⁹ The tax applies only if the amount of gain exceeds \$668,000 in 2013.²⁰ The gain may be delayed on a property-by-property basis until the property is actually sold.

The expatriation rules apply to U.S. citizens or long-term residents who had a Green Card in eight of the last 15 years preceding the application for expatriation. The expatriation rules are applicable if the taxpayer meets one of two tests. A “covered expatriate” is a taxpayer that meets the “net-worth test” of §877A(g)(1), which generally means that he or she has assets of \$2 million or more.²¹ Alternatively, under the “tax liability test,” the expatriation rules apply if the taxpayer’s tax liability for the five years preceding the year of expatriation exceeds \$155,000 (as of 2013).²² Regardless of the application of the preceding two rules, under a third test known as the “certification test,” the expatriation rules apply if the taxpayer fails to certify on Form 8854 that he or she is compliant with all federal tax obligations.

The expatriation rules are not applicable to taxpayers who became dual citizens at birth. To take advantage of this exception, a dual citizen from birth must have remained a dual citizen of both countries. Another exemption applies to taxpayers who both expatriate before age 18½ and did not qualify as U.S. residents under the substantial presence test for more than 10 years prior to the year of expatriation.²³

Section 877A subjects a covered expatriate to an exit tax on the net unrealized gain with respect to all worldwide property when the taxpayer terminates U.S. citizenship or permanent residency. The property is deemed sold on the day before expatriation occurs and the exit tax applies if the gain from the deemed sale exceeds an exemption threshold of \$668,000 in

2013. In the case of beneficial interests in grantor trusts, such trust assets are subject to the mark-to-market rules.²⁴ Beneficial interests in a nongrantor trust are exempt from taxation.

The exit tax base is predicated on the fair market value of all property. The taxpayer is able to adjust his or her tax basis on each item subject to the deemed sale to its fair market value on the expatriation date.²⁵ A covered expatriate may defer the payment of the exit tax in exchange for providing security to the IRS that satisfies the requirements of §877A(b)(4). The taxpayer irrevocably waives any treaty benefits that might otherwise preclude a tax assessment. Interest accrues at the normal underpayment rate of §6621.

Deferred compensation items, such as interests in qualified plans or nonqualified stock options, are subject to the exit tax.²⁶ “Eligible” items such as an interest in a qualified plan are subject to a 30% withholding tax at the time of payment. The taxpayer must make an irrevocable waiver of any tax treaty benefits. Deferred compensation items that do not fall within these parameters are taxed under the exit tax on the date preceding expatriation.²⁷

WHY PUERTO RICO?

Puerto Rican Tax Basics

Two important pieces of legislation were passed by the Puerto Rican legislature in 2012. Both the Export Services Act²⁸ and the Individual Investors Act²⁹ were signed into law by the Governor of Puerto Rico on January 17, 2012.

Puerto Rico is an unincorporated territory of the United States, commonly referred to as a U.S. commonwealth. It is subject to most federal laws unless “locally inapplicable.” The currency is the U.S. dollar, and the banks in Puerto Rico are regulated by the U.S. Federal Deposit Insurance Corporation. No U.S. passport is required for U.S. citizens to travel to Puerto Rico. The definition of a U.S. person under §7701(a)(30), however, does not include Puerto Rican entities. As a result, a Puerto Rican entity is not subject to U.S. income taxation unless the entity is engaged in a trade or business within the United States and its income is considered effectively connected in-

¹⁷ P.L. 110-245.

¹⁸ 2009-45 I.R.B. 598.

¹⁹ See Wood, “Ten Facts About Expatriation,” *Forbes*, Mar. 23, 2010, <http://www.forbes.com/2010/03/23/expatriation-exit-tax-limbaugh-obamacare-personal-finance-robert-wood.html>.

²⁰ §877A(a); Rev. Proc. 2012-41, 2012-45 I.R.B. 539, §3.16.

²¹ See §877A(g)(1)(A).

²² Rev. Proc. 2012-41, §3.15.

²³ See §877A(g)(1)(B)(i), (ii).

²⁴ Notice 2009-85, §3(A).

²⁵ Notice 2009-85, §3.

²⁶ Notice 2009-85, §5.

²⁷ Notice 2009-85, §5(A).

²⁸ Act to Promote the Exportation of Services, Act 20 of 2012, P.R. (hereinafter, Export Services Act).

²⁹ Act to Promote the Relocation of Investors to Puerto Rico, Act 22 of 2012, P.R. (hereinafter, Individual Investors Act).

come, or investment income that would be subject to a withholding tax under §871 (unless an exemption for portfolio interest under §881(a) applies).

Under §933, bona fide residents of Puerto Rico who have Puerto Rico-sourced income are exempt from U.S. taxation. Section 937 defines a bona fide resident for tax purposes. A person is a Puerto Rican resident for tax purposes if the person is present in Puerto Rico for at least 183 days during the taxable year and he or she does not have a tax home outside Puerto Rico and does not have a closer connection to the U.S. or a foreign country than to Puerto Rico.³⁰

Section 2209 provides that Puerto Rican residents are not subject to U.S. estate taxation at death provided that the Puerto Rican resident acquired his or her U.S. citizenship by virtue of birth in Puerto Rico or naturalization as a U.S. citizen in Puerto Rico. Puerto Rico administers its own estate and gift tax system that largely parallels the U.S. system. Note that a U.S. person who does not expatriate, but merely takes up Puerto Rican residency, will not avoid U.S. federal transfer taxes on worldwide assets, unless born in Puerto Rico (a group outside the scope of this article). The Puerto Rico estate tax for non-Puerto Rican property is 10%.

The Export Services Act

A business that relocates to Puerto Rico can significantly reduce its tax liability provided that the Puerto Rican entity is not engaged in a U.S. trade or business. The top U.S. corporate tax rate is 35% to 40% for most corporations, assuming a federal rate of 35% and a state rate of 5%.³¹ Under Puerto Rico's Export Services Act, the corporate tax rate is 4%.³² Additionally, shareholders who relocate to Puerto Rico will have a 100% exemption on corporate distributions received from the Puerto Rican company.³³

Under the Export Services Act, services that are directed to foreign markets may generate income that will qualify for the special tax rate. Services for foreign markets include services performed for nonresident individuals and businesses. To qualify as "promoter services" under the Export Services 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 Puerto Rico.³⁴ The term "eligible services" includes a wide range of service-oriented businesses from research and development to investment management.

³⁰ See §§937(a)(2), 911(d)(3).

³¹ See §11(b).

³² Export Services Act §4.

³³ Export Services Act §6.

³⁴ Export Services Act §3(j), (e).

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.³⁵ During the period of the exemption, the business will enjoy a 4% tax rate on its export services income and a 100% exemption on the distributions of earnings and profits from the services income. The business will also be eligible for a 100% property tax exemption during the first five years of operation and a 90% exemption after the fifth year.³⁶

Existing businesses that become eligible for benefits under the Export Services Act receive the special tax rate (4%) only 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 Puerto Rico.³⁷

The Individual Investors Act

Under the Individual Investors Act, neither capital gains, interest, nor dividends are subject to Puerto Rican taxation. Dividend income is subject to U.S. federal income taxation, as is interest income unless the interest income is exempt under the portfolio interest exemption.³⁸ Long-term capital gains derived by the resident individual investor that (1) were deemed to have accrued before the individual became a Puerto Rican resident and (2) are recognized within the first 10 years after the date the individual becomes a resident, will be taxed at a 10% rate. The Puerto Rican legislature adopted a proposal to extend the favorable tax treatment to short-term capital gains, which should suit hedge fund investors very well.³⁹

If the gains are recognized after the 10-year period but before January 1, 2036, the gains will be taxed at a 5% rate. Gains considered to have accrued after the investor becomes a U.S. resident will receive a 100% exemption. Dividend and portfolio interest income are exempt from Puerto Rican taxation under the new law.

Strategy Examples and Benefits

Case Study #1

Al Smith is a former business owner from New Jersey who is living off of the invested proceeds of the

³⁵ Export Services Act §§8, 9.

³⁶ Export Services Act §5.

³⁷ Export Services Act §4(c).

³⁸ See §871(h); see also §§881(c), 871(a).

³⁹ Alemar-Escabi & Rios-Mendez, "Investment Destination: Puerto Rico New Tax Incentives to Lure Business and Individual Investment," *Tax Mgmt. Wkly. State Tax Rpt.* (June 1, 2012).

sale of his business to a private equity firm for \$10 million. He had been contemplating a move to Florida to live for most of the year. He enjoys golf and the beach.

Al decides to inquire further into Act 22, known as the Act to Promote the Transfer of Individual investors to Puerto Rico. He learns that the law provides a complete exemption from income tax on investment income for anyone who becomes a resident of Puerto Rico, provided that he or she has not lived in Puerto Rico during the past 15 years. The total tax exemption on investment income is available until December 31, 2035. Al also learns that, if there is any gain realized on investment income that is not recognized before he moves to Puerto Rico, it will be taxed at the rate of only 5% once he has resided in Puerto Rico for 10 years. Al decides to look into the purchase of one of the many gorgeous luxury properties available in Puerto Rico with prices significantly lower than those of similar quality elsewhere in the United States. To his surprise, he finds there are incentives available to promote the purchase of real estate in Puerto Rico. For Al, it appears that by moving to Puerto Rico he can significantly improve his tax situation without risking the exit tax applicable to expatriates.

Case Study #2

Mike Jones owns a satellite manufacturing company that has a lucrative defense contract. Based on his high income tax exposure in California, his CPA asks Mike to take note of the growing aerospace industry in Puerto Rico and find out what the island has to offer. Also, as Puerto Rico is a commonwealth of the United States, the company can continue to make sensitive components if Mike moves his business to Puerto Rico. The company can qualify for the Economic Incentives Act and obtain the following incentives.

The company will have two alternatives for the business to pay income tax and royalty payments: (1) pay a 4% fixed income tax rate and 12% withholding tax on royalty payments made to nonresidents; or (2) pay an 8% fixed income tax rate and 2% withholding tax on royalty payments made to nonresidents. Corporate distributions would be 100% tax-exempt while a

gain on a sale of the company's stock would be subject to 4% tax during the term of the grant. The company would receive up to a 50% credit for research and development expenses tied to intangible property during the years of the investment.

The company would also receive up to a 10% credit for industrial energy consumption and a 35% credit for purchases of products manufactured in Puerto Rico that are recycled, which can enable the company to cut costs on the packaging of its product. The company will also receive a \$5,000 credit for each job created during the first year and sustained for three years.

The company's researchers can also benefit from the Scientific Investigator Incentives Act and from income tax income of up to \$195,000.

SUMMARY

The decision to give up U.S. citizenship is not an easy one for any reason — tax or personal. The decision comes at a cost, including having limited ability to return to the United States on a going-forward basis in that return trips must be coordinated to avoid triggering U.S. residency. For individuals who have children, grandchildren, or friends in the United States, the desire to spend a significant amount of time in the United States without restriction may make expatriation a non-starter.

However, Puerto Rican residency is an excellent alternative for those living primarily on investment income and desiring to maintain some ties to the United States. Puerto Rico's proximity to the United States and easy accessibility may present as the "new Florida" without imposing U.S. federal income taxation on most investment income and imposing no Puerto Rican income tax. The U.S. federal estate tax is still applicable to residents of Puerto Rico, but the possibility of its repeal always exists and the possibility of federal estate tax may be less unpalatable than the certainty of the exit tax for expatriates.

When it is all said and done, Puerto Rico tax residency may provide a good balance between maintaining proximity to the United States, shedding some of the more burdensome aspects of U.S. income taxation and enjoying substantial tax benefits offered under the Puerto Rican tax laws.