ADSUAR MUÑIZ GOYCO
SEDA & PÉREZ OCHOA, PSC

PUERTO RICO
BUSINESS LAW NOTES

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Are You a *Bona Fide* Resident of Puerto Rico for US Income Tax Purposes? IRS Issues Final Regulations

This Article updates and supersedes our November 9, 2004 (No. 2004-12) and May 26, 2005 (No. 2005-01) articles on this matter, and incorporates the changes adopted by the US Internal Revenue Service ("**IRS**") in the final regulations under Section 937 of the US Internal Revenue Code of 1986, as amended ("**US-IRC**").

Section 937 of the US-IRC was adopted in 2004 and provides that **in order for an individual to qualify as a Bona Fide Resident of Puerto Rico under US-IRC Section 933 ("*Bona Fide* PR Resident"), he/she must meet all of the following three tests: Presence Test, Tax Home Test, and Closer Connection Test.** The importance of Section 933 of the US-IRC for Puerto Rico residents is that it establishes that the Puerto Rico ("**PR**") source income of *Bona Fide* PR Residents is generally exempt from US income taxes (the "**933 Exclusion"**).

Prior to January 1, 2005, the determination of whether an individual was a *Bona Fide* PR Resident was made solely on the basis of a subjective facts and circumstances test. Under such test, a person actually present in PR, who was not a mere "transient," was deemed a resident of PR for US income tax purposes. Multiple facts and circumstances (i.e., principal home, location of family members, community relationships, among others) were considered in making such determination. The number of days the person spent in PR was merely one of the facts considered, but no specific number of days of presence in PR was required.

The implications of ceasing to be a *Bona Fide* PR Resident will be especially onerous to persons with investments in securities or in businesses whose income enjoys tax exemption or reduced tax rates in Puerto Rico (e.g., Puerto Rico GNMAs, AFICAs, PR government bonds sold only in the local market, preferred stock of local banks, local mutual funds, income and dividends from exempt manufacturing operations, etc.).

The rules for qualifying as a *Bona Fide* PR Resident are now much more complex, and they require compliance with the following three tests:

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(a) Presence Test. Pursuant to the Final Regulations under US-IRC Section 937 (the "**Regulations**"), the Presence Test can be met by complying with any of the following "**presence in Puerto Rico**" alternatives:

(1) the individual is present in Puerto Rico ("**PR**") at least 183 days during the taxable year;

(2) the individual is present in PR a minimum of 549 days during the three year period that includes the current taxable year and the two preceding taxable years, as long as the individual is also present in PR for a minimum of 60 day during each year of the three year period;

(3) the individual's presence in the United States ("**US**") does not exceed of 90 days during the taxable year;

(4) the individual generates no "earned income" from sources within the US (i.e., compensation for labor or personal services rendered by the individual in the US in excess of $3,000), and is present in PR for more days than in the US; or

(5) the individual has "no significant connection" to the US.

Please note that under alternatives 3, 4 and 5 above, the individual is not required to be PR for at least 183 days during the taxable year, and that for purposes of the Presence Test, PR is not considered part of the US. In addition, under alternative 2 above, the individual is required to be in PR for only an average of 183 days per year over a three year period, provide he/she is in PR for at least 60 days in each of those years. Thus, an individual may be in PR for 245 days in years one and two and only 60 days on year three, but the average over the three years is 183 days per year ([245 + 245 + 60] / 3 years = 183 days per year).

The following rules are used to determine "**days of presence in Puerto Rico**" for purposes of the Presence Test:

The following rules are used to determine "**days of presence in Puerto Rico**" for purposes of the Presence Test:

- physical presence in PR for any length of time during a given day counts as a "day" in PR;
- physical presence in the US for any length of time during a given day counts as a "day" in the US, except that if on the same day the individual is also present in PR, the presence in the US does not count as a day of presence in the US;

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- any day that an individual is outside PR to receive or to accompany a parent, spouse or child who is receiving "qualified medical treatment" (i.e., generally in-patient care in a hospital or hospice, for which extensive and specific documentation is required) will be considered as a "day of presence" in PR;

- any day during a 14-day period within which an individual is outside PR because he/she has left or is unable to return due to a major disaster (i.e. FEMA/Presidential declaration) will be considered as a "day of presence" in PR;

- days spent in transit between two points outside of the US do not count as a day in the US, so long as the presence in the US is less than 24 hours;

- days in the US as a student (as defined in US-IRC §152(f)(2)) do not count as "days of presence" in the US;

- days in the US serving PR as an elective representative of PR, or as a full time elected or appointed official or employee of the PR Government, do not count as "days of presence" in the US; and

- physical presence in PR and in another US possession (i.e., US Virgin Islands) on the same day, count as a "day of presence" in PR if the tax home of the individual is in PR.

The Presence Test is based on total days within a calendar year, not continuous days of presence within PR or the US.

The Presence Test is a clearly determinable objective test. If an individual does not meet any one of the five "presence in Puerto Rico" alternatives described above, he/she will not be considered a *Bona Fide* PR Resident during such year. Consequently, the worldwide income of such individual will be subject to US income taxes, regardless of compliance with the other two tests described in paragraphs (b) and (c) below.

It should be noted that if an individual is deemed to have "no significant connection" to the United States, as such term is described below, it does not matter how much time he/she spends in PR or in the US during a given year. Such individual will only be considered a *Bona Fide* PR Resident if he/she also meets the Tax Home Test and the Closer Connection Test described below. For these purposes, an individual is considered to have a "**significant connection**" to the US if he or she has:

(1) a permanent home in the US (which includes any accommodations, house, apartment or a furnished room that is available at all times, continuously and not only available solely for stays of short duration), regardless of whether such facilities are owned or rented by the individual, or otherwise made available to him/her, or owned by any entity controlled directly or indirectly by such individual;

(2) a spouse, or a child that has not attained the age of 18, whose principal place of abode is in the US (unless the spouse is legally separated under a decree of divorce or separate maintenance; or the child lives in the US with a custodial parent, or the child is in the US as a student); or

(3) a current registration to vote in the US.

The first "significant connection" criteria, as described above, implies that if you have a family member or friend that lives in the US, and within his/her home there is a furnished room that is available (presumably for your use) at all times, then you would be deemed to have a "significant connection" to the US. This is a very strict and subjective rule. A taxpayer who relies on the "no significant connection to the US" Presence Test alternative, but does not meet any of the other four Presence Test alternatives, should generally stay in hotels and/or short term rental accommodations while in the US, and avoid staying with family and friends.

Individuals who own a vacation home in the US (even if owned indirectly through a corporation or partnership), or who stay with family members or friends in the US that have a room that is available to them at all times, and who travel frequently to the US for extended periods, should keep a log of the number of days they were in and outside the US and PR, supported by documentary evidence to be used in the event of an IRS audit. It must be noted that a determination by the IRS is presumed to be correct and the taxpayer bears the burden of proving that he/she was a *Bona Fide* PR Resident. Finally, it should also be noted that there are special rules in the Regulations for when the US vacation home is rented to someone else during the year.

(b) Tax Home Test. This test is met if the individual does not have his/her regular place of business outside of Puerto Rico at any time during the taxable year.

A person's "tax home" is his/her regular or principal (if more than one) place of business that is claimed by the taxpayer for purposes of determining income tax deductions for traveling expenses while away from home in the pursuit of a trade or business. Absent such regular or principal place of business due to the nature of the business, or because the individual is an employee or is retired, his/her regular abode, in a real and substantial sense, is deemed his/her "tax home". The "abode" consideration, as well as the question of whether a person has closer connections to the US or another country other than PR, involves a subjective analysis of facts and circumstances surrounding the particular case.

(c) Closer Connection Test. This test is met if the individual has a closer connection with Puerto Rico than with the United States or a foreign country. This is a facts-and-circumstances test. The following is a list of some of the factors to be taken into consideration in making a "closer connection" test determination:

(1) the location of the individual's permanent home;

(2) the location of the individual's family;

(3) the location of personal belongings, such as automobiles, furniture, clothing and jewelry owned by the individual and his/her family;

(4) the location of social, political, cultural or religious organizations with which the individual has a current relationship;

(5) the location where the individual conducts his/her routine personal banking activities;

(6) the location where the individual conducts business activities (other than those that constitute the individual's tax home);

(7) the location of the jurisdiction in which the individual holds a driver's license;

(8) the location of the jurisdiction in which the individual votes; and

(9) the country of residence designated by the individual on all official government forms, documents and tax returns.

Caveat For Married Taxpayers. Couples should also be aware that these new rules apply to each of the spouses separately. Therefore, while one of the spouses might meet the Presence Test, and also meet the Tax Home and Closer Connection Tests, the other spouse could fail the Presence Test, the Tax Home or the Closer Connection Test.

In such cases, only the income attributable to the *Bona Fide* PR Resident spouse will be entitled to the 933 Exclusion, while all of the income attributable to the other spouse will be subject to US income taxes. Generally, due to the community property regime applicable in PR, and unless the spouses lived apart during all of the year or they had a prenuptial agreement, one half of the gross income of both spouses will be allocated to each spouse for US income tax purposes. Such gross income includes: (i) all salaries and business income earned by both spouses; (ii) all passive income (i.e., interest, dividends, rents and capital gains, etc.) earned on community property assets of the spouses ("bienes gananciales"); and (iii) all passive income earned on the private assets ("bienes privativos") of each of the spouses. It should be noted that, unless otherwise agreed through a prenuptial agreement, all income derived by the spouses from their private assets constitutes community property under PR law.

Change of Residence. The Regulations require that the IRS be notified when a person becomes or ceases to be a *Bona Fide* PR Resident. IRS Form 8898 must be used for these purposes and its filing due date is the same as the US income tax return. This form must also be filed by those who became *Bona Fide* PR Residents after the tax year 2000, and it is due on the due date for the 2005 tax return. Special rules apply for the year during which the taxpayer moves from Puerto Rico.

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Estate Tax Considerations. The criteria for determining residence for US income tax purposes and for US estate and gift tax purposes are not the same.

The estate of a person who is a "resident" of PR at the time of death and who was born in PR or acquired US citizenship solely by residence in PR, is not subject to US or PR estate taxes, except for that portion of the estate that is located in the US or outside PR. For estate tax purposes, a person is a "resident" of PR if he or she is "domiciled" within PR. According to the US-IRC regulations, a person acquires a domicile in a place by living there, even for a brief period of time, with no definite, present intention of later relocating there from. Residence without the requisite intention to remain indefinitely at such place will not constitute "domicile." Thus, mere presence or residence outside PR, without the required intention to remain there indefinitely does not constitute domicile.

While it could be relatively easy to determine residence, the inherent difficulty of determining a person's intention is aggravated when dealing with a person who has died. In the end, the question of intention depends entirely on a series of facts and circumstances indicative of such intent.

Even though the *Bona Fide* PR Resident rules described above are not applicable for estate tax purposes, we should be aware that a claim of PR domicile for US estate or gift tax purposes by a person that does not qualify as a *Bona Fide* PR Resident for US income tax purposes requires special and careful planning as it may be challenged by the IRS and/or by a State taxing authority.

The preceding presentation constitutes a general summary. This presentation is only for informative purposes, and does not constitute an opinion or legal advice. The contents of this presentation can not be reproduced, transmitted or distributed without the consent of Adsuar Muñiz Goyco Seda & Pérez-Ochoa, P.S.C.

If you have any questions concerning this article, please contact the following partners of Adsuar Muñiz Goyco Seda & Pérez-Ochoa, P.S.C.: Ricardo Muñiz at (787) 281-1818, Fernando Goyco-Covas at (787) 281-1802, César R. Rosario-Vega at (787) 281-1820, and/or Vanessa I. Raffucci at (787) 281-1801.

ADSUAR MUÑIZ GOYCO
SEDA & PÉREZ-OCHOA, P.S.C.

WESTERNBANK 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) 474-0004
FAX: (787) 756-9010 & (787) 474-0005