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Navigating Tax Paradise: Key U.S. Tax Considerations for U.S. Taxpayers and Businesses Relocating to Puerto Rico

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In this article, Raghuvanshi explains the complex relationship between the IRC and Puerto Rican tax law and provides insights for individuals and businesses transitioning from the United States to Puerto Rico.

The opinions expressed in this article are the author's and do not necessarily reflect those of Greenberg Traurig LLP or any other individual or entity.

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I. A Brief History of Puerto Rico

Puerto Rican history is a complex and multifaceted story that spans centuries of colonialism, the struggle for autonomy, and eventual incorporation into the United States as a territory.[1] Centuries before the arrival of European explorers to its coasts, Puerto Rico was home to the Taíno people, an indigenous community characterized by a vibrant culture and profound ties to the terrain.[2] They referred to their native land as "Borikén," or "Borinquen," translating to "the Land of the Valiant and Noble Lord."[3] The Taíno civilization prospered through agriculture, fishing, hunting, and the mastery of various crafts, leaving an enduring heritage of art, language, and

[1] For detailed history on Puerto Rico, see "Puerto Rico," History.com (last updated Aug. 1, 2023).

[2] Irving Rouse, *The Tainos: Rise and Decline of the People Who Greeted Columbus* (1992).

[3] *See* "A Brief History of Puerto Rico," DiscoverPuertoRico.com (last accessed Dec. 4, 2023).

spirituality that continues to shape Puerto Rican culture today.

For nearly four centuries, Spain controlled Puerto Rico, which left an indelible mark on the island's language, religion, and culture. However, the 19th century brought winds of change, with calls for independence and autonomy resonating across the island. At the end of the 19th century, the United States emerged victorious in the Spanish-American War, leading to the Treaty of Paris signed on December 10, 1898, in Paris.[4] As part of the treaty, Puerto Rico, along with Guam, the Philippines, and Cuba, was ceded to the United States by Spain.[5] This marked the beginning of a new era for Puerto Rico, because it transitioned from Spanish colonial rule to American oversight.

In 1917 President Woodrow Wilson signed the Jones-Shafroth Act (also known as the Puerto Rican Federal Relations Act) which granted Puerto Ricans U.S. statutory citizenship, a significant milestone in the island's history. This act also established a civil government for the territory, providing Puerto Rico with a degree of self-governance.

Today, Puerto Rico stands as an unincorporated territory of the United States, with its residents being U.S. citizens. The relationship between Puerto Rico and the United States remains a topic of discussion and negotiation, with some advocating for statehood, others for independence, and some preferring the current territorial status.

II. Rules in Puerto Rico and the United States

A. Puerto Rico

Being a self-governing territory of the United States, Puerto Rico has introduced several tax incentives to attract investors and companies to stimulate its economic development. In 2012 Puerto Rico implemented two key pieces of legislation known as the Export Services Act, commonly referred to as "Act 20," and the Individual Investors Act, or "Act 22." Act 20 offered tax benefits to specific entities incorporated in Puerto Rico engaged in exporting services outside the territory. Under Act 20, income generated from qualified services provided to nonresidents of Puerto Rico, both individuals and businesses, is subject to a reduced tax rate of 4 percent through a tax exemption if certain criteria are met. Similarly, Act 22 granted bona fide residents of Puerto Rico a 100 percent tax exemption on certain interest, dividends, and capital gains.

On July 1, 2019, Governor Ricardo Rosselló of Puerto Rico enacted Act 60, establishing the Incentives Code that replaced acts 20 and 22, consolidating and expanding Puerto Rico's tax incentives into a single, comprehensive law.

Act 60 includes a wide range of incentives for businesses and individuals. For businesses, it retains many of the benefits from Act 20 (like a 4 percent corporate income tax rate), but it also introduces new incentives and expands the eligibility criteria. For individuals, it maintains the capital gains and dividends exemptions from Act 22. Also, it introduced new incentives for residents in areas like technology, tourism, and film production. Thus, with the right tax planning, a U.S. citizen who relocates to Puerto Rico can lower their overall effective tax rate to only 4 percent.

B. United States

As a general tax principle, under IRC section 1, U.S. citizens and residents are ordinarily required to report and pay taxes on all of their income, regardless of where it is earned, including both domestic and foreign sources.[6] However, a noteworthy exception exists in the code: Section 933 establishes a distinctive tax framework.[7] This provision allows for the

[4] "Treaty of Paris," Britannica (last updated Dec. 3, 2023).

[5] *Id.*

[6] Reg. section 1.1-1(a) and (b). Subject to the provisions of section 933, if an alien individual is resident in either American Samoa or in Puerto Rico, section 876 categorizes them as a resident alien for U.S. income taxation. Consequently, that individual becomes liable for U.S. income tax on their global income under section 1.

[7] The initial regulations governing the status of Puerto Rico's residents were established in 1950, as documented in sections 220 and 221 of the Revenue Act of 1950 (P.L. 81-814), which laid the groundwork for what are now IRC sections 876 and 933.

exclusion of income arising from Puerto Rican sources from the gross income of a U.S. citizen, but only if that individual can substantiate their bona fide residency in Puerto Rico for the complete tax year.[8]

It is important to note that income derived from sources located outside Puerto Rico and generated by a U.S. citizen who qualifies as a bona fide resident of Puerto Rico is typically subject to U.S. federal taxation in the same manner as it would be for any other U.S. citizen, irrespective of their residency status in Puerto Rico.

The allure of Act 60, in conjunction with section 933 of the code, has led to a considerable influx of U.S. investors relocating to Puerto Rico with the goal of significantly mitigating their overall tax liability. Act 60 provides substantial tax incentives for businesses and individual investors who choose to establish themselves in Puerto Rico, which piqued the interest of many individuals seeking to optimize their tax strategies. Partly because of the adoption of remote work, many U.S. citizens have relocated to Puerto Rico or are planning to do so to take advantage of tax incentives and claim the exemption from U.S. federal income tax.

While section 933 can substantially reduce the overall ETR and provide tax planning opportunities, the application of section 933 is intricate and often ambiguous. This complexity stems from the nuanced U.S. federal income tax issues it raises, including the determination of the source of income (like the allocation of income to U.S. and Puerto Rican sources), considerations related to controlled foreign corporations, and passive foreign investment companies. Also, section 933 incorporates an array of complex rules governing the tax year in which a U.S. citizen relocates either to or from Puerto Rico. It also outlines the tax treatment of gains stemming from the sale of capital assets or other personal property.

[8]The exemption from U.S. federal income tax under section 933 does not apply to amounts received for work performed in the capacity of a U.S. government employee or its agencies. *See* section 933(1).

III. Bona Fide Resident of Puerto Rico — General Rules

Section 937(a), introduced in 2004, provides the definition of a "bona fide resident" in the context of a person who is a resident of a U.S. possession.[9] Generally, determining whether a U.S. citizen qualifies as a bona fide resident of Puerto Rico for a tax year depends on a set of stringent criteria aimed at ensuring the individual's substantial connection to the possession. Thus, under the code and as further elaborated by the regulations, a U.S. citizen will be considered a bona fide resident of Puerto Rico if that individual (i) is physically present in Puerto Rico under one of the five tests discussed below,[10] which necessitates that the individual spends a substantial amount of time physically in Puerto Rico during that tax year; (ii) does not have a tax home outside Puerto Rico,[11] which requires the individual to establish Puerto Rico as their primary tax residence, meaning that their economic activities, work, or business operations should predominantly take place within the territory; and (iii) does not have a connection to the United States or a foreign country that is closer than their connection to Puerto Rico, which emphasizes that the individual's principal affiliations should be with Puerto Rico rather than elsewhere.[12]

A. Physical Presence Test

Except for specific regulations that apply to the tax year in which a U.S. citizen relocates to or from Puerto Rico, as further discussed below, an individual is considered to fulfill the physical

[9]*See* the American Jobs Creation Act of 2004 (P.L. 108-357), section 908(d)(2). Only natural persons can qualify as bona fide residents of Puerto Rico, while legal entities like corporations, partnerships, trusts, and estates cannot be categorized as "bona fide residents" under the regulations. *See* reg. section 1.937-1(b)(3).

[10]Reg. section 1.937-1(c)(1).

[11]Reg. section 1.937-1(d).

[12]Reg. section 1.937-1(e).

presence test if they meet at least one of the following five tests:[13]

i. **The 183-Days Test:** The individual was present in Puerto Rico for at least 183 days during the tax year.[14] In general, if an individual is physically in Puerto Rico at any time during a day, they are considered to be in Puerto Rico for that day.[15] Similarly, if an individual is physically present in one or more of the 50 states of the United States for any part of a day, they are considered to be in the United States for that day.[16] If an individual is in both the United States and Puerto Rico on a specific day, it is counted as a day of presence only in Puerto Rico.[17]

ii. **The 549-Days Test:** The individual was in Puerto Rico for a minimum of 549 days over a three-year period, which includes the current tax year and the two preceding years.[18] This requirement would be met only if the individual is present in Puerto Rico for at least 60 days in each of those years.[19]

iii. **The 90-Days Test:** The individual was not present in the United States for more than 90 days during the tax year.[20]

iv. **$3,000 Income and Days Comparison:** During the tax year, the individual spent more days in Puerto Rico than in the United States and earned an income (such as wages, salary, professional fees, and compensation for services performed) in the United States not exceeding $3,000.[21]

v. **Significant Connection:** The individual had no significant connection to the United States during the tax year.[22] An individual is considered to have a significant connection to the United States if they meet any of the following criteria: (1) they maintain a permanent home[23] in the United States, (2) they are registered to vote in any U.S. political district, or (3) the primary residence of their spouse or a child under 18 is located in the United States.[24]

B. Tax Home Test

The tax home test is met if the individual does not establish a tax home anywhere other than in Puerto Rico at any point during the tax year.[25] A person is generally treated as having a tax home at their regular place of business or, if there is more than one regular place of business, the principal place of business.[26] The tax home of a person with no regular or principal place of business is the individual's regular place of abode in a real and substantial sense.[27]

C. Closer Connection Test

To qualify as a Puerto Rican bona fide resident,[28] an individual must also demonstrate that they have a closer connection to Puerto Rico than to the United States or any foreign jurisdiction during any part of the tax year.[29] Assessing a closer connection with Puerto Rico compared with the United States or another

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[13] Reg. section 1.937-1(c).

[14] Reg. section 1.937-1(c)(1)(i).

[15] Reg. section 1.937-1(c)(3)(i).

[16] Reg. section 1.937-1(c)(3)(ii).

[17] Reg. section 1.937-1(c)(3)(iii)(A).

[18] Reg. section 1.937-1(c)(1)(ii).

[19] *Id*. Besides the days of actual physical presence, an individual is deemed to be within a territory on days when they are not physically there for specific reasons: (a) to receive medical treatment or accompany certain family members for such treatment, (b) during a period of up to 14 days following a federally declared disaster, (c) when a mandatory evacuation notice is in effect, or (d) for business or personal travel under specific conditions. *See* reg. section 1.937-1(c)(3)(i).

[20] Reg. section 1.937-1(c)(1)(iii).

[21] Reg. section 1.937-1(c)(1)(iv).

[22] Reg. section 1.937-1(c)(1)(v).

[23] A permanent home is generally a dwelling that is consistently accessible at all times and not intended solely for brief stays. Thus, any short-term travel to the United States for business and staying temporarily at a parent's house will not cause that house to be treated as a permanent home. Reg. section 1.937-1(c)(5)(ii)(A) and (g) Ex. 2.

[24] Reg. section 1.937-1(c)(5)(i). If a child is under the age of 18, their place of residence is not taken into account if they are: (1) residing in the United States with a custodial parent as determined by a custodial decree or a multiple support agreement, or (2) a full-time student. *Id.*

[25] Reg. section 1.937-1(d).

[26] *See* sections 937(a)(2), 162(a)(2); reg. section 301.7701(b)-2(c)(1). An individual would have a "tax home" in Puerto Rico if they would qualify for a deduction under section 162(a)(2) for business-related travel expenses incurred when they are away from Puerto Rico in pursuit of a trade or business. Section 911(d)(3).

[27] Rev. Rul. 73-529, 1973-2 C.B. 37.

[28] Reg. section 1.937-1(e)(1); reg. section 301.7701(b)-2(d).

[29] Reg. section 1.937-1(e)(1).

foreign country relies on a comprehensive consideration of all available information and circumstances.[30] Certain factors are listed in the regulations to determine whether an individual maintains a closer connection to Puerto Rico:[31]

i. the location of the individual's permanent home;[32]
ii. the location of the individual's family;
iii. the location of personal belongings, like automobiles, furniture, clothing, and jewelry owned by the individual and their family;
iv. the location of social, political, cultural, or religious organizations with which the individual has a relationship;
v. the location where the individual conducts their routine personal banking activities;
vi. the location where the individual conducts business activities (other than those that constitute the individual's tax home);
vii. the location of the jurisdiction in which the individual holds a driver's license;
viii. the location of the jurisdiction in which the individual votes; and
ix. the country of residence designated by the individual on forms and documents.

No single factor, mentioned above, is dispositive, and it is necessary to take all these factors into account to ascertain if an individual possesses a closer connection with Puerto Rico. Also, a closer connection to Puerto Rico must be established for the entire tax year.[33]

IV. Bona Fide Residence — First Tax Year

In the tax year when a U.S. citizen moves to Puerto Rico,[34] the tax home test and the closer connection test are considered satisfied only if all the below conditions are met:[35]

i. the individual was not a bona fide resident of Puerto Rico for any of the three preceding tax years;
ii. the individual does not have a tax home in the United States or a foreign country at any time within the last 183 days of the tax year and does not have a closer connection to the United States or a foreign country during that period;[36] and
iii. the individual is a bona fide resident of Puerto Rico for each of the three years following the tax year of the change of residence.

Because of the second prong of this test, if a person relocates to Puerto Rico in a particular tax year but spends a greater amount of time in the United States during the latter half of the tax year, they likely would not qualify as a bona fide resident of Puerto Rico for that year, irrespective of whether they satisfy the 183-day test for the entire tax year.

> Example: D, a U.S. citizen, files returns on a calendar year basis. From January [2021] through May [2024], D resides in the United States. In June [2024], D moves to [Puerto Rico], purchases a house, and accepts a permanent position with a local employer. D's principal place of business from July 1 through December 31, [2024] is in [Puerto Rico], and during that period (which totals at least 183 days) D does not have a closer connection to the United States or a foreign country than to [Puerto Rico]. For the remainder of [2024], and throughout years [2025] through [2027], D continues to live and work in [Puerto Rico] and maintains a closer connection to

[30] *Id.*

[31] Reg. section 301.7701(b)-2(d)(1).

[32] The type of permanent home, whether it's a house, apartment, or furnished room, and whether it is owned or rented by the foreign individual, is immaterial. However, it will be material if the dwelling is consistently available and not exclusively intended for short stays. Reg. section 301.7701(b)-2(d)(2).

[33] *Id.*

[34] Individuals who begin or end their bona fide residence must file IRS Form 8898, "Statement for Individuals Who Begin or End Bona Fide Residence in a U.S. Possession."

[35] Reg. section 1.937-1(f)(1).

[36] This rule applies only if the individual moves to Puerto Rico and stays there for at least 183 days during the tax year of the change of residence. Thus, if the individual moves to Puerto Rico during the second half of the tax year, they would be considered a bona fide resident of Puerto Rico only the following tax year, if other conditions are met.

> [Puerto Rico] than to the United States or any foreign country. D is treated as satisfying the tax home and closer connection tests for [2024]. Accordingly, assuming that D also satisfies the presence test (i.e., the 183-day test), D is a bona fide resident of [Puerto Rico] for all of taxable year [2024].[37]

If D relocates to Puerto Rico in January 2024 and stays there until the end of August 2024 but returns to the United States for the remainder of the tax year, D would meet the requirements of the physical presence test. Nevertheless, D might encounter difficulty establishing the closer connection test and the tax home test for the latter part of the year, which could result in D not being considered a bona fide resident of Puerto Rico for 2024, despite meeting the physical presence test during the first half of the year and satisfying the bona fide residence test for each of the three following years.

V. Bona Fide Residence — Tax Year Leaving Puerto Rico

If a U.S. citizen who has maintained bona fide residency in Puerto Rico for at least two years ceases to be a resident of Puerto Rico, section 933(2) and the regulations thereunder[38] exempt from their U.S. gross income any income derived during the year of change to the extent that income is from Puerto Rican sources and is attributable to the portion of the tax year preceding the change in residence from Puerto Rico to either the United States or any other country, provided that they meet all the following conditions:[39]

i. they are a bona fide Puerto Rican resident for at least the two tax years preceding the change year;
ii. they cease to be a bona fide Puerto Rican resident during the tax year;
iii. they cease to have a tax home in Puerto Rico during the tax year; and
iv. they have a closer connection to Puerto Rico than the United States or a foreign country throughout the part of the tax year preceding the date the individual ceases to have a tax home in Puerto Rico.[40]

See the following example:

> R, a U.S. citizen who files returns on a calendar year basis, satisfies the requirements to be a bona fide resident of Puerto Rico for years [2022] and [2023]. From January through April [2024], R continues to reside and maintain his principal place of business in, and closer connection to, Puerto Rico. On May 5, [2024], R moves and changes his principal place of business (tax home) to State N and later that year establishes a closer connection to the United States than to Puerto Rico. R would not satisfy the physical presence test for [2024] with respect to Puerto Rico. Moreover, because R had a tax home outside of Puerto Rico and establishes a closer connection to the United States in [2024], R does not satisfy the requirements of the tax home test and the closer connection test to be a resident of Puerto Rico for [2024]. However, because R was a bona fide resident of Puerto Rico for at least two taxable years before his change of residence to State N in [2024], for the taxable year [2024], he may exclude from U.S. taxation any income derived from Puerto Rican sources and attributable to the period from January 1 through May 4, [2024].[41]

If R moved to Puerto Rico in 2021, he should be able to satisfy the tests relating to his departure from Puerto Rico in 2024, but he may not satisfy the residency tests for the year of his move to Puerto Rico, because he will not have been a resident of Puerto Rico for at least three years after the year of his move. Further, if R moved from

[37] *See* reg. section 1.937-1(g), Ex. 8.

[38] Reg. sections 1.933-1(b) and 1.937-1(f)(2).

[39] Reg. section 1.937-1(f)(2)(ii).

[40] *Id.* This rule applies regardless of the individual's failure to meet the physical presence, tax home, and closer connection tests for the entire tax year in which the individual moves from Puerto Rico.

[41] *See* reg. section 1.937-1(g), Ex. 10.

Puerto Rico to the United States after having met the tests above, for more than 183 days during 2024, he could exclude any income derived from Puerto Rican sources from U.S. taxation for the period that he met those tests.[42]

While the IRS's position is not explicitly stated, based on an old revenue ruling,[43] it would likely hold that income originating from Puerto Rican sources and linked to the period before a change in residence from Puerto Rico, even if received or accrued in a tax year following the year of the residence change, is eligible for exclusion under section 933(2).

VI. Excluding Income Received by U.S. Citizen Residents of Puerto Rico

A. General Source of Income

Under section 933, income derived from Puerto Rican sources is typically exempted from a taxpayer's gross income if the individual qualifies as a bona fide resident of Puerto Rico for the entire tax year (except for special rules when a U.S. citizen relocates to or from Puerto Rico).[44] Thus, a bona fide resident of Puerto Rico is exempt from U.S. federal income tax only for income that is Puerto Rican-source income.

The rules outlined in reg. section 1.937-2 are applicable when determining whether income is from Puerto Rican sources. Sections 861 through 865, along with their corresponding regulations, are generally employed to ascertain both gross and taxable income from sources within and outside Puerto Rico.[45] When applying these principles, the term "United States" will be substituted with the relevant possession (in this case, Puerto Rico), and, when applicable, substitute the term "bona fide resident of" followed by Puerto Rico for "United States resident."[46] As an illustration, the rule in section 865(a)(1) stating that "income from the sale of personal property by a United States resident shall be sourced in the United States" would be interpreted as "income from the sale of personal property by a bona fide resident of Puerto Rico shall be sourced in Puerto Rico." However, the regulations emphasize that under no circumstances will a bona fide resident of Puerto Rico end up with more income from sources within Puerto Rico than the amount of income from sources within the United States that a similarly situated U.S. person, not a bona fide resident, would have under sections 861 through 865.[47]

Further, income from sources in Puerto Rico will not include any item of income as determined under sections 861 through 865, and the regulations thereunder, if that income is either (A) derived from sources within the United States or (B) effectively connected with the conduct of a trade or business within the United States effectively connected income.[48] Therefore, according to these ordering rules, it is important to initially establish whether a particular income item is from U.S. sources or is ECI. The Puerto Rican-source rules outlined in reg. section 1.937-2 would then be used to ascertain if the income qualifies as Puerto Rican-source income.

The following example will illustrate the ordering rules. Assume a U.S. limited partnership (PQR LP) is engaged in the business of trading in commodities. PQR LP has three partners P, Q, and R. P and Q are bona fide residents of Puerto Rico, and R is a resident of State A. The partnership does not have a U.S. office or fixed place of business. All the trading decisions, negotiations, and execution of contracts are concluded by P and Q in Puerto Rico. R is a passive investor in the partnership.

The first step would be to determine whether the partnership is engaged in a U.S. trade or business and whether income from trading in commodities would be treated as ECI. Under the commodities "trading safe harbor," foreign

[42] Section 933(2); reg. section 1.937-1(f)(2)(ii).

[43] *See* Rev. Rul. 68-7, 1968-1 C.B. 345.

[44] Reg. section 1.933-1(a). The exemption applies irrespective of whether the eligible person is a U.S. citizen, a resident alien, or a nonresident alien. *Id.* Under section 876, alien individuals who are bona fide residents of Puerto Rico are not subject to tax under the provisions of section 871 ("Tax on Nonresident Alien Individuals"). Instead, these alien individuals are subject to tax on their worldwide income under section 1 at the rates applicable for U.S. tax residents. However, section 933 and the regulations thereunder allow such NRA individuals to exclude Puerto Rican-source income from their gross income.

[45] Reg. section 1.937-2(b).

[46] *Id.*

[47] *Id.*

[48] Reg. section 1.937-2(c)(1)(i)-(ii).

persons (including foreign entities) that trade in stock, securities, or commodities (and derivatives based on stock, securities, or commodities) in the United States for their own account will not be considered to be engaged in a U.S. trade or business.[49] That trading can be done in the United States by the taxpayer through its own officers, managers, and employees, or through a resident broker, commission agent, custodian, or other agent, regardless of whether the employee or agent has discretionary authority to make decisions carrying out the transactions.[50] It is also irrelevant whether the foreign person has an office or other fixed place of business in the United States. If PQR LP is trading on its own behalf, it should meet the commodities trading safe harbor, and the partnership income allocated to P and Q should not be treated as ECI.[51]

After establishing that the income is not ECI, the next step is to ascertain if the income originates from U.S. sources under the general source rules of sections 861-865. Typically, under section 865(a), gain resulting from selling personal property (excluding inventory) is attributed to the seller's place of residence.[52] When a partnership sells property, except as provided in regulations, the determination of whether the sale is by a resident or a non-U.S. resident is made at the partner level for the partner's distributive share.[53] Therefore, when a person classified as a U.S. resident sells personal property, the income is typically considered U.S. source. Conversely, if an individual categorized as a nonresident sells personal property, the income is generally sourced outside the United States.

To apply the residence-based rule of section 865(a), section 865(g)(1) and (2) typically treats a U.S. citizen or resident alien as a nonresident regarding a personal property sale *only if* that individual maintains a tax home in a foreign country and pays an income tax of at least 10 percent to a foreign country in connection with the sale.[54] This implies that a U.S. citizen or resident alien who qualifies as a bona fide Puerto Rican resident, typically meeting the tax home test, may be eligible to treat any gain from the sale of personal property as Puerto Rican-source income, qualifying for the section 933 exclusion, only if the individual pays an income tax to Puerto Rico at an effective rate of at least 10 percent on the gain.[55] Section 865(g)(3) provides an exception to this requirement *for sales of corporate stock (but not other personal property)* by bona fide residents of Puerto Rico if the following three conditions are met: (1) the individual should be a bona fide resident of Puerto Rico for the entire tax year when the stock sale takes place;[56] (2) the individual's profit should stem from selling stock in a corporation that is actively engaged in conduct of a trade or business in Puerto Rico;[57] and (3) the gain must arise from selling stock in a corporation that, over the three years leading up to the close of the tax year just before the sale, derived more than 50 percent of its gross income from actively conducting trade or business in Puerto Rico.[58] Any gain derived from sources outside the United States because of the exception under section 865(g)(3) should be considered income from Puerto Rican sources.[59]

While the exception to the 10 percent rule provided in section 865(g)(3) does not apply to sales of personal property other than corporate stock, section 865(j)(3) grants Treasury the authority to issue regulations that can eliminate the 10 percent income tax requirement for income derived from sales of other personal property by

[49]Section 864(b)(2)(B)(ii).

[50]Reg. section 1.864-2(d)(2).

[51]This article does not discuss the trading safe harbor in detail, which should be carefully analyzed to determine whether relevant trading activities qualify for it.

[52]For purposes of section 865, any possession of the United States (such as Puerto Rico) is treated as a foreign country. Section 865(i)(3).

[53]Section 865(i)(5).

[54]Section 865(g)(1)(A)(i)(I) and (g)(2). *See also* Joel D. Kuntz, Robert J. Peroni, and John A. Bogdanski, *U.S. International Taxation*, "Taxation of Individual Residents of Puerto Rico," Chapter D1 (2010).

[55]This conclusion, however, can be reached only if the individual does not maintain an office or fixed place of business in the United States that materially participates in generating the income, as further discussed below.

[56]Section 865(g)(3).

[57]Section 865(g)(3)(A).

[58]Section 865(g)(3)(B).

[59]Reg. section 1.937-2(f)(2)(i)(A).

bona fide residents of Puerto Rico. The IRS, as stated in Notice 89-40, has indicated that coming regulations under section 865(j)(3) will exempt a bona fide resident of Puerto Rico from the 10 percent tax requirement outlined in section 865(g)(2) for the entire tax year.[60]

Consequently, a bona fide resident of Puerto Rico, typically meeting the tax home test, will be treated as a non-U.S. resident for section 865 sourcing rules, irrespective of the 10 percent requirement. Thus, for example, a bona fide Puerto Rican resident's gain from the sale of personal property that is not inventory property will be Puerto Rican-source income under section 865(a)(2) and (g)(2), without regard to whether a 10 percent tax is paid to Puerto Rico. This is critical because the Puerto Rican resident seller will generally pay no U.S. federal income tax on the gain because of section 933, unless the exception under section 865(e) applies.[61] However, the rule contained in Notice 89-40 may not be considered as law unless specific regulations under section 865(j)(3) are issued. Still, it likely reflects the position of the IRS for applying the 10 percent rule for a bona fide Puerto Rican resident. Section 865(j)(3) provides that the legislative intent is "that regulations to be promulgated under section 865(j)(3) provide the exception only in the case where the possession has delinked from the mirror Internal Revenue Code."[62] There is no additional guidance on this, but a plain reading suggests that the exception provided by Notice 89-40 would apply to Puerto Rico as only the following three U.S. territories have adopted a "mirrored" version of the code: Guam, the U.S. Virgin Islands, and the Commonwealth of the Northern Mariana Islands.[63] Even though no regulations under section 865(j)(3) are issued to date, Notice 89-40 states that it "serves as an administrative pronouncement as that term is described in section 1.6661-3(b)(2)[64] of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or procedure."[65] It further provides that the rules contained therein will be "incorporated in regulations to be promulgated under Section 865 and any modification of the rules will be prospective only."[66]

Thus, with the application of Notice 89-40, a bona fide resident likely will be treated as a nonresident for section 865 purposes. As briefly mentioned above, section 865(e)(1) provides an exception to the residence-based general source rule in section 865(a) for sales by *U.S. residents* who maintain offices or fixed places of business in foreign countries.[67] Section 865(e)(1) treats the gain from the sale of personal property attributable to such fixed place of business as foreign-source income. However, section 865(e)(1) does not apply unless the U.S. resident actually pays an income tax of at least 10 percent to the foreign country for the income from the sale. Like the exception for the application of section 865(g)(2), section 865(j)(3), again, authorizes Treasury to issue regulations waiving this 10 percent tax requirement in appropriate cases for section 933 purposes. Thus, for example, Treasury could provide that a U.S. citizen or resident alien who is a bona fide resident of Puerto Rico and maintains a fixed place of business there has Puerto Rican-source income on sales attributable to that fixed place of business, even if the citizen or resident alien does not pay at least a 10 percent tax on the gain. Treasury and the IRS have not issued any regulations on this issue. However, because a bona fide Puerto Rican resident would likely be treated as a "nonresident" for section 865 purposes under Notice 89-40, as discussed above, section 865(e)(1) should not apply to this case. Instead, section 865(e)(2), as discussed below, should apply to determine whether any sale by nonresidents will be U.S.-source income.

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[60] *See* Notice 89-40, 1989-1 C.B. 681.

[61] *See* section 865(e)(1), 865(e)(2).

[62] *See* Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647), Senate Report 100-445.

[63] In general, a mirror code exists when the income tax laws of a U.S. territory are generally identical to the Internal Revenue Code (except for the substitution of the name of the relevant territory for the term "United States" where appropriate).

[64] Section 6661 was repealed in 1989. Similar language now is found in the regulations under section 6662. *See* reg. section 1.6662-4(d)(3)(iii).

[65] *See* Notice 89-40, at section 1.

[66] *Id.*

[67] *See supra* note 61.

Under section 865(e)(2), if a nonresident (which would include a bona fide resident of Puerto Rico under Notice 89-40) maintains a fixed place of business in the United States, income attributable to it from the sale of personal property is sourced to the United States for which no exemption under section 933 will be allowed. Thus, it is imperative that any gain from the sale of personal property (other than stock in a corporation) is not attributable to a fixed place of business of PQR LP in the United States.

Generally, an office or other fixed place of business includes a place, site, structure, or other similar facility through which the taxpayer conducts a trade or business.[68] It includes a factory, store, sales outlet, workshop, and so forth.[69] A fixed place of business of an "independent agent" is never considered as the fixed place of business of the taxpayer, regardless of whether the agent has the authority to negotiate and finalize contracts for the taxpayer or keeps a stock of goods to fulfill orders on the taxpayer's behalf.[70] A fixed place of business of a "dependent" agent is considered a fixed place of business of the taxpayer only if the agent either (1) holds the authority to consistently negotiate and finalize contracts in the taxpayer's name or (2) maintains a stock of the taxpayer's merchandise, regularly fulfilling orders on their behalf.[71]

A sale is considered to be attributable to a fixed place of business that a nonresident alien or foreign corporation has in the United States only if the fixed place of business is a "material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that" fixed place of business.[72] Generally, if a U.S. fixed place of business actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale, it may result in a "material factor" realization of gain.[73]

In this case, R is a passive investor and does not actively participate in the decision-making, negotiation, and execution of contracts. Further, PQR LP does not have any other office or fixed place of business. As a result, income of PQR LP from trading in commodities allocable to P and Q should not be treated as U.S.-source income.

The next step is to determine whether such income would be treated as income from Puerto Rican sources for the exemption under section 933. Applying the rules outlined in reg. section 1.937-2, income from the sale of personal property by a bona fide Puerto Rican resident shall be sourced in Puerto Rico. Further, because in the given scenario PQR LP does not maintain a U.S. office or fixed place of business, income of PQR LP allocable to P and Q should be treated as income from Puerto Rican sources eligible for the exemption under section 933.

B. Specific Source Rules

Generally, the principles of sections 861 through 865 of the code and the rules outlined in reg. section 1.937-2(b) (relating to the determination of income from sources within and without the United States) will be applied to determine the income from sources within the United States and Puerto Rico.[74] However, certain special rules apply for dividends, interests, inventory sales, and capital gains.[75]

1. Dividends

Dividends received by a U.S. citizen who is a bona fide resident of Puerto Rico from a Puerto Rican corporation will typically be treated as derived from sources within Puerto Rico.[76] However, special rules would apply if at least 25 percent of the Puerto Rican corporation's income is ECI,[77] or if the recipient meets the definition of a possessions shareholder.[78] This term refers to a bona fide resident of Puerto Rico who owns, directly or indirectly, at least 10 percent of the total

[68] Reg. section 1.864-7(b)(1).

[69] Reg. section 1.864-7(b).

[70] Reg. section 1.864-7(d)(2).

[71] Reg. section 1.864-7(d)(1).

[72] Reg. section 1.864-6(b).

[73] Reg. section 1.864-6(b)(3)(i).

[74] *See* Mary F. Voce and Pallav Raghuvanshi, "Investing in Puerto Rico: U.S. Tax Considerations," *Tax Notes Int'l*, Mar. 20, 2017, p. 1099.

[75] As discussed in more detail below, some of these special rules are turned off when determining whether a Puerto Rican corporation is a CFC.

[76] Reg. section 1.937-2(b); section 861(a)(2)(A).

[77] *See* last sentence of reg. section 1.937-2(b); section 861(a)(2)(B).

[78] *See* reg. section 1.937-2(g)(1)(i).

voting stock of the Puerto Rican corporation making dividend distributions.[79]

Generally, under the ordering rules, a portion of dividends by a Puerto Rican corporation will be treated as U.S. source if 25 percent or more of the gross income from all sources was ECI for the three-year period ending with the close of its tax year preceding the declaration of a dividend.[80] In this case, dividends paid by the Puerto Rican corporation will be treated as U.S.-source income in an amount that bears the same ratio to these dividends as the gross income of the corporation for such period that was ECI bears to its gross income from all sources.[81]

In a possessions shareholder's case, the rules determining the source of dividends vary depending on whether the Puerto Rican corporation is engaged in an active trade or business within Puerto Rico.

a. Not Engaged in Active Trade or Business Within Puerto Rico

Dividends received by a U.S. citizen who is a possessions shareholder will be treated as derived from sources within Puerto Rico based on the *possession source ratio* of the dividend. For this metric, the numerator represents the Puerto Rican corporation's gross income from sources within Puerto Rico, and the denominator is its overall gross income.[82]

b. Engaged in Active Trade or Business Within Puerto Rico

For a Puerto Rican corporation actively engaged in a trade or business within Puerto Rico, the total dividends distributed to a possessions shareholder will be considered as income from Puerto Rican sources if two conditions are met: (1) at least 80 percent of the gross income of the Puerto Rican corporation over the three-year period ending at the close of the tax year in which the dividend was paid originated from sources within Puerto Rico or was effectively connected with the conduct of a trade or business in Puerto Rico as determined under the provisions of reg. section 1.937-3; and (2) at least 50 percent of the gross income during that three-year period was derived from actively conducting a trade or business within Puerto Rico (referred to as the "80-50 test").[83] Any income considered to be effectively connected with the conduct of a Puerto Rican trade or business will not include any item of income from sources within the United States or effectively connected to a U.S. trade or business.[84]

If the taxpayer fails to meet the 80-50 test, dividends will be from Puerto Rican sources based on the possession source ratio. The regulations also include a subsidiary look-through rule. According to this rule, if a Puerto Rican corporation holds (either directly or indirectly) a minimum of 25 percent (by value) of another corporation's stock, the Puerto Rican corporation is treated as if it directly received its proportional portion of the income of the other corporation and actively engaged in any trade or business conducted by that other corporation.[85]

2. Interest

Generally, interest paid or accrued by a Puerto Rican corporation is treated as income from sources within Puerto Rico to the extent this interest is allocable to assets that generate, have generated, or could reasonably have been expected to generate income from Puerto Rican sources or income that is effectively connected with the conduct of a trade or business within Puerto Rico.[86] If the Puerto Rican corporation that is paying the interest meets the 80-50 test, the entire amount of the interest will be treated as

[79] Reg. section 1.937-2(g)(1)(i)(B).

[80] Reg. section 1.937-2(c)(1)(i)-(ii); section 861(a)(2)(B).

[81] Section 861(a)(2)(B). There are exemptions specified under section 884(d)(2), section 243(e) (pertaining to particular dividends from foreign corporations), and section 992(a) (associated with domestic international sales corporations). However, the rules applicable for bona fide Puerto Rican corporations provide that special rules relating to dividends for which deductions are allowable under section 243 or 245 do not apply. *See* reg. section 1.937-2(g)(2).

[82] Reg. section 1.937-2(g)(1)(i)(A).

[83] Reg. section 1.937-2(g)(1)(ii). In applying these tests, there is a look-through rule for corporations in which the Puerto Rican corporation owns, directly or indirectly, at least 25 percent (by value) of the stock. Reg. section 1.937-2(g)(1)(iv).

[84] Reg. section 1.937-3(c).

[85] Reg. section 1.937-2(g)(1)(iv).

[86] Reg. section 1.937-2(i)(1)(i).

income from Puerto Rican sources.[87] Further, interest payments or accruals from a partnership will be regarded as income sourced within Puerto Rico to the extent that this interest is linked to income effectively connected with the operation of a trade or business in Puerto Rico.[88]

3. Gain From Certain Property Transactions

Generally, gain from the sale of certain property,[89] like the stock of a corporation or certain investment partnerships,[90] by an individual recognized as a bona fide resident of Puerto Rico is not treated as Puerto Rican-source income of a U.S. citizen (and thus will be subject to tax by the United States) if the stock was owned by the seller before the seller became a bona fide resident of Puerto Rico and the seller was a U.S. citizen or resident (and not a bona fide resident of Puerto Rico) for any of the 10 years preceding the year of the sale.[91] Nevertheless, the regulations permit an individual to choose to designate a portion of the gain as originating from sources within Puerto Rico. This designation is based on the proportion of the individual's holding period for the stock during which they were a resident of Puerto Rico.[92] For marketable securities, the gain linked to the possession holding period is determined based on the fair market value at the market's close on the first day of that period.[93] For nonmarketable property, the gain linked to the possession holding period is calculated by multiplying the total gain by a fraction: the days in the possession holding period over the total days in the individual's holding period.[94]

On the other hand, if a U.S. citizen purchases the stock of a corporation or certain investment partnerships after becoming a bona fide resident of Puerto Rico and remains a bona fide resident of Puerto Rico through the year in which the stock is sold, the gain on the sale should be Puerto Rican-source gain not subject to tax by the United States.[95]

The regulations are silent on how losses from the disposition of a property are allocated and whether these losses can be used to offset other U.S.-source income. The regulations provide that a taxpayer generally cannot deduct expenses, losses, or other deductions, or claim any credit associated with or chargeable against any income excluded under section 933.[96] One interpretation suggests that if losses cannot be attributed to income excluded under section 933, they could be used to offset other income from the U.S. sources. Following this approach, the losses would be available in the United States regardless of when the property was acquired (whether before or after the individual moved to Puerto Rico).

VII. CFCs and PFICs: Puerto Rican Tax Issues

A. Special Rules for Determining Puerto Rican CFCs

In general, a CFC is a foreign (that is, non-U.S.) corporation[97] that is owned (directly, indirectly, or through certain constructive ownership rules)[98] more than 50 percent (by vote or value) on any day during the tax year of this foreign corporation by one or more U.S. persons, each of whom are treated as "U.S. 10 percent Shareholders."[99] This is any U.S. person, as defined in section 957(c), who owns (directly, indirectly, or constructively)[100] 10 percent or more of the total combined voting power or value of shares in the foreign corporation.[101]

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[87] Reg. section 1.937-2(i)(1)(ii).

[88] Reg. section 1.937-2(i)(2).

[89] *See* section 954(c)(1)(B) for the types of property included for such sale transaction.

[90] *See* section 731(c)(3)(C)(i) for the definition of an investment partnership, which generally includes a partnership that has never been engaged in a trade or business in which substantially all its assets consist of passive assets like stock in a corporation, notes, foreign currencies, and so forth.

[91] Reg. section 1.937-(2)(f)(1).

[92] Reg. section 1.937-2(f)(1)(vi).

[93] Reg. section 1.937-2(f)(1)(vi)(A). If an individual is a bona fide resident of the relevant possession for multiple continuous periods, the gain is the sum of portions attributable to each holding period. *Id.*

[94] Reg. section 1.937-2(f)(1)(vi)(B). If there are multiple continuous periods of residency, the numerator includes the aggregate days for each possession holding period. The denominator considers days required by applicable holding period rules in the IRC. *Id.*

[95] *Id.*

[96] Section 933; reg. section 1.933-1(c).

[97] A Puerto Rican corporation is treated as a foreign corporation, as discussed above.

[98] *See* section 958(a) and (b).

[99] Section 957(a).

[100] The direct or indirect ownership of shares is determined by applying the rules of section 958(a).

[101] Section 951(b).

A U.S. person generally includes any U.S. citizen or resident of the United States.[102] However, to determine whether a Puerto Rican corporation meets the definition of a CFC, an individual will *not* be considered to be a "U.S. person" of the corporation (even if the individual would otherwise meet the general definition of a U.S. person) if (i) the individual is a bona fide resident of Puerto Rico *and* (ii) based on the general source rules, a dividend paid by the Puerto Rican corporation would be treated as income derived from sources within Puerto Rico.[103]

The source rules for dividends paid by a Puerto Rican corporation are extremely complex, and different rules apply for determining the source of actual dividends paid by a Puerto Rican corporation and for whether the corporation is a CFC. For the latter, the regulations clearly turn off the special source rules for dividends from a Puerto Rican corporation,[104] so the general source rules, which mirror the principles of sections 861 through 865 of the code, would apply.[105] However, these rules are less than clear in this context.

Under one interpretation of the general source rules, all dividends from a Puerto Rican corporation arguably may be treated as Puerto Rican-source income for purposes of the CFC rules, in which case the bona fide Puerto Rican resident would be relieved from reporting any subpart F income or section 956 inclusions for a Puerto Rican corporation.[106] This interpretation applies the mirror application of section 861(a)(2)(A) in a manner that assumes that because a dividend from a U.S. corporation will always be a U.S.-source dividend, a dividend from a Puerto Rican corporation should therefore always be treated as Puerto Rican source.

However, there are two compelling reasons why the above interpretation is incorrect. First, the general source rules include a limiting rule, under which a bona fide resident of Puerto Rico may not have more income from sources within Puerto Rico than the amount of income from sources within the United States that a similarly situated U.S. person who is not a bona fide resident of Puerto Rico would have.[107] Second, Treasury regulations exclude from the Puerto Rican source any item of income determined under the rules to be from sources within the United States.[108] Section 861(a)(2) provides that if 25 percent or more of a foreign corporation's income consists of U.S. ECI, dividends from that foreign corporation will be considered to be from U.S. sources in the ratio that the gross income from U.S. ECI bears to total gross income. In addition to the limiting rule, this provision presumably removes a corporation that meets this test from the "mirror" application of sections 861 through 865 of the code to determine whether dividends from this corporation are Puerto Rican source.

Accordingly, under another interpretation (which is likely the correct one), 100 percent of the dividends paid by a Puerto Rican corporation would be Puerto Rican-source income only if less than 25 percent of the company's total gross income for the three-tax-year period ending immediately before the tax year in which the dividend is paid is ECI.[109] Under this second interpretation, if a Puerto Rican corporation derives 25 percent or more of its gross income in the form of U.S. ECI, a dividend paid in any year would be treated as U.S.-source income to the extent of the company's U.S. ECI for that three-year period.[110] Under this interpretation, a Puerto Rican corporation that is owned more than 50 percent by U.S. 10 percent shareholders (including those who are bona fide residents of Puerto Rico), which derives 25 percent or more of its gross income in the form of U.S. ECI, is a CFC. If this

[102] Sections 951(c) and 7701(a)(30).

[103] Section 957(c)(1). For the CFC rules, it is unclear whether 100 percent, or some lesser percentage, of the foreign corporation's dividends must be Puerto Rican-source income. If a U.S. citizen who is a bona fide resident of Puerto Rico is considered to be a U.S. 10 percent shareholder to determine whether a Puerto Rican corporation is a CFC, that individual will also be subject to taxation as a U.S. 10 percent shareholder of the CFC (that is, that individual will be required to pay U.S. tax on the CFC's subpart F income and section 956 inclusions on a current basis).

[104] Reg. section 1.957-3(b)(2).

[105] Reg. section 1.957-3(a)(2)(iv) and (b)(2).

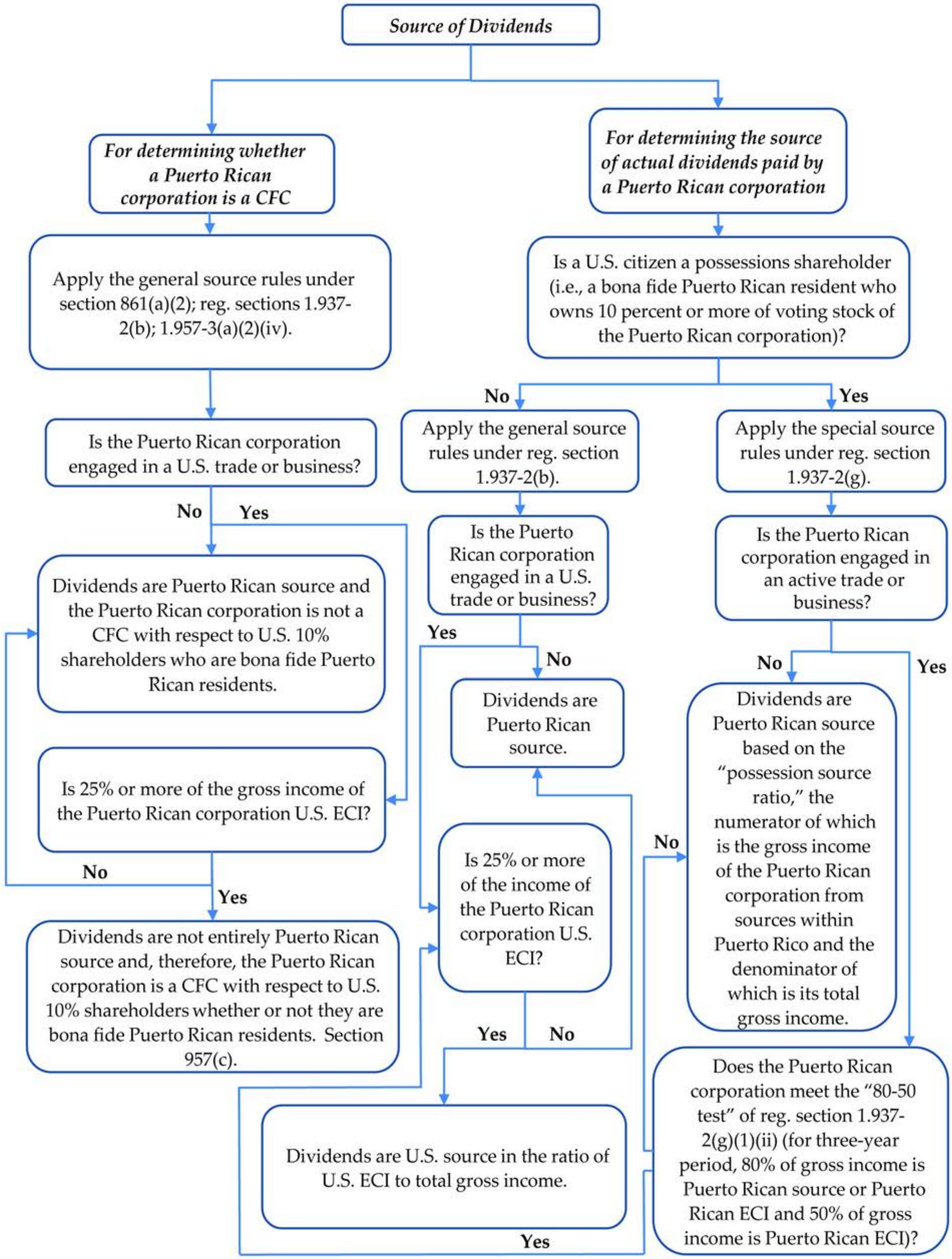
[106] Reg. section 1.937-2(b).

[107] *Id. See also* T.D. 9391 (corrected May 13, 2008).

[108] *See* reg. section 1.937-2(c), as further discussed above.

[109] Reg. section 1.937-2(c)(1) provides, in relevant part, that "income from sources within the relevant possession will not include any item of income determined under the rules of sections 861 through 865 and the regulations under those provisions to be — (i) From sources within the United States."

[110] Section 861(a)(2); reg. sections 1.937-2(b) and 1.957-3(b)(2).



Note: Based on Mary F. Voce and Pallav Raghuvanshi, "Investing in Puerto Rico: U.S. Tax Considerations," *Tax Notes Int'l*, Mar. 20, 2017, p. 1099.

the CFC will be subject to U.S. tax on a current basis on (i) their pro rata share of certain categories of income (known as subpart F income and global intangible low-taxed income) earned by the CFC, regardless of whether it is distributed; and (ii) their pro rata share of the amount of the CFC's earnings and profits that are invested in specified categories of U.S. property during the tax year (section 956 inclusions). To prevent unintended adverse U.S. federal tax consequences resulting from a CFC classification under this interpretation, U.S. investors who are bona fide residents of Puerto Rico should consider operating their U.S. trade or business through a U.S. corporation while establishing an intercompany relationship with a Puerto Rican corporation solely engaged in a Puerto Rican trade or business. This arrangement would prevent the ECI effect from the U.S. trade or business by having the U.S. corporation serve as a blocker. Profits should be allocated between the U.S. and Puerto Rican corporations at arm's length.

B. Applying PFIC Rules to Bona Fide Residents

A foreign corporation is a PFIC if 75 percent or more of its gross income for a tax year is passive investment income or if 50 percent or more of its assets (by value) held during the tax year are held for the production of passive income.[111] If a U.S. person receives an excess distribution (defined as the distributions in any tax year that exceed 125 percent of the average annual distributions during the three preceding tax years) from a PFIC or realizes gain on the sale or other disposition of stock in a PFIC, that distribution or gain will be taxed as ordinary income and as earned over the holding period for the stock.[112] Income allocated to a year before the taxpayer received an "excess distribution" or realized gain is susceptible to an interest charge for tax deferral.[113] Under certain conditions, a shareholder has the option to make an election, known as the qualified electing fund election,[114] allowing them to promptly pay taxes on their portion of PFIC earnings.[115] This involves marking the stock to market and settling taxes as if the stock had been sold on that day.[116]

While a Puerto Rican corporation may qualify as a PFIC for U.S. citizens who are bona fide residents of Puerto Rico, proposed regulations provide that such an individual would only have adverse U.S. tax consequences from an investment in a Puerto Rican corporation that is a PFIC to the extent a PFIC distribution or gain from the sale of PFIC stock is allocated to a tax year during which the shareholder was not a bona fide resident of Puerto Rico entitled to exclude Puerto Rican-source income from U.S. income under section 933.[117] However, the proposed rules do not exempt these individuals from the obligation to file IRS Form 8621, "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund." The regulations provide an exemption from reporting and filing for U.S. shareholders who are bona fide residents of a U.S. territory with a mirror code system of taxation, which includes Guam, the Northern Mariana Islands, and the U.S. Virgin Islands.[118] However, the regulations do not include shareholders who are bona fide residents of Puerto Rico or American Samoa.

For most Puerto Rican corporations engaged in active trade or business (for example, software development, digital marketing, consultancy, e-commerce, and so forth) PFIC status should usually not be a concern.[119] However, a Puerto Rican corporation might readily satisfy the tests to

[111] Section 1297(a).

[112] Section 1291(a)(1) and (2).

[113] Section 1291(a), (b), and (c).

[114] A U.S. resident who makes a QEF election must include their proportionate share of the earnings of the PFIC in their U.S. income on a current basis.

[115] Sections 1293, 1295, 1296, and 1291(d).

[116] Section 1296.

[117] Prop. reg. section 1.1291-1(f). Proposed regulations generally are only directional in that they provide insight into how the IRS is interpreting the law and are not binding on the IRS or taxpayers, unless the IRS clearly states otherwise. However, the proposed regulations relating to PFICs have been in proposed form for more than 20 years, and as a practical matter, both taxpayers and the IRS tend to rely upon them.

[118] Reg. section 1.1298-1(c)(8).

[119] Even on those facts, a foreign corporation can be a PFIC. For example, if it sold products and broke even or had a loss on those activities, but it had positive interest income on working capital, it would be a PFIC.

be a PFIC if it engages in no activity other than holding less than 25 percent of the shares of an active Puerto Rican corporation. Further, if a Puerto Rican corporation is used purely for passive investment purposes, it may become important to elect that the entity be treated as a passthrough entity for federal income tax purposes to the extent the underlying income would be treated as income from Puerto Rican sources. In certain situations when a Puerto Rican corporation is used for providing services, it can consider distributing cash on a regular basis to mitigate the risk of PFIC status.

VIII. Other Tax Considerations

While the law seems to be silent, there are other tax considerations that a taxpayer may take into account that, under suitable facts, may aid the taxpayer to mitigate overall tax exposure.

A. Repatriation of Untaxed Earnings of Non-U.S. Corporations

1. Loan by a CFC to a Puerto Rican Corporation

Under section 956, U.S. shareholders of a CFC will be subject to U.S. tax as a "constructive dividend"[120] when the CFC invests its earnings in certain specified categories of U.S. property. One category includes loans made by a CFC to a U.S. shareholder (or a related U.S. corporation).[121] However, any loans to a foreign person, whether related or not, are not treated as investments in U.S. property for section 956 purposes. Thus, if a U.S. shareholder of a CFC becomes a bona fide resident of Puerto Rico and forms a Puerto Rican corporation, a loan from the CFC to the Puerto Rican corporation should generally not be subject to section 956.

Under specific antiabuse regulations, a CFC will be considered to indirectly hold investments in U.S. property acquired by a related foreign corporation "if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of section 956 with respect to the controlled foreign corporation."[122] However, this antiabuse rule specifically applies to U.S. property held indirectly by a CFC through a related foreign person. As mentioned, U.S. property excludes loans to foreign corporations, including those in Puerto Rico. So it is probable that the funds can be used either for investment by the Puerto Rican corporation (assuming it is not invested in a related U.S. corporation) or for Puerto Rican trade or business purposes. Further, subject to the sourcing rules for dividends, any dividends from the Puerto Rican corporation to a bona fide resident of Puerto Rico could also be exempt from U.S. tax.

Also, careful consideration should be given to whether any debt cancellation by the CFC would result in adverse tax consequences for either the Puerto Rican corporation or the bona fide Puerto Rican resident.[123]

2. Merger of a CFC Into a Puerto Rican Corporation

As an alternative to providing a loan to a Puerto Rican corporation, a CFC may explore the option of merging into a newly established Puerto Rican corporation through an asset reorganization if all relevant details align appropriately. In such a merger, the CFC's E&P would generally be carried over to the surviving Puerto Rican corporation.[124]

Assuming the Puerto Rican corporation meets the possession source ratio requirement or the 80-50 test, if it is engaged in an active trade or business in Puerto Rico, any dividends by the Puerto Rican corporation, including the distributions of the untaxed E&P of the merged CFC, would likely be eligible for the section 933 exemption.

[120] The amount of a constructive dividend for a U.S. shareholder of a CFC is the lesser of the following: (1) the excess (if any) of the U.S. shareholder's pro rata share of the average of the amounts of "United States property" held (directly or indirectly) by the CFC as of the close of each quarter of such tax year over the amount of E&P previously taxed under section 959(c)(1)(A) regarding such shareholder, or (2) the U.S. shareholder's pro rata share of the applicable earnings of the CFC. Section 956(a). The applicable earnings of a CFC is the sum of its accumulated E&P (not including deficits) and current E&P reduced by distributions during the current year and certain previously taxed E&P. *See* sections 956(b)(1) and 959(c)(1).

[121] Section 956(c)(1)(C) and (2)(F).

[122] *See* reg. section 1.956-1T(b)(4).

[123] This is beyond the scope of the article.

[124] Sections 381(a) and (c).

It is essential, however, to carefully consider the implications of section 367(a), including the obligation to enter into a gain recognition agreement to prevent an immediate gain on the merger.[125]

B. Use of Treaties

Treaties can potentially be used to receive certain U.S.- or foreign-source income to mitigate the U.S. tax exposure at the level of the U.S. shareholder who becomes a bona fide Puerto Rican resident.

As an illustration, consider a U.S. entity with all U.S. citizen owners engaged in acquiring royalty streams from various sources, including drug developers like scientists, pharmaceutical companies, and universities. Typically, these royalty streams, whether originating from U.S. or foreign sources, would be subject to taxation at the U.S. entity level (if it's a corporation) or at the individual level (if it's a passthrough entity).

To minimize the U.S. tax exposure on royalty income, U.S. citizens may contemplate relocating to Puerto Rico, establishing bona fide residency in Puerto Rico, and forming a Puerto Rican corporation. The Puerto Rican corporation would likely not be considered a CFC if all the conditions related to U.S. trade or business are satisfied. Subsequently, the Puerto Rican corporation can establish an entity in a jurisdiction with low or no taxes (Treaty Co), which provides benefits of the U.S. treaty to a U.S. person regardless of the Puerto Rican benefits received by the U.S. person and make a check-the-box election to be treated as a disregarded entity for U.S. tax purposes. Treaty Co is likely to qualify for treaty benefits because it derives income for local jurisdiction's tax purposes, and all its direct or indirect owners are U.S. citizens.[126]

Payments of U.S.-source royalties would likely be exempt under the applicable tax treaty. Treaty Co may be exempt from entity-level taxation in the local country (or may be subject to a lower tax rate), and if applicable, there may not be any withholding tax on distributions, a scenario commonly observed in certain foreign jurisdictions. As the Puerto Rican corporation should not be treated as a CFC, the royalties it receives should not be subject to any adverse U.S. anti-deferral rules.[127] While dividends from the Puerto Rican corporation may not be eligible for the section 933 exemption because it would likely fail the 80-50 test, any distribution upon the liquidation of the entity would likely be Puerto Rican-source income, exempt from U.S. tax.

IX. Conclusion

Individuals and investors in many industries, like technology (including blockchain and other emerging technologies), services (research and development, finance, law, marketing, management, and so forth), real estate management, pharmaceutical, and gaming have become increasingly interested in lowering their overall effective rate to 4 percent.

Because the U.S. tax law that grants exemptions to individuals who relocate to Puerto Rico is complex and often unclear, tax planning becomes essential before an individual becomes a bona fide Puerto Rican resident and sets up a business. While Puerto Rican tax planning strategies may work for some taxpayers, not many contenders interested in lowering their overall ETR by relocating to Puerto Rico can meet such arduous requirements because of their individual circumstances or their business model. Also, taxpayers who have already relocated to Puerto Rico should review their tax structures, income reporting, and filing obligations.

In 2021 this issue became particularly relevant because the IRS Large Business and International Division announced[128] the initiation of a campaign targeting taxpayers who have taken advantage of tax incentives under Act 60. The IRS's concern is that many of those individuals do not meet the requirements of the code for the exemption from federal income tax. As a result, it believes that these individuals may be evading U.S. tax by failing to report their income on a filed U.S.

[125] An analysis of section 367(a)'s application is beyond the scope of this article.

[126] Accordingly, section 897(c) would also not be applicable because income is considered "derived by" the ICAV in Ireland.

[127] The U.S. shareholder may still be required to report the Puerto Rican corporation as a PFIC on IRS Form 8621.

[128] *See* IRS release, "IRS Announces the Identification and Selection of Two Large Business and International Compliance Campaign(s)" (Jan. 27, 2021).

income tax return or by failing to file a U.S. tax return altogether. This campaign aims to address noncompliance in this area through various methods, including examinations, outreach, and soft letters. According to a report published by the IRS and Puerto Rican government officials, several Criminal Investigation special agents and forensic accountants are in Puerto Rico collaborating and exchanging information with the Puerto Rican government to identify cases of fraud and tax evasion.[129] In October 2020 the Justice Department indicted a partner of a large public accounting firm for purportedly facilitating tax evasion and wire fraud arising from aggressive Puerto Rican tax planning.[130]

Section 933 of the IRC and Act 60 in Puerto Rico undoubtedly present advantageous tax opportunities for U.S. investors. However, it is crucial to acknowledge that these benefits are not without their intricacies and potential pitfalls. The realization of these tax advantages is contingent upon navigating a complex landscape of limitations and conditions, making it essential to engage in thorough tax planning to avoid unintended and unfavorable consequences.

Despite Puerto Rico's status as a U.S. territory, the intricacies of federal income tax treat it as a foreign entity under section 933. This unique status necessitates a careful examination of whether a Puerto Rican corporation could be classified as a CFC, particularly in the context of U.S. citizens who are bona fide residents of Puerto Rico. In certain cases, individuals may find themselves obligated to include subpart F income or section 956 inclusions in their U.S. income, introducing an added layer of complexity. The absence of CFC rules does not exempt individuals from potential adverse implications related to the PFIC rules. Therefore, a comprehensive assessment is required to determine if there are any PFIC-related concerns and, if so, whether strategies can be implemented to circumvent them. Further, it is important to examine the regulations governing the source to fully comprehend eligibility for the exemption outlined in section 933.

While the transition of a U.S. citizen to bona fide Puerto Rican residency generally does not incur adverse U.S. federal income tax consequences, the importance of strategic tax planning cannot be overstated. This is especially true when considering a move to Puerto Rico, establishing a business there, or contemplating a return to the United States. Meticulous planning in these scenarios is essential to navigate the intricate tax landscape effectively and ensure that the intended benefits are realized while mitigating any potential drawbacks. ■

[129] On July 14, 2023, the IRS announced that it has "recently identified about 100 high-income individuals claiming benefits in Puerto Rico without meeting the residence and source rules involving U.S. possessions. These wealthy individuals are attempting to avoid U.S. taxation on U.S.-source income, and we expect many of these cases to proceed to criminal investigation." *See* IRS release, "Building on Filing Season 2023 Success, IRS Continues to Improve Service, Pursue High-Income Individuals Evading Taxes, Modernize Technology," IR-2023-126 (July 14, 2023).

[130] *See* United States Attorney's Office, District of Puerto Rico release, "Puerto Rico CPA Indicted and Arrested on Wire Fraud Charges in Relation to Act 20 and Act 22 Scheme" (Oct. 21, 2020).