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SPECIAL REPORT

Investing in Puerto Rico: U.S. Tax Considerations

by Mary F. Voce and Pallav Raghuvanshi

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In this article, the authors examine Puerto Rican tax incentives meant to attract non-Puerto Rican investors and companies and the U.S. tax consequences of investing.

Puerto Rico, a self-governing U.S. territory, has offered several tax incentives intended to attract non-Puerto Rican investors and companies to help drive the area's economic growth. Puerto Rico enacted two laws in 2012, generally known as the Export Services Act (Act 20) and the Individual Investors Act (Act 22). Act 20 provides tax incentives to specific entities incorporated in Puerto Rico that are engaged in the business of exporting services from Puerto Rico. Under Act 20, income from eligible services provided to non-Puerto Rican residents (both individuals and entities) is taxed at a reduced rate of 4 percent if other conditions are met. Similarly, under Act 22, individuals who are bona fide residents of Puerto Rico are entitled to a 100 percent tax exemption on some interest, dividends, and capital gains.

Generally, under the Internal Revenue Code, U.S. citizens and residents are taxed on their worldwide income. However, IRC section 933 provides a special regime under which income derived from sources in Puerto Rico is excluded from a U.S. citizen's gross income if that individual is a bona fide resident of Puerto Rico for the entire tax year. Income of a U.S. citizen who is a bona fide Puerto Rican resident derived from non-Puerto Rican sources generally is subject to U.S. tax in the same manner as any other U.S. citizen. Acts 20 and 22, coupled with section 933, have attracted U.S. investors hoping to significantly lower their overall tax burden. However, the application of section 933 is complex and often unclear because it raises intricate U.S. federal income tax questions regarding the source of income, application of the controlled foreign corporation and passive foreign investment company regimes, and the taxation of gains from the sale of the stock of a Puerto Rican corporation. It also contains complex rules regarding the tax year in which a U.S. citizen moves to or from Puerto Rico.

This article focuses on Puerto Rican companies organized principally to provide services, such as research and development, marketing and advertising, managerial, and consulting and financial services, to U.S. customers through the efforts of employees in Puerto Rico. Those companies generally will have U.S. citizens as investors, only some of whom will be bona fide residents of Puerto Rico, and may have some management, technology, or support staff in the United States, resulting in at least some of the operating income being attributable there. Beyond the sourcing and attribution of the operating income (which is not discussed in this article), some of the more interesting U.S. tax questions involve the sourcing of dividends from those Puerto Rican corporations and the application of the CFC rules.

I. Bona Fide Resident of Puerto Rico

Generally, for U.S. federal income tax purposes, a U.S. citizen will be considered a bona fide resident of Puerto Rico for a tax year if, during that tax year, he:

- is physically present in Puerto Rico under one of five tests (the physical presence test);
- does not have a tax home outside Puerto Rico (the tax home test); and

- does not have a connection to the United States or a foreign country that is closer than his connection to Puerto Rico (the closer connection test).[1]

A. Physical Presence Test

Subject to special rules applicable to the tax year in which a U.S. citizen moves to or from Puerto Rico, an individual will be deemed to meet the physical presence test if he:

- was in Puerto Rico for at least 183 days during the tax year;
- was in Puerto Rico for at least 549 days during the three years consisting of the tax year and the two immediately preceding tax years, and was in Puerto Rico for at least 60 days during each of those years;
- was not in the United States for more than 90 days during the tax year;
- was in Puerto Rico during the tax year more than he was in the United States and had earned income — that is, wages, salary, professional fees, and compensation for personal services actually rendered — in the United States of not more than $3,000; or
- had no significant connection to the United States during the tax year.[2]

B. Tax Home Test

The tax home test is satisfied if the individual does not have a tax home outside Puerto Rico during any part of the tax year.[3] A person is generally treated as having a tax home at her regular place of business or, if there is more than one regular place of business, at her principal place of business.[4] The tax home of a person with no regular or principal place of business is her regular place of abode in a real and substantial sense.[5]

C. Closer Connection Test

The determination of closer connection to Puerto Rico than to the United States or a foreign country is based on all the facts and circumstances.[6] The regulations list factors to determine whether an individual maintains a closer connection to Puerto Rico:

- the location of the individual's permanent home;
- the location of the individual's family;
- the location of personal belongings, such as automobiles, furniture, clothing, and jewelry, owned by the individual and her family;
- the location of social, political, cultural, or religious organizations with which the individual has a current relationship;
- the location where the individual conducts her routine personal banking activities;
- the location where the individual conducts business activities (other than those that constitute the individual's tax home);
- the location where the individual holds a driver's license;
- the location where the individual votes; and
- the country of residence designated by the individual on forms and documents.

None of the above factors is dispositive, and they are all considered in determining whether an individual has a closer connection to Puerto Rico. Further, a closer connection to Puerto Rico must be established for the entire tax year.

D. Special Rule When Moving to Puerto Rico

During the tax year in which a U.S. citizen relocates to Puerto Rico, the tax home test and the closer connection test are deemed satisfied for the entire tax year only if all of the following conditions are met:

- the individual was not a bona fide resident of Puerto Rico for any of the three preceding tax years;
- 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; and
- 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.[7]

Consider an example. D, a U.S. citizen, files returns on a calendar-year basis. From January 1, 2015, through May 31, 2017, D resides in the United States. In June 2017 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, 2017, is in Puerto Rico, and during that period (which totals more than 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 2017, and through 2020, D continues to live and work in Puerto Rico and maintains a closer connection to Puerto Rico than to the United States or any foreign country. D is treated as satisfying the tax

[1] IRC section 937.

[2] U.S. Treas. reg. section 1.937-1(c)(1)(i)-(v).

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

[4] *See* IRC section 937(a)(2); reg. section 301.7701(b)-2(c)(1).

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

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

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

home and closer connection tests for 2017. Accordingly, assuming that D also satisfies the presence test, D is a bona fide resident of Puerto Rico for all of tax year 2017.

E. Special Rule When Moving From Puerto Rico

If a U.S. citizen has been a bona fide resident of Puerto Rico for at least two years and then ceases to be a resident of Puerto Rico, IRC section 933(2) and the regulations thereunder exclude from the U.S. citizen's U.S. gross income any income for the year of change that is derived from Puerto Rican sources and is attributable to that part of the tax year before the U.S. citizen changed his residence from Puerto Rico to either the United States or any other country, if he:

- is a bona fide Puerto Rican resident for at least the two tax years preceding the change year;
- ceases to be a bona fide Puerto Rican resident during the tax year;
- ceases to have a tax home in Puerto Rico during the tax year; and
- has a closer connection to Puerto Rico than to the United States or a foreign country throughout the part of the tax year preceding the date on which he ceases to have a tax home in Puerto Rico.[8]

Another example shows that 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 2018 and 2019. From January 1 through May 4, 2020, R continues to reside and maintain his principal place of business in, and closer connection to, Puerto Rico. On May 5, 2020, 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 does not satisfy the physical presence test for 2020 for Puerto Rico. Moreover, because R had a tax home outside Puerto Rico and establishes a closer connection to the United States in 2020, R does not satisfy the requirements of the tax home or closer connection tests to be a resident of Puerto Rico for 2020. However, because R was a bona fide resident of Puerto Rico for at least two tax years before his change of residence to State N in 2020, for the tax year 2020, 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, 2020.[9]

In the above example, if R moved to Puerto Rico during 2017, he should be able to satisfy the tests regarding his departure from Puerto Rico in 2020, but he may not satisfy the residency tests that would permit him to be considered a bona fide resident of Puerto Rico for all of 2017 because he will not have been a resident of Puerto Rico for at least three years after the year of his move.[10]

F. U.S. Tax Effect of Relocating to Puerto Rico

IRC section 877A provides rules regarding individuals who expatriate from the United States. That section generally applies to any U.S. citizen who has relinquished his citizenship and any long-term resident who has ended his U.S. resident status for U.S. federal income tax purposes. Section 877A imposes a mark-to-market regime under which all the expatriate's property is deemed sold for its fair market value on the day before the expatriation date, and any gain arising from the deemed sale is taken into account for the expatriating individual's tax year of the deemed sale.

However, section 877A does not apply to a U.S. citizen's relocation to Puerto Rico, because the relocation by itself does not require or otherwise involve any renunciation of U.S. citizenship. Therefore, if a U.S. citizen relocates to Puerto Rico, the relocation to Puerto Rico without a renunciation of citizenship does not result in a deemed sale of that person's assets.[11]

II. Taxing Dividends and Stock Gain

As mentioned, under section 933, income from sources within Puerto Rico generally is excluded from a U.S. citizen's U.S. gross income if she is a bona fide resident of Puerto Rico for the entire tax year. As a general rule, the principles of IRC sections 861 through 865 and the regulations thereunder (regarding the determination of income from sources in and outside the United States) will be applied, in mirror form, in determining whether income is from sources in or outside Puerto Rico (the general source rules).[12] However, some exceptions apply to dividends from, and capital gains derived from the sale of the stock of, a Puerto Rican corporation.

The source rules for dividends paid by a Puerto Rican corporation are particularly complex, and different rules apply for determining the source of dividends

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[8]Reg. sections 1.933-1(b), 1.937-1(f). However, it seems to be the IRS's view that Puerto Rican-source income attributable to the period before the change of residence from Puerto Rico but received or accrued in a tax year after the year of the residence change does not qualify for the IRC section 933(2) exclusion. *See* Rev. Rul. 68-7, 1968-1 C.B. 345.

[9]If R moved from Puerto Rico to the United States after having met the four tests for more than 183 days during 2020, he could exclude from U.S. taxation any income derived from Puerto Rican sources for the period when he met those tests. Unlike the rule regarding the year of moving to Puerto Rico, satisfying those tests for more than 183 days does not result in the individual being treated as a bona fide resident of Puerto Rico for the entire tax year.

(Footnote continued in next column.)

[10]IRC section 933(2); reg. section 1.937-1(f)(2)(ii).

[11]If the U.S. person is a long-term U.S. resident but not a U.S. citizen, special immigration rules might apply, in which case IRC section 877A might apply to that person's relocation to Puerto Rico. That discussion is beyond the scope of this article.

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

actually paid by a Puerto Rican corporation and for determining their source for ascertaining whether the Puerto Rican corporation is a CFC. The flowchart outlines those alternative source rules.

A. Dividends Paid by a Puerto Rican Corporation

1. General Source Rule

Based on the general source rules applicable to dividends, dividends paid by a Puerto Rican corporation and received by a U.S. citizen who is a bona fide resident of Puerto Rico generally will be treated as derived entirely from sources within Puerto Rico if less than 25 percent of the Puerto Rican corporation's gross income for the three years ending with the close of the tax year preceding the declaration of the dividend (or if the corporation has been in existence for less than three years, for the part of that period during which the corporation exists) is effectively connected with the conduct of a U.S. trade or business.[13] If 25 percent or more of the Puerto Rican corporation's gross income for that period is U.S. effectively connected income, the dividend will be considered to be from U.S. sources in the ratio that the corporation's U.S. ECI bears to its total gross income, and the remainder will be considered to be from Puerto Rican sources.[14]

2. Rules Regarding Possessions Shareholders

Under U.S. Treas. reg. section 1.937-2(g)(1), if the recipient of a dividend from a Puerto Rican corporation meets the definition of a possessions shareholder, special source rules apply. A possessions shareholder is a bona fide resident of Puerto Rico who directly or indirectly owns at least 10 percent of the total voting stock of a Puerto Rican corporation.

For a Puerto Rican corporation not engaged in an active trade or business in Puerto Rico, dividends received by a possessions shareholder will be treated as derived from sources within Puerto Rico based on the possession source ratio of the dividend. The numerator of that factor is the gross income of the Puerto Rican corporation from sources in Puerto Rico and the denominator is the corporation's total gross income.

For a Puerto Rican corporation engaged in the active conduct of trade or business in Puerto Rico, all the dividends it distributes to a possessions shareholder will be treated as income from Puerto Rican sources if (a) at least 80 percent of its gross income during the three years ending at the close of the tax year in which the dividend was paid (or if the corporation has been in existence for less than three years, for the part of that period during which the corporation existed) was derived from sources in Puerto Rico or was effectively connected with the conduct of a trade or business in Puerto Rico, and (b) at least 50 percent of the gross income during that period was derived from the active conduct of a trade or business in Puerto Rico (the 80-50 test).[15] If the 80-50 test is not met, dividends received by the possessions shareholder will be considered Puerto Rican sourced based on the possession source ratio.

B. Gain From the Sale of the Stock

Generally, gain from the sale of the stock of a Puerto Rican corporation by a U.S. citizen who is a bona fide resident of Puerto Rico is not treated as Puerto Rican-source income (and thus will be subject to U.S. tax) if (1) the stock was owned by the seller before the seller became a bona fide resident of Puerto Rico, and (2) 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.[16] In other words, if the individual owned the stock before he became a bona fide resident of Puerto Rico, he must hold the stock for 10 years (and remain a bona fide resident of Puerto Rico during that period) before he can sell it without U.S. tax being imposed.

However, under reg. section 1.937-2(f)(1)(vi), if that individual sells the stock before the expiration of the 10-year period, she may elect to treat the gain as from sources in Puerto Rico to the extent attributable to the portion of her holding period for the stock during which she was a bona fide resident of Puerto Rico. For stock actively traded on an established financial market, the gain attributable to the period during which the individual was a bona fide resident of Puerto Rico is determined by reference to the stock's FMV on the first day she became a bona fide resident of Puerto Rico, so that the appreciation during that period of residence will be exempt from U.S. taxation. For stock that is not actively traded, the gain attributable to the period during which the individual was a bona fide resident of Puerto Rico is determined by multiplying the total gain by a fraction, the numerator of which is the number of days she was a bona fide resident of Puerto Rico and the denominator of which is the total number of days in the individual's holding period for the stock.

If a U.S. citizen purchases the stock of a Puerto Rican corporation after becoming a bona fide resident of Puerto Rico and remains a bona fide resident through the year in which the stock is sold, the gain on the sale

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

[14]*See* reg. section 1.937-2(b); IRC section 861(a)(2)(B); and reg. section 1.937-2(c). For further explanation, see Section III.A, *infra*.

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

[16]Reg. section 1.937-(2)(f)(1). That rule applies to some other categories of passive investment assets as well as stock of a Puerto Rican corporation.

should be considered to be Puerto Rican-source gain that is not subject to U.S. tax regardless of the holding period.

III. Tax Consequences of CFCs and PFICs

A. CFCs and U.S. 10 Percent Shareholder

In general, a CFC is a foreign — that is, non-U.S. — corporation owned more than 50 percent (by vote or value) by one or more U.S. citizens or residents, each of whom owns stock that has at least 10 percent of the foreign corporation's voting power (each a U.S. 10 percent shareholder).[17] For determining whether a Puerto Rican corporation is a CFC (and for determining whether an individual will be subject to U.S. tax as a U.S. 10 percent shareholder), an individual will not be considered a U.S. 10 percent shareholder of the corporation (even if he would otherwise meet the definition) if:

- he is a bona fide resident of Puerto Rico; and
- a dividend he receives from the Puerto Rican corporation would be treated as income derived from sources within Puerto Rico.[18]

For determining whether a dividend received by an individual who would otherwise meet the definition of a U.S. 10 percent shareholder is from Puerto Rican sources, reg. section 1.957-3(b)(2) clearly turns off the special source rules for dividends received discussed above.[19] Accordingly, the general source rules, which apply the mirror principles of IRC sections 861 through 865, are the starting point for this determination.[20] However, they are less than clear in this context.

Applying the mirror application of IRC section 861(a)(2)(A), a dividend from a Puerto Rican corporation generally would be a Puerto Rican-source dividend. However, reg. section 1.937-2(c) specifically excludes from Puerto Rican-source income any item of income determined under those rules to be from sources in the United States or that constitutes U.S. ECI (the U.S. income rule). Further, the general source rules include a limiting rule, under which a bona fide resident of Puerto Rico may not have, as a result of the application of those rules, more income from sources in Puerto Rico than from sources in the United States that a similarly situated U.S. person who is not a bona fide resident of Puerto Rico would have under the U.S. source rules (the limiting rule).[21]

Taken together, those rules may limit the amount of dividends from a Puerto Rican corporation that will be considered Puerto Rican-source dividends if it has U.S. business operations. More specifically, IRC section 861(a)(2) provides that if at least 25 percent of a foreign corporation's income is U.S. ECI, dividends from that corporation will be considered to be from U.S. sources in the ratio that the U.S. ECI bears to total gross income. Therefore, if at least 25 percent of a Puerto Rican corporation's income is U.S. ECI, that portion of its dividends will be U.S.-source income and thus precluded from qualifying as Puerto Rican-source dividends.[22] As a result, a Puerto Rican corporation owned more than 50 percent by U.S. 10 percent shareholders (including those who are bona fide residents of Puerto Rico) would be a CFC. Also, each U.S. 10 percent shareholder (whether or not a bona fide resident of Puerto Rico) who owns stock on the last day of the year in which the corporation is a CFC will be subject to U.S. tax on a current basis on (1) his pro rata share of specific categories of income (subpart F income) earned by the CFC, regardless of whether that income is distributed,[23] and (2) his 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).

B. PFIC Rules and Bona Fide Residents

Under IRC section 1297(a), a foreign corporation is a PFIC if at least 75 percent of its gross income for a tax year is passive investment income or if at least 50 percent of its assets (by value) held during the tax year are held for the production of passive income. If a U.S. person receives an excess distribution (defined as 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. Further, penalty interest might be imposed on those amounts calculated as if the PFIC had distributed its earnings on a current basis and as if the U.S. shareholder should have paid tax in the years of the deemed distributions

[17] IRC section 951(b). For this purpose, a bona fide resident of Puerto Rico who is a U.S. citizen is considered a U.S. shareholder, except under special rules.

[18] IRC section 957(c)(1). Although not clearly stated, it appears that 100 percent of the dividend must be Puerto Rican-source income.

[19] Because a U.S. citizen who would otherwise meet the definition of a U.S. 10 percent shareholder of a Puerto Rican corporation would also meet the definition of a possessions shareholder, the special source rules applicable to possessions shareholders should therefore not apply for determining whether a dividend received by that U.S. 10 percent shareholder is from Puerto Rican sources.

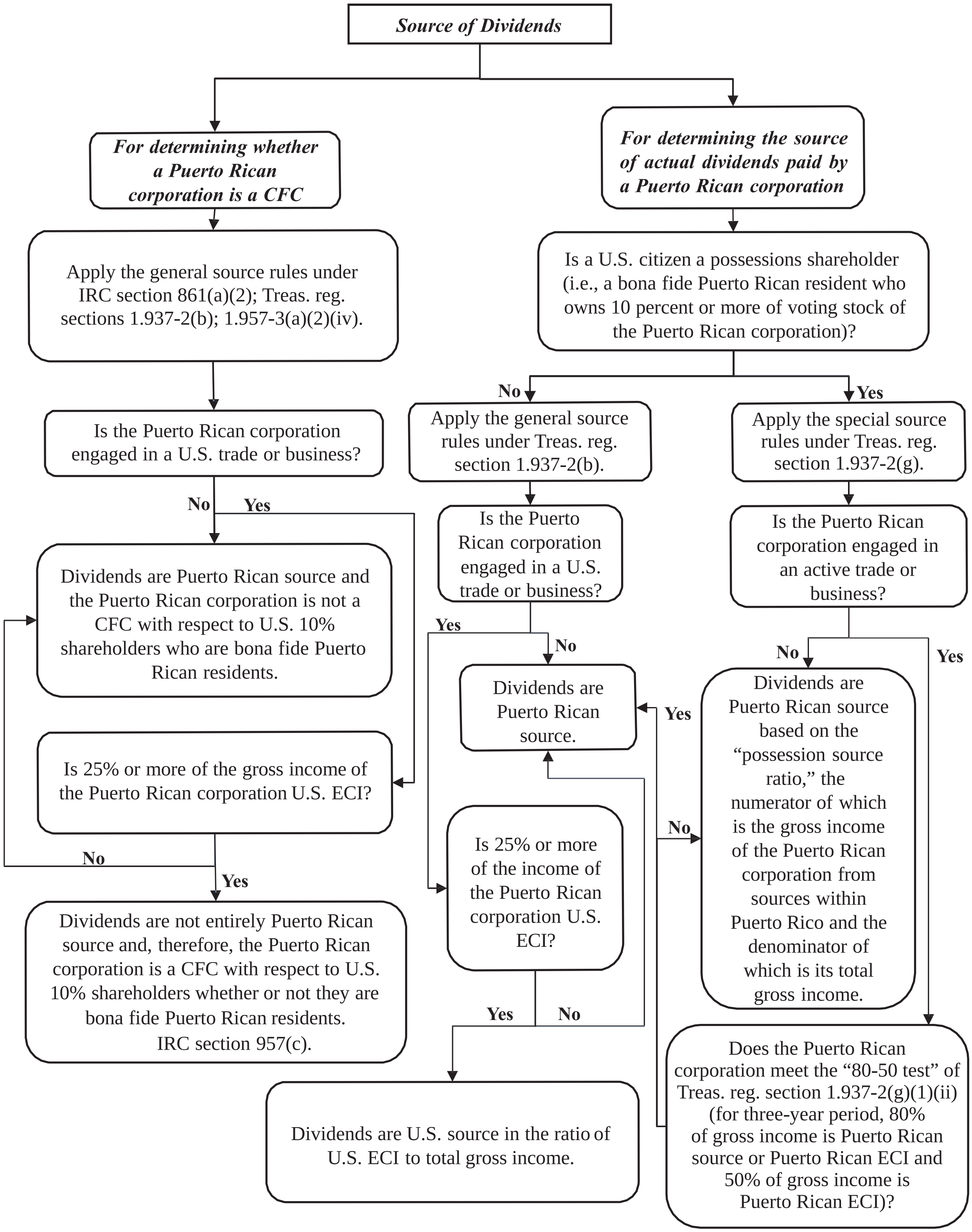
[20] *See* reg. section 1.957-3(a)(2)(iv); reg. section 1.957-3(b)(2).

[21] Reg. section 1.937-2(b). *See also* T.D. 9391 (corrected May 13, 2008).

[22] IRC section 861(a)(2); reg. sections 1.937-2(b), -2(c), and 1.957-3(b)(2).

[23] There may not be any subpart F income inclusion for a Puerto Rican CFC that is engaged in the business of providing services — that is, an Act 20 Puerto Rican corporation — if those services are not provided for or on behalf of a related person and are provided by the employees of that corporation in Puerto Rico.

Alternative Source Rules



and failed to do so. 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 those individuals would have adverse U.S. tax consequences from an investment in a Puerto Rican corporation that is a PFIC only if 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 his U.S. income under section 933, as discussed above.[24]

Although the PFIC status of each corporation should be analyzed based on the actual facts, a Puerto Rican corporation could avoid PFIC classification on the basis that its assets and income are predominantly active, which generally could be the case if the entity is eligible for Act 20 benefits in Puerto Rico.[25] However, a Puerto Rican corporation might readily satisfy the tests to be a PFIC if it engages in no activity other than holding less than 25 percent of the shares of an Act 20 Puerto Rican corporation. If it appears that a corporation might be a PFIC, its U.S. shareholders should consider whether they should make a qualified electing fund election[26] (or a mark-to-market election if the company is publicly traded).[27]

IV. Conclusion

IRC section 933 and Puerto Rican acts 20 and 22 undeniably provide tax advantages for U.S. investors. However, those advantages have limitations and conditions that could result in unanticipated and undesirable outcomes without proper tax planning. Although Puerto Rico is a U.S. territory, it is treated as a foreign country for U.S. federal income tax purposes, subject to the special treatment under section 933. Accordingly, it is important to determine whether a Puerto Rican corporation could be treated as a CFC for U.S. citizens who are bona fide residents of Puerto Rico. If it can, those individuals would be required to include in their U.S. income on a current basis any subpart F income or inclusions under IRC section 956.

If the CFC rules do not apply, it will be important to determine whether there are any adverse PFIC implications and, if so, whether they can be avoided. Although there should be no adverse U.S. federal income tax consequences for a U.S. citizen who moves to or becomes a bona fide Puerto Rican resident, tax planning is essential before that individual moves to Puerto Rico and sets up a business and before he plans to move back to the United States. ◆

[24]Prop. reg. section 1.1291-1(f). Proposed regulations generally are not binding on the IRS or taxpayers, unless the IRS states otherwise. However, the proposed PFIC regulations have been in proposed form for more than 20 years and, as a practical matter, both taxpayers and the IRS tend to rely on them.

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

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

[27]IRC section 1296.