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RECENT DEVELOPMENTS ON PR AND US ESTATE AND GIFT TAXES AFFECTING PUERTO RICO RESIDENTS

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The transfer of assets upon death of a Puerto Rico (**"PR"**) resident may be subject to estate and gift taxes imposed by PR and the United States ("**US**"). In this article, we will summarize recent amendments to the PR and US estate and gift tax regime.

A. PUERTO RICO DEVELOPMENTS

The following changes to the PR estate and gift tax rules were adopted under the recently enacted New Puerto Rico Internal Revenue Code (Act No. 1 of January 31, 2011, the "NPR-IRC"), and are effective with respect to persons who passed away after December 31, 2010 and gifts made after April 1, 2011. Generally, these rules are applicable to residents of PR that:

- *were born in PR, or*
- *acquired US citizenship "solely" by residence in PR (hereinafter these PR residents are referred to as* "**PR Persons**").

(1) Tax Rate. The NPR-IRC imposes a fixed 10% tax upon the "taxable estate" of and "taxable gifts" by PR Persons. For PR Persons who died prior to 2011, the estate tax rate ranged from a low of 18% to a maximum of 50%.

(2) New Tests for Shares of Stock of PR Corporations and Interest in PR Partnerships to be Considered "Property Located Within PR". Shares of stock of a PR organized corporation, or interest in a PR partnership, that is more than 10% owned (value or vote) by the decedent PR Person, will only be considered Property Located Within PR, for purposes of the PR estate tax NPR-IRC deduction for such property, if:

(a) 80% or more of the gross income of such entity (together with the gross income of all those other entities directly or indirectly more than 50% owned by such entity) was derived from the "conduct of a trade or business" during the 3-year-period ended prior to his/her demise ("**80% Active Income Test**"); or

(b) 100% of the assets of said corporation or partnership constitutes "Property Located Within PR", as defined in paragraph (1) and (3) through (10) of Section 2023.02(b) of the NPR-IRC ("**100% Asset Test**").

The term "conduct of a trade or business" is not defined in the NPR-IRC; however, it generally requires that the entity be actively involved in a trade or business, and not merely holding property as an investment or to generate income.

Many PR corporations and partnerships are not engaged in the "conduct of a trade or business," and some of those so engaged might fail the 80% Active Income Test directly (or indirectly through its ownership of more than 50% of other entities). In such cases, it is critical to ensure that the entity meets the 100% Asset Test by not owning (not even accidentally owning) any assets that might fail to qualify as "Property Located Within PR".

It should be noted that the 80% Active Income Test also applies to the gift tax deduction for property located within PR in the case of PR residents, effective for gifts made on or after April 1, 2011. However, for gift tax purposes, the 100% Asset Test is not an available remedy when the entity fails the 80% Active Income Test.

(3) Other Changes to the Definition of "Property Located Within PR"**.** US government bonds were excluded from the definition of "Property Located Within PR" under the NPR-IRC for estate tax purposes. Furthermore, the NPR-IRC clarifies that deposits, certificates of deposits and savings accounts booked at banks branches located in Puerto Rico are considered "Property Located Within PR".

The NPR-IRC also excludes from the definition of "Property Located Within PR" the proceeds paid under a life insurance policy with no designated beneficiary, or having the estate as beneficiary, which are included in the estate. The definition of the term "insurance" excludes all life insurance policies. As such, the proceeds from a life insurance policy with no designated beneficiary or having the estate as beneficiary could be considered property located outside PR for PR estate tax purposes under the NPR-IRC.

(4) PR Estate Tax Exemption. PR Persons that die after December 31, 2010 will be entitled to a PR estate tax exemption of $1 million, that must be prorated among the estate assets.

The PR estate tax exemption for those who died prior to 2011, was $400,000; however, this exemption was irrelevant in most cases because the $400,000 amount was reduced by the value of the "Property Located Within PR" that was part of the estate.

(5) Credit for Responsible Taxpayers. A new "Responsible Taxpayers Credit" (to offset the above described 10% estate tax if any on the taxable estate of a PR Person) is now available under the NPR-IRC when:

(a) the decedent, and any entity owned 10% or more by the decedent, owes no PR taxes (i.e., taxes due to the PR Treasury, property taxes and municipal taxes) at the time of death; and

(b) the state's administration pays all taxes that accrued prior to death within the time periods established by law.

Considering that it is impossible to predict whether the decedent's estate will meet the above conditions for this new credit, and since tax assessment notifications and tax debt records are highly unreliable in PR, too much reliance should not be placed on the availability of this credit when planning for PR estate taxes.

(6) Investment Considerations. For PR Persons that die after December 31, 2010, the fixed 10% estate tax rate, plus the prorated $1,000,000 exemption amount and the Responsible Taxpayer Credit, add completely new considerations on the location of their investments. Caution, however, is still required with respect to US investments (i.e., "Property Located Within the US," as defined in the US Internal Revenue Code of 1986, as amended – the "**US-IRC**"), since PR Persons continue to be exposed to substantial US estate taxes if they own US investments, as generally they are only entitled to a $60,000 US estate tax exemption.

Prior to the NPR-IRC, Puerto Rico had an estate tax structure that was a real and effective disincentive for PR Persons to invest outside PR. Now, when PR Persons invest outside PR, and if such investments are considered "Property Located Outside the US" under the US-IRC (i.e., so that they are not subject to US estate taxes), such disincentive has been significantly reduced. These now favored "Foreign Investments" (i.e., investments outside PR and outside the US) include, but are not limited to, shares of stock and obligations of European, Canadian, Asian, Australian and other foreign issuers, and foreign real estate, are only exposed to a maximum 10% PR estate tax, if any. These investments represent a new and broader palette of investment options that PR Persons have typically shunned in the past.

B. UNITED STATES DEVELOPMENTS.

Amendments to the US estate and gift tax provisions of the US-IRC were approved last December 2010. Such amendments (i) are effective with respect to persons that die, and gifts made, after December 31, 2010, and (ii) are mainly applicable to residents of Puerto Rico that were born outside PR and did not acquire their US citizenship solely due to their residence in PR (hereinafter these PR residents are referred to as "**US Persons**"). The US amendments are the following:

(1) The maximum US estate tax rate will be 35% during 2011 and 2012, but will increase to 55% after 2012.

(2) The unified US estate and gift tax credit applicable to "citizens and residents" of the US, as these are defined under the US-IRC estate and gift tax provisions, will be $5 million during 2011 and 2012, and $1 million after 2012.

These changes provide a unique tax saving gifting opportunity during 2011 and 2012, as US Persons will be able to transfer by gift up to $5 million without triggering US gift taxes. However, US Persons that are PR residents have to be careful that they only transfer "Property Located Within PR", as defined under the NPR-IRC, otherwise they will trigger PR gift taxes, if their annual gifts of "Property Located Outside PR" exceeds $10,000 per donee. Note that the above described PR "Responsible Taxpayer Credit" and $1,000,000 exemption are not applicable to PR gift taxes.

(3) An additional benefit for persons dying during 2011 and 2012 is the so called the "portability" of the US estate tax exemption between spouses. Portability means that the surviving spouse can elect, on the timely filed US estate tax return of the first spouse to die, that the unused portion of the deceased spouse's $5 million exemption amount be added to her/his own future estate tax exclusion. Prior to 2011, this could only be achieved when the spouses had wills that created credit shelter trusts. Portability is now available, even when the first spouse to die has no will. Even though "portability" is set to expire after 2012, it is a key consideration in handling the estate of a married US Person decedent during 2011 or 2012, as it is likely to be extended after 2012.

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Should you have any questions with respect to the above, please contact Ricardo Muñiz, Esq. at (787) 281-1818 or Caridad Muñiz-Padilla, Esq. at (787) 281-1817.

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