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Move To Puerto Rico, Slash Your Taxes To Zero? Not Exactly

Many Americans feel over-taxed despite modest tax cuts in 2017. State income taxes can be especially annoying, particularly now. It was 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 on your federal tax return, there is even more lemon juice in that paper cut. Some focusing on state taxes move to tax-free states like Texas, Florida, Washington or Nevada. In places like California, leaving over taxes is nothing new, but some try to avoid California & other state taxes with trusts. Some Americans even renounce citizenship, going through an exit process with the IRS and State Department, but that is way too drastic for many people. Puerto Rico seems alluring, where advertisements suggest 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.

After all, aren't U.S. citizens taxable on their worldwide income? Yes, but Puerto Rico is a U.S. Commonwealth, 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 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 the 13.3% California (or other state) rate sounds pretty good. What's more, there is no tax on dividends, and no capital gain tax in Puerto Rico.

However, some big cautions are in order. First, forget about easily avoiding U.S. tax on the appreciation in your assets *before* you move. If you move with appreciated stock, bitcoin or other property, and *then* sell, all that pre-move appreciation is still subject to U.S. tax. 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 *ten years after* you move. That is hardly a quick fix. What about selling your U.S. real estate? 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 wait ten years before selling.

There are other fundamentals about the rules too. First, as with any move, you have to *actually* move! Your tax home—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, 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 December 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 that's approved, it's a binding contract and you'll get:

- Tax-free interest and dividends earned after you become a resident.
- No long-term capital gains tax on appreciation after you become a resident.
- 5% tax on long-term capital gain 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, etc.

This is not legal advice. For tax alerts or tax advice, email me at Wood@WoodLLP.com.