Adsuar Muñiz Goyco Seda & Pérez-Ochoa, P.S.C.
Attorneys and Counselors at Law
http://www.amgprlaw.com

PUERTO RICO
BUSINESS LAW NOTES

2013-TAX-02

Newsletter Date: February 19, 2013

US and PR Estate Tax considerations for Puerto Rico Residents Born in PR or Who Acquired US Citizenship Solely by Residency in PR (PR Persons)

By: Ricardo Muñiz, Esq.

The transfer of assets upon death by residents of Puerto Rico ("**PR**") may be subject to estate taxes imposed by the United States ("**US**") and/or PR. The US recently amended its estate tax provisions, and in 2011 PR enacted major changes to its estate tax provisions. The following is an updated analysis of these taxes, their impact on certain PR residents (i.e., those considered "PR Persons," as defined below), and the estate planning considerations faced by these residents of PR.

US estate taxes are extremely onerous (i.e., the minimum tax rate is 22% and the maximum tax rate is 40%), while the PR estate tax will be a fixed 10% rate when it cannot be avoided. These taxes are assessed on the fair market value of the properties of a decedent at the date of death.

To determine the impact of US and PR estate taxes on a particular PR resident, we must first determine whether such individual is what we call a "PR Person" or a "US Person". For purposes of this article, "PR Persons" and "US Persons" have the following meaning:

"**PR Persons**," are those residents[1] of PR that:

- *were born in PR,*
- *acquired US citizenship "solely" by residence in PR, or*
- *are "PR citizens."* [2]

"**US Persons**," are those residents of PR that:

- *were born outside PR (who are not "PR citizens"), and*
- *did not acquire their US citizenship solely[3] due to their residence in PR.*

This article deals exclusively with those PR residents that are "PR Persons".

The US and PR estate tax treatment, the applicable exemptions and the estate planning considerations for a "US Person" are discussed in a separate article (See AMG Puerto Rico Business Law Notes **2013-TAX-03**).

1. THE ESTATE.

The estate of a decedent is generally comprised of 50% of the community property assets, and 100% of the privately owned property. For estate tax purposes, the estate also includes assets over which a person had an interest, such as life insurance, annuities, pension and retirement plans, assets held by certain trusts and those over which the decedent held certain other rights.

For purposes of determining the assets of a PR resident for estate taxes, community property held by a married couple is deemed to be owned one half by each spouse, irrespective of under whose name the property or any account is titled, as both spouses are presumed to own an undivided interest in such property.

For PR Persons, the "location" (defined differently under US and PR law) of the assets they own, and those they are deemed to own,[4] determines the US and PR estate tax treatment applicable to the transfer of such assets upon death.

2. US ESTATE TAXES (PR PERSONS).

Upon the demise of a PR Person, he or she will be considered a non citizen/non resident of the US (i.e., non resident alien or "NRA") for US estate tax purpose. As such, only those assets of a PR Person's estate that are considered "Property Located Within the US," as defined under the US Internal Revenue Code ("US-IRC"), will be subject to US estate taxes at the time of death. Conversely, all other assets of a PR Person's estate will not be subject to US estate taxes.

"**Property Located Within the US**" for US estate tax purposes includes:

(a) obligations of the 50 states and their political subdivisions (including bonds that are exempt from US income taxes under Section 103 of the US-IRC);

(b) obligations of US citizens (including PR residents);

(c) stock and options of US organized corporations;

(d) mutual funds organized in the US;

(e) real property and tangible personal property located within the US;

(f) interest in a pension plan whose trust is considered a US Person; and

(g) cash and funds held in US money market accounts of brokerage firms, including those with offices in PR.

It is not clear under the US-IRC whether the following are considered "Property Located Within the US": annuities issued by US organized insurance companies; and obligations of the US Government, its agencies, and US organized corporations that pay interest that qualifies as "portfolio interest" under the US-IRC.

"**Property Located Outside the US**" for US estate tax purposes, and thus not subject to US estate taxes when owned by the estate of a PR Person, includes:

(a) life insurance benefits, including those paid by US organized life insurance companies;

(b) deposits in branches of US banks located outside the US;

(c) cash;

(d) stock and obligations of corporations organized outside the US (i.e., PR and foreign); and

(e) real property and tangible personal property located outside the US.

The estates of PR Persons are entitled to the estate tax credit applicable to NRAs, which is equivalent to a $60,000 exemption, and certain frequently prorated deductions. In those instances where the "Property Located Within the US" of a PR Person exceeds 27.8% of the gross value of the estate such credit/exemption amount increases proportionately, but up to a maximum exemption of $187,500.

The estate of a PR Person, since it is considered as the estate of a NRA, is not entitled to the US estate tax exemption ($5 million adjusted yearly for inflation) that is applicable to US Persons.

When a PR Person invests in "Property Located Within the US," without undertaking estate planning strategies designed to mitigate or minimize such taxes, he is exposing his estate and heirs to a very onerous US estate tax liability. For example, the US Estate Taxes applicable to a decedent who is a PR Person, that dies married and without a will in 2013, with 3 children from the same marriage, and whose estate of $4,000,000 (net of the surviving spouse 50% interest in the community property) includes $1,500,000 in "Property Located Within the US," amounts to $528,250 if the executor does not make a QTIP election,[5] or $428,250 if a QTIP election is made. The PR estate tax would be $112,500, which is 10% of $1,125,000 ($1.5 million less $375,000, or 37.5% of the $1.0 million PR exemption). While the PR tax will most likely be reduced to zero, due to credit for US taxes paid, or due to the PR responsible taxpayer credit described below, the US tax ($528,250 or $428,250) still remains an onerous burden that could be avoided with proper estate planning.

3. **PR ESTATE TAXES (PR PERSONS).**

In addition to US estate taxes, if applicable, Puerto Rico imposes an estate tax on the estate of any PR Person that owns or is deemed to own "Property Located Outside PR." Common examples of "**Property Located Outside PR**", include:

(a) US Government obligations and US agency obligations (including TVA, FHLB, FNMA, Farm Credit, among others);

(b) obligations of the 50 States of the US and their political subdivisions;

(c) real property and tangible personal property located outside PR (e.g., house or apartment in Florida, New York, Madrid; yacht in Virgin Islands or Florida);

(d) deposits booked at banks branches located outside PR; and

(e) stock of PR organized corporations and partnerships, that are more than 10% held by the decedent, and that fail to meet the "80% Active Income Test" or the "100% Asset Test" described below.

PR Estate Tax Exemption. PR Persons are entitled to a PR estate tax exemption of $1 million, that must be prorated among the estate assets if the total assets exceed $1 million. For example, a $4 million estate that has $1 million in "Property Located Outside PR" (i.e., 25% of the estate) will be entitled to 25% of such exemption, or $250,000.

In addition to this exemption, the Puerto Rico Internal Revenue Code of 2011 ("PR-IRC") grants an unlimited deduction for "Property Located Within PR". **Thus, any "Property Located Within PR" that is owned by the estate of a PR Person is entitled to full exemption from PR estate taxes, in addition to full exemption from US estate taxes if these are also "Property Located Outside the US" as this term is defined under the US-IRC.**

Property Located Within PR. For PR estate tax purposes, and persons who die after 2010, the term "Property Located Within PR" includes:

(a) real estate located within PR;

(b) deposits and bank accounts booked at PR branches of banks;

(c) obligations of corporations or partnerships organized in PR;

(d) obligations guaranteed by real property located within PR;

(e) obligations of the PR Government, its political subdivisions, instrumentalities and public corporations;

(f) obligations of individuals who are PR residents;

(g) obligations of corporations or partnerships organized outside PR that derive 80% or more of their gross income from PR sources during the prior three years;

(h) IRAs under the PR-IRC;

(i) amounts payable as life insurance and annuities, even if the company that issues the insurance policy was organized outside PR;

(j) amounts accumulated under pension plans qualified under the PR-IRC, or under the US-IRC; and

(k) stock of corporations, and interests in partnerships, organized outside PR that derive 80% or more of their gross income from PR sources during the prior three years; provided, that if the decedent owns more than 10% of the stock or interest (value or vote) it must also meet the "80% Active Income Test" described below.[6]

<u>Tests for Shares of Stock of PR Corporations and Interest in PR Partnerships to be Considered "Property Located Within PR".</u> Shares of stock of a PR organized corporation, or interests in a PR partnership, that is more than 10% owned (value or vote) by the decedent, will only be considered Property Located Within PR if:

(a) 80% or more of the gross income of such entity (together with the gross income of all those other entities directly or indirectly more than 50% owned by such entity) was derived from the "conduct of a trade or business" during the 3-year-period ended prior to his/her demise ("**80% Active Income Test**"); <u>or</u>

(b) 100% of the assets of said corporation or partnership constitutes "Property Located Within PR", as defined in paragraphs (1) and (3) through (10) of Section 2023.02(b) of the PR-IRC ("**100% PR Asset Test**").

The term "conduct of a trade or business" is not defined in the PR-IRC; however, it generally requires that the entity be actively involved in a trade or business, and not merely holding property as an investment or to generate income.

In fact, many PR corporations and partnerships are not engaged in the "conduct of a trade or business"; and even some of those so engaged might fail the 80% Active Income Test directly (or indirectly through its ownership of more than 50% of other entities). Therefore, the owners of any entity that might fail the 80% Active Income Test should be certain that it meets the 100% PR Asset Test by not owning (not even accidentally owning) any assets that might fail to qualify as "Property Located Within PR".

It should also be noted that for purposes of the PR-IRC gift tax deduction for property located within PR, the 80% Active Income Test also applies. However, for gift tax purposes, the 100% PR Asset Test is not an available remedy when the entity fails the 80% Active Income Test.

PR Estate Tax Rate. The PR-IRC imposes a 10% fixed PR estate tax rate on the taxable estate, if any, of a PR Person.

The fixed 10% PR estate tax rate adds a completely new consideration for investments by PR Persons. Once we consider the continued exposure to US estate taxes for PR Persons that own US investments (i.e., Property Located Within the US – See Part 2 above), the low 10% PR estate tax exposure (or zero if the Responsible Taxpayers Credit is available), provides an incentive for PR persons to invest in "Properties Located Outside PR" that are also considered Property Located Outside the US under the US-IRC. These so called "Non PR/Non US" investments include, but are not limited to, shares of stock and obligations of European, Canadian, Asian, Australian and other foreign issuers. This represents a new and broader palette of investment options, one that investors that are US Persons would have typically shunned in the past.

PR Tax Estate Credit for Responsible Taxpayers. A new "Responsible Taxpayers Credit" is now available under the PR-IRC to offset the above described 10% estate tax, when:

(a) the aggregate "PR tax debts" (i.e., taxes due to the PR Treasury, property taxes and municipal taxes) at the time of death of decedent, and any entity owned 10% or more by the decedent, do not exceed the lesser of 1% of the gross estate or $5,000; and

(b) the estate's administration pays all taxes that accrued prior to death within the time periods established by law.

Considering that it is impossible to predict whether the decedent's estate will meet the above conditions for this new credit, and since tax assessment notifications and tax debt records are highly unreliable in PR, not much reliance should be placed on the availability of this credit when planning for PR estate taxes.

4. ESTATE PLANNING FOR PR PERSONS.

Even though a majority of the assets that for US estate tax purposes will be considered "Property Located Within the US" are also considered "Property Located Outside PR" for PR estate tax purposes, there will generally[7] be no double federal/local taxation, as PR grants a credit for taxes paid to the US on US located property that is considered located outside PR under the PR-IRC.

An essential consideration in estate planning for all PR residents are the PR Civil Code rules that prohibit gifts between spouses, and that limit the amount that a PR resident can bequeath to the surviving spouse or to charitable institutions. Thus, as a general rule, many estate planning strategies that are widely used in the US are not fully viable in PR.

PR Persons, particularly married couples, should not react to these taxes by simply avoiding investments within the US or outside PR, as diversification is an essential element to any investment strategy and properly designed estate planning strategies can shelter their estates from these taxes.

Adsuar Muñiz Goyco Seda & Pérez-Ochoa, P.S.C. regularly advises PR Persons on those estate tax planning strategies that will avoid or at least minimize their exposure to US and PR estate taxes. In addition to properly drafted wills and trusts, these include consideration of investment options, and alternatives for holding investments outside PR. These strategies must be individually designed for such person's marital and family circumstances, the heirs' particular needs, current and future investment holdings and investment preferences.

5. <u>US PERSON MARRIED TO PR PERSON</u>.

Finally, if the PR resident is a PR Person married to a US Person (or vice versa), unique investment and estate tax planning considerations need to be jointly considered, as their respective estate tax planning considerations and strategies will be completely different. Estate planning for such couples entails a higher degree of complexity.

---

[1] All references to PR residents herein refer to persons that are residents of and domiciled in PR at the time of their death.

[2] Generally, "PR citizens" are those former Spanish citizens that were residents of PR from April 11, 1899 to April 12, 1900, who did not choose to continue being Spanish citizens, and the children of such persons that were born outside the US and PR subsequent to such dates.

[3] As a general rule, in order to acquire US citizenship "solely" by residence in PR, the person must have been a resident of PR during the full five (5) year period prior to becoming a US citizen.

[4] For US estate taxes, a person's gross estate also includes:
(a) property previously transferred, but over which the decedent retained rights to the income, enjoyment or certain other rights described in the US-IRC;
(b) transfers taking effect at death;
(c) life insurance benefits payable to the estate;
(d) life insurance benefits payable to designated beneficiaries, if the decedent had the right to change beneficiaries, revoke or transfer the policy, use the policy as collateral for loans or had other reversionary interests; and
(e) transfer of an interest in any property, or the relinquishment of a power with respect to any property, during the 3-year-period ending on the date of decedent's death, that would have been included in the decedent's estate pursuant to any of the circumstances described in paragraphs (a), (b) or (c) above.

[5] Provisions similar to (a), (b), (c) and (d) of footnote 4 above also apply in determining the decedent's gross estate for PR estate tax purposes.

[6] Even though all the prior items of "Property Located Within PR" are exempt from PR estate taxes, the following could be considered "Property Located Within the US" for US estate tax purposes and subject to US estate taxes: obligations of PR residents; annuities issued by a US organized insurance company; pension plans whose trusts are considered US persons under the US-IRC; and shares of stock of any US organized corporation.

[7] The US-IRC does not allow a marital deduction when the surviving spouse receives or is entitled to a terminable interest in property. However, the executor of an estate can make a "qualified terminable interest property," or QTIP, election that will allow such a deduction, and generally defer taxation until the demise of the surviving spouse.

****

Should you have any questions with respect to the above, or require our advice on estate planning, wills, trusts, estates and inheritances, please contact Ricardo Muñiz, Esq. at (787) 281-1818 / muniz@amgprlaw.com or Caridad Muñiz-Padilla, Esq. at (787) 281-1817 / cmuniz@amprlaw.com

The above summary is intended for information purposes only. It cannot be considered a legal opinion, and it does not intend to consider all the tax and legal considerations that could be relevant to any particular person or entity. It should also be noted that the changes discussed herein were recently enacted, and that the PR Treasury has not yet issued regulations, tax forms or interpretative announcements on such changes.