Adsuar Muñiz Goyco Seda & Pérez-Ochoa, P.S.C.
Attorneys and Counselors at Law

http://www.amgprlaw.com

PUERTO RICO
BUSINESS LAW NOTES

2014-TAX-03

Newsletter Date: July 23, 2014

US Income Tax Considerations of Puerto Rico Residents Holding Passive Investments Through PR Organized Entities

By: Ricardo Muñiz

In the past, many bona fide residents of Puerto Rico ("PR Resident(s)")[1] avoided investing in non-PR securities as they were generally concerned with exposure to United States ("US") and PR estate taxes upon their demise; reluctant to file US income tax returns; and/or mesmerized by the high rates of return generated by PR government/ agency bonds ("PR Bonds") and tax exempt PR mutual funds that generally invest over 2/3 of their assets in PR Bonds ("PR Funds"). Such rates of return were then much higher that similarly rated US investment alternatives. As a result, many PR Residents failed to adhere to one of the basic rules of successful investing, diversification, including geographical diversification, and ended up with PR Bonds and PR Funds representing most, or a very large portion, of their investment portfolios.

Now, as a direct result of the downgrade in the credit rating of PR Bonds, and the reduction in value of PR Bonds and PR Funds, many PR Residents are considering investing in US securities, such as corporate, government, agency and municipal bonds, US mutual funds, exchange traded funds ("ETFs"), shares of stock of US entities, and real estate investment trust, among others. This is a welcomed development for PR Resident investors, as more of them are now recognizing the benefits of diversifying their passive investments, both geographically and by types of investments.

US Estate Tax. However, when PR Residents that were born in PR (or who acquired their US citizenship solely due to their residence within PR) consider investments outside PR, one still remaining major deterrent is the exposure to US estate tax[2]. PR Residents have available various estate planning strategies involving wills, gifts, trusts, life insurance, selection of investments within and outside PR, among others, that can mitigate, defer or even avoid the US estate tax exposure.

---

[1] It should be noted that upon the demise of PR residents that were born in PR, or who acquired their US citizenship solely due to their residence in PR, they will be considered foreigners ("non resident aliens") for US estate tax purposes. This implies that only those "properties located within the US" owned by such person's estate will be subject to US estate taxes, while "properties located outside the US" will not be subject to US estate taxes. If such person owns "properties located within the US" at the time of death, generally his estate will only be entitled to a $60,000 US estate tax exemption, instead of the $5,340,000 exemption available during 2014 for all other US citizens and residents. This exemption may exceed $60,000, but not more than $187,500, when more than 26.7% of the estate consists of "property located within the US." Even though such persons' estates will be entitled to a very small US estate tax exemption, all properties located outside the US that are held by the estate will not be subject to US estate tax, regardless of the amount thereof.

[2] The US estate tax rate commence at 26% after the $60,000 exclusion, and is 40% when the "property located within the US" exceeds $1 million.

Among these other estate planning strategies, PR Residents can invest in US Securities through a PR organized entity (i.e., corporation, limited liability company, trust, special partnership and even a partnership) that under the US Internal Revenue Code ("US-IRC") is considered a "corporation" for income and estate tax purposes (collectively referred to hereinafter as "PR Corporation(s)"), **which if property structured, can avoid the US estate tax exposure, and not result in an onerous or unexpected US income tax exposure[3].** If not properly structured, exposure to US estate tax may not be avoided, and dire US income tax consequences may arise.

PR Estate Tax. Since 2011 the PR estate tax rate applicable to the value of "property located outside PR" held by the estate of a PR Resident born in PR (or who acquired his US citizenship solely due to his residence within PR) has been only 10%. Meanwhile "property located within PR" held by these PR Residents is not subject to the PR estate tax. Pursuant to the PR Internal Revenue Code of 2011 ("PR-IRC"), if the estate of such PR Resident owns a more than 10% interest in a PR Corporation that is primarily used for investing in cash, stock and bonds, including PR investments, such corporation will likely be considered "property located outside PR". However, the PR 10% estate tax may be fully offset with the "responsible taxpayer credit", so long as on the date of such PR Resident's demise, and during the administration of his estate, neither he, any corporation of which he owned more than 10% of its issued and outstanding shares (by vote or value), nor the estate, owes or fails to timely pay any taxes imposed by the PR-IRC (i.e., income tax, excise tax, sales and use tax and gift tax), real or personal property taxes, or municipal license taxes in an aggregate amount in excess of the lesser of (i) one percent (1%) of his gross estate, or (ii) $5,000.

US Income Tax - Caution. For US income tax purposes, PR Residents need to exercise extreme caution when they invest in US Securities through PR Corporations[4], as they are US citizens and will have to carefully navigate the various US income tax implications, and the multiple US-IRC tax filing requirements, that result from holding passive investment through a PR Corporation, or other foreign corporations. In particular, pursuant to the US-IRC, a PR Corporation is considered a foreign corporation for US federal income and estate tax purposes. Thus, whenever a US citizen (including a PR Resident) utilizes a PR Corporation to hold passive investments (i.e., bonds, stock, mutual funds, ETFs, etc.), he or she must consider the implications of those provisions of the US-IRC that were designed to prevent US citizens (as well as all other US persons) from deferring US income taxation on passive income earned through foreign corporations.

---

[3]The US estate tax rate commence at 26% after the $60,000 exclusion, and is 40%when the "property located within the US" exceeds $1 million.

[4]Shares of stock in PR Corporations that are taxed as corporations under the US-IRC do not constitute "property located within the US" for US estate tax purposes.

The principal US-IRC income tax provisions that these PR Residents need to consider are those dealing with passive foreign investment companies ("**PFIC**"), controlled foreign corporations ("**CFC**"), the US-IRC's source of income rules, the comprehensive regulations issued under US-IRC section 937 (including source and PR residency rules), the 3.8% Medicare Tax on passive income, and the still evolving FATCA[5] reporting requirements. These provisions and filing requirements were generally designed to prevent US citizens and US residents (including those that reside in PR) from deferring US income taxation on passive income earned through a foreign corporation, including PR Corporations which are considered foreign under the US-IRC. A comprehensive analysis of these provisions and their interaction, particularly with respect to PR Residents and PR Corporations, is beyond the scope of this Article; however, we will proceed to highlight below some of their provisions, except for the US-IRC and FATCA reporting requirements that will be discussed in a separate article.

PFIC. If a PR Resident owns stock of a PR Corporation that meets any of the following tests, the PR Corporation will be considered a PFIC under the US-IRC:

(1) the PR Corporation's passive income (interest, dividends, capital gains, etc.), including PR source income, represents 75% or more of its gross income for the taxable year ("**Income Test**"); or

(2) the PR Corporation's assets that produce passive income, including its PR assets (i.e., PR Government Bonds, PR Mutual Funds, etc.), or that are held for the production of passive income (including cash or cash equivalents), represent at least 50% of the average percentage of its assets ("**Assets Test**").

Thus, for example, if a PR Corporation owns rental property worth $500,000, generates $60,000 in gross rental income, and owns $600,000 in cash, stock and bond (including PR Bonds), it meets the PFIC Income Test. If another PR Corporation owns various real estate parcels in PR worth $2,000,000, generates $10,000 of gross rental income, and owns cash, stock and bonds that generate $40,000 of passive gross income, it will also meet the PFIC Asset Test.

Generally, under the US-IRC's PFIC rules, if a PR Resident that is a shareholder of a PFIC (regardless of the percentage of its stock that he owns) receives a distribution from a PFIC in excess of 125% of the average amount of distributions that he has received from the PFIC during the three (3) prior taxable years (or shorter period if the PFIC has not existed three (3) years), he is treated as receiving an "excess distribution" that is taxed under the US -IRC as ordinary income at the highest United States income tax rates; and to the extent such distribution is attributed to earlier years in which he owned shares of the PFIC, he will be subject to an interest charge.

[5] FATCA refers to the Foreign Account Tax Compliance Act, which was enacted on March 18, 2010.

In addition, if he were to "dispose" (i.e., sell, exchange, gift, transfer at death, exchange pursuant to a liquidation or redemption and even transfers otherwise entitled to non recognition treatment) PFIC stock at a gain, he will be treated under the US-IRC's PFIC provisions as receiving an "excess distribution" equal to such gain, with such gain subject to ordinary income treatment instead of capital gains from the sale, exchange or other disposition of PFIC's shares of stock (the "**PFIC Penalties**").

CFC. Pursuant to the US-IRC controlled foreign corporation ("**CFC**") provisions, "subpart F" income (generally passive income) derived by a foreign corporation that is a CFC[6] may be imputed for US income tax purposes to those US persons that directly or indirectly own 10% or more of the total combined voting power of all classes of stock of the foreign corporation[7].

Generally, the CFC provisions of the US-IRC will not be applicable to the owners of a PR Corporation if (i) 50% or more of its voting rights or value are held by five (5) or less US persons that are PR Residents; and (ii) dividends from the PR Corporation constitute income from sources within PR. If however, 50% of a PR Corporation's voting rights or value are held by US persons that are not PR Residents, it will be a CFC.

SECTION 937 REGULATIONS. Dividends and interest paid by a PR Corporation may be subject to US income taxation under either the Conduit Rule or the 10% Shareholder Rule of Regulations issued under Section 937 of the US-IRC.

(a) **Conduit Rule.** A PR Corporation will be considered a Conduit if pursuant to a plan or arrangement (i) dividends from the Corporations are received by a PR Resident "in exchange for consideration provided to another person, and (ii) such person (or other person) provides the same consideration (or consideration of a like kind) to a third person in exchange for one or more payments constituting income from sources within the US.

(b) **10% Shareholder Rule.** If a PR Resident directly or indirectly (pursuant to certain attribution rules) owns 10% or more of a PR Corporation's voting rights, and during the 3 taxable years ending with the close of the taxable year of payment of the dividend, or that portion of such period during which the PR Corporation has been in existence (i.e., the Testing Period), the PR Corporation derived (A) at least 80% of its gross income from sources within PR or effectively connected with a PR trade or business, and (B) at least 50% of its gross income from the active conduct of a trade or business in PR (the "**80%/50% Test**")[8], dividends and interest paid by such corporation to said shareholder will be considered PR source income, unless such PR Corporation is considered a Conduit under the US-IRC.

[6] Generally, a CFC is a foreign corporation that has more than 50% of (i) the total combined voting power of all classes of stock entitled to vote, or (ii) the total value of its stock, owned by "US Shareholders" (including US citizens that are PR Residents) at any time during its taxable year.

[7] It should be noted that a person that possesses certain key powers with respect to a CFC, and 20% or more of the total number of shares of any class of stock of such corporation, will be deemed to own 10% of the voting power, even if he has no voting power.

[8] Investing in stock and bonds generally does not constitute the active conduct of a trade or business.

Generally, a PR corporation that is primarily used for investing in cash, stock and bonds, including PR investments, will not meet the 80%/50% Test.

If the 80%/50% Test is not met by a PR Corporation, the only portion of such corporation's dividend that will constitute income from sources within PR will be an amount equal to the product of the dividend and a fraction, with a numerator equal to the gross income of the corporation from sources within PR for the Testing Period and a denominator equal to the total gross income of the corporation for such period. Conversely, the remaining portion of the PR Corporations dividend will not be PR source income, and will be subject to US income taxation when received by a PR Resident.

If a PR Resident directly, or indirectly (as certain US-IRC attribution rules are applicable), owns less than 10% of the voting rights of the PR Corporation, dividends that the PR Resident receives from such corporation, or entity, are generally from sources within PR and not subject to the 10% Shareholder Rule, unless the PR Corporation is considered a Conduit under the US-IRC.

3.8% MEDICARE TAX. A PR Resident that earns passive income that is not from sources within PR (including income from dividends and interest considered US source income under Section 937 Regulations), may also be subject to the 3.8% Medicare Tax on investment income, if he meets certain US source "net investment income" level thresholds.

****

Adsuar Muñiz Goyco Seda & Pérez-Ochoa, P.S.C. can help you set-up the proper entity and operational guidelines to hold your various non-PR investments, while avoiding exposure to US estate taxes and reducing the impact of US/PR income taxes, consistent with your estate planning needs. On these matters, please contact any of the following attorneys from our Income Tax and Estate Planning, Wills and Trusts Practice Groups: Ricardo Muñiz, Esq. (787) 281-1818; Fernando Goyco, Esq. (787) 281-1802; or Caridad Muñiz-Padilla, Esq. (787) 281-1817.

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.

IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

World Plaza
268 Muñoz Rivera Ave. Suite 1400
San Juan, PR 00918

PO Box 70294
San Juan, PR 00936-8294

Telephone: (787) 756-9000 & (787) 641-9001
Fax: (787) 756-9010 & (787) 756-9023