
Alert: IRS to “Campaign” into Puerto Rico; How can Taxpayers Defend?

February 3, 2021

The IRS has announced a new “Campaign.” It will focus its attention on U.S. persons who have reduced their U.S. tax burden by claiming benefits under Puerto Rico Act 22. This comes as no surprise following recent increased interest from Congress, the Treasury Department, and the IRS on the revenue lost when U.S. taxpayers relocate to Puerto Rico.

The IRS will start by gathering the names of individuals who may be audited. It may do so based on returns filed directly with the IRS that take Puerto Rico-specific positions, from Hacienda through tax sharing agreements, and possibly from subpoenas to return preparers located in Puerto Rico. In fact, we know from a recent draft IRS report¹ that much of this has already happened.

A formal Campaign signals a coordinated effort across the IRS to address a narrow set of issues. This often leads to a standard examination process. The IRS may adopt template-based information requests that are the same for all taxpayers. It may also adopt and follow consistent settlement procedures across cases. This means that all audits within the Campaign tend to be deep and protracted, and that the timing of settlement may be driven by considerations outside of an individual’s particular case.

In this Campaign, the IRS explained that it will address noncompliance through examinations, outreach, and soft letters (which are less than an audit, but more than a suggestion) to U.S. taxpayers who currently claim benefits under Act 22. Although the Campaign only references Act 22 participants, one can reasonably expect that an IRS inquiry into an individual holding an Act 22 decree would likely expand into at least a review of the Act 20 entities which provide sources of income to such individuals.

Examinations under the Campaign will target U.S. individuals who may be improperly excluding income subject to U.S. tax; who may be improperly claiming bona fide residency in Puerto Rico; or who may be incorrectly reporting U.S. source income as Puerto Rican source income in order to avoid U.S. taxation. More specifically, the IRS will undoubtedly focus on factual and legal issues commonly associated with U.S. participants in Act 22, like:

- Whether a U.S. person properly established bona fide residency in Puerto Rico under three separate tests: (1) the presence test; (2) the tax home test; and (3) the closer connection test;
- Ensuring that bona fide residents of Puerto Rico have maintained their residency and detailed recordkeeping, which requires analyses of quantitative data (e.g., day counts, income figures, and business details) and qualitative data (e.g., personal relationships and affiliations);

¹ Draft Report to Congress Pursuant to Pub. L. 116-93 Regarding Interaction of Certain Puerto Rico and U.S. Tax Laws, published in Tax Notes, *Doc 2020-43051* (Nov. 2020).

- Analyzing whether a company was properly formed in Puerto Rico, including whether a participant paid any U.S. “exit” tax under U.S. Tax Code section 367 and properly filed Form 926;
- Reviewing on-going transactions between Puerto Rican companies and related U.S. companies to determine whether transactions satisfy U.S. transfer pricing rules;
- Determining whether Puerto Rican companies have operated through a “U.S. trade or business,” which could subject the company to U.S. tax, and whether Forms 1120-F (even protective ones) have been filed;
- Evaluating whether a preexisting U.S. entity that migrated substantially all of its assets to a Puerto Rican entity is subject to U.S. anti-“inversion” rules, allowing the IRS to treat the entity as a fully-taxable U.S. corporation; and
- Others.

The tone of the Campaign – i.e., specifically referencing possible tax avoidance motives – may indicate that the Department of Justice (DOJ) will not stand by while the IRS confines its review to the civil arena. As was widely publicized, on October 21, 2020, the Department of Justice indicted and arrested the head of BDO Puerto Rico’s Tax Division for allegedly violating the rules of Acts 20 and 22. The DOJ’s announcement of the indictment suggests more upcoming activity, noting “IRS Criminal Investigation will vigorously pursue any individuals and professionals that fraudulently enrich themselves by abusing government tax incentive programs.”²

The DOJ indictment, along with the fact that the IRS (at the request of Congress) has already created a list of those benefitting from Puerto Rico’s tax regimes, serves as a warning to anyone participating in Acts 20 and 22 (now Act 60) and other Puerto Rico incentive programs that an IRS audit could be forthcoming. Taxpayers should review their reporting positions and, if appropriate, consider rectifying past non-compliance now. [Caplin & Drysdale](#) has experience counseling clients through voluntary disclosures and through civil audits and criminal examinations, as well as evaluating Puerto Rico-specific U.S. tax issues. Tom Duffy has experience with Puerto Rico tax issues, and with working under Kovel to file amended returns. For more information, please contact the authors:



² Puerto Rico CPA indicted and arrested on wire fraud charges in relation to Act 20 and Act 22 scheme (October 21, 2020), available at: <https://www.irs.gov/compliance/criminal-investigation/puerto-rico-cpa-indicted-and-arrested-on-wire-fraud-charges-in-relation-to-act-20-and-act-22-scheme>.

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