Defending Your Puerto Rico Source Income in an IRS Campaign Audit

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In January 2021, the IRS launched a "campaign" focused on auditing U.S. citizens who had recently moved to Puerto Rico and obtained an Act 22 decree.[1] This alert, the third and final in a series on how to defend these IRS "Campaign Audits," explains how to anticipate and defend against challenges that may arise with respect to Puerto Rico source income earned directly by a *bona fide* resident of Puerto Rico or by a Puerto Rico corporation owned by such a *bona fide* resident.

Why does the source of income matter?

Due to the interplay between U.S. income tax rules that exempt certain income of Puerto Rican residents (sections 933 and 937[2]) and Puerto Rico's tax incentives for new residents (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.

Thus, obtaining the benefits of being a *bona fide* resident of Puerto Rico is dependent upon demonstrating that items of income are Puerto Rico source. This is not a straightforward task. U.S. tax law defines what is *not* Puerto Rico source income: income treated as income from sources within the United States or as effectively connected with the conduct of a trade or business within the United States.[3] To determine what *is* Puerto Rico source income, one must apply rules similar to those for determining whether income is from sources within the United States or is effectively connected with the conduct of a trade or business within the United States.[4] Generally, it is sufficient to substitute "Puerto Rico" for the "United States" and to substitute "*bona fide* resident of Puerto Rico" for "United States resident" when reading and applying the normal source rules.[5] Note that many provisions of the Code that are relevant to determining the source of income refer to a "non-resident alien."[6] A U.S. citizen who is a *bona fide* resident of Puerto Rico is not a non-resident alien and arguably should not be treated as one under these mirror rules. The bottom line is that the rules are complicated and it is important to evaluate each item of income to understand if it is Puerto Rico source.

What is the source of my capital gain income?

Capital gains of a *bona fide* resident of Puerto Rico are generally Puerto Rico source[7] – with two prominent exceptions.

If the taxpayer maintains an office or other fixed place of business in the Unites States to which the capital gains are attributable, the capital gains are U.S. source.[8] The office of an agent who has the authority to negotiate and conclude contracts in the name of the *bona fide* resident and regularly exercises that authority is imputed to its principal.[9] Also, if the *bona fide* resident is a member or partner in a limited liability company or partnership that is classified as a pass-through entity for U.S. tax purposes, the U.S. office (and any U.S. trade or business) of the entity are attributed to the taxpayer.[10]

Gain is considered to be attributable to a U.S. office or other fixed place of business only if the office or fixed place of business is material factor in the production of the gain and if the gain is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business.[11] No gain will be attributable to an office or other fixed place of business if the taxpayer is at no time during the taxable year engaged in a trade or business in the United States.[12] These provisions create the potential for activities of a taxpayer that constitute being ETB to "contaminate" the sourcing of capital gains realized by the taxpayer, particularly if both activities are carried on from the same location in the United States.

A second exception to Puerto Rico sourcing of capital gains relates to property owned when an individual became a *bona fide* resident of Puerto Rico. Such gains are sourced to the United States, although an election is allowed to split source the gains between the United States and Puerto Rico, either based on how long the individual held the property in each location or, if the property is marketable securities, based on the market price on the day the individual became a *bona fide* resident of Puerto Rico.

Note that trading in stocks or securities for the taxpayer's own account by the taxpayer, its employees or a U.S.-resident agent does not render the taxpayer ETB unless the taxpayer is a dealer in stocks or securities.[13] Similar rules apply to commodities customarily traded on an organized commodity exchange.[14] The extent to which these rules apply to trading cryptocurrencies is uncertain at this time and may depend upon how and where the particular cryptocurrency is traded.

What is the source of my services income?

Services income is generally sourced to the place where the services are performed.[15] For sourcing purposes, Puerto Rico is not treated as part of the United States.[16] Thus, compensation for services performed in Puerto Rico generally would be Puerto Rico-source income, and compensation for services performed in the United States generally would be U.S. source income. When services are performed partly within and partly outside of the United States, the regulations provide for split-sourcing.[17] Specifically, source should be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.[18]

Recall, however, that income treated as U.S. source is not Puerto Rico source. If a taxpayer is a partner or member of a pass-through entity, the taxpayer's income is U.S. source to the extent that the pass-through entity's income is U.S. source, even if the taxpayer renders all services from Puerto Rico. Thus, there is a meaningful difference between a taxpayer rendering services as a partner or member of a pass-through entity as compared to rendering such services in the taxpayer's personal capacity as an independent contractor.

Even if such services are purportedly rendered to the pass-through entity as an independent contractor, that status may not be respected if the service provider is also a direct partner in the service recipient. If a *bona fide* resident of Puerto Rico providing services to a pass-through entity is currently a partner or member of the pass-through entity, it could be advantageous to interpose a blocker corporation, usually a subchapter S corporation, between the individual and the pass-through entity. Other structures exist to address the issue.

How is income of my Puerto Rico corporation taxed by the United States?

The above-outlined source rules apply equally to a Puerto Rico corporation and to an individual who is a *bona fide* resident of Puerto Rico. If a Puerto Rico corporation employs individuals who render services while physically present in the United States, the compensation received by the corporation for those services is U.S. source. In the case of a Puerto Rico corporation that has an employee who works both within the United States and outside of the United States (including Puerto Rico), it must first determine the relative value of the services rendered by that employee compared with the services rendered by other employees, and then it must allocate that value between U.S. source and foreign/Puerto Rico source, typically based on the relative amount of time the employee spends working within the United States versus outside of the United States/in Puerto Rico.[19] Both *bona fide* residents of Puerto Rico and Puerto Rico entities should keep contemporaneous records as to where they or their employees are located each day of the taxable year and whether and where they render services each day.

If a Puerto Rico corporation has U.S. source income, it is taxable by the United States under one of two regimes. If the corporation is engaged in a U.S. trade or business ("ETB"), it is subject to U.S. federal income tax at a 21% rate on its net income to the extent that the income is effectively connected ("ECI") with such U.S. trade or business.[20] Certain types of U.S. source income, including interest, dividend and services income that is not ECI is taxable on a gross basis (i.e., without deductions) at a 30% rate.[21] Generally, if a Puerto Rico corporation is ETB at any time during the taxable year, all of its U.S.-source income is treated as ECI, but its foreign-source services income is not ECI. A foreign corporation having either ECI or non-ECI U.S. source interest, dividend or services income during the taxable year has U.S. tax liability and is obliged to file a U.S. tax return.[22]

In addition to the corporate income tax of 21%, the earnings of a Puerto Rico corporation that is ETB may be subject to a further 30% "branch profits tax".[23] This tax may apply because a Puerto Rico corporation is taxed by the United States as a foreign corporation. Further, if an Act 20/60 export services company earns substantial ECI, dividends that it pays to *bona fide* residents of Puerto Rico may be treated in part as "qualified dividends" and subject to federal income taxation at a rate of 23.8%.[24]

How should I prepare for a source of income audit?

There is no substitute for properly structuring business activities inside and outside of Puerto Rico in order to maximize the amount of Puerto Rico source income earned by a *bona fide* resident of Puerto Rico or a Puerto Rico corporation. The use of separate contracts with respect to services rendered by the taxpayer or its employees within Puerto Rico and outside of Puerto Rico will usually be desirable. Maintaining contemporaneous documentation of your working days/time and those of your employees 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. Using blocker corporations to avoid having U.S. source service income or the ETB status of a pass-through entity being imputed to the taxpayer can also be key elements of such a structure. Taxpayers should consider having a tax advisor perform a prophylactic audit of their ownership and service structures before a Campaign Audit strikes.

Optimizing your structure will provide a response to many issues that the IRS might raise in a Campaign Audit. While restructuring to optimize your Puerto Rico source income cannot be done retrospectively, doing so will limit your exposure to a Campaign Audit with respect to periods after the restructuring.

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 *bona fide* residents of Puerto Rico and Act 20/22/60 decree holders. We have evaluated the ownership and service structures for dozens of taxpayers claiming *bona fide* residency in Puerto Rico. Our combined tax controversy and technical tax teams already represent multiple taxpayers defending Campaign Audits. We stand ready to assist you if you also face a Campaign Audit.

Conclusion

If you would like to understand how the source of income, ETB or ECI rules apply to you or your corporation, or to discuss how to prepare effectively for or defend a Campaign Audit, please contact any of the undersigned.

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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] IRC §937(b)(2).

[4] IRC §937(b)(i).

[5] Treas., Reg. §1.937-2(b).

[6] *See, for example*, IRC §864(c)(8)(A).

[7] IRC §865(a)(2).

[8] IRC §865(e)(2).

[9] IRC §864(c)(5)(A).

[10] IRC §875(1); *Unger v. Commissioner*, 936 F.2d 1316 (D.C. Cir. 1991); *Donroy Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962).

[11] IRC §864(c)(5)(B); Treas. Reg. §1.864-6(b) .

[12] Treas. Reg. §1.864-6(c).

[13] IRC §864(b)(2)(A).

[14] IRC §864(b)(2)(B).

[15] I.R.C. §861(a)(3), 862(a)(3), 862(b)(1).

[16] I.R.C. §7701(a)(9).

[17] *See* Treas. Reg. §1.861-4(b)(1)(i).

[18] *Id.*

[19] Treas. Reg. §1.861-4(b)(1)-(2).

[20] Treas. Reg. §1.864-4(b).

[21] I.R.C. §881.

[22] I.R.C. §6012(a)(2); Treas. Reg. §1.6012-2(g)(1)(i).

[23] IRS §884. When combined with the 21% corporate income tax, this branch profits tax can produce an effective rate of approximately 45%.

[24] *See* Treas. Reg. § 1.937-2(g)(1) (applying a "possessions sourcing ratio" to treat a portion of dividends received from a Puerto Rico corporation as from non-Puerto Rico sources if more than certain percentages of the corporation's income was earned, during a "testing period" from trade or business activities conducted outside of Puerto Rico). Together with the corporate income tax rate of 21% and the branch profits tax of 30%, the 23.8% qualified dividends tax can produce an effective rate of taxation of approximately 58%.

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