Puerto Rico: America's Tax Haven or Vacation Paradise

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I. INTRODUCTION

"In this world nothing can be said to be certain, except death and taxes."1 Puerto Rico passed some aggressive tax legislation during 2012 to entice affluent investors to relocate. The Puerto Rican government believes it will help boost their economy and the island's general welfare,2 and might enhance its reputation as a vacation paradise. Puerto Rico has passed these types of laws in the past. A few examples of such legislation include: the Puerto Rico Industrial Incentives Act of 1954, the Puerto Rico Industrial Incentives Act of 1963, and the Puerto Rico Tax Incentives Act of 1987.3 Incentives included exempting income for up to ten years4 or excluding up to 90 percent of income from tax.5 As these tax incentives expired, Puerto Rico needed to pass new legislation to continue to attract wealthy investors and businesses.

Plans to reduce tax and maintain wealth are not new concepts and are often powerful motivators to cause people to relocate.6 A tax haven is "[a] country, that imposes little or no tax on the profits from transactions carried on there or on persons residence there."7 While the avoidance and reduction of tax is legal, tax evasion is illegal.8 This article will evaluate the financial decisions affecting an individual's choice to relocate to a potential tax haven.

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4. Id. § 10001.
This article will discuss how the following three Puerto Rican incentives: (1) Act 20; (2) Act 22; and (3) Act 273, could affect three distinct groups of individuals who are considering moving from the United States to Puerto Rico. After explaining the rules, the section will apply those rules to our groups, and the article will demonstrate whether the rule/code is favorable to the individual group.

The United States and Puerto Rico both have vast and complex Internal Revenue Codes (IRC). Therefore, this article is written within a vacuum, ignoring certain items such as the following: deductions, expenses, credits, subpart F income, certain FDAP income, withholding issues, entity-formation issues, entity-relocation issues, entity-dissolution issues, fund-relocation tax issues, RICs, dividend received deduction, employment taxes, and the alternative minimum tax under both codes. Section I summarizes the three Puerto Rican legislative acts. Section II addresses the geographical definitions of the United States and Puerto Rico and its application to residency. Section III explains the similarities and differences between the United States' Internal Revenue Code (IRC) and Puerto Rico's Internal Revenue Code (IRC) regarding the definitions of interest, dividends, and capital gains. Section IV discusses the matter in which both IRC's treat income sourcing related to retirement income, interest, dividends, and capital gains. Section V, the final section, compares the tax rates of both locations related to corporations, partnerships, and individuals. This article concludes by highlighting the tax advantages and disadvantages of the Puerto Rican incentives to each group, and then makes a recommendation for each group. The three groups are described below. The groups use fictitious scenarios to highlight the potential tax treatment that the Puerto Rican incentives offer based on his or her specific situations.

A. Jason and Jen—The Retired Couple

Jason is a married, seventy-year-old retired, blue-collar worker. He and his wife Jen, also retired, survive solely on their retirement income that includes social security benefits and some investments income, including interest, dividends, and capital gains. Jen constantly nags Jason about the outrageously high United States tax rates. The tax rates are so high that both of them might have to go back to work to make ends meet. They both yearn for the “sweet life” and want to spend their final years in a sandy-beached paradise. Unfortunately, they cannot afford southern California or Hawaii, and despise the elderly stereotypes of Florida.

B. Jon and Nichole—The Attorney and Hedge Fund Manager

Jon is a married, world-renowned international law attorney who teaches at a prominent law school. His brilliant wife Nichole is an affluent investor who manages a hedge fund. The two are happily married with two children. Nichole made millions during the dot-com bubble, and started her own company that now manages a hedge fund. With Jon's
continued support, Nichole continued to manage her hedge fund, which she primarily does from home despite their substantial wealth. Jon's amazing success, combined with Nichole's intuitive investment abilities made them a fortune, which they tucked away in a multitude of diversified investments. Thus, a substantial portion of their income is from interest, dividends, and capital gains. They both worry the United States tax rates could jump back up to 80 or 90 percent in the near future. They both crave reduced workloads and retirement to a sandy-beached paradise to spend more time with each other and their wonderful children.

C. MIKEY—THE ENTREPRENEUR

Mikey is a genius, hardworking, single entrepreneur. He has worked one year and a day on his current and third startup. His previous companies were amazingly successful. While his company is in the early development stages, he is confident it will be incredibly successful and sell for a large sum of money. He believes he paid too much tax when he sold his previous companies, and does not want to pay the same high tax rates when he sells his current company. He suspects the already high United States tax rates will significantly increase in the near future because the United States is facing so many budget problems. In addition to his United States concerns, the high California tax rates also concern him. If the tax incentives are significant enough, he is willing to relocate his company to a suitable alternative location.

II. SPECIFIC PUERTO RICAN LEGISLATIVE INCENTIVE ACTS

As mentioned above, Puerto Rico has a long history of passing tax and business incentives to attract foreign investment. The new incentive acts acknowledge that while Puerto Rico is granting significant tax exemptions, the presence of these high net worth investors within the island will positively support its economy. Puerto Rico recently passed numerous incentive laws to entice businesses and individuals to relocate. This article focuses on three more recent and aggressive pieces of legislation: Act 20—The Export Services Incentives Act, Act 22—The Individual Investor Act (both passed January 17, 2012), and Act 273—The International Financial Center Incentives Act (passed September 25, 2012).

A. ACT 20—THE EXPORT SERVICES INCENTIVE ACT

Act 20 incentivizes businesses to relocate its operation to Puerto

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Rico.\textsuperscript{13} The act lists an abundance of approved business activities, but the most notable activities are as follows: research and development; consulting services for any trade or business; professional services such as legal, tax, and accounting; centralized management services; services performed by electronic data processing centers; shared service centers; call centers; investment banking and other financial services; and anything else allowed by the Secretary.\textsuperscript{14} If an individual relocates their business to Puerto Rico, their business could be exempt from the normal Puerto Rican IRC tax rates and subject to a flat 4 percent tax, which could become a 3 percent tax if the business is considered “strategic.”\textsuperscript{15} The exemption applies for twenty years with a ten year renewal.\textsuperscript{16} The business’s personal and real property are completely exempt from Puerto Rican state and municipal taxes for the first five years, and subject to a 90 percent exemption thereafter.\textsuperscript{17} Additionally, company benefits or dividends distributed to the shareholders, members, or partners could be exempt from Puerto Rican tax.\textsuperscript{18} To receive this exemption, the company must file the necessary application and sign a contract with the Puerto Rican government.\textsuperscript{19} The benefits granted under the exemption remain valid during the exemption period even if subsequent Puerto Rican laws invalidate the exemption.\textsuperscript{20}

B. ACT 22—THE INDIVIDUAL INVESTORS INCENTIVES ACT

Act 22 incentivizes individuals to move to Puerto Rico.\textsuperscript{21} The incentives are only available to individuals who are not a bona fide Puerto Rican resident within the last fifteen years,\textsuperscript{22} and meet the residency requirements discussed below.\textsuperscript{23} The Act exempts all passive income obtained from investments from Puerto Rican taxes.\textsuperscript{24} Investment income includes interest, dividends, and capital gains.\textsuperscript{25} If the individual moves to Puerto Rico with built-in capital gains, those capital gains are subject to a 5 percent tax on the pre-move appreciation if the individual resides

\textsuperscript{13} 2012 P.R. LAWS no. 20 p. 1.
\textsuperscript{14} Id. at 7-8; P.R. LAWS ANN. tit. 13, § 30041(a)(12) (2013)(defining “the Secretary” as the Secretary of the Treasury of Puerto Rico).
\textsuperscript{16} Id. at 16-17.
\textsuperscript{17} Id. at 13.
\textsuperscript{18} Id.
\textsuperscript{19} See id. at 25; see generally DEPARTMENT OF ECONO. DEV. & COMM., TAX INCENTIVES APPLICATION, available at http://www2.pr.gov/agencias/oeci/Documents/Solicitudes/Solicitudes/Application%20for%20Act%202012%20Fillable.pdf (last revised Jul. 17, 2013).
\textsuperscript{20} 2012 P.R. LAWS no. 20 p. 34.
\textsuperscript{22} Id. at 2.
\textsuperscript{24} 2012 P.R. LAWS no. 22. p. 1.
\textsuperscript{25} Id. at 2-3.
in Puerto Rico for at least ten years. To obtain this incentive, the individual must notify the Puerto Rican Secretary of his or her intent to obtain residency, file the necessary application with the Puerto Rican government, and sign a contract with the Puerto Rican government, which is then valid until December 31, 2035.

C. ACT 273—THE INTERNATIONAL FINANCIAL CENTER INCENTIVES ACT

Act 273 focuses on setting up and relocating international banks to Puerto Rico. An individual can either move or incorporate his or her corporate bank in Puerto Rico. The move allows the investor to obtain significant financial incentives by signing a contract with the Puerto Rican government. The corporation must pay an initial $5,000 filing fee along with providing the necessary ownership information. If approved, the entity must pay a $250,000 license fee. There is also an annual $5,000 renewal fee. After securing the license, the entity is exempt from tax under Puerto Rico’s IRC and subject only to a flat 4 percent tax. The entity is also exempt from paying Puerto Rican municipal taxes, real or personal property taxes, or tangible or intangible property taxes. The exemption is valid for fifteen years. The entity can renew its exemption for another fifteen years by filing a renewal notice no more than six months before the initial fifteen-year exemption expires. Within six months of the thirty-year renewal’s expiration, the entity can apply for another fifteen-year exemption, for a total of forty-five years. During the last fifteen years, the Secretary has the option to either leave the entity’s tax rate at 4 percent or increase the entity’s tax rate up to 10 percent. If other Puerto Rican laws are inconsistent with this law, this law shall prevail. But the entity must employ at least four Puerto Rico re-

26. Id. at 3.
29. Id. at 12.
30. Id. at 9.
31. Id. at 6.
32. Id. at 11.
33. Id. at 8.
35. Id. § 3807 (a)(8)(c).
36. Id.
37. Id.
38. Id.
39. Id. § 3103.
sidents as full-time employees. Fortunately, a valid Act 22 exemption can waive this requirement. Some have criticized these aggressive incentives as making Puerto Rico a tax haven. While the United States has tax credits and incentives to encourage businesses and individuals to relocate and start business within the United States, Puerto Rico’s recent tax incentives are far more aggressive than any United States incentives.

III. GEOGRAPHICAL DEFINITION OF PUERTO RICO AND THE UNITED STATES APPLIED TO RESIDENCY

The United States IRC’s geographical definition of the United States significantly affects income sourcing for Puerto Rico and the United States. Puerto Rico and the United States have their own independent IRCs, but the Puerto Rican IRC is modeled after the United States IRC, where both systems have exclusive authority to tax their own residents. Although, Puerto Rico and the United States have a tax coordination agreement, as opposed to a treaty, to help define how the two systems coexist.

“The term ‘United States’ when used in a geographical sense includes only the States and the District of Columbia.” The term ‘State’ shall be construed to include the District of Columbia, where such construction is necessary to carry out provisions of this title,” and includes the fifty recognized states. The United States and State geographical definitions exclude the United States possessions, which are Puerto Rico, Guam, American Somoa, and the Northern Mariana Islands (Possessions). Unless explicitly mentioned to the contrary, any reference to a Possession shall include Puerto Rico. To add some additional confusion to the already complex United States IRC, some United States IRC sections treat Puerto Rico as a foreign country, while others sections treat Puerto Rico.

40. Id. § 3092(a).
47. Id. § 7701(a)(10).
48. Id. §§ 7701(a)(9)–(a)(10), 7701(d).
49. Id. § 7701(d).
50. Id. §§ 7701(a)(9), 872(b)(8).
Puerto Rico as part of the geographical United States,\textsuperscript{51} which complicates how Puerto Rican income and residents are classified. If Puerto Rico is not part of the United States by definition, logically, it should be a foreign country, its residents' foreign individuals, its corporations' foreign corporations, and income from Puerto Rico sourced to a foreign country.\textsuperscript{52}

When determining if an individual is part the United States or a foreign country, the individual is classified as a United States citizen/person (United States resident), a resident alien, or a nonresident alien.\textsuperscript{53} A United States citizen is a person that applies for a "[U]nited States passport (or renewal thereof), or applies to be lawfully accorded the privileges of residing permanently in the United States as an immigrant in accordance with the immigration law."\textsuperscript{54} A United States person means "a citizen or resident of the United States, a domestic partnership, [and] a domestic corporation."\textsuperscript{55} The United States IRC treats an alien individual as a United States resident (which is referred to as a resident alien) for any year the alien individual is a lawful permanent resident within the United States for a calendar year, meets the substantial presence test (discussed below), or makes the proper first year election in accordance with the statute.\textsuperscript{56} "A nonresident alien individual is an individual who is neither a citizen of the United States nor a resident of the United States."\textsuperscript{57} Some United States IRC sections define a nonresident alien individual to include a United States citizen living in Puerto Rico,\textsuperscript{58} while other sections do not.\textsuperscript{59} According to the Puerto Rican IRC, a nonresident alien "[m]eans an individual who is not a United States citizen and is not a resident of Puerto Rico."\textsuperscript{60}

If an individual is a United States citizen or resident alien, the United States will tax his or her worldwide income, regardless of location,\textsuperscript{61} subject to some exceptions.\textsuperscript{62} The United States also taxes nonresident alien individual income to the extent his or her income is from sources within the United States,\textsuperscript{63} subject to certain investment exemptions,\textsuperscript{64} or income "effectively connected" to a United States "trade or business."\textsuperscript{65} While these provisions cast a large taxation blanket on United States based income, the United States IRC exempts a United States citizen's

\textsuperscript{51}Id. § 881(b)(3)(A).
\textsuperscript{54}Id. § 6039E(a).
\textsuperscript{55}Id. §§ 7701(a)(30)(A)–(C).
\textsuperscript{56}Id. §§ 7701(b)(1)(A)(i)–(iii).
\textsuperscript{57}Id. § 7701(b)(1)(B).
\textsuperscript{59}See I.R.C. § 7701(b)(1)(B).
\textsuperscript{60}P.R. LAWS ANN. tit. 13 § 30041(a)(21) (2013).
\textsuperscript{61}I.R.C. § 1 (2014); Treas. Reg. § 1.1-1 (2008); see, e.g., Specking v. Comm'r., 117 T.C. 95, 101-02 (2001), aff'd sub nom Haessly v. Comm'r., 68 F.App'x 44 (9th Cir. 2003) and aff'd sub nom Umbach v. Comm'r., 357 F.3d 1108 (10th Cir. 2003).
\textsuperscript{62}I.R.C. § 911(a) (2014).
\textsuperscript{63}Id. § 871(b)(1).
\textsuperscript{64}Id. § 871(k)(1)(A).
\textsuperscript{65}Id. § 872(a).
foreign earned income if the United States citizen earns the income while residing in the foreign country, up to a certain amount adjusted annually for inflation.\textsuperscript{66}

A United States citizen or resident alien is subject to United States tax on his or her worldwide income unless that income is Puerto Rican sourced.\textsuperscript{67} A United States citizen living in Puerto Rico is exempt from United States tax and subject only to Puerto Rico tax on his or her Puerto Rican based income.\textsuperscript{68} Additionally, an alien individual residing in a Possession is subject to United States taxation in the same manner as a United States alien resident.\textsuperscript{69}

Although excluded from the United States and State geographical definition, Puerto Rico is part of the United States, and its residents are United States citizens.\textsuperscript{70} While the United States enters into treaties to bridge relations with foreign countries, Puerto Rico and the United States entered into an implementation agreement and not a treaty.\textsuperscript{71} The implementation agreement states the United States IRC, and not the Puerto Rican IRC, establishes the requirements to become a Puerto Rican resident.\textsuperscript{72} To become a Puerto Rican resident the United States IRC uses three tests: (1) the presence test;\textsuperscript{73} (2) the tax home test;\textsuperscript{74} and (3) the closer connection test.\textsuperscript{75} According to the United States IRC, a “[b]ona fide Puerto Rican resident means a person who is present for at least 183 days during the taxable year,” was present “for at least 549 days during the three-year period consisting of the taxable year and the two (2) immediately preceding taxable years,” provided that the individual was present in Puerto Rico for at least sixty days each year\textsuperscript{76} and does not have a closer tax home\textsuperscript{77} or a closer connection to the United States or a foreign country.\textsuperscript{78}

An individual is present in the United States on any day in which he or she is physically present in the United States.\textsuperscript{79} Multiple factors determine a significant connection, like “a permanent home in the United States,” current United States voter registration, or a child in the United

\begin{footnotes}
\item[66] Id. § 911(b)(2).
\item[67] Id. § 933(1).
\item[68] Id. § 933(2).
\item[69] Treas. Reg. § 1.876-1 (b) (2014).
\item[70] P.R. LAWS ANN. tit. 1, § 7 (2014).
\item[72] I.R.C. § 937 (2014); Rhoades & Langer, supra note 71.
\item[73] Treas. Reg. § 1.937-1(c)(1); see also, IRS, I.R.S. FORM 8898: STATEMENT FOR INDIVIDUALS WHO BEGIN OR END BONA FIDE RESIDENCE IN A UNITED STATES POSSESSION (2007), available at http://www.irs.gov/pub/irs-pdf/f8898.pdf (this form provides a non-exhaustive, but comprehensive list of what is a closer connection) [hereinafter I.R.S. FORM 8898].
\item[74] Treas. Reg. § 1.937-1(d)(1) (2014); see also, I.R.S. FORM 8898, supra note 73.
\item[75] Treas. Reg. § 1.937-1(e)(1) (2014); see also, I.R.S. FORM 8898, supra note 73.
\item[76] I.R.C. § 937(a); Treas. Reg. §1 .937-1(c).
\item[77] Treas. Reg. § 1.937-1(d) (2014).
\item[78] Id. § 1.937-1(e).
\item[79] I.R.C. § 7701(b)(7).
\end{footnotes}
States who is not there as a student or based on a custodial decree.\textsuperscript{80} The tax home test ensures that an individual does not have a tax home closer than his or her tax home in Puerto Rico.\textsuperscript{81} Alternatively, the Puerto Rican IRC defines a resident individual as an individual domiciled in Puerto Rico, and presumes he or she is a resident if they are present within Puerto Rico for 183 days\textsuperscript{82}

An individual must file I.R.S. Form 8898 to demonstrate that he or she met the above three tests.\textsuperscript{83} This form notifies the United States Secretary of Treasury of the individual’s intent to become a Puerto Rican resident.\textsuperscript{84} Additionally, the individual must file a form with the Puerto Rican Secretary\textsuperscript{85} stating his or her intent to become a Puerto Rican resident.\textsuperscript{86} An individual does not become a Puerto Rican resident until he or she meets the three tests above for an entire year—only then can he or she exclude Puerto Rican sourced income from United States tax.\textsuperscript{87}

These rules ensure that a person actually resides in Puerto Rico and does not merely rent a mailbox or residence in Puerto Rico to make that address his or her residence for documentation purposes. For the past fifty years, when the government challenges a residency claim the courts examine eleven factors to determine if there is substance to an individual’s move.\textsuperscript{88} Those factors are as follows:

1. Intention of the taxpayer;
2. Establishment of his home temporarily in the foreign country for an indefinite period;
3. Participation in the activities of his chosen community on social and cultural levels, identification with the daily lives of the people and, in general, assimilation into the foreign environment;
4. Physical presence in the foreign country consistent with his employment;
5. Nature, extent and reasons for temporary absences from his temporary foreign country;
6. Assumption of economic burdens and payment of taxes to the foreign country;
7. Status of resident contrasted to that of transient or sojourner;
8. Status of resident contrasted to that of transient or sojourner;
9. Treatment accorded his income tax status by his employer;
10. Marital status and residence of his family;

\textsuperscript{80} Treas. Reg. § 1.937-1(c)(5) (2014); \textit{see also}, I.R.S. Form 8898, \textit{supra} note 73.
\textsuperscript{81} Treas. Reg. § 1.937-1(d).
\textsuperscript{82} P.R. Laws Ann. tit. 13 § 30041(a)(30) (2011).
\textsuperscript{83} I.R.C. § 937(c)(1); I.R.S. Form 8898, \textit{supra} note 73.
\textsuperscript{84} \textit{Id}.
\textsuperscript{85} P.R. Laws Ann. tit. 13 § 30041(a)(12) (2011) (the secretary “[m]eans the Secretary of the Treasury of [Puerto Rico]”).
\textsuperscript{86} \textit{See Application to Notify the Puerto Rico Secretary to Obtain Residency, supra} note 27.
\textsuperscript{88} Vento v. Dir. Of V.I. Bureau of Internal Revenue, 715 F.3d 455, 466–67 (3rd Cir. 2013) (\textit{citing} Sochurek v. Comm’r, 300 F.2d 34, 38 (7th Cir. 1962)); \textit{see also}, I.R.S. Form 8898, \textit{supra} note 73 (listing many factors that the Secretary of Treasury will use to evaluate if the move to the possession is valid).
10. Nature and duration of his employment; whether his assignment abroad could be promptly accomplished within a definite or specified time;

11. Good faith in making his trip abroad; whether for purpose or tax evasion.\(^8\)

While no one factor is determinative, nor is a lack of any particular factor an immediate failure, they are evaluated in four groups.\(^9\) The four groups are (1) intent (factors one, two, seven, ten, and eleven); (2) physical presence (factors two, four, five, and seven); (3) a taxpayer's social, family, and professional relationships (factors three and nine); and (4) the taxpayer's own representations (factors six and eight).\(^9\)

To determine the location of a corporation or partnership under the United States IRC, the term “domestic” as applied to a “[c]orporation or partnership means created or organized in the United States or under the law of the United States or of any State, unless in case of a partnership, the Secretary provides otherwise by regulations.”\(^9\) The United States IRC defines a “foreign corporation” or “partnership” as “a corporation or partnership which is not domestic.”\(^9\) A Puerto Rican domestic corporation or partnership “[m]eans created or organized in Puerto Rico or under the laws of Puerto Rico.”\(^9\) A foreign Puerto Rican corporation or partnership “[m]eans a corporation or partnership which is not domestic.”\(^9\)

How do these residency tests affect our groups? These requirements mean that each group of individuals must move themselves, their businesses, and their families to Puerto Rico.

Jason and Jen should not encounter transitional problems. As a retired blue-collar couple, they are unlikely to have significant business connections that would hinder their move. Their assets likely consist of a home that they would sell, a car that they could ship, personal belongings, and intangible assets like a bank or stock account. Retirement income and social security benefits should easily transfer too if they provide the necessary paperwork. To meet the presence test they can buy a new home in Puerto Rico which will become their new principal residence.\(^9\) They will meet the tax home test because they will give up their tax home in the United States when they establish a Puerto Rican tax home.\(^9\) They can meet the closer connection test by establishing a bank account to receive their retirement income, forming social and professional relationships in Puerto Rico, registering to vote in Puerto Rico, registering their car in

89. Vento, 715 F.3d at 466–67 (3rd Cir. 2013) (citing Sochurek, 300 F.2d at 38).
90. Id.
91. Id. at 467.
93. Id. § 7701(a)(5).
95. Id. § 30041(a)(7) (2011).
96. Treas. Reg. § 1.937-1(c) (2014); see also, I.R.S. FORM 8898, supra note 73.
97. Treas. Reg. § 1.937-1(d) (2014); see also, I.R.S. FORM 8898, supra note 73.
Puerto Rico, and obtaining a Puerto Rican driver’s license, among other things. Their biggest challenge is leaving their social and family relationships. Additionally, Jason and Jen must file the necessary paperwork and sign a contract with the Puerto Rican government to take advantage of the Puerto Rican incentives.

Jon and Nichole’s situation is more complex. Jon will have to quit his teaching job because flying back and forth from Puerto Rico to the United States means he might not meet the presence test and he will have a closer connection to the United States than Puerto Rico due to his work. Jon might be able to circumvent this requirement if he could lecture via a podcast or video conference, but that is beyond the scope of this article. Nichole will have significant difficulty because she has an active home business. She must either move the entire entity to Puerto Rico or close this entity and start a new one in Puerto Rico to satisfy the closer connection test. The couple will also have to file the necessary paperwork depending on what exemptions they seek.

Mikey may have more issues than the entire group combined. Not only must he uproot his entire life, but he must also relocate his business. To take advantage of Puerto Rico’s favorable tax incentives, he must seek approval from the Puerto Rican government, sign a contract with them, and actually conduct business. If approved, he must transfer his business, find a suitable location, move all his assets, and hire employees. The moving process might impose some barriers to entry because Mikey needs employees and machines, whereas Jon and Nichole require only computers and communication connections.

While the United States and Puerto Rican systems share some similarities, they also have some differences. Puerto Rico and the United States have their own exclusive tax systems and exclusive Treasury systems. Additionally, Puerto Rican courts can enforce the tax laws of other States, so long as the State would enforce the Puerto Rican IRC in its courts. United States citizens who are Puerto Rican residents are not subject to United States tax on his or her Puerto Rican sourced income

98. Id.
100. See Bergersen v. Secretary, 109 F.3d 56 (1st Cir. 1997) (holding that a dentist did not meet the closer connection test to Puerto Rico, and his income was taxable by the United States where the dentist continued to maintain his dental practice and dental supply distribution company in Illinois, stayed at his parent's house when he was back to service patients, continued to receive business mail for his practice and his dental supply company in Illinois despite the fact that he moved his family to Puerto Rico and re-headquartered his dental supply business to Puerto Rico).
101. Treas. Reg. § 1.937-1(e) (2014); see also, I.R.S. FORM 8898, supra note 73.
104. P.R. LAWS ANN. tit. 13 § 343 ("State—Means any state, territory or possession of the United States of America").
105. Id. §§ 342, 341.
even though the United States taxes the worldwide income of their citizens.\textsuperscript{106} Furthermore, many United States tax incentives require only filling a form with the tax return, rather than signing contract(s) with the government.\textsuperscript{107} In Puerto Rico, a taxpayer’s tax return is considered a public document available to inspection upon a validly approved request.\textsuperscript{108} In the United States, tax returns are confidential.\textsuperscript{109}

IV. UNITED STATES INTERNAL REVENUE CODE AND PUERTO RICAN INTERNAL REVENUE CODE DEFINITIONS AND APPLICABLE TAX RATES FOR INTEREST, DIVIDENDS, AND CAPITAL GAINS

A. INTEREST

Black’s Law Dictionary defines interest as “[t]he compensation fixed by agreement or allowed by law for the use or detention of money, or for the loss of money by one who is entitled to its use.”\textsuperscript{110} The United States IRC does not explicitly define interest, but some sections define various types of interest.\textsuperscript{111} Investment interest is any amount “paid or accrued on indebtedness properly allocable to property held for investment.”\textsuperscript{112} Puerto Rico offers definitional guidance by stating interest is “[a]ny interest on bonds, notes and other obligations issued by a domestic corporation or partnership, or by a foreign corporation of partnership.”\textsuperscript{113}

Puerto Rico and the United States tax interest from income differently. Interest in the United States could be subject to the top United States individual ordinary income tax rate of 39.6 percent.\textsuperscript{114} Puerto Rico could tax interest income at the top Puerto Rican individual ordinary income tax rate, which depending on the year, ranges from 30 to 33 percent.\textsuperscript{115} However, a Puerto Rican resident’s interest income could be eligible for a special preferred tax rate of 10 percent, if the interest meets certain statutory requirements and the taxpayer makes the election.\textsuperscript{116} Puerto Rico’s Act 22 exemption eliminates the taxpayer’s liability for interest

\textsuperscript{106} I.R.C. § 933(1) (2014).
\textsuperscript{108} P.R. Laws Ann. tit. 13 § 33213.
\textsuperscript{109} I.R.C. § 6103(a) (2014).
\textsuperscript{110} Black’s Law Dictionary, 886 (9th ed. 2009).
\textsuperscript{111} Rhoades & Langer, United States Int’l Tax’n & Tax Treaties § 25.02 (2014), available at https://advance.lexis.com/GoToFullDocumentFromHistory?vidquestid=f36363-25e8-c93e-c762-7075c026995f-e5fd3b2c-e1ca-df-ff-f00de07903-f377f25e-c85f-20db-ab64-3f83f3b9afa,d3111e2e-4a75-990-cb63-911c27858ed8,f6fd9f8-4cd6-33fb-99a1-39b74368461a&crid=3f4c43b9-f413-30b7-cad9-5705e4ea60d3.
\textsuperscript{114} I.R.C. § 1(a) (2014).
\textsuperscript{115} P.R. Laws Ann. tit. 13 § 30061 (2011).
\textsuperscript{116} Id. §§ 30111(a)(4), 30085(b), 30084(1).
B. DIVIDENDS

Both the United States and Puerto Rico IRC define a dividend very similarly, as

"[a]ny distribution of property made by a corporation to its shareholders [whether it is money or property] out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year . . . without regard to the amount of the earnings and profits at the time the distribution was made."119

For length and simplicity purposes, this article disregards specially taxed qualified dividends and preferred stock dividends.120 This means Puerto Rico and the United States will tax dividends as ordinary income.121 Therefore, they could be subject to tax at the top United States individual ordinary income tax rate of 39.6 percent.122 Puerto Rico could tax dividends at the top Puerto Rico individual ordinary income tax rate, which, depending on the year, could range from 30 to 33 percent.123 Although, a Puerto Rican resident's dividend income could be eligible for a special preferred tax rate of 10 percent if the dividends meet certain statutory requirements and the taxpayer makes the election.124 Thus, if a significant portion of any of our group's income is from dividends, Puerto Rico’s Act 22 exemption eliminates the Puerto Rican resident's tax liability,125 subject to sourcing issues discussed below. The United States has no such exemption for dividends.

C. CAPITAL GAINS

The United States and Puerto Rican IRC define a capital asset in the negative, which means that they define what a capital asset is not.126 Therefore, anything not specifically enumerated is a capital asset.127 In Puerto Rico, a capital asset is not inventory, depreciable property used in a trade or business, accounts receivable, energy credits, literary rights, musical rights, artistic rights, or any similarly created rights by the taxpayer.128 The United States definition is similar but leaves out the energy

119. Id. § 316(a) (2014); P.R. LAWS ANN. tit. 13 § 30149(a) (2011).
120. Id. §§ 245, 244, 243, 1(h)(11) (2014).
121. Id. § 1(a) (2014); P.R. LAWS ANN. tit. 13 § 30061(2011).
122. Id. § 1(a) (2104).
124. Id. § 30111(a)(6); P.R. LAWS ANN. tit. 13 § 30086 (2011).
127. Id. § 1221(a); P.R. LAWS ANN. tit. 13 § 30141(a)(1).
128. P.R. LAWS ANN. tit. 13 § 30141(a)(1).
credits and adds "any commodities derivative financial instrument held by a commodities dealer," any hedging transaction that is clearly identifiable as a hedging transaction, and supplies "regularly used or consumed by the taxpayer in the ordinary course of a trade or business." The United States additions could affect stock traders. Stock traders are a target group Puerto Rico hopes to attract and probably the reason why it was not included.

The codes differ in how they define a long-term and short-term capital asset. In Puerto Rico, a capital asset sale is long-term if the taxpayer held the asset for more than six months, and short-term if held less than six months. In the United States, a capital asset sale is long-term if the taxpayer held the asset for more than one year, and short-term if held for one year or less. The long-term and short-term differences matter because both codes tax long-term assets at a lower rate.

Puerto Rico taxes net long-term capital gains at a flat 10 percent. A taxpayer who moves to Puerto Rico with pre-move capital asset appreciation is subject to a 10 percent tax on the pre-move appreciation. If the individual is a Puerto Rican resident for more than ten years, this lowers the tax rate to 5 percent and excludes that pre-move gain from United States tax entirely. Act 22 exempts an individual's passive investment income, which means long-term and short-term capital gains are exempt from Puerto Rican income tax. The exemption only applies to assets acquired after establishing his or her Puerto Rican residency. This is a significant advantage over the United States IRC because stock traders, whose business activities are typically all capital transactions, could exempt all of his or her income from tax. Furthermore, a Puerto Rican taxpayer may elect to treat his or her long-term capital gains as ordinary income and pay taxes according to his or her ordinary income tax rate. A taxpayer is likely to make this election only if he or she is in the lower tax brackets. The United States automatically exempts a taxpayer's long-term capital gains if the taxpayer is in the lowest two tax brackets.

The United States taxes long-term capital gains on a progressive scale. United States long-term capital gains do receive a lower tax

129. I.R.C. § 1221(a).
130. P.R. LAWS ANN. tit. 13 § 30141(a)(2)-(9).
133. P.R. LAWS ANN. tit. 13 § 30082(a).
135. Id.
137. Id. at 3.
139. Id.
140. I.R.C. § 1(h) (2014).
141. Id. § 1.
rate, but it depends upon the taxpayer's ordinary income tax bracket.\textsuperscript{142} The long-term capital gain tax rate can range from 0 percent in the lowest two tax brackets, to 20 percent if you are in the highest tax bracket.\textsuperscript{143} Moreover, the Affordable Care Act added an additional 3.8 percent tax to long-term capital gains in the highest bracket,\textsuperscript{144} raising the top long-term capital gain rate to 23.8 percent.\textsuperscript{145} Of course, the United States tax rates mentioned include solely federal tax, and do not include state taxes. By adding state taxes, which could be up to 13.3 percent,\textsuperscript{146} an individual's long-term capital gain could be subject to tax at over 30 percent. When compared to Puerto Rico's 10 percent tax\textsuperscript{147} or Puerto Rico's Act 22 complete exemption,\textsuperscript{148} an individual choosing to remain in the United States could pay between 20 to 40 percent more, despite the favorably lower tax treatment.

While this article compares the Puerto Rican and United States IRCs, it should be noted that a United States resident and his or her company could also be subject to state taxes in addition to federal taxes, subject to sourcing issues discussed below. A Puerto Rican resident and his or her company are only subject to Puerto Rico tax subject to sourcing issues discussed below. Thus, the move could save the individual or company the applicable state tax on that income.

\textbf{V. INCOME SOURCING}

Puerto Rico's incentives only apply to income subject to taxation under Puerto Rico's IRC because income not subject to Puerto Rico tax does not need Puerto Rico incentives, which is why sourcing is very important. The sourcing treatment can differ depending upon the type of income, the business's location(s), the owners' location(s), where he or she is conducting business, and the type of business, among many other factors.\textsuperscript{149} This article addresses only four income types: (1) retirement; (2) interest; (3) dividends; and (4) capital gains. Each scenario assumes that the individuals, the business, and its owners, are located solely within Puerto Rico or solely within the United States. Each group of individuals is still considered United States citizens subject to United States tax on their worldwide income.\textsuperscript{150} Fortunately, any United States citizen, who becomes a Puerto Rican resident and earns income within or has income sourced to Puerto Rico, is exempt from United States tax.\textsuperscript{151} Therefore, this article will not analyze the United States taxation of a United States citizen...

\begin{thebibliography}{99}
\bibitem{142} Id. § 1(h).
\bibitem{143} Id.
\bibitem{144} Id.
\bibitem{145} I.R.C. §§ 1411, 1(h) (2014).
\bibitem{146} CAL. REV. & TAX. CODE § 17041 (West 2013).
\bibitem{147} P.R. LAWS ANN. tit. 13 §§ 30111(a)(2), 30082(a) (2011).
\bibitem{149} I.R.C. §§ 861-865, 871-872, 881-882.
\bibitem{150} Id. § 1; Treas. Reg. § 1.1-1 (2008).
\bibitem{151} I.R.C. § 933(1).
\end{thebibliography}
citizen's worldwide income where the United States citizen is now a Pu-
erto Rican resident and his or her income was earned within, or sourced
to Puerto Rico. As stated earlier, certain sections explicitly treat United
States citizens who are now Puerto Rican residents as nonresident alien

A. SOURCING GENERALLY

Rules similar to the rules for determining whether income is income
from sources within the United States or is effectively connected with the
conduct of a trade or business within the United States shall apply for
purposes of determining whether income is from sources within a posses-
sion. As such, any income treated as income from sources within the
United States or as effectively connected with the conduct of a trade or
business within the United States shall not be treated as income from
sources within any such possession or as effectively connected with the
conduct of a trade or business within any such possession.\footnote{154. Id. § 937(b).}

Puerto Rico and the United States use the United States IRC to deter-
mine whether income is sourced within or outside the country, and
whether that income is effectively connected to a trade or business within
that country.\footnote{155. Id. § 937(b).} Recently, Puerto Rico passed its own rules regarding in-
come sourcing,\footnote{156. P.R. LAWS ANN. tit. 13 § 30114 (2011).} which could complicate sourcing issues. Fortunately,
the Puerto Rican IRC is very similar to the United States IRC.

United States sourced personal or corporate income from a trade or
business is trade or business income effectively connected to a United
States trade or business and subject to United States tax.\footnote{157. I.R.C. §§ 882(b), 872(a), 861(b).} A foreign
entity's or foreign individual's income is subject to United States tax, and
is sourced within the United States if it is effectively connected to a
United States trade or business.\footnote{158. Id. §§ 937(b), 882(a)(1), 871(b)(2).} A “'trade or business within
the United States includes the performance of personal services within the
United States at any time within the taxable year.'”\footnote{159. Id. § 864(b).}

Aside from performing personal services within the United States,\footnote{160. See id. § 864(b)(1) (trade or business within the United States does not include, “the performance of personal services for a nonresident alien individual, foreign corporation, foreign partnership not engaged in a trade or business within the [United States] or for an office or place of business maintained in a foreign country or in a possession of the [United States] by an individual who is a citizen or resi-
dent of the [United States]...” if they do not exceed ninety days and the compensa-
tion is less than $3,000).} an effectively connected trade or business is negatively defined in the
United States IRC, which states two exceptions that are not a trade or
business. These two exceptions not considered a trade or business within the United States are (1) "performance of personal services for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or for an office or place of business maintained in a foreign country, or " . . . possession by a [United States] citizen, resident [alien], . . . a domestic corporation, or a domestic partnership"; or (2) trading securities on a taxpayer's own account so long as the taxpayer does not have an office or fixed place of business that conducts those transactions. While the United States taxes its citizen's worldwide income, the United States only taxes non-resident aliens to the extent his or her income is sourced within the United States or is effectively connected to a United States trade or business. Puerto Rico similarly taxes nonresident alien individuals or corporations not engaged in a Puerto Rican trade or business to the extent the income is sourced within Puerto Rico. But during the year of the move from the United States to Puerto Rico, "[a]mounts received from sources outside Puerto Rico attributable to the period of residence outside of Puerto Rico" are exempt from Puerto Rico tax.

When determining if the income is sourced to the United States or to the foreign country, "the name of the particular foreign country shall be used instead of the term United States, and the term domestic shall be construed to mean created or organized in such foreign country." "[T]he term 'foreign person' means any other person other than a United States person, or a person who would be a United States person if references to the United States in section 7701 included references to a possession of the United States." The rules for determining income sourcing and if a trade or business is effectively connected to the United States from foreign countries shall apply to possessions, unless otherwise stated.

A foreign corporation or nonresident alien individual is engaged in a trade or business within the United States and has effectively connected income associated with that trade or business when (1) he or she generates a gain or loss from selling capital assets sourced within the United States and connected to his or her trade or business within the United States; (2) all gains or losses are from sources within the United States; (3) the income is sourced outside the United States and is effectively connected to the United States, if that income is attributable to an office or fixed place of business within the United States; (4) the office or fixed place of business within the United States receives interest or dividend

161. Id.
162. Id.
163. Id § 1; Treas. Reg. § 1.1-1 (2008).
169. I.R.C. § 893(b).
income from banking or similar businesses within the United States; (5) the income is "received by a corporation the principal business of which is trading in stocks or securities for its own account"; or (6) the income is attributable to selling capital assets through an office or fixed place of business within the United States.\textsuperscript{170} Income from sources outside the United States is not effectively connected if it "consists of dividends, interest, . . . paid by a foreign corporation in which the taxpayer owns" . . . or is considered to own "more than 50 percent of the total combined voting power of all classes of stock entitled to vote."\textsuperscript{171} If a Puerto Rican resident trades securities within the United States, he or she is not effectively connected to a United States trade or business so long as the Puerto Rican resident does not have an office or fixed place of business within the United States that executes the transactions.\textsuperscript{172}

The broad United States source rules ensure some of our individuals' income is sourced within the United States. Jason and Jen will have very little trouble with sourcing issues because they do not operate a business and do not work. Their income consists of pension payments, social security, and possibly some investments. Even these limited income sources pose some problems, which are discussed below.

Jon, Nichole, and Mikey will have significant issues because they operate businesses and provide personal services within the United States. Jon can not regularly fly back and forth to teach or service clients because he would then fail the closer connection test\textsuperscript{173} and source that income within the United States to an effectively connected United States trade or business.\textsuperscript{174} Nichole and Mikey both operate businesses and perform personal services for businesses that will source the income to the United States, effectively connecting that income to a United States trade or business.\textsuperscript{175} At a minimum, the salaries that Nichole and Mikey receive from their companies are sourced within the United States because their entities are within the United States and they perform personal services for those companies within the United States.\textsuperscript{176}

To avoid sourcing issues when Nichole and Mikey move to Puerto Rico, they should move their entire business to Puerto Rico, therefore ensuring there is no office or fixed place of business within the United States.\textsuperscript{177} Removing the office or fixed place of business from the United States ensures that the business's income is sourced within Puerto Rico and is not effectively connected with a United States trade or business. Nichole will not have excessive sourcing issues because she primarily

\begin{itemize}
\item \textsuperscript{170} \cite{Id. § 864(c) (2014)}.
\item \textsuperscript{171} \cite{Id. § 864(c)(4)(D); see also, I.R.C. § 952 (2014) (which describes subpart F income as it relates to controlled foreign corporations)}.
\item \textsuperscript{172} \cite{Id. § 864(b)(2)(C)}.
\item \textsuperscript{173} \cite{Treas. Reg. § 1.937-1(c)(5) (2014)}.
\item \textsuperscript{174} \cite{I.R.C. §§ 864(b)(1), 861(a)(3)}.
\item \textsuperscript{175} \cite{Id}.
\item \textsuperscript{176} \cite{Id}.
\item \textsuperscript{177} \cite{Id. § 864(b)(1); Treas. Reg. § 1.864-4(b)(5)(iii) (2013)}.
\end{itemize}
trades stocks. The sourcing rules carve out an applicable stock exception, provided Nichole does not have an office or fixed place of business within the United States.\textsuperscript{178}

\section*{B. Retirement Income}

An individual's retirement income is sourced to his or her state of domicile.\textsuperscript{179} Puerto Rico is a state for purposes of retirement income sourcing.\textsuperscript{180} A United States citizen who is now a Puerto Rican resident should exclude his or her retirement income when he or she calculates his or her gross income from other United States sourced income or United States effectively connected income.\textsuperscript{181} The major difference between Puerto Rico and the United States is that a Puerto Rican resident is subject only to Puerto Rican tax on his or her retirement income, whereas a United States resident is subject to United States tax and state tax on the same income.\textsuperscript{182} Additionally, Puerto Rico exempts the first $15,000 of a resident's pension from tax if the individual is sixty years or older,\textsuperscript{183} while the United States does not.

Unfortunately, social security income is sourced within the United States no matter where the individual resides.\textsuperscript{184} A nonresident alien individual receiving social security benefits of any type has income not effectively connected with a United States trade or business, but sourced within the United States.\textsuperscript{185} The United States taxes only 85 percent of an individual's social security benefits.\textsuperscript{186}

Hopefully, all of our individuals will receive retirement income someday. Currently, retirement income is only an issue for Jason and Jen. Jason and Jen's pensions are sourced to their state of domicile, which could include Puerto Rico.\textsuperscript{187} Even though they are not effectively connected to a United States trade or business, 85 percent of their social security benefits are considered as income sourced within the United States and subject to United States tax.\textsuperscript{188} Jason and Jen will also enjoy Puerto Rico's $15,000 exemption of their retirement income.\textsuperscript{189} Their remaining retirement income is still subject to Puerto Rican tax, which reaches a top

\begin{itemize}
\item \textsuperscript{178} I.R.C. § 864(b).
\item \textsuperscript{179} 4 U.S.C. § 114(a) (2014).
\item \textsuperscript{180} Id. § 114(b)(3).
\item \textsuperscript{181} I.R.C. § 871(f)(1); see also, 4 U.S.C. § 114(a) ("[n]o State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State)"); see also, I.R.C. § 933 (2014) (Puerto Rico sourced income is exempt from United States IRC taxation if the individual is a bona fide resident of Puerto Rico).
\item \textsuperscript{182} I.R.C. § 933(1).
\item \textsuperscript{183} P.R. Laws Ann. tit. 13 § 30102(a)(13) (2011).
\item \textsuperscript{184} I.R.C. § 861(a)(8) (2014).
\item \textsuperscript{185} Id. § 871(a)(3).
\item \textsuperscript{186} Id. § 871(a)(3)(A).
\item \textsuperscript{187} 4 U.S.C. § 114(b)(3) (2014).
\item \textsuperscript{188} I.R.C. § 871(a)(3)(A).
\item \textsuperscript{189} P.R. Laws Ann. tit. 13 § 30102(a)(13).
\end{itemize}
rate of 33 percent after $50,000.\textsuperscript{190} If they received $100,000 of retire-
ment income and stay in the United States, then they will pay $16,233 in
United States taxes, versus paying $20,740 if they moved to Puerto Rico,
which could change based on the amount of social security income re-
ceived. The calculation changes substantially if they received $75,000. In
that case, they would pay $10,358 in United States taxes and $17,440 in
Puerto Rican taxes.

C. Interest

Interest income is sourced to the payor, regardless of how and where
the interest was paid.\textsuperscript{191} Interest not sourced within the United States is
sourced outside the United States.\textsuperscript{192} Thus, a nonresident alien individual
living in Puerto Rico receiving interest income from a United States
source has gross income sourced within the United States subject to
United States tax.\textsuperscript{193} A nonresident alien individual’s taxable United
States gross income does not include “interest on deposits with a foreign
branch of a domestic corporation or a domestic partnership if such
branch is engaged in the commercial banking business”\textsuperscript{194} or interest on
business deposits not effectively connected with a trade or business
within the United States.\textsuperscript{195} Additionally, United States sourced portfo-
lio interest income received by a Puerto Rican corporation or Puerto Ri-
can resident is not subject to United States tax.\textsuperscript{196}

“[P]ortfolio interest means any interest (including original issue dis-
count) which would be subject to tax under subsection (a) but for this
subsection, and is paid on an obligation which is in registered form, and
with respect to which” a United States person is otherwise required to
withhold under IRC section 1441(a) and the United States person “re-
ceives a statement . . . that the beneficial owner of the obligation is not a
United States person.”\textsuperscript{197} Portfolio interest does not include interest
from United States obligations, interest received by a bank on a loan or
extension of credit made in the ordinary course of business, interest re-
ceived from a 10 percent shareholder of the company making the loan, or
interest received from a related party’s controlled foreign corporation.\textsuperscript{198}
A corporation is not a controlled foreign corporation if a United States
citizen who is now a Puerto Rican resident owns 50 percent or more of
the foreign corporation because a Puerto Rican resident is not a United
States person for this section.\textsuperscript{199}

\textsuperscript{190} Id. § 30061.
\textsuperscript{191} I.R.C. § 861(a)(1) (2014).
\textsuperscript{192} Id. § 862(a)(1).
\textsuperscript{193} I.R.C. § 861(a)(1).
\textsuperscript{194} Id.
\textsuperscript{195} Id. § 871(i)(2)(A) (2014).
\textsuperscript{196} Id. §§ 881(c)(1), 871(h)(1) (2014).
\textsuperscript{197} Id. § 871(h)(2).
\textsuperscript{198} Id. §§ 871(h)(2), 881(c)(3); see also id. § 864(d)(4) (defining related controlled for-
eign corporation); see also id. § 318 (defining corporate attribution rules).
\textsuperscript{199} Id. § 957(c) (2014).
A nonresident alien individual or corporation has interest income sourced within Puerto Rico and effectively connected to Puerto Rico if the interest is from "bonds, notes, or other interest-bearing obligations of resident persons, whether natural or juridical." Interest is outside of Puerto Rico if (1) paid by foreign corporations, partnerships, domestic corporations, or partnerships engaged in business in Puerto Rico, except for a banking business, where less than 20 percent of the entity's gross income for the three years ending when the interest was paid was from sources within Puerto Rico; (2) it is interest from deposits from Puerto Rican banks; (3) it is interest on mortgage payments secured by Puerto Rican land; and (4) it is interest on bonds, notes, or other obligations that derive or accumulate interest received by individuals that are citizens of the United States and are not residents of Puerto Rico. Interest income is from without Puerto Rico if it is interest other than that derived from sources within Puerto Rico as provided directly above.

While endless scenarios could exist relating to the receipt of interest income, Jason, Jen, Jon, Nichole, Mikey, and their respective corporations are likely to encounter the same three scenarios described below. The first scenario occurs when someone has a bank account with a United States domestic bank that pays him or her interest. The interest payor is the United States bank, and the Puerto Rico recipient is treated as a non-resident alien individual or foreign corporation because he or she is a Puerto Rican resident. This means the interest is from sources within the United States. Although the interest received by the nonresident alien individual or foreign corporation is sourced within the United States, it is not effectively connected to a United States trade or business. Thus, it is exempt from United States tax.

The second scenario occurs when a nonresident alien individual or foreign corporation has some type of United States government-issued security or bond, state-issued security or bond, or municipal bond. The payor is the United States government, which sources the income within the United States. If the United States sourced income is not effectively connected to a United States trade or business, then it is exempt from United States tax. Although, a banking corporation created under Puerto Rican laws operating as a bank in Puerto Rico that holds United States government obligations has income effectively connected with a United States trade or business, whether or not the Puerto Rican bank was operating within the United States.
The third scenario occurs when the nonresident alien individual or foreign corporation invested its money in the stock market or a mutual fund and the resulting interest income meets the portfolio income requirements.\textsuperscript{209} The interest income is sourced outside the United States, is not effectively connected to a United States trade or business, and is exempt from United States tax.\textsuperscript{210}

While Puerto Rican residents are exempt from United States tax on the interest income,\textsuperscript{211} they are still subject to Puerto Rican tax on their interest income up to 25 percent.\textsuperscript{212} Fortunately, Act 22 exempts their interest income from Puerto Rican tax.\textsuperscript{213} If our group’s individuals remain in the geographical United States, their interest income is considered ordinary income subject to the top United States tax rate of 39.6 percent,\textsuperscript{214} which does not include state taxes.

If our individuals keep their corporations in the United States, the corporations’ interest income is subject to corporate tax between 15 and 39 percent.\textsuperscript{215} By moving the corporations to Puerto Rico and obtaining an Act 20 or Act 273 exemption, the corporations are subject to Puerto Rican corporate tax at 4 percent,\textsuperscript{216} as opposed to the normal Puerto Rican corporate tax rates that could be up to 25 percent.\textsuperscript{217} If the Puerto Rican corporations have interest income from a trade or business effectively connected to the United States, then they are subject to a United States tax of 30 percent.\textsuperscript{218}

\section*{D. Dividends}

The sourcing treatment for dividends differs from the interest treatment. The source of a dividend is the location of the corporation’s income responsible for paying the dividend.\textsuperscript{219} A nonresident alien individual residing in Puerto Rico, or foreign corporation organized under Puerto Rican laws, has income sourced within the United States if he or she receives a dividend from a United States domestic corporation.\textsuperscript{220} A United States domestic corporation distributing a dividend to a corporation organized under Puerto Rican laws is subject to a 10 percent tax, rather than 30 percent if the corporation satisfies certain statutory requirements.\textsuperscript{221}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{209} \textit{Id.} § 881(c)(2) (stating the portfolio requirements).
\item \textsuperscript{210} \textit{Id.} §§ 881(c), 871(h)(2).
\item \textsuperscript{211} \textit{Id.}
\item \textsuperscript{212} P.R. \textsc{laws} \textsc{ann.} tit. 13 §§ 30072, 30071(b) (2011).
\item \textsuperscript{214} I.R.C. § 1 (2014).
\item \textsuperscript{215} \textit{Id.} § 55(a) (2014).
\item \textsuperscript{216} 2012 P.R. \textsc{laws} no. 20 p. 10; 2012 P.R. \textsc{laws} No. 273 p. 10, \textit{available at} http://www.lexjuris.com/lexlex/Leyes2012/leslex2012273.htm.
\item \textsuperscript{217} P.R. \textsc{laws} \textsc{ann.} tit. 13 §§ 30072, 30071(b).
\item \textsuperscript{218} I.R.C. § 881(a).
\item \textsuperscript{219} \textit{Id.} § 861(a)(2).
\item \textsuperscript{220} \textit{Id.} §§ 881(a)(1), 871(a)(1), 861(a)(2).
\item \textsuperscript{221} \textit{Id.} § 881(b)(1).
\end{itemize}
\end{footnotesize}
Puerto Rican corporation must have the following elements: (1) a United States citizen or Possession resident owns at least 75 percent of the corporation's stock; (2) at least 65 percent of the company's gross income for the last three years ending on the close of the taxable year is from a Possession resident or the United States; and (3) "no substantial part of the income of such corporation is used . . . to satisfy obligations to persons who are not bona fide residents of such a possession or the United States." 222 Nevertheless, the dividend is exempt from United States tax if the foreign corporation's gross income from all sources for the three year period, or the corporation's existence if less than three years—ending on the close of the taxable year preceding the dividend's declaration—was more than 75 percent effectively connected to sources within the United States. 223 Dividends received by a nonresident individual not engaged in a United States trade or business are exempt from United States tax. 224

Puerto Rico defines a domestic corporation as any corporation "created or organized in Puerto Rico under the laws of Puerto Rico." 225 A dividend is from sources within Puerto Rico and effectively connected to Puerto Rico if the dividend is from a domestic corporation or partnership that derives more than 20 percent of its gross income from sources within Puerto Rico for the previous three years, ending on the close of the taxable year when the dividend was paid. 226 "[D]ividends and benefits not derived from sources within Puerto Rico as provided" directly above are from outside Puerto Rico. 227

Our individuals are likely to receive dividends from United States domestic corporations. Jason and Jen do not operate a business. Their dividends are unrelated to an effectively connected United States trade or business, so they are exempt from United States tax. 228 Any dividends they receive are from sources within the United States, but exempt from United States tax. 229 If they remain in the United States, then those dividends are taxed as ordinary income up to 39.6 percent, 230 plus applicable state tax. If they move to Puerto Rico and obtain an Act 22 exemption, then those dividends are exempt from Puerto Rican tax. 231 If Jason and Jen did not have the Act 22 exemption, then they would be subject to Puerto Rican tax up to 25 percent. 232

Jon, Nichole, and Mikey might have dividends from a United States sourced trade or business. If so, as Puerto Rican residents, then they will...

222. Id. §881(a)(1)-(b)(1).
223. Id. §§ 871(i)(2)(D), 861(a)(2).
224. Id. §§ 871(b)(2), 871(i)(2).
226. Id. § 30151(a)(2).
227. Id. § 30152(a)(2).
229. Id. § 871(i)(2).
230. Id. § 1.
232. P.R. LAWS ANN. tit. 13 §§ 30072, 30071(b).
have income from sources within the United States effectively connected to a United States trade or business subject to United States tax at 30 percent.\(^{233}\) If their Puerto Rican based corporations receive a dividend from a United States domestic corporation, then the corporations are subject to a United States tax of 10 percent, instead of 30 percent.\(^{234}\) If their corporations remain in the United States and receive a dividend from another United States domestic corporation, then that dividend is taxed at the standard United States corporate tax rates that range between 15 and 39 percent.\(^{235}\) If the entity moved to Puerto Rico and did not have the exemption, the entity could pay tax up to 25 percent.\(^{236}\) If the corporation receives an Act 20 exemption, the corporation is subject to a 4 percent on their dividend income.\(^{237}\) Additionally, a valid Act 20 exemption will exempt the corporate shareholder from paying tax when the corporation distributes the income to them as a dividend.\(^{238}\) The Act 20 exemption from Puerto Rican tax on corporate dividends is exclusive of an Act 22 exemption. This is very useful because the Act 20 exemption could last for thirty years,\(^{239}\) and the Act 22 exemption expires on December 31, 2035.\(^{240}\) An Act 273 exemption allows a corporation to pay a 4 percent tax on any dividend income.\(^{241}\) Furthermore, any dividends paid from the corporation to the owners are taxed at 6 percent during the exemption period, which could last up to forty-five years.\(^{242}\) The Act 273 exemption could also outlast the Act 22 exemption for individuals,\(^{243}\) which would provide significant benefits to the corporation’s owners when they receive dividend distributions from the corporation.

E. CAPITAL ASSETS

When determining the source of a capital asset sale by a United States citizen who is a Puerto Rican resident, or a Puerto Rican based entity, the individual or entity is treated like a nonresident alien individual or a foreign corporation.\(^{244}\) “[T]he sale of personal property by a United States resident shall be sourced in the United States, or by a nonresident shall be sourced outside the United States.”\(^{245}\)

\(^{233}\) I.R.C. § 871(a)(1)(A).
\(^{234}\) Id. § 881(b)(2).
\(^{235}\) Id. § 55(a).
\(^{236}\) P.R. LAWS ANN. tit. 13 §§ 30072, 30071(b).
\(^{238}\) Id.
\(^{239}\) Id. at 16–17.
\(^{242}\) Id. at 11.
\(^{243}\) Compare 2012 P.R. LAWS no. 22, p. 2; with 2012 P.R. LAWS no. 273.
\(^{244}\) I.R.C. § 865(g)(1) (2014).
\(^{245}\) Id. § 865(a).
A nonresident alien individual who trades stocks, securities, or commodities, for business or for personal purposes, whether on his or her own, through an employee, a resident broker, a commission agent, a custodian, or other independent agents "whether or not any such" individuals have discretionary authority to execute the transaction, is not conducting a trade or business within the United States, or performing personal services within the United States. Such actions are not sourced within the United States, provided "[t]he taxpayer does not have an office or other fixed place of business within the United States through which or by the direction of" the transactions are executed.

All of our individuals are likely to have some type of capital gains. Their capital gains will relate to the sale or exchanges of securities, investments portfolios, or the sale of some personal property or real property. Provided that the sale of capital assets such as these is unrelated to an office or fixed place of business within the United States, a Puerto Rican resident or corporation is exempt from United States tax on that sale.

Jason and Jen will have the least difficulty with this issue. They are a retired couple who do not own, operate, or have a business within the United States or Puerto Rico. They would receive capital gains from their investments, which are not subject to United States tax. Although these distributions are taxable income to Jason and Jen in Puerto Rico, the Act 22 exemption eliminates the requirement to pay Puerto Rican tax. If Jason and Jen remained in the United States, any short-term capital gains are subject to ordinary income tax treatment at rates up to 39.6 percent. If their capital gains are long-term, they are subject to a maximum tax rate of 23.8 percent. By contrast, if Jason and Jen were to move to Puerto Rico, absent the Act 22 exemption, they would be subject to a 10 percent tax on their long-term capital gains, and up to a 25 percent tax on their short-term capital gains. Jason and Jen will benefit from the Act 22 exemption, but unless their income consists of significant capital gains, their benefit is minimal.

Jon and Nichole might benefit the most from the lack of United States tax on capital gains distributed from United States sources to Puerto Rican residents or Puerto Rican corporations. Jon has substantial portfolio income, which likely includes capital gains. Act 22 will exempt those...
capital gains from Puerto Rican tax. Nichole’s hedge fund income will contain substantial capital gains, which can leave the United States tax-free. If Nichole made $10,000,000 in capital gains from trading stocks, that amount would be subject to a 10 percent Puerto Rican tax, which is $1,000,000. Conveniently, Nichole’s Puerto Rican-based income is exempt from United States tax. Therefore, when Nichole combines her exemption from United States tax with her Act 22 exemption on capital gains, she will pay no tax on her $10,000,000.

If Nichole remained in the United States, her capital gains would be broken into long-term capital gains and short-term capital gains. The maximum tax on her long-term capital gains is 23.8 percent, which is a tax of $2,380,000. The maximum tax on her short-term capital gains is 39.6 percent, which is a tax of $3,960,000. If Nichole were to keep her corporation within the United States, then that corporation’s $10,000,000 in gains will be subject to United States corporate tax amounting to $3,400,000.

Comparatively, if Nichole moves to Puerto Rico and obtains an exemption under either the Act 20 or Act 273, her capital gains will be subject to Puerto Rican tax of 4 percent, which is $400,000. If Nichole’s corporation obtains an Act 20 exemption, income distributed as dividends to Nichole will be exempt from Puerto Rican tax. An Act 20 exemption could outlast an Act 22 exemption, which would allow Nichole to continue to exempt significant amounts of income. If Nichole obtains an Act 273 exemption for her corporation, then income distributed as dividends to her will be subject to a Puerto Rican tax of 6 percent, which is $600,000. Act 22 could eliminate this 6 percent tax until the exemption expires on December 31, 2035. At that point, the 6 percent tax under Act 273 would apply.

Mikey’s situation is very different. He probably has some capital gain income from some investments, but that amount is likely minimal. Regardless, Act 22 will exempt the full amount of his capital gain income.
Mikey’s big benefit will come when he sells his business. Even with an Act 22 exemption, he must pay Puerto Rican tax on his business’s pre-move appreciation. Act 22 only exempts post-move appreciation from Puerto Rican tax. If he resides in Puerto Rico for more than ten years, then his pre-move appreciation is taxed at 5 percent rather than 10 percent. If Mikey remains within the United States, any capital gain income is taxed at a maximum rate of 23.8 percent. By moving to Puerto Rico, Mikey can save 23.8 percent on any post-move appreciation, and between 13.8 to 18.8 percent on any pre-move appreciation.

VI. UNITED STATES AND PUERTO RICO TAX RATE COMPARISON FOR INDIVIDUALS, CORPORATIONS, AND PARTNERSHIPS

A. Corporations and Partnerships

The United States and Puerto Rico used to tax corporations and partnerships differently from each other. In 2011, Puerto Rico enacted an entirely new IRC. Before the new Puerto Rican IRC, Puerto Rico taxed corporations and partnerships with rates ranging from 20 to 30 percent, based on the entity's income and number of Puerto Rican based employees. The Puerto Rican corporate tax now could reach 25 percent. This tax rate could change if the entity qualifies as a special entity, but the special entity designation is disregarded in this article because they do not qualify. A partnership does not have an entity level tax, but the partners are liable for tax on their individual tax returns.

A nonresident alien individual who is a partner in a partnership that is engaging in trade or business in Puerto Rico “[s]hall be deemed as engaged in a trade or business in Puerto Rico with respect to its distributive share in the income . . . of the partnership.”

United States corporations are taxed on a progressive tax scale starting at 15 percent of income not exceeding $50,000, but subject to 39 percent tax on income between $100,000 and $335,000, and topping out at 35 percent for amounts exceeding $18,333,333. Unfortunately, United States corporations, like Puerto Rican corporations, are subject to double taxation. The corporation is initially taxed on its income at the corporate level. Later, when the corporation distributes income as dividends or

270. Id. at 3.
271. Id. at 3–4.
272. Id. at 3.
276. P.R. LAWS ANN. tit. 13 § 8415(b) (2010).
277. Id. §§ 30072, 30071(b) (2011).
278. Id. § 30071(c) (2011).
279. Id. § 30331(2011).
280. Id.
282. Id.
benefits, the shareholders or employees are taxed upon receipt,\textsuperscript{283} thus, double taxation results.

Like a regular Puerto Rican partnership, United States partnerships are not taxed at the federal level at all.\textsuperscript{284} A partnership is merely a flow through entity, where “[p]ersons carrying on a business as partners shall be liable for income tax only in their separate or individual capacities.”\textsuperscript{285} The character of income received at the partnership level will flow through to each partner maintaining its character.\textsuperscript{286} This article does not address any state taxes or fees on corporations or partnerships, which could be significant.

The entity differences will not affect Jason and Jen because they do not operate a business. Jon, Nichole, and Mikey will benefit the most from the tax rate differences because a properly structured tax exemption could shelter significant amounts of income.

Under Puerto Rican law, Jon could face an entity level tax if he starts a corporation.\textsuperscript{287} Thus, Jon should apply for the Act 20 exemption.\textsuperscript{288} The exemption would subject Jon’s corporation to a flat 4 percent tax, which would significantly reduce his corporate tax liability for up to thirty years.\textsuperscript{289} If Jon started a partnership, he should still apply for the Act 20 exemption because Act 20 also provides an exemption to recipients of company distributions and exemptions from property and municipal taxes.\textsuperscript{290} While Jon might have some concerns about an entity level tax, the major concerns revolve around Nichole.

The tax treatment of her business depends on her entity choice. Hedge funds typically choose a flow-through entity like a partnership because the partnership’s income is taxed to the partners not the entity,\textsuperscript{291} and avoids the double taxation associated with a corporation. Nichole’s main issues revolve around income sourcing and the entity’s tax treatment. As a hedge fund manager, Nichole will conduct tens of thousands of capital transactions throughout the year. To conduct her business in Puerto Rico, Nichole must either associate herself with a Puerto Rican bank, an international bank within Puerto Rico, or, for the low price of $250,000, start her own bank!\textsuperscript{292} Starting her own bank means Nichole is not subject to frustrating bank fees or servicing issues, and potentially exempt from some banking usury laws.\textsuperscript{293} If she decides to start her own bank,
she should apply for the Act 273 exemption that allows her entity to pay flat 4 percent tax\textsuperscript{294} for up to forty-five years.\textsuperscript{295} Although, the Puerto Rican Secretary has the discretion to modify the entity’s tax rate up to 10 percent for the last fifteen years.\textsuperscript{296}

Another potential issue for the Act 273 exemption is the four-employee requirement.\textsuperscript{297} The cost and headaches associated with employing four employees could outweigh the Puerto Rican law’s incentives. Fortunately, Act 22 grants Nichole’s banking entity an exception from the four-employee requirement.\textsuperscript{298} If Nichole did not have an Act 22 exemption, the Puerto Rican Secretary may waive the employee requirement upon Nichole’s request.\textsuperscript{299}

If Nichole continues to reside in the United States, her primary benefit is the lack of an employee requirement if she is unable to obtain an exemption or waiver. Nichole’s share of partnership income will maintain its characteristics as it flows through to her personal tax return.\textsuperscript{300} Those amounts are then taxed at her applicable individual tax rates.\textsuperscript{301} Jon and Nichole are likely subject to the top ordinary income tax rates of 39.6 percent,\textsuperscript{302} and top long-term capital gain tax rates of 23.8 percent\textsuperscript{303} when they combine their income, excluding state taxes. If Nichole and Jon make $10,000,000, the most tax they would owe is $3,960,000,\textsuperscript{304} and the lowest tax they would owe is $2,380,000,\textsuperscript{305} provided they operated a partnership. If they operated a corporation, their corporation will pay an entity level tax of $3,400,000,\textsuperscript{306} meaning the most the corporation could distribute to them is $6,600,000. Then, whatever amounts the corporation distributed to them is subject to tax at their respective individual rates. If the corporation then distributed this entire amount to them, the most tax they would pay is $2,613,600\textsuperscript{307} and the lowest is $1,570,800.\textsuperscript{308} Altogether, they could pay tax ranging from $6,013,600 to $4,970,800, which is about 49 to 60 percent of their $10,000,000 income, excluding state taxes.

If Jon and Nichole relocated their business to Puerto Rico, and became Puerto Rican residents with valid Act 22 and Act 273 exemptions, the
corporation will pay a tax of $400,000 on their $10,000,000, and a partnership will pay zero. A Puerto Rico move with a valid exemption will save them $3,000,000 in corporate tax. If Jon and Nichole started a Puerto Rican partnership, because partnership income maintains its character, Nichole will pay Puerto Rican income tax on anything Act 22 does not exempt. If the entity is a corporation or partnership and distributes interest, dividends, or capital gains, Act 22 will exempt these amounts from tax.

Mikey’s situation differs from the others. His startup company is still not worth any money, but it is poised for rapid growth. He should relocate his company to Puerto Rico to source as much post-move appreciation to Puerto Rico, which is then eligible for Act 22 exemption. This requires him to establish a Puerto Rican residency before his business’s value skyrockets. The Act 20 business exemption will subject his entity to Puerto Rican tax of 4 percent for up to thirty years, rather than Puerto Rico’s entity level tax up to 25 percent. He will save up to 21 percent in Puerto Rican tax annually.

If Mikey stays in the United States, the United States IRC will dictate his business and personal tax liability. If Mikey’s entity is a corporation instead of a partnership, he is subject to tax at the corporate level between 15 and 35 percent, and then tax at the individual level when the company distributes profits through dividends or pays him a salary. A Puerto Rico move would save Mikey 11 to 31 percent in corporate tax annually.

B. INDIVIDUALS

As previously stated, the United States and Puerto Rico each have their own individual exclusive taxing systems, and both maintain a progressive tax structure. The top United States individual rate is 39.6 percent, and Puerto Rico’s top rate ranges from 30 to 33 percent, depending on the year. While the lower Puerto Rican rate looks more favorable, it applies to all income from $61,300 to $121,500, depending on
the year. This article will use the 30 percent rate that applies to income of $121,500 and over for all income earned after December 31, 2015. The top United States rate begins for single individuals at $400,000 and for married joint filers at $450,000. In the United States, a single person making $500,000 would pay tax of $155,764, and a married individual would pay tax of $145,646. If the same person made $500,000 in Puerto Rico, he or she would pay tax of $133,600. The United States calculations do not include state taxes, which could add between 0 and 13.3 percent or more depending on the specific states.

All of our groups are likely have a capital transaction because each group should sell its house. A house is a capital asset because it is not explicitly defined as not a capital asset. Upon selling their homes, all are likely to qualify for a sale of personal residence exemption. This exemption excludes gains of up to $250,000 if single, and $500,000 if married filing joint. To qualify, he or she must have lived in the house for twenty-four of the last sixty months. Puerto Rico recently enacted a similar exemption, but it only applies to individuals who are sixty years and older who lived in their home for thirty-six of the last sixty months, and exempts only $150,000. Any amount exceeding the exemption is a long-term capital gain. The sale of United States real property is United States sourced income explicitly subject to United States tax, no matter where the individual lives and when the home was sold, making it ineligible for any Puerto Rican tax benefits.

Assuming the sale results in a gain, this excess capital gain tax might affect our groups differently. Jason and Jen might receive the worst or best treatment. Assume that they bought their home many years ago. Their home likely appreciated significantly over the years, and may exceed the $500,000 exemption, which will push their other income into higher brackets (the worst treatment). This income increase could subject them to the top capital gain rate of 23.8 percent for any excess gain. This excess gain could also push their ordinary income tax toward the 39.6 percent bracket. Jason and Jen have limited retirement income and cannot work anymore. Thus, they are relying on this sale to

323. Id.
324. Id. § 30061(a)(6).
325. I.R.C. § 1(c).
326. Id. § 1(i)(3).
327. Id. § 1.
331. Id.
333. Id.
335. I.R.C. § 861(a)(5).
336. Id. § 121.
337. Id. §§ 1411 (2014), 1(h).
338. Id. § 1(a).
fund their move and to purchase a new house. Conversely, the exemption could shield their entire gain up to $500,000 (the best treatment).339

Jon, Nichole, and Mikey are all young and able to work. They could work extra hours to offset the moving costs. Both groups should qualify for the exemption, shielding any gain from tax. These two groups are unlikely to have owned their homes for as long as Jason and Jen, thus, the exemption is likely to cover any applicable appreciation. While the home sale is likely an isolated capital transaction, there are other capital transactions that warrant more concern.

Jon and Nichole are both highly successful and receive significant investment income. If Jon continues to teach or practice law, his wage income is subject to Puerto Rican taxation at rates ranging from 30 to 33 percent.340 Act 22 exempts any investment income attributable to interest, dividends, or capital gains from taxation, but not wage or salary income.341 Nichole will have tens of thousands of long-term and short-term capital transactions during the year. The United States requires Nichole to hold a capital asset for one year and a day to become long-term.342 Puerto Rico only requires her to hold a capital asset for six-months to qualify as a long-term capital asset.343 The difference between the long-term classifications could have a significantly positive impact on her business, in addition to benefitting from the lower tax rates.344 Conveniently, Act 22 exempts capital gains whether long-term or short-term,345 an immense advantage to her.

If Jon and Nichole stay in the United States, the United States IRC will dictate their tax liability.346 Jon and Nichole are likely in the top 39.6 percent tax bracket for ordinary income,347 which includes interest, dividends, and short-term capital gains.348 Long-term capital gains are taxed at a maximum of 23.8 percent.349 If they move to Puerto Rico, their wages are subject to the top Puerto Rican tax rate ranging from 30 to 33 percent depending on the year.350 Any long-term capital gains are subject to a 10 percent tax,351 absent an Act 22 exemption.352 By moving to Puerto Rico, Jon and Nichole could exempt interest, dividend, and capital

339. Id. § 121.
344. 2012 P.R. LAWS no. 22 p. 3-4.
345. Id.
347. I.R.C. § 1.
348. Id. § 1(a).
349. Id. §§ 1411, 1(h)(1)(C).
351. Id. §§ 30111(a)(2), 30082(a).
gains from tax, which are subject to ordinary income tax rates in the United States up to 39.6 percent, a 39.6 percent. While Jon and Nichole enjoy significant Act 22 exemptions on their yearly income, Mikey will enjoy that exemption during one big sale.

Mikey should hire an appraiser to value his company before he moves if his company’s value is not easily ascertainable. This will lock in the pre-move value and source any post-move appreciation to Puerto Rico. Any post-move appreciation generated while he is a Puerto Rican resident is eligible for the capital gain exclusion under Act 22. Mikey should reside in Puerto Rico for more than ten years so that his pre-move appreciation is subject to a lower 5 percent tax, rather than a 10 percent tax. Comparatively, if he continued to reside in the United States, the sale of his company should put him in the top long-term capital gain tax bracket of 23.8 percent, plus any applicable state tax. Mikey could save up to 18.8 percent by subjecting his pre-move appreciation to Puerto Rican tax, and fully exempt any post-move appreciation, which will save him 23.8 percent. Mikey should reside in Puerto Rico for more than ten years so that his pre-move appreciation is subject to a lower 5 percent tax, rather than a 10 percent tax. Mikey should reside in Puerto Rico for more than ten years so that his pre-move appreciation is subject to a lower 5 percent tax, rather than a 10 percent tax.

If Mikey stays in the United States, his best option is to sell the business as a stock sale because he could exclude between 50 and 100 percent of the gain that does “not exceed the greater of $10,000,000 or ten times the aggregate adjusted basis of qualified small business stock.” To qualify, Mikey must meet IRC section 1202’s requirements, but because he started the company from the ground up, he is likely within its parameters. But, a buyer of Mikey’s company is unlikely to select this option because a buyer usually benefits more from an asset sale. An advantage of an asset sale is that the buyer can depreciate the company assets and reject company liabilities. If the parties allocated any of the purchase price to goodwill, the buyer can amortize that amount over fifteen years. If Mikey sells solely the rights to his intellectual property, which has a set expiration date, the buyer can amortize the purchase price over the remaining life. Asset and intellectual property sales can be significantly more advantageous to a buyer than a stock sale, which is why it is unlikely.

The following illustrates the benefits of selling Mikey’s business with Puerto Rico’s incentives versus staying in the United States and paying the United States tax. Mikey’s initial basis in his company is $500,000, his pre-move appreciation is $1,000,000, and after ten years, which is when he

353. Id.
354. I.R.C. § 1(a).
355. 2012 P.R. LAWS no. 22 p. 3.
357. I.R.C. §§ 1411, 1(h).
358. See id.
359. Id. § 1202(b)(1)(B).
360. Id. §§ 1202(c)–1202(e).
361. Id. § 167.
362. Id. § 197(a), 197(d)(1)(A).
363. Id. § 197(d)(1)(D).
sells, the business appreciated to $40,000,000. If he stays in the United States, assuming no exclusions apply, when he sells his business for $41,500,000, he will pay a tax of $9,758,000,364 plus applicable state taxes. If he moves to Puerto Rico, the $1,000,000 pre-move appreciation is taxed at 5 percent, which is $50,000,365 and Act 22 exempts any post move appreciation from tax.366 If Mikey moves to Puerto Rico, he will pay a total tax of $50,000, on a business worth $41,500,000. The Puerto Rico move could save him $9,708,000 in taxes!

VII. CONCLUSION

The Puerto Rican incentives provide very enticing financial incentives to encourage one to seek Puerto Rican residency. For individuals like Jason and Jen, who will receive minimal benefits, these benefits are not substantial enough, and therefore they should not move. The residency test, closer connection test, and tax home test ensure that an individual actually becomes a Puerto Rican resident and is not simply renting a mailbox or home in Puerto Rico to enjoy the benefits. The individual moving to Puerto Rico remains a United States citizen, even though the tax code often defines him or her as a non-resident alien individual.

The significant financial incentives provided in the three Puerto Rican legislative incentives discussed are powerful motivators to persuade someone to relocate to Puerto Rico. For financially motivated individuals whose income consists primarily of interest, dividends, and capital gains, these benefits are enormous. Jon and Nichole will benefit significantly from the exemption and should move to Puerto Rico. An Act 22 tax exemption lasts until December 31, 2035367 and an Act 273 exemption can be valid up to forty-five years.368 While briefly mentioned, the Act 273 also exempts the corporation from paying municipal taxes and taxes on real or personal property or tangible or intangible property, which could be significant.369 Jon and Nichole could quickly amass a fortune upon which they may pay little to no tax.

Mikey had a different situation throughout this entire article. Not only is he moving his life and business to Puerto Rico, but also he must find qualified individuals within Puerto Rico to help grow his business. Jon and Nichole both have the intellectual knowledge to conduct their business without outside assistance. Mikey needs workers to help his company grow, which Puerto Rico can provide. If Mikey desires to reap the benefits of the various Puerto Rican incentives, he should do so before his business significantly appreciates so he can source as much apprecia-

364. See I.R.C. §§ 1(h), 1411.
366. Id. at 4.
367. Id. at 1.
369. Id. at 29.
tion and income to Puerto Rico as possible. The potential tax exemption he receives upon selling his business is a major incentive that should persuade him to relocate.

As stated above, this article discussed a variety of issues within a vacuum and excluded a list of items, including, but not limited to deductions, expenses, credits, subpart F income, certain FDAP income, withholding issues, entity-formation issues, entity-relocation issues, entity-dissolution issues, fund-relocation tax issues, RICs, dividend-received deduction, employment taxes, and the alternative minimum tax under both codes. An individual contemplating a move to Puerto Rico for the purpose of benefiting from these tax incentives should consult a knowledgeable attorney and tax expert before he or she undertakes the journey. A tax haven is "a country, that imposes little or no tax on the profits from transactions carried on there or on persons resident there."370 Is Puerto Rico America's tax haven or simply a vacation paradise? Like the answer to almost any legal question, it depends; and depending on the situation, Puerto Rico could be America's tax haven.

Case Note