GUIDE

Becoming a Puerto Rico Resident

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BECOMING A PUERTO RICO RESIDENT

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Understanding the Puerto Rico tax system and its interrelation with the United States is crucial for individuals and entities doing business in Puerto Rico. Puerto Rico is not a state; it's a territory, with its own Business and Payroll laws and regulations.

The following is designed to give an insight into doing business in Puerto Rico. It provides relevant background information, which will be of assistance to individuals and organizations considering establishing in the Island. Nonetheless, it is highly recommended to seek advice and counsel from qualified professional sources before undertaking any determination.

Certain exclusions and exemptions may apply, and when specific problems occur in practice, it will often be necessary to refer to the laws and regulations of Puerto Rico, and to obtain appropriate accounting and legal advice.

Our firm's familiarity with this kind of issues on an everyday basis can be a resource to clients who wish to ensure that their decision is not only faithful and accurate but also will minimize potential future issues.

Understand that the following overview does not constitute any formal rendering of either legal, accounting, tax or professional services. If advice or assistance is required, an attorney, CPA or tax adviser should be consulted.

Torres CPA Group is an Advice Certified Public Accounting Firm offering Audit, Tax, Consulting and Financial Outsourcing services for over 33 years. If you require any further information, please do not hesitate to contact us.

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BECOMING A PUERTO RICO RESIDENT

Newcomers include the winter-weary USA citizens, who have opted for the Puerto Rico sun and Sandy beaches as their residence. One of the advantages of doing so is that they are exempt from Federal income tax on their earned income (Company's Net Income, and Services); and of the state income tax as an Act 20 on non-passive and as an Act 22 Resident on passive income (Capital Gain, Dividends, Interest).

Source income as Bona Fide Residents of Puerto Rico is exempt from US income taxes, the "933 Exclusion".

The distinction between USA residency and non-residency is important since USA residents are taxed on their worldwide income. Non-residents (as Puerto Rico Residents), on the other hand, can only be US taxed on income that is derived from or associated with USA sources.

What are the Bona Fide residence and Present Test requirements?

Bona Fide Requirements

The are four requirements to satisfy the bona fide residence test:

- You must be a US citizen and resident living in Puerto Rico.
- Your actions must be considered resident-worthy. In other words, the IRS will determine if you are establishing residency in Puerto Rico through your intentions and actions and the nature and length of your stay.
- You cannot have any plans of returning to the United States.

Exceptions to the Bona Fide or Physical Presence Tests

The only exception or waiver to the time requirements is if you have to leave due to civil unrest, war or similar adverse conditions. You must demonstrate that you reasonably could have expected to meet the minimum time requirements if the adverse conditions had not occurred.

The Physical Presence Test

The physical presence test does not depend on the kind of residence you establish, your intentions about returning, or the nature and purpose of your stay abroad, it is the Physical Presence Day and you must **earn income** while you are in Puerto Rico.

A full day is a period of 24 consecutive hours starting at midnight. The time spent on or in international waters or airspace does not count towards the 183 days.

The Presence Test can be met by complying with **any** of the following:

- Present in Puerto Rico (“PR”) at least 183 days during the taxable year;

- 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 days during each year of three-year period; Thus, a person may be in PR for 245 days in years one and two and only 60 days in year three, but the average over the three years is 183 days per year ([245 + 245 + 60] / three years = 183 days per year).

- The individual’s presence in the United States (“US”) does not exceed 90 days during the taxable year;

- The person generates no “earned income” from sources within the US (i.e., compensation for labor or personal services rendered by the individual in the US more than $3,000, or passive income paid by a US corporation), and is present in PR for more days than in the US; or

- The individual has “no significant connection” to the US.

Do I have to pass the same test each year?

No. You can switch back and forth depending on your circumstances. For each tax year, you must satisfy an entire test’s requirements, either the bona fide residence test or the physical presence test. It is common to pass the physical presence test one year, and then meet the criteria for the bona fide residence test the following year. Arguably the bona fide residence test is harder is reach, but also allows more flexibility for trips back to the United States.

Which other tests are needed to be passed?

For an individual to qualify as a Bona Fide Resident of Puerto Rico ("Bona Fide PR Resident"), he/she must pass two tests:

- Tax Home Test
- Closer Connection Test

The Tax Home or Abode (Residence) Test

An (Abode) residence defines as one's home, habitation, residence domicile or place of dwelling. The abode is a domestic term while tax home is a vocational, and both are independently important. Typically, you live in your tax home, and therefore, this minor distinction is not relevant. But if you travel a lot on business/pleasure it could be relevant.

If your regular or principal place of business, employment or duty post is PR, then that is your Tax Home. If not, you need to pass the Abode Test.

Your tax home does not necessarily define the location of your residence or domicile for tax purposes. If you maintain a dwelling in the United States, you will instantly be ineligible for having a tax home in Puerto Rico, However, if you maintain a house in the United States whether or not housing is used by spouse and dependents, does not necessarily mean that your dwelling is your abode.

Abode has been defined as one's home, habitation, residence, domicile, or place of dwelling. While an exact definition of "abode" depends upon the context in which the words are used, it apparently does not mean one's principal place of business. The courts have concluded that an abode is based upon person's:

- The blocks of time spent
- Bank account
- Driver's license
- Voter's registration
- The taxpayers had strong familial, economic and personal ties

The IRS does a decent amount of follow-up and even carries out exams on taxpayers claiming change or residence, don't try to pull a fast one, you will lose.

The Closer Connection Test

This test determines 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 taken into consideration in making a "closer connection" test determination:

- Location of the individual's permanent home
- The site of the person's family
- Location of personal belongings, such as automobiles, furniture, clothing, and jewelry owned by the person and his/her family
- Place of social, political, cultural or religious organizations with which the individual has a current relationship
- A place where the person conducts his/her routine personal banking activities;
- A place where the individual conducts business activities (other than those that constitute the individual's tax home);
- Location of the jurisdiction in which the person holds a driver's license;
- Place of the jurisdiction in which the individual votes; and
- Country of residence designated by the person 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.

Generally due to the community property regime applicable in PR, and unless the spouses lived apart during all of the year or each spouse for US and PR income tax purposes. Such gross income includes:

- All salaries and business income earned by both spouses
- All passive income (i.e., interest, dividends, rents and capital gains, etc.) won on community property assets of the spouses
- All passive income earned on private ownership of each of the spouses. It should be noted that, unless otherwise agreed through a prenuptial agreement, all revenue 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 is used for these purposes, and its filling 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.

Form 8898

A taxpayer is well-advised to pay close attention to the answers to the questions in form 8898 to avoid raising a red flag that could lead to a residency audit, or which could be used against the taxpayer later if such an examination is commence.

A close reading of the instructions and the form itself make it clear that the IRS will use the form to test the legitimacy of the taxpayer's residency claim using the three criteria outlined in IRC section 937. The form closely follows the law and regulations, and it has sections on both **physical presence** and the **closer connection** concepts. Although not separately labeled, the closer connection section of the form also contains questions relating to the third test, the **tax home** concepts.

Many taxpayers and their stateside accountants will not have much familiarity with form 8898 and the types of answers that will best prepare them to defend against possible IRS activity.

Our firm's familiarity with this kind of issues on an everyday basis can be a resource to clients who wish to ensure that their form 8898 responses are not only faithful and accurate but also will minimize potential future issues.

NY Court Ruling on Residence

In February 2014, a major court case ruled for taxpayers in concluding that it is not enough just to maintain a New York residence. As the case states, "there must be some basis to find that the dwelling is utilized as the taxpayer's residence (Gaied vs USA State Tax Appeals). These findings will make it increasingly difficult to assert residency on a statutory basis. Even though it is a State case, it gives guidance as to requirements.

The Department has outlined five primary factors in its 2012 NYS Nonresident Audit Guidelines (the "Guidelines") as result of this case.

The Domicile Test – The Five Primary Factors

Home – When the person maintains more than one residence a comparison of the homes must be made. The state compares the size, value and nature of use (lifestyle); being the most important factors the character of the use. Auditors are directed to look at what type of life the person is leading. Where is the focus of the citizen's life — family, friends, holidays, social engagements, sports? Where do those activities take place? Home refers not only to the family residence but also ties to the community. It is also important to note that the sale of a primary residence under the IRS gain exclusion rules does not always correspond to a change of domicile. In fact, the taxpayer may even be a non-resident in the year of sale.

Business Involvement – Where you work or actively participate in a USA trade, business, occupation or profession is important in determining domicile. There are cases deciding were the taxpayer presumably moved to Puerto Rico, yet continued to play an active role in his USA business. The lines are blurred further when a taxpayer maintains an apartment near one's job (say, NYC) and uses it as a hotel while being domiciled in the suburbs where the focus of his/her life is.

Items Near and Dear – This refers to essential tangible items that most people would want to have with them in their homes such as family photos, collectible items, family heirlooms, documents, trophies and awards and valuable artwork. While the monetary value of these elements is necessary, the sentimental value is considered as well.

Time – This is an evaluation of the time spent at each location. Time spent could be a major factor if a significant amount of time is spent in the USA, but considered within the context of the primary factors.

Family – An audit analysis of family connections will be limited to the immediate family – the individual, the spouse or partner (in recognition of modern lifestyles and living arrangements) and any minor children. Where minor children attend school can be one of the most important factors in determining where someone is domiciling since the quality of schools is an important consideration in deciding where to live.

Other Factors

Mailing addresses of bank statements, bills, and other family business; the physical location of safe deposit boxes; the state in which vehicles, boats, and aircraft registering; the state of issue of drivers' licenses; the state in which taxpayers are registered to vote; an analysis of telephone services at each residence.

Or, to put it more simply, make sure that your home is where your heart is…