



## Investments in US Securities Without the Specter of U.S. Estate Taxes

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**M**any Puerto Rico investors are diversifying their portfolios by investing in bonds or shares of stock of United States issuers (“**US Securities**”). The risk of this diversification is the hefty United States federal estate tax on the value of such investments (i.e., maximum of 35% in 2012 and 55% thereafter). The risk is real. The \$5,120,000 federal estate tax exemption (reduced to \$1 million in 2013), which exempts many estates from federal estate taxes, is not applicable to United States citizens who like most Puerto Rico investors, acquired their citizenship solely by birth or residence in Puerto Rico, and at the time of death are domiciled in Puerto Rico (the “**P.R. Investors**”). The exemption applicable to P.R. Investors is generally limited to \$60,000. Thus, if the U.S. Securities are United States property pursuant to the situs rules of the United States Internal Revenue Code of 1986, as amended (the “**US-IRC**”) and their value (net of other applicable deductions) exceeds \$60,000, the harsh federal estate tax will be imposed upon such excess value.

In an effort to avoid the adverse impact of the federal estate tax, some P.R. Investors have created investment vehicles to indirectly invest in US Securities, hopefully without the risk of the estate tax. However, if such vehicles are not properly structured and the reporting requirements imposed by the US-IRC are not taken into account, the investors could be subject to significant federal

income taxes and penalties.

One of the traps for the unwary is the Conduit Rule of the regulations promulgated under section 937 of the US-IRC<sup>1</sup>. Pursuant to this rule, the dividends or other distributions from Puerto Rico entities created to invest in taxable US Securities may be treated as income from sources within the United States, subject to income tax under the US-IRC. Another trap is the 10% Shareholder Rule of such regulations<sup>2</sup>. This rule converts dividend and interest income that would otherwise be Puerto Rico source income not subject to United States federal income tax, into United States source income subject to such tax. The severe penalties for failure to comply with the reporting requirements imposed by the US-IRC on investments in certain foreign entities, such as certain corporations, partnerships, limited liability companies or trusts organized under the laws of Puerto Rico, are other unexpected costs that may result from an improperly structured investment vehicle.

Likewise, failure to identify the Puerto Rico tax liabilities applicable to the investment vehicle may result in Puerto Rico income and/or municipal license tax deficiencies. It is also critical to take into account the tax impact of the liquidation of the investment vehicle, to allow the heirs to cash out on the investment, minimizing the tax cost.

<sup>1</sup> Section 1.937-3(c)(2) of the regulations promulgated under Section 937 of the US-IRC.

<sup>2</sup> Section 1.937-2(g) of the regulations promulgated under Section 937 of the US-IRC.

Other P.R. Investors are relying on a certain I.R.S. private letter ruling to invest directly in bonds issued by the States of the United States (“**Municipal Bonds**”), assuming that the ruling will fend off the federal estate tax risk<sup>3</sup>. Relying on the private letter ruling may also result in adverse federal estate tax consequences. First, the private letter ruling is not applicable to Municipal Bonds that are exempt from federal income tax under section 103 of the US-IRC. Thus, P.R. Investors relying on such ruling to invest in such bonds will be subject to federal estate tax. Second, the private letter ruling only protects the taxpayer that requested and obtained the ruling. Consequently, P.R. Investors that are relying on the ruling to invest in taxable Municipal Bonds and other taxable fixed income securities of United States issuers could be subject to the estate tax, if the I.R.S. determines that such securities are subject to the federal estate tax. This is also a real risk. While the private letter ruling is a reasonable interpretation of the relevant provisions of the US-IRC, such provisions of the US-IRC and their legislative history could also be construed to deny the estate tax exemption to P.R. Investors and, in such event, the securities would be subject to federal estate taxes.

To ensure that the investment in US Securities, including taxable and exempt Municipal Bonds, will not result in unexpected federal or Puerto Rico tax costs, P.R. Investors should structure the investment vehicle taking into account (i) the impact of the Conduit and 10% Shareholder Rules on the income tax treatment of interest and dividend income; (ii) the Puerto Rico municipal license tax treatment of such income; (iii) the reporting requirements imposed by the US-IRC; and (iv) the income tax consequences of the liquidation of the investment vehicle after the death of the investor. Additionally, it is critical to adopt certain safeguards to ensure that the investment vehicle is not disregarded as a “sham” by the I.R.S., and federal estate taxes are imposed upon the entity’s US Securities.

**AMG** has the expertise to structure an investment vehicle tailor-made to the particular needs of each investor that will allow investments in the United States market without the potential United States estate tax cost, and avoiding the pitfalls that result in unexpected tax costs or penalties. If you wish to structure such vehicle you may contact our partner, Fernando Goyco at (787) 258-1802 ([goyco@amgprlaw.com](mailto:goyco@amgprlaw.com)).

<sup>3</sup>Private Letter Ruling 200752016.

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