

## All or Nothing: Defending Your Puerto Rico *Bona Fide* Residency Against an IRS Campaign Audit

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In January 2021, the IRS launched a “campaign” focused on auditing U.S. citizens who moved to Puerto Rico and obtained an Act 22 decree.<sup>[1]</sup> This alert, the second in a series on these IRS “Campaign Audits,” explains how to anticipate and defend against challenges to the *bona fide* Puerto Rico residency status of Act 22/60 decree holders. We also explain how to evaluate your *bona fide* Puerto Rican residency position outside the audit context and steps you might take now to shore up your position.

### Why does the IRS start with residency?

Residency is a threshold issue in all Campaign Audits. Due to the interplay between the U.S. income tax rules that exempt certain income of Puerto Rico residents (sections 933 and 937<sup>[2]</sup>) and Puerto Rico’s tax incentives for new residents (under Act 22, now Act 60), these new residents can pay a zero percent rate on Puerto Rico source capital gains. In addition, new residents who obtain an “export services” decree (under Act 20, now Act 60) pay just a four percent rate on certain Puerto Rico source personal services income.

These benefits are available only to *bona fide* residents of Puerto Rico. For the IRS, residency is thus an all-or-nothing issue. If the IRS prevails on residency, none of the taxpayer’s income is exempt from U.S. tax.<sup>[3]</sup>

The IRS fully appreciates this cliff effect. Each Campaign Audit begins with a standard information document request with typically 36 questions (a “Campaign IDR”), of which more than 20 focus in whole or in part on whether the taxpayer is a *bona fide* resident of Puerto Rico. Responding effectively to these questions involves, in the ideal case, both contemporaneous recordkeeping by the taxpayer, and strategic analysis by counsel of how to present the taxpayer’s facts in the best possible light and make appropriate legal arguments. As noted in our first alert in this series, responding to a Campaign IDR with documents only may be risky. A comprehensive memorandum of facts and law can put those documents into context for the revenue agent and draw upon them to explain why the taxpayer qualifies as a *bona fide* resident of Puerto Rico under the applicable three-part test.

### What is the three-part test for Puerto Rico *bona fide* residency?

To qualify as a *bona fide* resident of Puerto Rico for any tax year, a person must satisfy each of three distinct tests: (1) the “Presence Test”; (2) the “Tax Home Test”; and (3) the “Closer Connection Test”.<sup>[4]</sup> It is not enough merely to be present in Puerto Rico for 183 days in a given tax year. While that profile should satisfy the Presence Test, it will not necessarily satisfy the Tax Home and Closer Connection tests.

*The Presence Test.* A U.S. citizen or resident alien satisfies the Presence Test if the individual is present in Puerto Rico for at least 183 days during the taxable year.<sup>[5]</sup> For this purpose, “presence” means actual physical presence at any time during the day, treating travel days to or from Puerto Rico as Puerto Rico days.<sup>[6]</sup> Also treated as Puerto Rico days are: (i) days spent in the United States for (or to accompany a close relative for) inpatient medical treatment, (ii) up to 14 days spent outside Puerto Rico during the declared period of a major disaster, and (iii) up to 30 days on which the individual is outside Puerto Rico and the United States, if the taxpayer spends more days in Puerto Rico than in the United States during the year.<sup>[7]</sup> The day count rules that

deem certain days spent away from Puerto Rico due to medical treatment or major disaster as days present in Puerto Rico apply only for the specific period of the medical treatment or disaster and not for all days spent off island during the trip. While the 183-day test is the most commonly applied formulation of the Presence Test, there are four alternative formulations that a taxpayer who does not have 183 days of presence might nonetheless satisfy.[8]

*The Tax Home Test.* A taxpayer satisfies the Tax Home Test if the individual does not have a tax home outside Puerto Rico during any part of the taxable year. For this purpose, a taxpayer's tax home is the individual's "regular or principal place of business." [9] If an individual has multiple regular places of business, the principal place of business (and tax home) is generally determined based on relative time spent, productivity, and income generated, with time spent being the most important factor. [10] If the individual does not carry on a trade or business, the tax home is the individual's regular place of abode, determined on the basis of factors that largely overlap with those considered under the Closer Connection Test. [11]

*The Closer Connection Test.* A taxpayer satisfies the Closer Connection Test if the individual does not have a closer connection outside Puerto Rico during any part of the taxable year. [12] For this purpose, all places outside Puerto Rico are aggregated; the test compares connections with Puerto Rico to those with the rest of the world. [13] Regulations provide a non-exclusive list of connections to be taken into account, including the locations of family, permanent home, personal property and valuables, banking activity, voter registration and driver's license issuance, as well as how and with what address the taxpayer self-identifies on official forms. All relevant facts and circumstances must be taken into account. [14]

#### How does the Campaign IDR probe qualification under these three tests?

The Campaign IDR demands documents and information relevant to each of these three tests.

- *Presence Test:* Demands for, among other things, personal calendars and phone and travel records seem targeted to establish the taxpayer's physical location on all days during the year. If the taxpayer cannot substantiate—with evidence—that he or she was physically in Puerto Rico for a sufficient number of days, the IRS wins.
- *Tax Home Test:* Location information is also relevant to the Tax Home Test in that it can reveal regular places of business. The Campaign IDR seeks details (and U.S. and Puerto Rico income tax returns) of a taxpayer's business entities, information regarding payments from or to business entities connected with the taxpayer, and Forms W-2 and 1099, all of which are important to the tax home determination. If the documents show that U.S. earnings dwarf Puerto Rico earnings, the taxpayer may struggle to substantiate a Puerto Rico tax home absent a very high Puerto Rico day count.
- *Closer Connection Test:* The Campaign IDR requests copies of leases and real estate purchase and tax payment records, disclosure of homestead exemption claims, details of voter registration and driver's license issuance, insurance information, and evidence of community activities and memberships. Such information must be provided for Puerto Rico, the United States, and anywhere else in the world. Particularly for taxpayers who retain their former homes in the United States, these documents may paint an incomplete and unfavorable picture, and it may be advisable to disclose more information than requested to establish the strength of the taxpayer's Puerto Rico connections.

The IRS typically seeks information for a multi-year period, even if only a single year is under audit. For taxpayers who move to Puerto Rico midyear, this makes some sense. Midyear movers may qualify as *bona fide* residents in the first year by satisfying the Presence Test, Tax Home, and Closer Connection Tests for the last 183 days of the year, and remaining *bona fide* residents of Puerto Rico for the next three years—which means that facts over a four-year period affect “year one” of residency.[15] For taxpayers who claim *bona fide* residency under the general rule, however, demands for information and evidence outside the audit year(s) arguably overreach, and counsel should consider pushing back.

#### What are the key potential pitfalls in a *bona fide* residency audit?

Many Act 22/60 grantees are relatively familiar with the *bona fide* residency rules, but traps for the unwary remain—and can bite in a Campaign Audit. We offer three examples here.

First, day count can be deceptive. The rules that allow certain travel, medical, disaster and foreign days to count as days present in Puerto Rico apply only with respect to the Presence Test. Services income is sourced to the place of performance, not to the place of “presence” under these rules. In other words, there may be a sustainable residency position, but if most of the taxpayer’s income-producing activities are conducted off island, less income than expected might be sourced to Puerto Rico and exempt from U.S. federal income taxation.

In a tax controversy, the taxpayer has the burden of proving that all three prongs – Presence, Tax Home and Closer Connection – of the *bona fide* residency test are met. Taxpayers should consider ‘self-auditing’ their residency before a Campaign Audit strikes. For example, taxpayers should ensure that travel days are separately tracked, monitor full-day Puerto Rico day count, and separately track working time. Better yet, consider having your tax advisor assist with an audit of residency for prior years. We explain below how Caplin & Drysdale generally approaches such internal reviews.

Second, the Tax Home and Closer Connection Tests require sustained ties to Puerto Rico throughout the year. Under these tests, one must not have a tax home or closer connection outside Puerto Rico during any part of the year. “Part” is undefined, but means at least the first six months and last six months of the year—as evidenced by the special rule for midyear movers described above.[16] “Part” could also include periods of less than six months, such as calendar quarters or even months, as there is no direct authority on this issue.

For this reason, Taxpayers should be wary of lengthy stays outside Puerto Rico, especially in the first year of *bona fide* residency. Puerto Rico day count—that is, full-day Puerto Rico day count—should ideally be monitored on at least a quarterly basis. And during periods spent outside Puerto Rico, connections in Puerto Rico—a permanent home, organizational and club memberships, relationships with service providers, etc.—should be maintained.

Taxpayers should be particularly careful about enrolling their children in school in the U.S. if doing so requires the taxpayer’s spouse to live with the child in the U.S. At the very least, school vacations should be spent as a family in Puerto Rico.

Finally, what constitutes a “permanent home” is far from intuitive. Regulations define a permanent home as any place continually available to the taxpayer as an abode, and not merely for stays of short duration. If a taxpayer who moves to Puerto Rico maintains a home in the United States, that home counts as a permanent

one unless it is rented to a third party throughout most (if not all) of the year. The home also counts as a permanent one if it is occupied by a family member of the taxpayer, even if the taxpayer does not stay at the property when visiting. Similarly, a new resident of Puerto Rico who stays in hotels or short-term rentals in Puerto Rico for much of the year, rather than leasing or purchasing a home on the island, may have more to defend in a residency challenge if they also have maintained a permanent home in the United States or elsewhere off island.

Taxpayers claiming bona fide residency should make their Puerto Rico homes, home. If a former U.S. home is retained, it should not retain the trappings of a continued residence. At a minimum, the taxpayer should need to pack when visiting from Puerto Rico. Cherished personal items and valuables should be moved to the Puerto Rico home. Investing in upgrading the U.S. home suggests continued ties to the United States. The taxpayer controls the facts. In a Campaign Audit, if there are two or more homes, the permanent home issue will come down to which home is more important. Work to ensure that the Puerto Rico home wins by a landslide.

#### How should I prepare for the possibility of a residency audit?

We recommend a three-pronged approach to preparing for a residency audit. First, manage your expectations. If you hold an Act 22 decree and have been claiming bona fide residency in Puerto Rico, accept that your likelihood of receiving an IRS audit notice is necessarily higher than that of the average U.S. individual, high net worth or otherwise. Also accept that IRS audits—and particularly Campaign Audits—have a prescribed cadence. Having all of your ducks in a perfect row may not shortcut the process.

But getting those ducks into a perfect row will make the process a smoother one. Maintaining contemporaneous documentation of your day count, working days/time, and Puerto Rico and other connections, in an organized and readily retrievable manner, will save much time and many headaches for you and your counsel in the event of a Campaign Audit.

And speaking of your counsel, identifying counsel and establishing a relationship now will enable you to avoid unnecessary stress and respond timely and effectively if and when you receive a Campaign Audit notice. Caplin & Drysdale has substantial experience in both tax controversy and the technical issues relevant to Act 22/60 decree holders. We have evaluated residency for dozens of taxpayers claiming *bona fide* residency in Puerto Rico. Our process for doing so typically involves a short consultation with the taxpayer, followed by the taxpayer completing Caplin & Drysdale's residency questionnaire, a second call to discuss any challenges presented by the questionnaire response and, if helpful, a memo summarizing our findings.

#### Conclusion

Caplin & Drysdale's combined tax controversy and technical tax teams already represent multiple taxpayers defending Campaign Audits. If you are subject to a Campaign Audit, we stand ready to assist you with a vigorous defense tailored to your circumstances.

The next installment in this series of alerts will address whether a Puerto Rico export services company (an Act 20/60 decree recipient) is likely to have a U.S. trade or business and how to mitigate now any risks that may exist for past years. If you would like to understand these issues or those surrounding *bona fide* residency better now – or to discuss how to prepare effectively for or defend a Campaign Audit – please contact any of

the undersigned. Otherwise, watch this space.

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[1] *IRS Announces the Identification and Selection of Two Large Business and International Compliance Campaigns* (Jan. 27, 2021), available at: IRS LB&I Compliance Campaign(s) January 27, 2021 | Internal Revenue Service; see also, *Puerto Rico CPA indicted and arrested on wire fraud charges in relation to Act 20 and Act 22 scheme* | Internal Revenue Service (*irs.gov*) (Oct. 21, 2020) (announcing indictment related to Act 20/22 fraud).

[2] All section references are to the U.S. Internal Revenue Code of 1986, as amended.

[3] <https://www.irs.gov/businesses/corporations/lbi-active-campaigns> (January 14, 2023). Act 22 grantees must be *bona fide* residents of Puerto Rico to avoid federal income tax, and owners of Act 20 companies also must be *bona fide* residents in order to avoid federal taxes that negate the benefits of the 4% Puerto Rico tax.

[4] Treas. Reg. §1.937-1(b)(1).

[5] Treas. Reg. §1.937-1(c)(1)(i).

[6] Treas. Reg. §1.937-1(c)(3)(i)(A).

[7] Prop. Reg. §1.937-1(c)(1)(iii)(D).

[8] Treas. Reg. §1.937-1(c)(1)(i)-(v). The Presence Test is also satisfied if the taxpayer: (i) is present in Puerto Rico for at least 549 days during the three-year period ending with the current taxable year and for at least 60 days during each of the three years, (ii) is present in the United States for no more than 90 days during the year, (iii) is present in Puerto Rico for more days than in the United States and has U.S. earned income (i.e., compensation for personal services actually rendered) of no more than \$3,000 during the year, or (iv) has no

significant connection (i.e., no spouse or minor child, home, or current voter registration) to the United States during the year. *Id.* Treas. Reg. §1.937-1(c)(1)(ii)-(v).

[9] Treas. Reg. §1.937-1(d)(1).

[10] Rev. Rul. 54-147, 1954-1 C.B. 51.

[11] Treas. Reg. §1.937-1(d)(1).

[12] Treas. Reg. §1.937-1(e)(1).

[13] Treas. Reg. §1.937-1(e)(1)(ii).

[14] Treas. Reg. §§1.937-1(e), 301.7701(b)-2.

[15] Treas. Reg. §1.937-1(f)(1).

[16] Treas. Reg. §1.937-1(f)(1).

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