

WHAT MAKES YOU A BONA FIDE RESIDENT OF PUERTO RICO FOR US INCOME TAX PURPOSES, AND ACT 20 AND 22 IMPLICATIONS

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Whether you are planning to move to Puerto Rico (“PR”) to enjoy the benefits of Puerto Rico’s Act to Promote the Transfer of Investors to Puerto Rico, as amended (“Act 22”),¹ and/or the Act to Promote the Exportation of Services, as amended (“Act 20”),² you must carefully consider if you will qualify as a bona fide resident of PR (“**Bona Fide PR Resident**”) pursuant to the regulations issued under the US Internal Revenue Code of 1986, as amended (“US-IRC”). The extraordinary tax benefits available under Act 20 and 22 for an individual US citizen, or US resident, that becomes a Bona Fide PR Resident are not available anywhere else in the world.

Pursuant to Section 933 of the US-IRC, individuals that qualify as Bona Fide PR Residents are generally not subject to US income tax on their income from sources within PR. These provisions allows individuals that become Act 22 Grantees US and PR income tax exemption on income that consists of interest, dividends and capital gains from the sale of certain securities, provided that such income is from sources within PR (i.e., determined pursuant to the US-IRC source of income rules).

Furthermore, a Bona Fide PR Resident (including one that does not qualify under Act 22), that is a shareholder of a corporation organized under the laws of PR that is becomes an Act 20 Grantee, will not be subject to US or PR income tax on dividends paid by such corporation if all of the corporation’s income is derived from services rendered from PR. Furthermore, if the entity that enjoys the Act 20 tax Grant is a pass-through or disregarded entity under the US-IRC, the individual Bona Fide PR Resident will only be subject to the 4% income tax rate that PR imposes on the Act 20 entity’s income, without such individual being subject to US income tax, or any other PR income tax, on such income.

In order to enjoy these PR and US tax benefits, an individual must meet the tests described below in order to become a Bona Fide PR Resident.

Bona Fide PR Residence Tests

In general, pursuant to US-IRC Section 937 and the regulations promulgated thereunder (the “**Regulations**”), the term Bona Fide PR Resident means a person that meets three tests: (a) establishes his/her presence in PR (the “**Presence Test**”); (b) does not have a tax home outside of PR (the “**Tax Home Test**”), and (c) has a closer connection to PR than to the United States or a foreign country (the “**Closer Connection Test**”). In addition, there is a special rule for those planning to move to PR, known as the “**Year of Move to PR Rule**”, that is only applicable to the year when the individual moves to PR, and is conditioned on the individual continuing to qualify as a Bona Fide PR Resident during the following three (3) years.

(a) **Presence Test.** The Presence Test can be met by complying with any of the following “**presence in Puerto Rico**” alternatives:

- (1) the individual is present in 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
- (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.⁴

It should be noted that if an individual is deemed to have “no significant connection” to the US, 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. However, keep in mind that even if the individual has no significant connection “to the US, in order to be considered a Bona Fide PR Resident he/she must also meet the Tax Home Test and the Closer Connection Test described below.

Please note that under alternatives 3, 4 and 5 above, the individual is not required to be present in PR for at least 183 days during the taxable year.

The following rules are used to determine “**days of presence in Puerto Rico**” for purposes of the Presence Test:⁵

- 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;
- 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.

(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.

Since these factors are non-exclusive and involve a subjective analysis of the facts and circumstances of each particular case, it is advisable for an individual looking to qualify as a Bona Fide PR Resident to discuss his/her personal situation with a tax attorney to make sure all ties to the US and/or any foreign country have been effectively severed. For instance, to properly address the first factor above (i.e., permanent home), the individual is not only required to have his/her permanent home located in PR, but must also look to sell or lease his/her previous home in the US mainland or any foreign country, if applicable. Under the second factor above, a married individual must move to PR along with his/her spouse and minor children, if any. The third factor above implies that the individual must sell his/her personal belongings or ship them to PR.

Considering that bona fide residency in PR must be for the “entire” calendar year, the Tax Home Test and Closer Connection Test must be met on or before the December 31st preceding the calendar year of bona fide residency and the Presence Test must be met during the calendar year. **While an individual may meet the Presence Test by complying with any one of the five “presence in Puerto Rico” alternatives previously described, he/she will not be considered a Bona Fide PR Resident unless the Tax Home Test and Closer Connection Test are also met during the “entire” calendar year. Therefore, except for the Special Rule for Year of Move to PR described below, an individual who is physically present in PR for more than 183 days during a taxable year might still fail to qualify as a Bona Fide PR Resident if his/her regular place of business is deemed to be outside of Puerto Rico at any time during such year.**

(d) Special Rule for Year of Move to PR. Another alternative to qualify as a Bona Fide PR Resident is the “year of move rule”. Pursuant to this rule, the individual will qualify as a Bona Fide PR Resident, even though he is not a resident during the “entire” calendar year in which he/she moves to PR. To qualify under this alternative rule the individual: (i) may not have been a Bona Fide PR Resident for any of the three calendar years immediately preceding the year of move to PR; (ii) must meet the Presence Test for the calendar year in which he or she moves to PR; (iii) must comply with the Tax Home Test and the Closer Connection Test at least for each of the last 183 days of such calendar year; and (iv) must continue qualifying as a Bona Fide PR Resident for each of the three calendar years immediately following the calendar year of the move to PR. This three year requirement is not applicable if the individual meets the Tax Home Test and Closer Connection test commencing on January 1st of a calendar year, and meets the Presence Test during such year.

(e) **Caveat For Married Taxpayers.** Married couples should also be aware that these 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.

(f) **Notification to IRS of 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. Special rules apply for the year during which the taxpayer moves from Puerto Rico.

Estate Planning Considerations.

The assets of PR residents are subject to the forced heirship and inheritance rules of the PR Civil Code (“PRCC”) upon their demise. This includes those PR residents holding grants of tax exemption under Act 22.

The right of PR residents to freely determine through a valid Will how most of their estates will be distributed is significantly limited by the PRCC’s forced heirship rules. The PRCC provides that certain family members (i.e., “forced heirs”) are entitled to a fixed portion (i.e., the legitime portion) of the estate of a decedent that was a resident of PR at the time of his/her demise. This is contrary to the laws of most states of the US, where the usual limitation on how to distribute your assets upon death through a Will is that a portion of the estate must be left to the surviving spouse.



An important benefit of being Act 22 PR Residents is that they can make lifetime transfers of assets to trusts, while retaining rights over such assets, and when these transfers and trusts are properly structured they can avoid the PRCC's forced heirship and inheritance rules. This is a unique PR estate planning opportunity that is not available to other PR residents. However, whenever any PR resident (including an Act 22 PR Resident) transfers assets to trusts, he/she must be careful of which assets are being transferred, and how these transfers are structured, in order to avoid transfers that are subject to PR and/or US gift taxes.

¹Act 22 offers tax benefits to those individuals that become Bona Fide PR Residents after January 17, 2012, and were not residents of PR at any time during the six years prior to such date. The income that is exempted pursuant to Act 22 consists of sources interest, dividends, and capital gains from the sale of certain securities. In addition, if those individuals establish an Act 20 Export Service business in PR, they will be entitled to tax exemption on the income derived from such operations. Pursuant to Act 22, a tax exemption Grant will be issued to such individuals, and the Act 22 Grant will be conditioned on the Bona Fide PR Resident acquiring a residential property in Puerto Rico, and opening a deposit account (personal or business) in a bank or cooperative operating in Puerto Rico. Act 22 Grantees will have two (2) years from the date they notify their residency in Puerto Rico to provide evidence of acquisition of such property.

²Bona Fide PR Residents (including those that are not Act 22 Grantees) may organize a PR entity to render or provide services from PR to clients outside PR under a grant of tax exemption issued under Act 20 ("Export Services"). The Export Services that qualify for tax exemption under Act 20 include management, asset managers, technological, financial and other professional services. In order to obtain a tax grant under Act 20, the business must commit to having a minimum of five (5) full-time jobs. During the six months after commencing operations, Act 20 grantees will not be required to have any direct, full-time employees in Puerto Rico, but they should use this time to plan and execute their hiring process. After hitting the six-month mark, and for the next eighteen months, Act 20 grantees must have at least three (3) direct, full-time employees. For the remaining tax-exempted period, Act 20 grantees must comply with the five (5) direct, full-time employees minimum requirement.

³Under this alternative, 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 $([245 + 245 + 60] / 3 \text{ years} = 183 \text{ days per year})$.

⁴For 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) 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, have a "significant connection" to the US, thus whenever they travel to the US, they 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.

⁵The Presence Test is based on total days within a calendar year, not continuous days of presence within PR or the US.



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