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Are Tax Moves to Puerto Rico Worth It for Crypto Holders?

Some in the crypto community have embraced Puerto Rico, which seems to have done a good job of promoting itself. But is it for you? I can only address the tax issues, not anything else.

To a large extent, the tax issues depend on what kind of income you will generate, whether personal or business, from where you generate it, and when the income — or even the appreciation in assets — occurs. Ideally, you want all income and all gain to come from Puerto Rico, and all the income and even the appreciation in assets to occur after you become a resident.

United States taxes

Let's start with the assumption that many Americans feel over-taxed. We have federal taxes and in most cases state taxes, too. It is never pleasant to pay huge amounts of state taxes in California, New York or anywhere else. But now that you can deduct only $10,000 of state and local taxes on your federal income tax return, you might feel like you got lemon juice in an already painful paper cut. When it comes to state taxes, most of the movement seems to be directed to tax-free states like Texas, Florida, Washington, Wyoming or Nevada.

California's Franchise Tax Board (FTB) has many decades of experience with Californians who might want to step across the state line precipitously close to selling their company, or those who are settling a lawsuit or some other mega-income event. How and when you take such actions can matter a lot when it comes to how you should respond to the FTB. In California, moving away because of taxes is nothing new. More recently, some people stay put but try to avoid California and other state taxes with trusts.

Puerto Rico — Too good to be true?

For taxpayers thinking on an even grander scale, some Americans even renounce citizenship, going through an exit process with the IRS and Department of State. That is much too drastic for most people. Then, there is Puerto Rico, which seems alluring. The advertisements suggest that you don't have to actually ditch your passport, but can pay a fraction of the taxes you do now. It almost sounds too good to be true. But wait, isn't U.S. citizens' worldwide income taxable? Yes, but Puerto Rico is a U.S. commonwealth.

It is a part of the U.S. but in some ways still independent. Its tax system is a hybrid: part U.S., part not. If you can really move yourself and/or your business, you may be able to cut your income taxes to the bone. But as with just about all things related to taxes, you have to be careful. The interaction between the IRS and the taxman in Puerto Rico is nuanced, requiring some Puerto Ricans to file with the IRS, some with the Puerto Rico Department of Finance, and some with both. Still, Puerto Rico hopes to lure American mainlanders with an income tax of only 4%.

Legally avoiding the 37% federal rate and an additional 13.3% in California (and in other states as well) sounds pretty good. What's more, there is no tax on dividends, and no capital gains tax in Puerto Rico. However, some big cautions are in order.

Move, then sell?

First — and this seems to be the most common question tax-weary people ask about Puerto Rico — forget about easily avoiding U.S. tax on the appreciation in your assets before you move. That's right, it is worth stressing this point.

If you move with appreciated stock, Bitcoin or other property and then sell, all that appreciation before the move is still subject to U.S. tax. You might be a bona fide resident of Puerto Rico by the time you sell, but you still have to pay U.S. tax on all the pre-move appreciation in your assets. Only your post-move appreciation will be subject to the special tax rules in Puerto Rico. In fact, to escape U.S. tax on all of the pre-move appreciation, you generally must wait a full 10 years after you move. But 10 years is a long time, so the "move, then sell" idea is hardly a quick fix.

What about moving to Puerto Rico and then selling your U.S. real estate? The answer: That will always be U.S. source income. That means it is fully taxed in the U.S., even if you move to Puerto Rico, and even if you wait 10 years before selling. What about selling California real estate? You guessed it, not only is that always U.S. source income, but it is always California source income, too.

If you are just thinking about a move next door to Nevada, can you move to Nevada and then sell your California real estate? Yes, of course, but you have to pay California taxes on that sale even if you are no longer a resident. But cheer up, stock or Bitcoin is usually different.

Returning to Puerto Rico, there are other fundamentals about the rules, too. First, as with any move, you have to actually move. Your tax home — i.e., your real home — must be in Puerto Rico. Remember, just like any move from one state to another, it has to be real. Try to avoid messy facts that don't look like a permanent move. If possible, sell your home, move your family, sever connections to your old local clubs, and so on.

After all, if you are later ruled not to be a Puerto Rico resident, the IRS is back in the picture asking for back taxes, penalties and interest. To qualify for the special benefits, an individual must not have been a resident of Puerto Rico within in the last 15 years. You must become a resident of Puerto Rico by Dec. 31, 2035, and you must reside there for at least 183 days a year. You also have to do the paperwork, filing an application with the tax authority there.

Once it is approved, it becomes a binding contract, promising you: 1) tax-free interest and dividends earned after you become a resident, 2) no long-term capital gains tax on appreciation after you become a resident, and 3) 5% tax on long-term capital gains for appreciation before you move for any sales during your first 10 years as a resident.

Puerto Rico also has attractive incentives for business owners. But once again, you actually have to move the company, employees, and so on. Have you ever noticed that when it comes to taxes, nothing seems to be simple?