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THE TAX LAWYER

TAXES 01/09/22

Puerto Rico Tax Haven Is Alluring, But Are There Tax Risks?

Waves of people are moving to Puerto Rico, including investors, lawyers, hedge funders, and more. Given the astounding tax benefits, many are doing it with good reason. The crypto community may be the biggest wave of all, as the alluring press coverage keeps noting. With [zero taxes, golf and beach houses creating a crypto island paradise](#), what could go wrong? Compared to the benefits, perhaps very little. But as with anything that looks this good, there are some potential qualifiers and hiccups that some people may be ignoring. Puerto Rico's incredible tax savings deals for new residents who jump through all the requisite hoops are not new. However, it is only relatively recently that the island has virtually exploded with an enormous uptick in moves and economic boom times. Real estate prices have experienced a virtually stratospheric rise. Part of Puerto Rico's government tax incentive programs require buying a home within the first two years of a move, and you have to pay for the privilege of getting lower taxes. Just how low?

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.

3. 5% tax on long-term capital gain for appreciation before you move for any sales during your first 10 years as a resident.



Among the most glossed over qualifiers to the rules is about Puerto Rico source income. You get the great benefits only on income sourced in Puerto Rico, not on everything else—which the IRS can still tax. Many people might like to ignore established sourcing rules, and might imagine that if they live in Puerto Rico, everything is Puerto Rico source income. Another qualifier is the rule that pre-move appreciation on your assets is still taxed by the IRS. The rules for stocks are quite clear on this point. The rules for crypto are not as clear, so there are some differences of opinion about how crypto will be treated.

If you think the IRS is the biggest loser, you'd be right. The IRS and the Puerto Rican government are cooperating to identify people who are cutting corners, or even outright cheating. There are bound to be scores of audits, even for

overworked government agencies. Even some criminal tax cases seem likely. In 2020, a prominent [Puerto Rico CPA was indicted and arrested](#) over an alleged scheme to turn U.S. source income into Puerto Rico income. A short time later his large U.S. accounting firm exited the Puerto Rico market.

Despite qualifiers, of course, Puerto Rico's program is incredible. U.S. citizens are taxable on their worldwide income. That unforgiving price tag has caused some [Americans to renounce their citizenship](#), going through an exit process with the IRS and State Department. But given the long list of benefits of being American and the irrevocability of such a decision, renouncing citizenship is way too drastic for most people. Puerto Rico seems alluring, where you remain American, keep your passport, but can pay a fraction of the taxes you do now. 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. As with any move, you have to *actually* move. Your tax home—your *real* home—must be in Puerto Rico. 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. Ideally 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, and you must reside there for at least 183 days a year, or meet one of several other tests that are less clear cut.

Perhaps the hardest overall test to meet—which comes as a kind of overlay on everything else—is the closer connections test. Where are your connections

closest, Puerto Rico or somewhere else? You also have to do the paperwork, filing an application with the tax authority there. Once that's approved, it's a binding contract for the low taxes mentioned above. But among the most misunderstood rules is the web of interactions between federal taxes with the IRS and local taxes in Puerto Rico. In many if not most cases, you must file taxes in two places, with the IRS and with the Puerto Rico Department of Finance.

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 is a jaw-dropping benefit. What's more, there is no tax on dividends, and no capital gain tax in Puerto Rico. To return to the qualifiers, forget about easily avoiding U.S. tax on the appreciation in your assets *before* you move. If you move with appreciated stock or other property, and *then* sell, the 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. The rules for crypto are still being developed, and some more adventurous taxpayers believe that appreciation in crypto will not be bifurcated like stock.

For stock, 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. Many Americans feel over-taxed, and the Biden administrations plans are probably not helping that trend. State income taxes add to the burden, particularly in high tax states, and particularly with a general federal tax rule that you can deduct only \$10,000 in state taxes on your federal tax return. Increasingly, when taxpayers are looking at leaving a high tax state for a tax free state, they might be looking to Puerto Rico too.

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