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Thinking of Moving to Florida? Maybe a Little Further South is a Better Option

By Jonathan Kinney and Samuel Banks

In an effort to revitalize its economy, Puerto Rico has passed tax laws intending to attract investment to the island. Located two hours from Florida, the Caribbean territory of the U.S. offers several substantial tax exemptions to people willing to relocate themselves and their businesses to the island. Known as the Export Services Act ("Act 20") and the Individual Investors Act ("Act 22"), these 2012 tax reforms enable qualified individuals and businesses to effectively reduce their income tax to four percent on active income and pay no tax on passive income.

As a result, many high-net-worth individuals have already made Puerto Rico their home, including John Paulson, a billionaire hedge fund manager who is expected to invest over a billion dollars in real estate and infrastructure to establish English- and Spanish-speaking luxury resorts. Other big name investors are expected to make investments totaling in the hundreds of millions of dollars this year.

Besides the ability to live on a tropical island close to the mainland, the appeal of using Puerto Rico as a tax "haven" instead of Singapore or the Cayman Islands is that individuals are able to retain their U.S. citizenship since Puerto Rico is a territory of the U.S. Another benefit of living in Puerto Rico instead of states like Florida or Nevada, which have no state income tax, is that qualified individuals can eliminate federal income taxes. Although this article gives an introduction to the benefits and requirements of the Puerto Rican tax exemptions, anyone interested should consult with a tax professional proficient in Puerto Rico income tax law before making any decisions.

The general rule is that any individual who qualifies as a bona-fide resident of Puerto Rico during the entire taxable year will be exempt from any income derived from sources within the island territory. This includes interest, dividends and capital gains, which will be exempt from federal income tax if the requirements are met. There are two statutory requirements that must be met to qualify for the tax exemptions that Puerto Rico offers. The first is that an individual taxpayer must become a bona-fide resident of Puerto Rico. The second is that any income earned must be derived from sources within Puerto Rico. In addition to the two main requirements, an individual taxpayer must also request a tax exemption decree from the Puerto Rican Secretary of Economic Development and Commerce in order to qualify for the tax exemptions. The IRS must be notified when an individual becomes, or ceases to be, a bona fide resident of Puerto Rico—this is accomplished by submitting form 8898 with an individual's income tax return.

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Becoming a Bona-Fide Resident of Puerto Rico

Section 933 of the Internal Revenue Code of the United States (the "IRC") excludes from taxation by the U.S. government any income derived from sources within Puerto Rico that is earned by a bona fide resident of Puerto Rico. In order to become a bona fide resident section 937 of the IRC states that an individual must (1) be present in Puerto Rico for at least 183 days of the tax year, (2) have no other tax home outside of Puerto Rico for the tax year and (3) not have a closer connection to the US or a foreign country than Puerto Rico. If those three requirements are met and a taxpayer becomes a bona fide resident of Puerto Rico, they will not be subject to U.S. income tax on income derived from Puerto Rico sources. Again, to ensure an individual's situation meets the complexities of the tax code and the regulations, a qualified tax attorney or accountant should be consulted.

Income Derived From Sources within Puerto Rico

In order to take advantage of the income tax exemptions, a bona fide resident of Puerto Rico must also show that all exempted income was derived from sources within Puerto Rico. The rules for determining whether income is derived from sources within the U.S. also apply in determining whether income is derived from sources within Puerto Rico. Generally, interest received from the United States, non-corporate residents or domestic corporations are treated as income from sources within the U.S. Amounts received as dividends from a U.S. domestic corporation and certain foreign corporations engaged in business in the U.S. are also treated as income from sources within the U.S. In other words, the location of the payer of interest and dividends generally determines the source of the income. As a result, interest and dividends received from Puerto Rico, Puerto Rican residents and Puerto Rican companies will be considered income from Puerto Rican sources. Any income derived from sources within the U.S. shall not be treated as income derived from sources within Puerto Rico, and the tax payer will be required to fill out the normal U.S. form 1040.

Capital gains from the sale of securities acquired and owned by a resident of Puerto Rico are considered to be from sources within Puerto Rico. Generally, gains are not required to be from Puerto Rican securities to qualify as derived from sources within Puerto Rico. As a result, capital gains realized from the disposition of any security, regardless of the security's source, acquired after an individual becomes a resident of Puerto Rico will be exempt from U.S. and Puerto Rican income tax. Gains from the sale of securities owned by the individual prior to becoming a bona fide resident of Puerto Rico will be considered income derived from sources outside Puerto Rico. However, the portion of gain from the sale of securities that can be attributed to the period of time after an individual becomes a resident of Puerto Rico may be considered income derived from sources within Puerto Rico, and as a result, exempt from income tax. Real property gains are considered to be derived from the source of the location of the property. If the capital gains are determined to be from sources within Puerto Rico, the individual will pay no tax on those gains, which includes both short and long term capital gains. These rules are also subject to the various complexities of the tax code and regulations, so a tax professional should be consulted on an individual basis.

Who Can Benefit

There are two groups of U.S. citizens that can easily benefit from the tax exemptions in Puerto Rico: (1) people who derive most of their income from capital gains and (2) service providers who can render their services from Puerto Rico to non-Puerto Rican clients. The first group—people whose primary source of income come from capital gains—includes high net worth individuals such as hedge fund managers, securities traders, venture capitalists and other similar financial professionals. Act 22 specifically targets this group with strong tax incentives to relocate by exempting income tax on passive income. For these individuals, moving to Puerto Rico would result in an exemption of 100 percent of all long and short term gains because taxes on capital gains are based on wherever the investor resides.

The second group—service providers who can render services from Puerto Rico for export to their clients outside of Puerto Rico—includes a diverse array of professions such as financial managers, attorneys, accountants, research scientists, engineers, architects, telecom service providers and any other service provider who can work from Puerto Rico. Under Act 20, business dividends distributed from a Puerto Rican entity to a resident of Puerto Rico would constitute income derived from sources within Puerto Rico, and therefore is not subject to U.S. income tax. Puerto Rican export-service businesses qualify for a flat four percent income tax rate. In order to take advantage of the exemptions, these service providers must organize a business entity in Puerto Rico through which to offer their services. They are also required to employ at least three people.

An owner would be required to take a normal salary for the services performed, which would be exempt from the federal income tax rate, but still subject to the lower Puerto Rican tax rate. However, individuals may be able to limit the salary requirement to the lesser of $250,000 annually or thirty percent of the profit of the Puerto Rican entity, which would help to maximize the amount of exempt dividends. Another advantage to choosing Puerto Rico to establish a service-based business over a tax-advantaged foreign country is that moving employees over from the United States does not require dealing with visa issues. So far, these incentives have been effective. In fact, in 2013 Puerto Rico received 155 new applications from companies wishing to relocate to Puerto Rico, and the government is expecting more than twice that number in 2014.

Is Puerto Rico right for you? Probably not for most individuals, but perhaps, under the right circumstances, for some. Making the move to Puerto Rico could allow you to take advantage of serious tax exemptions while still maintaining your U.S. citizenship, all while living on a tropical island.

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New Investment Thinking for Trustees?

By Jennifer Schiffer and Jonathan Kinney

Traditionally, trustees invest the assets within a trust to ensure the assets are preserved for when they are distributed to the beneficiaries, often when the beneficiaries reach a certain age. However, this “cautious” investing by trustees, while in line with modern day portfolio theory and existing law, may not be the most advantageous for the beneficiaries.

Current Practices

General wisdom for trustees investing trust funds with set distribution dates suggests the trust invest in “safe” options similar to a set date retirement fund, like the 2050 XYZ Mutual Fund (funds which historically reduce their exposure to equities and increase their exposure to bonds over time). While these types of funds may be less likely to have downturns than regular equities, they also appear to have a smaller upside. “…[A] portfolio that starts at 30% equities and finishes at 70% equities has a higher (91.5%) probability of success, not to mention a lower average equity exposure through retirement (an average of only 50% in equities instead of 60%),” said Michael Kitces and Wade Pfau, financial planners. In theory, the same results should hold true when investing for a set time frame.

Does the General Wisdom Make Sense?

Generally, a trustee has a responsibility to take affirmative actions to protect the trust. For example, in Fontenot v. Chopin, the trustee was removed for various reasons, including failure to invest life insurance proceeds. Rather than investing the proceeds, the trustee simply placed the funds in an interest-bearing checking account. The Court held this was not sufficient to fulfill the

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fiduciary duties of the trustee, and thus removed her. The court said that "a violation by a Trustee of a duty she owes to a beneficiary, as Trustee, is a breach of trust. A Trustee shall administer the Trust solely in the interest of the beneficiary. A Trustee in administering a Trust shall exercise such skill and care as a person of ordinary prudence would exercise in dealing with her own property. A Trustee is under a duty to a beneficiary to take reasonable steps to take, keep control of, and preserve the Trust property."

This raises the question of whether a trustee who simply invests trust funds in a set year stock/bond fund, for example, could also be breaching his fiduciary duties knowing that a different investment strategy likely would result in higher returns.

The Rising Glide Equity Path

"Recent research shows that despite the contrary nature of the strategy—allowing equity exposure to increase during retirement when conventional wisdom suggests it should decline as a retiree ages—it turns out that a "rising equity glide path" (where the path of equity exposure 'glides' higher year after year) actually does improve retirement outcomes," said Kitces and Pfau.

Based on this recent research, a trustee should consider using a "rising equity glide path" to produce the best result for the trust's beneficiaries. Trustees are aware from Fontenot that simply investing in the safest option (e.g. interest bearing checking account) can be a breach of fiduciary duties. Therefore, they should consider whether with the new research on the rising equity path they are opening themselves to removal if they just invest the assets in a "safe" investment such as a pre-set standard of equities and bonds with equities decreasing over time instead of investing using a rising equity path.

Just how successful the equity glide path truly is depends on many factors in the marketplace. Because it challenges conventional wisdom, it is something trustees should consider when determining how best to invest the assets under their control. Trust grantors should consider giving explicit investment guidance to trustees by indicating if the trust should be managed to "produce" the best returns for beneficiaries or to preserve existing capital. Existing portfolio guidance seems to favor preservation over return. While such a standard may meet most trust grantor's objectives, it should not be an automatic default particularly where the trust grantor wants the trust managed for return over preservation.

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