

Preparing for Battle: The IRS Puerto Rico Campaign Takes Off

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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 first in a series on how to defend these IRS “Campaign Audits,” discusses who is at risk and what to expect in an audit.

What is the focus of the IRS Campaign?

The interplay between the U.S. federal 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) enables qualifying new residents to pay a zero percent tax rate on Puerto Rican source capital gains. In addition, new residents who obtain an “export services” decree (under Act 20, now Act 60) pay just a four percent tax rate on certain Puerto Rican source personal services income. The stated focus of the IRS campaign is on whether a taxpayer claiming these benefits is in fact a *bona fide* resident of Puerto Rico and has properly excluded income from U.S. tax.[3]

At first, the campaign announcement produced much talk but little action. Yes, Hacienda issued letters to some Act 22 decree recipients requesting support for their *bona fide* residency (and revoked several hundred decrees).[4] And yes, Hacienda provided the information it received to the IRS.[5] But the wave of IRS audits that was initially expected did not materialize. Until now.

In the past few months, the IRS has initiated a flurry of closely coordinated Campaign Audits. Each audit begins with a standard information document request with typically 36 questions (a “Campaign IDR”). As expected, many Campaign IDR questions address whether the taxpayer is a *bona fide* resident of Puerto Rico, but others focus on whether the taxpayer has improperly excluded non-Puerto Rican source income from U.S. tax. The Campaign IDRs reflect a sophisticated strategy and seek meticulous substantiation for responses.

Are you at risk for an audit?

Yes. All new residents of Puerto Rico must file Form 8898 with their U.S. federal income tax returns (Forms 1040) claiming a change in residency to Puerto Rico.[6] In addition, new residents must seek Act 20/22/60 decrees from Puerto Rico to obtain the benefits of the 0% and 4% rates. We expect that, through these filings, the IRS possesses a complete list of every person who has become a decree holder since 2012, when Acts 20 and 22 first became effective. We understand that the total number of individuals who might be subject to audit is approximately 10,000. The IRS could, with its new funding,[7] have the resources to audit them all.

What should you do if you receive an audit notice?

Step one should be hiring a competent advisor – one with material IRS controversy experience – to represent you in discussions with the IRS. Engaging personally and directly with the IRS is not recommended. Anything you say to an IRS agent is an admission, and things that mean one thing to a lay person can often be interpreted to mean something else by the IRS. It is unrealistic to hope that a succinct, sincere explanation will cause the IRS to go away quickly. The IRS has a process, particularly in a Campaign Audit, and is likely to follow

that process through to the end. Direct communications could be particularly ill-advised if the agent is part of the IRS Criminal Investigation Division. If contacted by an employee of the IRS by phone or in person, we recommend simply requesting the agent's name, badge number, email and phone number and letting them know that your advisor will be in touch.

A competent tax controversy advisor will have experience not only with IRS administrative processes (Exam and Appeals), but also with tax litigation. Because these are high-stakes issues, it makes sense to hire someone from the outset who can defend or take matters to court if necessary, rather than having to switch or add counsel down the road. That generally means hiring an attorney rather than relying exclusively on your return preparer to manage the audit, particularly when the return preparer could become a fact witness.

The firm you hire also should have relevant technical tax experience. Campaign Audits implicate not only *bona fide* residency (analyzed under Treasury Regulations section 1.937-1) and special Puerto Rico sourcing rules (found in Treasury Regulations section 1.937-2), but also other highly technical international tax rules. Responding effectively to a Campaign IDR requires broad and deep knowledge of these substantive tax rules.

Caplin & Drysdale has substantial experience in both tax controversy and the technical issues relevant to Act 20/22/60 decree holders. Our combined tax controversy and technical tax teams already are defending multiple Campaign Audits. If you become the subject of a Campaign Audit, we would be happy to have a consultation about how we can help.

What is the expected scope of a Campaign Audit?

Our experience so far is that the IRS starts each Campaign Audit with a focus on *bona fide* residency. This makes sense because it is an all-or-nothing issue. For any period that the taxpayer was not a *bona fide* resident, all income excluded from U.S. federal income taxation on the basis of *bona fide* residency will instead become subject to full U.S. tax. Residency is thus a high-stakes threshold issue and the taxpayer bears the burden of proving on audit that the test for residency has been met.^[8]

The Campaign IDR's questions about residency include requests for information about your: (1) family; (2) home ownership, leases, and homestead exemptions; (3) property tax bills; (4) voter registration; (5) driver's license and registration; (6) social and political organizations; (7) calendars and travel records; (8) phone records; and (9) bank accounts and credit card use. Taxpayers must document that they became *bona fide* residents, when that occurred, and that they remained *bona fide* residents throughout the audit period. For "year-of-the-move" residents, it may be necessary to prove that you remained a *bona fide* resident in Puerto Rico for three years after the year of the move.

Beyond residency, the Campaign IDR also requests information about:

- Income tax and reporting returns of every stripe, including 1040s, trust returns, partnership returns, S corporation returns, related K-1s, 1099s and Puerto Rican income tax and reporting returns;
- Gain and loss transactions;
- Non-taxable income (such as gifts and the proceeds of loans);
- Payments to an Act 20 company or other relevant affiliate, whether received from third parties or related parties;

- Employment contracts; and
- The identity of persons who “promoted” Act 20 and 22 to you, as well as any non-disclosure agreements.

As the above list suggests, a Campaign Audit can expand from one year’s Form 1040 to other types of tax returns (e.g., an Act 20 company’s return). It can also extend to other taxable years (e.g., surrounding years with claims of *bona fide* residency).

How does a Campaign Audit typically progress?

Defense of a Campaign Audit should start with an assessment of the procedural posture. The IRS ordinarily has three years from the filing of a tax return to assess additional tax for that year, but administrative guidance directs IRS auditors not to commence an audit with less than one year left in that assessment period. We have found auditors to be responsive to suggestions that an audit was commenced too late; they may not stop the audit, but they may narrow its scope. On the other hand, the IRS will request that taxpayers sign extensions of the three-year statute. We generally advise doing so, although some judgment must be brought to bear on whether and for how long to extend it, and whether to seek a concession from the agent (for example, as to scope) in exchange. Notably, the statute is six years, not three, if 25% or more of the taxpayer’s income was omitted from the return – as could be the case for a year in which you claimed *bona fide* residency and omitted all Puerto Rican source income from your Form 1040.[9]

Two critical strategic issues should also be considered early in a Campaign Audit. Your attorney should identify potential collateral sensitivities and work to protect them. In particular, you may have an unrelated tax position that need not come under the microscope if the issue of *bona fide* residency is handled effectively. Equally important, you and your advisor should consult closely to determine an audit endgame. This entails identifying hoped-for results that are realistic based on the application of law to facts, and developing a strategy for achieving those results through discussions with the IRS audit team.

As explained above, in a Campaign Audit, the IRS will issue a Campaign IDR. Upon receiving one, you should immediately begin gathering responsive documentation. Your attorney will need time to analyze the documentation to determine what is (or is not) responsive, and to develop a process for identifying and withholding privileged documents.

Responding to a Campaign IDR with documents only may be risky, especially because IRS revenue agents are trained to make a binary decision based on whether or not a taxpayer meets the applicable technical test. For this reason, technical legal arguments generally should accompany document responses to IRS revenue agents. An experienced tax attorney will evaluate how to produce responsive information in the most effective legal and factual context, such as with a narrative providing appropriately-tailored legal arguments explaining how the information supports the taxpayer’s *bona fide* residency or other positions. For Campaign Audits, it likely will be beneficial to develop a comprehensive memorandum of facts and laws in support of *bona fide* residency.

As the audit progresses, we recommend a cooperative approach. Providing detailed responses helps assure the IRS agent that you have a sound basis for claiming *bona fide* residency or any other position and are not trying to hide anything. Overall, revenue agents focused on Campaign Audits will see a broad range of quality and completeness to Campaign IDR responses. You have the opportunity to differentiate yourself with the quality of your responses.

Your attorney should also build strong professional relationships with the IRS team, including the revenue agent, the agent's supervisor, IRS Counsel (who can be a surprising resource for the taxpayer when the revenue agent is not following IRS procedures or the law), and Campaign issue specialists/coordinators. When handled proactively, an exam involves many communications with the IRS team on substantive and procedural matters, such as:

- Clarifying or narrowing the definitions used in the Campaign IDR (which typically include several pages of boilerplate definitions) or reducing the number of years for which documents are requested based on application of law to your circumstances;
- Offering written analyses of how the legal authorities apply to your facts, to educate the IRS team;
- Ensuring the agent follows IRS procedures,[10] which provide certain protections to taxpayers; and
- Asserting your rights (*g.*, attorney-client privilege, the statute of limitations,[11] and statutory rights to notices, such as notice of third-party contacts[12]).

How does a Campaign Audit end?

Audit duration can vary depending on the substantive scope and number of years at issue, and there may be trade-offs between the speed and quality of the outcome. Throughout the audit, all agreements and understandings with the IRS should be carefully memorialized in writing and communicated to the IRS team. Any interim agreements should lay the groundwork for a final settlement or, in the best case scenario, a full concession of the audit. The IRS's position typically will be set forth first in a notice of proposed adjustment (or "NOPA") that can be challenged at IRS Appeals, and later – if any tax is found to be owing – in a notice of deficiency.

If an unacceptable notice of deficiency is issued, there are several forums for challenging the assessed tax, including the U.S. Tax Court (where an assessment can be challenged without pre-paying the tax), and U.S. District Court or Court of Federal Claims (both of which have jurisdiction only after a tax deficiency has been paid and a refund is sought by the taxpayer). Caplin & Drysdale has substantial experience representing clients in all of these venues.

Conclusion

The next installment in this series of alerts will break down the legal issues in a residency audit. If you want to understand these issues better now – or to discuss how to effectively prepare 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] See, e.g., Michelle Kantrow-Vazquez, NimB, *Gov't revokes 121 tax incentives decrees under Act 22* (Dec. 16, 2021), available at: *Gov't revokes 121 tax incentives decrees under Act 22 – News is My Business*; NimB, *DDEC strips 311 decrees from Act 22 beneficiaries* (Aug. 2, 2022), available at: *DDEC strips 311 decrees from Act 22 beneficiaries – News is My Business*.

[5] Puerto Rico Information Bulletin 21-03 (Feb. 19, 2021) (Puerto Rico Secretary of the Treasury Francisco Pares Alicea confirming that Hacienda is exchanging information with the IRS on mutual campaigns relating to Act 22).

[6] I.R.C. § 937(c) (requiring a taxpayer to notify the IRS upon a change in residency to or from a U.S. possession); Form 8898 (Rev. October 2022) (*irs.gov*).

[7] Inflation Reduction Act of 2022, Pub. Law No. 117-169 (Aug. 16, 2022). See Scott Horsely, NPR, *The IRS got \$80 billion to beef up and target rich tax evaders: NPR* (Aug. 14, 2022).

[8] An upcoming alert will focus on the residency tests and some of the associated audit risk that taxpayers may face.

[9] I.R.C. § 6501(e)(1). Showing total gross income and excluded Puerto Rican source income on your returns may avoid the 6-year statute; however.

[10] Internal Revenue Manual, e.g., Part 4. Examining Process, available at: | Internal Revenue Service (*irs.gov*).

[11] I.R.C. § 6501.

[12] I.R.C. § 7602(c).

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