GUIDE

BECOMING A PUERTO RICO RESIDENT

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PUERTO RICO TAX COMPLIANCE GUIDE

By Torres CPA Group
CifrasPR

Currently, Puerto Rico, a territory of the United States of America, presents ample opportunities for individuals and entities interested in doing business in the Island. Understanding the Puerto Rico tax system and its interrelation with United States is crucial for the success of any project. It is important to emphazise, that Puerto Rico is not a state; it is a territory, with its own Business, Payroll and Employment laws and regulations.

The following White Paper is designed to give an introductory insight to Tax Issues in Puerto Rico. It provides relevant background information, which will be of assistance to organizations considering establishing business in the Island. Nonetheless, it does not cover the subject exhaustively, it was designed as a basic orientation tool. It is highly recommended to seek advice and counsel from qualified professional sources before undertaking any business.

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

The following document and its content does not constitute any formal rendering of either legal, accounting, tax, or professional services or advise. It is intended for information purposes only. If legal advice or other assistance is required, an attorney, CPA or tax adviser should be consulted.

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BECOMING A PUERTO RICO RESIDENT

Puerto Rico (PR) is the most eastern of the Greater Antilles between the Caribbean Sea and the Atlantic Ocean. Newcomers include the winter-weary USA citizens, who have opted for the Puerto Rico (PR) year-long warm temperatures and sandy beaches as their residence. One of the many advantages of doing so is that qualified individuals are exempt from Federal income tax on their earned income (Company's Net Income, on export Services and Hub Trading Business); and of the state income tax as an Act 20/60 on non-passive and as an Act 22/60 Resident on passive income (Capital Gain, Dividends, Interest) as Investors.

Source income as Bona Fide Residents of Puerto Rico (PR) is exempt from US income taxes, commonly referred to as the "933 Exclusion". The distinction between USA residency and non-residency is extremely important since USA residents are tax on their worldwide income. Non-US residents (including PR Residents), on the other hand, can only be US taxed on income that is derived from or associated with USA sources.

Definition of “Residence”

A person present in PR who is not a mere transient or sojourner is considered a resident for income tax purposes. Whether he is a transient or not, it will be determined by the person’s intentions concerning the length and nature of the stay.

For example, one person comes to PR for a definite purpose. Let’s suppose this purpose may be promptly accomplished if the person a transient; but, if the intention is of such a nature that an extended stay may be necessary for its accomplishment, and at the same time make his home here permanent, the person becomes a resident.

“Bona Fide Residence”

There is no filing required for Puerto Rico residence, in order to become a PR resident, you need to meet the IRS Bona Fide residency requirements.

Generally, you are a bona fide resident in PR if, during the tax year, you:

- Meet the substantial presence test,
- Does not have a tax home outside PR, and
- Does not have a closer connection to the United States or a foreign country than PR.
- You cannot have any plans of returning on a permanent basis to the United States.

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The Physical Presence Test

You meet the presence test for the tax year if you **meet one** of the following conditions:

- You were present in PR for at least 183 days during the tax year.
- You were present in PR for at least 549 days during the three years, including the current tax year and the two **immediately prior** tax years. During each year of the three years, you must also be present in the PR for at least 60 days.
- You were present in the United States for no more than 90 days during the tax year.
- You had $3,000 or less of earned income from US sources and were present for more days in the PR than in the United States during the tax year.
- You had no significant connection to the United States during the tax year.

Do I have to pass the same test each year?

You can switch back and forth depending on your circumstances. You must satisfy an entire test's requirements for each tax year, 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 bona fide residence test criteria the following year. Arguably, the bona fide residence test is more challenging in reach and allows more flexibility for trips back to the United States.

Days present in Puerto Rico

Generally, you are treated as being present in PR on any day that you are physically present at any time during the day. If you were physically present in the United States and a PR during a single day, that day is counted as a day of presence in the PR.

If you were physically present in PR and in territories during a single day, that day is counted as a day of presence in the PR in which you have your tax home.

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Also count these as days of presence in the PR for purposes of the presence test. Do not count them as days of presence in the United States.

1. Any day you were outside PR to receive (or to accompany on a full-time basis a parent, spouse, or child who is receiving) qualified medical treatment. For complying with this purpose, the child must be your son, daughter, stepchild, foster child, adopted child, or a child lawfully placed with you for legal adoption. Qualifying Medical Treatment is generally provided by (or under the supervision of) a physician for an illness, injury, impairment, or physical or mental condition. The treatment typically involves:

Any period of inpatient care that requires an overnight stay in a hospital or hospice, and any period immediately before or after that inpatient care to the extent it is medically necessary; or • Any temporary period of inpatient care in a residential medical care facility for medically necessary rehabilitation services.

2. Any day you were outside PR because you left or were unable to return to the PR during any 14-day period within which a major disaster occurred in the PR that was declared a disaster area by the United States President.

3. Any day you were outside the PR because you left or were unable to return to the PR during any period for which a mandatory evacuation order was in effect for the area in PR where you lived.

4. Any day (up to a total of 30 days) that you are outside the relevant PR and the United States for business or personal travel, but this rule:

a. Applies only if the number of days you are considered present in PR exceeds the number of days you are considered present in the United States and

b. It does not apply to calculate the minimum 60 days of presence in PR required for the 549-day presence test.

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Days not present in the United States

The following days does not count as days of presence in the United States for the "presence test" purposes.

1. Any day you were in the United States for less than 24 hours when traveling between two places outside the United States.

2. Any day, you were temporarily present in the United States as a professional athlete to compete in a charitable sports event (defined later).

3. Any day you were temporarily in the United States as a full- time student (defined later).

Exceptions to the Bona Fide or Physical Presence Tests

The only exception or waiver to the time requirements is leaving 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 Tax Home or Abode (Residence) Test

An (Abode) residence defines one's home, habitation, residence domicile, or dwelling place. The abode is a domestic term, while tax home is 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 for business/pleasure reasons, 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

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for having a tax home in PR. However, if you keep a house in the United States, whether or spouse and dependents use housing, it does not necessarily mean that your dwelling is your abode.

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

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

NOTES: An individual cannot have two tax homes at the same time: Andrews v. Commissioner, 931 F.2d 132 (1st Circuit, 1991).

If an individual does not have a regular or principal place of business, the individual's tax home is at his or her place of abode in a real and substantial sense. IRC § 911(d)(3), Treasury Regulation § 1.911-2(b), and Revenue Ruling 93-86.

If an individual is temporarily present in the United States, this does not necessarily mean that the individual has an abode in the United States during that time. Treasury Regulation § 1.911-2(b).

Important note: If an individual has a house in the United States, this does not necessarily mean the individual has an abode in the United States, even if the individual's family resides in that house. Treasury Regulation § 1.911-2(b).

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The Closer Connection Test

This test determines if the individual has a **closer** connection with PR than with the United States or a foreign country. This is a facts-and-circumstances test. You meet the closer connection test if you do not have a **closer** connection to the United States or a foreign country than to PR.

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
- Place of residence designated by the person on all official government forms, documents, and tax returns.

Your connections to the PR will be compared to the total of your connections with the United States and foreign countries.

Significant Connection

You have a significant connection to the United States if:

You have a permanent home in the United States,
You are registered to vote in any political subdivision of the United States, or
You have a spouse or child under 18 whose principal home is in the United States.

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For this purpose:

1. A spouse does not include a spouse from whom you are legally separated under a decree of divorce or separate maintenance regime; and
2. The child must be your son, daughter, stepchild, foster child, adopted child, or a child lawfully placed with you for legal adoption. But a child does not include:
a. A child who lives in the United States with a custodial parent under a custodial decree or multiple support agreement, or
b. A child who is in the United States as a student (defined earlier).

Permanent Home

A permanent home generally includes accommodations such as a house, an apartment, or a furnished room that is available at all times, continuously and not solely for short-term stays. However, let's suppose you or your spouse/partner owns the dwelling unit and rents it to someone else during the tax year. In that case, the dwelling unit is not your permanent home unless, during that tax year, you use some part of it for personal purposes for more than the greater of 14 days, or 10% of the days the property is rented to others at a fair rental price.

Generally, the rental property is considered used for personal purposes on any day it is not being rented to someone else at fair rental value for the entire day or is used by you, a family member, or anyone else who has an interest in the property. The rental property is not considered used for personal purposes on any day on which the principal purpose for using the property is to do repair or maintenance work.

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Change of Residence

The Regulations require that the IRS is 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 PR.

Your answers to the questions on Form 8898, Part III, will help establish the jurisdiction to which you have a closer connection.

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 be used against the taxpayer later if such an examination commences.

The form instructions are extremely specific on this subject. A close examination of the instructions will reveal 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 dedicated to 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.

On a regular basis, many taxpayers and their stateside accountants are not familiar with form 8898 and the types of answers that will best prepare them to defend against possible IRS activity.

Year of Move to Puerto Rico

If you are moving to or from a PR during the year, you may still be able to meet the tax home test for that year. See Special Rules in the Year of a Move.

Year of Moving to a PR

If you did not move to PR on the first day of the year you could have two tax homes. You will satisfy the tax home and closer connection tests in the tax year of changing your residence to the relevant PR if you meet all of the following:

1) You have not been a bona fide resident of the relevant PR in any of the three tax years immediately preceding your move.

2) In the year of the move, you do not have a tax home outside the relevant PR or a closer connection to the United States or a foreign country than to the relevant PR during any of the last 183 days of the tax year.

3)You are a bona fide resident of the relevant PR for each of the three tax years immediately following your move.

If you do not meet all of the above conditions, you **do not** meet the tax home and closer connection tests under this exception. Instead, you must meet the requirements explained under Tax Home Test and Closer Connection Test.

Caveat for Married Taxpayers

Couples should also be aware that these new rules apply to each of the spouses separately. Therefore, while one spouse might meet the Presence Test and 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 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.) earned 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.

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Examples

Examples were obtained from IRS publications tailored to PR situations.

Example—closer connection to the United States.

Marcos Reyes, a US citizen, moved to PR in 2020 to start an investment consulting and venture capital business. His spouse and two teenage children remained in California to allow the children to complete High School. Reyes traveled back to the United States regularly, to see his spouse and children, to engage in business activities, and to take vacations. Marcos had an apartment available for his full-time use in PR, but remained a joint owner of the residence in California, where his spouse and children lived. Reyes and his family had automobiles and personal belongings such as furniture, clothing, and jewelry located at both residences.
Although, Reyes was a member of the PR Chamber of Commerce, he also belonged to and had active relationships with social, political, cultural, and religious organizations in California. Marcos received mail in California, including bank and brokerage statements and credit card bills. He conducted his personal banking activities in California. He held a California driver's license and was also registered to vote there. Based on all of Marcos's particular facts and circumstances, he was not a bona fide resident of PR in 2020 because he had a closer connection to the United States than to PR.

Example—tax home and a closer connection to PR.

Pearl Blackmon, a US citizen, is a permanent hotel employee in PR but works only during the tourist season. For the remainder of each year, Pearl lives with her spouse and children in the PR, where she has no outside employment. Most of Pearl's personal belongings, including her automobile, are located in the PR. She is registered to vote in and has a driver's license issued by the PR. She does her banking in the PR and routinely lists her PR address as her permanent address on forms and documents. Pearl satisfies the presence test concerning both PR and PR. She meets the tax home test concerning PR because her regular place of business is in PR.

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Pearl satisfies the closer connection test concerning PR and PR because she does not have a closer connection to the United States or any foreign country. Pearl is considered a bona fide resident of PR, the location of her tax home.

Example Year of Move.

Dwight Wood, a US citizen, files returns on a calendar year basis. He lived in the United States from January 2014 through May 2020. In June 2020, he moved to the PR, purchased a house, and accepted a permanent job with a local employer. From July 1 through December 31, 2020 (more than 183 days), Dwight's principal place of business was in the PR, and, during that time, he did not have a closer connection to the United States or a foreign country than to the PR.
If he is a bona fide resident of the PR from 2021 through 2022, he will satisfy the tax home and closer connection tests for 2020. If Dwight also met the presence test in 2020, he will be considered a bona fide resident of the PR for the 2020 tax year.

Example—No significant US connection.

Ann Green, a US citizen, is a sales representative for a company based in PR. Ann lives with her spouse and young children in PR, where she is also registered to vote. Her business travel requires her to spend 120 days in the United States and another 120 days in foreign countries. Ann generally stays at hotels when traveling on business but sometimes stays with her brother, who lives in the United States. Ann's stays are always of short duration, and she asks her brother's permission to stay with him. Her brother's house is not her permanent home, nor does she have any other accommodations in the United States that would be considered her permanent home. Ann satisfies the presence test because she has no significant connection to the United States.

Example—The significant US, but presence test met.

Eric connection and Wanda Brown live for part of the year in a condominium, which they own, in the PR. They also own a house in Maine where they live for 120 days every year to be near their grown children and grandchildren. The Browns are retired, and their only income is from pension payments, dividends, interest, and social security benefits.
In 2020, Eric and Wanda spent only 160 days in the PR because of an 85-day vacation to Europe and Asia and 120 days in the United States. Although the Browns were present

in the United States for more than 90 days and had a significant connection to the United States because of their permanent home there, they satisfied the presence test concerning the PR because they had no earned income in the United States and were considered physically present in the PR for at least 183 days (160 days plus 30 days deemed present during their 85-day vacation to Europe and Asia for a total of 190 days).

Example Backward 3 Year Test

H, a US citizen, is engaged in a profession that requires frequent travel. H spends 195 days of each of the years 2005 and 2006 in PR. In 2007, H spent 160 days in PR. Satisfies the presence test concerning PR for the taxable year 2007. Assuming that in 2007 H does not have a tax home outside of PR and does not have a closer connection to the United States or a foreign country, then regardless of whether H was a bona fide resident of PR in 2005 and 2006, H is a bona fide resident of PR for the taxable year 2007.

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Example. Presence test.

W, a US citizen, lives part of the taxable year in a condominium, which she owns, located in PR. W also owns a house in State N where she lives for 120 days every year to be near her grown children and grandchildren. W is retired, and her income consists solely of pension payments, dividends, interest, and Social Security benefits. For 2006, W is only present in PR for 175 days because of a 70-day vacation to Europe and Asia. Thus, for the taxable year 2006, W is not present in PR P for at least 183 days, is present in the United States for more than 90 days, and has a significant connection to the United States because of her permanent home. However, W still satisfies the presence test concerning PR P because she has no earned income in the United States and is present for more days in PR than in the United States.

Example. Presence test.

T, a US citizen, was born and raised in State A, where his mother still lives in the house where T grew up. T is a sales representative for a company based in PR. T lives with his wife and minor children in their house in PR. T is registered to vote in PR and not in the United States. In 2006, T spent 120 days in State A and another 120 days in foreign countries. When traveling on business to State A, T often stays at his mother's house in the bedroom he used when he was a child. T's stays are always of short duration, and T asks for his mother's permission before visiting to make sure that no other guests are using the room and that she agrees to have him as a guest in her house at that time. Therefore, T's mother's house is not a permanent home of T. Assuming that no other accommodations in the United States constitute a permanent home concerning T, T has no significant connection to the United States. Accordingly, T satisfies the presence test for the taxable year 2006.

Example. An alien resident of PR - presence test.

F is a citizen of Country G. F's tax home is in PR, and F has no closer connection to the United States or a foreign country than PR. F is present in PR for 123 days and in the United States for 110 days every year. Accordingly, F is a nonresident alien concerning the United States and a bona fide resident of PR.

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Example. Seasonal workers - tax home and closer connection.

P, a US citizen, is a permanent employee of a hotel in VI but works only during the tourist season. For the remainder of each year, P lives with her husband and children in PR, where she has no outside employment. Most of P's personal belongings, including her automobile, are located in PR. P is registered to vote in and has a driver's license issued by PR. P does her banking in PR, and P routinely lists her address in PR as her permanent address on forms and documents. P satisfies the presence test concerning both PR Q and VI because, among other reasons, she does not spend more than 90 days in the United States during the taxable year. P satisfies the tax home test only concerning PR because her regular place of business is in VI. P satisfies the closer connection test concerning PR and VI because she does not have a closer connection to the United States or any foreign country (and PRs generally are not treated as foreign countries). Therefore, P is a bona fide resident of PR for purposes of the Internal Revenue Code.

Example. Closer connection to the United States than to PR.

Z, a US citizen, relocated to PR in a prior taxable year to start an investment consulting and venture capital business. Z's wife and two teenage children remain in State C to allow the children to complete high school. Z travels back to the United States regularly to see his wife and children, engage in business activities, and take vacations. He has an apartment available for his full-time use in PR, but he remains a joint owner of the residence in State C, where his wife and children reside. Z and his family have automobiles and personal belongings such as furniture, clothing, and jewelry located at both residences. Although Z is a member of the PR Chamber of Commerce, Z also belongs to and has current relationships with social, political, cultural, and religious organizations in State C. Z receives mail in State C, including brokerage statements, credit card bills, and bank advices. Z conducts his personal banking activities in State C. Z holds a State C driver's license and is registered to vote in State C. Based on the totality of the particular facts and circumstances pertaining to Z, Z is not a bona fide resident of PR because he has a closer connection to the United States than PR.

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Example. Year of the move to PR.

D, a US citizen, files returns on a calendar year basis. From January 2003 through May 2006, D resides in State R. In June 2006, D moved to PR, purchases a house, and accepts a permanent position with a local employer. D's principal place of business from July 1 through December 31, 2006, is in PR. During that period (which totals at least 183 days), D does not have a closer connection to the United States or a foreign country than to PR. For the remainder of 2006. Throughout 2007 through 2009, D continues to live and work in PR and maintains a closer connection to PR than to the United States or any foreign country. D satisfies the tax home and closer connection tests for 2006. Accordingly, assuming that D also meets the presence test, D is a bona fide resident of PR for all of the taxable year 2006.

Example. Year of move from PR.

J, a US citizen, files returns on a calendar year basis. From January 2007 through December 2009, J is a bona fide resident of PR C because she satisfies the requirements for each year. J continues to reside in PR C until September 6, 2010, when she accepts new employment and moves to State H. J's principal place of business from January 1 through September 5, 2010, is in PR. During that period (which totals at least 183 days), J does not have a closer connection to the United States or a foreign country than to PR. For the remainder of 2010 and throughout 2011 through 2013, D continues to live and work in State H and is not a bona fide resident of PR. J satisfies the tax home and closer connection tests for 2010 concerning PR. Accordingly, assuming that J also meets the presence test, J is a bona fide resident of PR for all of the taxable year 2010.

Example Presence test Outside of PR and US.

In 2016, H spent 360 days in PR and six days in the United States; in 2017, H spends 45 days in PR N, 290 days in foreign countries, and 30 days in the United States; and in 2018, H spends 180 days in PR and 185 days in the United States. During the three years from 2016 through 2018, H is present in PR for 615 days, including 30 days spent in foreign countries in 2017, which are treated as days of presence in PR. Although H is present in PR for more than the required 549 days during the three years, His only presence for 45 days in PR N during one of the period's taxable years (2017) is less than the 60 days of minimum presence required. The rule of days outside US and PR does not apply to determine whether H is present in PR for the 60-day minimum required.

New York Court Ruling on “Residence”

In February 2014, the New York State Court of Appeals (the state’s highest court) ruled for taxpayers in concluding that it is not enough 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 22 NY3d 592 (2014). These findings will make it increasingly difficult to assert residency on a statutory basis. However, even though it is a State case, it gives guidance as to the requirements.
The Department has outlined five primary factors in its 2012 NYS Non-resident Audit Guidelines (the "Guidelines") resulting from 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 essential factors of 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. 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. Cases are deciding where the taxpayer presumably moved to PR 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.

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Items Near and Dear – This term refers to essential tangible items that most people 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, sentimental value is considered as well.

Time: This is an evaluation of the time spent at each location. Time spent could be a significant factor if a considerable amount of time is spent in the USA but considered within 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 critical 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...

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