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BUSINESS LAW NOTES

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US and PR Estate Tax Considerations for Puerto Rico Residents Born Outside PR that Did Not Acquire US Citizenship Solely Due to Residence in PR (US Persons)

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All US citizens and residents,[1] except for those residents of Puerto Rico ("PR") that are considered "PR Persons" (as defined below), are subject to US estate taxes on their worldwide assets.[2]

Based on the provisions of the US Internal Revenue Code ("US-IRC"), and for purposes of this article, whether a particular resident of Puerto Rico is a "PR Person" or a "US Person" is determined based on the following criteria:

"**US Persons**," are those residents of PR[3] that:

- *were born outside PR (who are not "PR citizens"[4]), and*
- *did not acquire their US citizenship solely[5] due to their residence in PR.*

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

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

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

The US and PR estate tax treatment, the applicable exemptions and the estate planning considerations for a "PR Person" are discussed in a separate article (See AMG Puerto Rico Business Law Notes **2013-TAX-02).**

"US Persons" that are residents of PR, particularly high-net-worth individuals, must consider their estate's potential exposure to US estate taxes upon their demise, if any, and how they can avoid or minimize the impact of such taxes.

1. THE ESTATE

The estate of a decedent that was a resident of PR 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.[6] 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.

US Estate Taxes (US Persons). When the PR resident is a US Person, the location of the assets that comprise his or her estate is irrelevant, as the estates of US Persons are taxed by the US on their worldwide assets, and their taxable estate is subject to the US estate tax. However, US Persons are entitled to the $5 million (indexed for inflation after 2012) exemption, plus certain deductions and credits. In 2013 this exemption amounts to $5,250,000.

However, we must emphasize that this $5 million exemption is not applicable to those US citizens that reside in PR and are considered "PR Persons," as defined above.

The US estate tax rate for US Persons is now 40%.[7] For example, the US Estate Taxes applicable to decedent who is a US Person, that dies married and without a will in 2013, with 3 children from the same marriage, and whose estate of $8,000,000 is composed solely of his 50% interest in the community property that was jointly held with his spouse, amounts to: $1,100,000 if the executor does not make a QTIP election (as defined below), or $566,667 if a QTIP election is made.

US Gift Taxes. For US gift tax purposes, the lifetime gift tax exclusion will also be $5 million, and such amount will also be indexed for inflation. This provides a tax saving gifting opportunity for US Persons, as they will be able to transfer up to the exemption amount during their lifetime without triggering US gift taxes. To the extent that the $5 million exemption is used for lifetime gifts, it will not be available to offset estate taxes.

Potential PR Gift Tax Exposure. US Persons that are PR residents and plan to use the US gift tax exemption have to be careful that the gift involves the transfer of "Property Located Within PR," as defined in the PR Internal Revenue Code of 2011 ("PR-IRC"). If the gift by such US Person involves property that under the PR-IRC is considered "Property Located Outside PR," the gift will trigger PR gift taxes when such person's total annual gifts of "Property Located Outside PR" exceeds $10,000 per donee.

2. PR ESTATE TAXES (US PERSONS).

Puerto Rico has a different estate tax treatment for US Persons, than the one applicable to PR Persons, under rules that are designed to avoid double taxation in PR. The estates of US Persons will pay as PR estate taxes that amount which the US allows as a credit against US estate taxes; thus the estate tax due to PR is determined based on US law and it reduces the US estate tax liability.

The PR estate tax treatment of US Persons makes most of the estate tax considerations for PR Persons (i.e., Property Located Within the US, Property Located Within PR or Outside PR, the PR Estate Tax Exemption, the 10% PR Fixed Estate Tax Rate and the Credit for Responsible Taxpayer) completely irrelevant for PR residents that are considered US Persons.

3. ESTATE PLANNING FOR US PERSONS.

The estate planning considerations for US Persons differ significantly from those of PR Persons. The estate tax exposure of US Persons can be reduced, eliminated or mitigated through the proper use of wills, testamentary dispositions, trusts and lifetime gifts, setting up assets in structures that allow for valuation or minority interest discounts, the marital deduction (which can be augmented with a timely made qualified terminable interest property or "QTIP" election when the surviving spouse receives or is entitled to a terminable interest in property) the charitable deduction, and, if necessary, the acquisition of life insurance to provide funds for payment of estate taxes. For US Persons it is also essential that the holding of life insurance and/or beneficiary designation be structured so that life insurance benefits are excluded from the gross estate of the decedent, and a surviving spouse that is also a US Person.

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. Therefore, as a general rule many estate planning strategies that are widely used in the US are not fully viable in PR.

Finally, an additional recently enacted benefit for US Persons is the so called "portability" of the US estate tax exemption between spouses. Portability means that the surviving spouse can elect, on the timely filed US estate tax return of the first spouse to die, that the unused portion of the deceased spouse's exemption amount be added to her/his own estate tax exclusion. Prior to 2011 this could only be achieved when the spouses had wills that created credit shelter trusts. Portability is now available, even when the first spouse to die has no will.

Adsuar Muñiz Goyco Seda & Pérez-Ochoa, P.S.C. regularly advises US Persons on estate tax planning strategies that will avoid or minimize their exposure to US and PR estate taxes. Properly drafted wills and trusts, individually designed to account for such person's marital and family circumstances, and their particular needs, are an essential component of these strategies.

4. US PERSON MARRIED TO PR PERSON.

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

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[1] Any foreign national (i.e., non US citizen) that at the time of his demise is "domiciled" in the "United States," will be considered a "US resident," for US estate tax purposes, and all of his or her estate will be subject to US estate taxes regardless of where it is located. For these purposes "United States' includes only the States and the District of Columbia.

[2] Thus, regardless of where their assets are located, their estates (net of the applicable exemptions and deductions) are subject to US estate taxes.

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

[4]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.

[5] 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.

[6] 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.

[7] This tax is assessed on the fair market value of the properties of a decedent (not on their cost, their book value or the unrealized appreciation on such properties).

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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.

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