After Puerto Rico: Is Expatriation Worth Considering?

For some Act 60 participants, growing old in Puerto Rico is not a realistic part of the long-term plan. Few people relish the thought of returning to the mainland U.S. tax system after enjoying the enviable Act 60 tax benefits. In some instances, a return to the mainland U.S. tax regime is simply unimaginable, and quite a few individuals explore renouncing their U.S. citizenship.

Anticipating that U.S. citizens and long-term green card holders would attempt to minimize their U.S. tax liability by renouncing their U.S. citizenship or abandoning their green card ("expatriating"), Congress established an exit tax regime. Under the exit tax regime, an expatriate, assuming they meet certain financial thresholds, is treated as having sold their worldwide assets for fair market value on the day prior to expatriating. This "deemed sale" or "mark-to-market" regime dissuades many high net-worth taxpayers from expatriating, since most of these taxpayers have much of their wealth tied up in non-liquid assets, and liquidating some of those assets to pay the tax bill is often too onerous and expensive.

Although the exit tax regime is often sufficiently oppressive to dissuade most taxpayers from consummating expatriation, there are very unique opportunities for Act 60 participants who have been bona fide residents of Puerto Rico for more than ten years. Many practitioners are not aware of these auspicious opportunities and others consider them almost too good to be true. However, for a select group of taxpayers whose time in Puerto Rico has run its course, expatriation might be worth considering.

The example below provides an illustration of how these rules apply. We include a 'Background' of a hypothetical taxpayer followed by an 'Issues' section describing the types of issues commonly encountered. The first part of the analysis, the 'Summary Conclusions' section, includes short form answers to the Issues for the casual reader. The second part, 'Discussion' section, provides a more detailed, technical analysis of the Issues, as well as planning opportunities for those who might consider expatriation as a next step.

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BACKGROUND

Jack and Diane are U.S. citizens who are bona fide residents of Puerto Rico. Both Jack and Diane were granted Act 22 tax decrees (now referred to as Act 60) by the government of Puerto Rico.[1] They relocated to Puerto Rico from California and have been living in Puerto Rico for the last 11 years. They are in their 50s, have been married over 30 years, and their kids are grown and live in the U.S.

Jack and Diane's parents were both from Ireland. As a result, they both have been able to obtain Irish citizenship. They are now dual Irish citizens and U.S. citizens. They have always wanted to live in Europe and travel the world. It has been something they have talked about for many years.

After spending 11 years in Puerto Rico, they have become accustomed to very low tax rates. Leaving Puerto Rico, giving up Puerto Rican residency status, and going back to normal combined federal and state tax rates, which can exceed 50%, is something that does not appeal to them. They are thinking of renouncing their U.S. citizenship.

They have discussed at length with their U.S. immigration lawyer the various immigration drawbacks of renouncing their U.S. citizenship. As just one example, their immigration lawyer has advised them that they may be refused entry back into the United States if the reason they renounced their U.S. citizenship was to avoid paying U.S. income taxes.[2] After being fully advised of all the immigration concerns with renouncing their U.S. citizenship, they are still considering renunciation.

Their plan is to purchase a home in Switzerland. They have discussed with a Swiss tax advisor the requirements to be taxed in Switzerland under the special "forfait" tax regime.

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[1] Act 60–2019, known as the Puerto Rico Incentives Code, was signed into law on July 1, 2019, with an effective date of January 1, 2020 ("Act 60"). Act 60, among other things, consolidated various tax decrees, including Act 20, the Promotion of Export Services Act, and Act 22, the Act to Promote the Relocation of Individual Investors to Puerto Rico.

[2] See https://en.wikipedia.org/wiki/Reed_Amendment_(immigration) (page visited on July 26, 2024).

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USCo and PRCo

Jack and Diane own 100% of a U.S. C corporation ("USCo") and 100% of a Puerto Rican entity ("PRCo"). USCo was established 30 years ago and operates a profitable business in the U.S. For each of the last 11 years, USCo has paid a management consulting fee to PRCo of approximately $10 million. PRCo is a Puerto Rican LLC that is classified as a corporation for U.S. tax purposes and holds an Act 20 (now referred to as Act 60) Export Services tax decree. The Act 20 decree affords PRCo a 4% corporate tax rate with dividends received by the shareholders fully exempt from Puerto Rico tax.

Prior to renouncing their U.S. citizenship, Jack and Diane anticipate selling the stock of USCo to a long-term employee who has overseen the U.S. operations since inception. The sale will be for $70 million. The employee does not have the cash to buy USCo outright, so he will issue a promissory note to Jack and Diane, which will be payable with interest, over 10 years. Jack and Diane will elect out of the installment method and recognize the entire gain in the year of the sale. Jack and Diane's tax basis in the shares of USCo is $10 million.

Jack and Diane will continue to do some consulting for USCo after the sale, but it will be limited in scope. Post renunciation, they anticipate earning roughly $2 million a year in consulting fees from USCo.

PRCo generally distributes its profits as dividends to Jack and Diane. After distributions, PRCo has little value.

Other Material Assets

Jack and Diane each own 50% of a U.S. limited liability company ("US LLC"). US LLC is classified as a partnership and owns U.S. real estate with a tax basis of $20 million and a fair market value of $50 million. US LLC has no debt, and Jack and Diane's tax basis in US LLC is $20 million. The U.S. real estate generates roughly $2 million of rental income for the couple. To simplify the analysis below, it is assumed that US LLC holds no assets that would be unrealized receivables or inventory items as defined in Code §751.[3]

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[3] All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

Jack and Diane own a home in Puerto Rico with a tax basis of $5 million and a fair market value of $9 million. After moving to Switzerland, they do not plan to ever return to Puerto Rico.

Jack and Diane have various brokerage accounts which hold U.S. equities. The U.S. equities are regularly traded on the New York Stock Exchange or the Nasdaq. The fair market value of the brokerage accounts is $60 million, and their tax cost is $40 million.

Jack has a 401k that holds assets worth $3 million. Jack has a zero-tax basis in the 401k.

The following is a summary of Jack and Diane's material assets:

Description	Tax Basis	FMV	Gain
USCo (C corp)	$10,000,000	$70,000,000	$60,000,000
US LLC (P'ship)	$20,000,000	$50,000,000	$30,000,000
Puerto Rican home	$5,000,000	$9,000,000	$4,000,000
U.S. equities	$40,000,000	$60,000,000	$20,000,000
401k	$0	$3,000,000	$3,000,000
Total	$75,000,000	$192,000,000	$117,000,000

ISSUES

1. If Jack and Diane renounce their U.S. citizenship, will they be subject to the U.S. mark-to-market regime?
2. Can bona fide residents of Puerto Rico generally exclude Puerto Rican-source income from their U.S. taxable income?
3. If some of Jack and Diane's property was owned by them prior to becoming bona fide residents of Puerto Rico, do the special former U.S. resident rules apply?
4. If Jack and Diane move to Switzerland and renounce their U.S. citizenship at a U.S. embassy in Switzerland, is it likely that they would be considered bona fide residents of Puerto Rico at that time?
5. If Jack and Diane sell USCo while they are bona fide residents of Puerto Rico, should gain on the sale be Puerto Rican-source income?
6. Is it possible for Jack and Diane to trigger gain recognition on other assets prior to termination of their residency in Puerto Rico?

7. Should gains recognized by Jack and Diane on their Puerto Rican home and on the U.S. equities be Puerto Rican-source income while they are bona fide residents of Puerto Rico?
8. If Jack and Diane were to delay the sale of the U.S. equities until after they moved to Switzerland but before they renounced their U.S. citizenship, would the gains be Puerto Rican-source income?
9. Should Jack and Diane consider triggering gain on their Puerto Rican home prior to listing it for sale?
10. If US LLC sells the U.S. real estate, will the gain on the real estate that flows through to Jack and Diane be Puerto Rican-source income?
11. If Jack and Diane sell their interests in US LLC, should the gain on the sale of US LLC be Puerto Rican-source income?
12. If Jack provides Form W-8CE to his 401k administrator within 30 days of renouncing his U.S. citizenship, will Jack be treated as having received a full distribution from his 401k on the day before he renounces?
13. If Jack does not provide Form W-8CE to his 401k administrator within 30 days of renouncing his U.S. citizenship, will Jack be treated as having received a full distribution from his 401k on the day before he renounces?
14. Can Jack and Diane rely on the Switzerland-U.S. Income Tax Treaty to avoid U.S. tax on the interest income they receive on the promissory note related to the sale of USCo?
15. Will Jack and Diane be subject to U.S. tax on the consulting fee income they receive from USCo?
16. If, after renouncing their U.S. citizenship, Jack and Diane decide to make gifts or bequests to their U.S.-citizen children, will their children be subject to a U.S. tax equal to 40% of the value of gifts or bequests?
17. Should Jack and Diane consider gifting assets to their U.S.-citizen children prior to renouncing their U.S. citizenship?
18. If Jack or Diane passes away while owning U.S.-situs assets, will those assets be subject to U.S. estate tax?
19. Will Jack and Diane <u>each</u> be required to include Form 8854 with their U.S. tax return for the year they renounce their U.S. citizenship?

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SUMMARY CONCLUSIONS

1. Yes. If Jack and Diane renounce their U.S. citizenship, they will be treated as if they sold all of their worldwide property for fair market value on the day before renunciation.
2. Yes. Bona fide residents of Puerto Rico can generally exclude Puerto Rican-source income from their U.S. taxable income.
3. No. The special former U.S. resident rules only apply for a 10-year period. Because Jack and Diane have been bona fide residents of Puerto Rico for more than 10 years, the special former U.S. resident rules do not apply.
4. No. If Jack and Diane move to Switzerland and renounce their U.S. citizenship at a U.S. embassy in Switzerland, it is likely that they would no longer be considered bona fide residents of Puerto Rico. Because they would no longer be bona fide residents of Puerto Rico, they would not be able to exclude the mark-to-market gain recognized on the day before renunciation.
5. Yes. As long as the sale takes place after 10 years in Puerto Rico and before Jack and Diane cease to be bona fide residents of Puerto Rico, the gain on the sale of USCo should be Puerto Rican-source income. By electing out of the installment method, the full amount of the gain should be recognized while Jack and Diane are bona fide residents of Puerto Rico.
6. Yes. There are multiple options for Jack and Diane to trigger gain recognition on other assets prior to termination of their residency in Puerto Rico. Some of the options for triggering gain include: (1) selling assets to unrelated parties for fair market value consideration, (2) contributing assets to a U.S. corporation in exchange for nonqualified preferred stock, or (3) contributing assets to a foreign corporation.
7. Yes. As long as the sales takes place after 10 years in Puerto Rico and before Jack and Diane cease to be bona fide residents of Puerto Rico, the gains on their Puerto Rican home and on the U.S. equities should be Puerto Rican-source income.
8. No. If Jack and Diane were to delay the sale of the U.S. equities until after they moved to Switzerland but before they renounced their U.S. citizenship, the gains would not be Puerto Rican-source income. After Jack and Diane move to Switzerland, their tax homes will be in Switzerland. Gains on sales of personal property when an individual has a tax home outside of Puerto Rico is not considered Puerto Rican-source income.

   To assure that Jack and Diane have a closer connection to Puerto Rico when triggering gains, it may make sense for them to not purchase a home in Switzerland or have any significant connections to Switzerland prior to triggering the gains. They might even want

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to trigger gains in one taxable year and move out of Puerto Rico in the following taxable year.

9. Yes. It may make sense for Jack and Diane to trigger gain on their Puerto Rican home prior to listing it for sale. The act of listing their Puerto Rican home for sale may be a factor in determining whether Jack and Diane have moved their tax home outside of Puerto Rico. If Jack and Diane have moved their tax home outside of Puerto Rico, they would no longer be bona fide residents of Puerto Rico.
10. No. If US LLC sells the U.S. real estate, the gain on the real estate that flows through to Jack and Diane will not be Puerto Rican-source income.
11. Yes. If Jack and Diane sell their interests in US LLC, the gain on the sale of US LLC should be Puerto Rican-source income. However, if US LLC had unrealized receivables or inventory items as defined in Code §751, gains attributable to those items may or may not be U.S.-source income. Recent court cases addressing this issue have conflicted.
12. No. If Jack provides Form W-8CE to his 401k administrator within 30 days of renouncing his U.S. citizenship, he will not be treated as having received a full distribution from his 401k on the day before he renounces.
13. Yes. If Jack does not provide Form W-8CE to his 401k administrator within 30 days of renouncing his U.S. citizenship, Jack will be treated as having received a full distribution from his 401k on the day before he renounces.
14. No. Jack and Diane cannot rely on the Switzerland-U.S. Income Tax Treaty to avoid U.S. tax on the interest income they receive on the promissory note related to the sale of USCo. They will not be able to rely on the treaty because they will not be considered residents of Switzerland for purposes of the treaty. However, it may be possible for Jack and Diane to avoid U.S. tax on the interest income by structuring the promissory note to qualify for the portfolio interest exception.
15. No. Jack and Diane will not be subject to U.S. tax on the consulting fee income they receive from USCo. The consulting fee income will be for services performed outside the U.S. Therefore, the consulting fee income will not be U.S.-source income.
16. Yes. If, after renouncing their U.S. citizenship, Jack and Diane decide to make gifts or bequests to their U.S.-citizen children, their children will be subject to a U.S. tax equal to 40% of the value of gifts or bequests.
17. Yes. Jack and Diane should consider gifting assets to their U.S.-citizen children prior to renouncing their U.S. citizenship. To the extent of the gift tax exemption, such gifts would not be subject to gift tax.

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18. Yes. If Jack or Diane passes away while owning U.S.-situs assets, those assets will be subject to U.S. estate tax. The estate tax exemption for non-U.S. citizens that are not domiciled in the U.S. is only $60,000.
19. Yes. Jack and Diane will each be required to include Form 8854 with their U.S. tax return for the year they renounce their U.S. citizenship. The penalty for failing to file Form 8854 is $10,000.

DISCUSSION

Expatriation Mark-to-Market Regime (Issue 1)

The U.S. generally imposes a mark-to-market regime on U.S. citizens who renounce their U.S. citizenship.[4] Under this regime, all property of the individual is treated as sold for its fair market value on the day before renunciation.[5] To the extent deemed gains are characterized as ordinary income, the gains are taxed at graduated ordinary income tax rates up to 37%.[6] To the extent the gains are characterized as long-term capital gain, the gains are generally taxed at graduated rates up to 20%.[7] In addition, the gains may be subject to the 3.8% net investment income tax.[8]

The amount of the gain is reduced (but not to below zero) by an exclusion amount, which is annually adjusted for inflation.[9] For the calendar year 2024, the exclusion amount is $866,000.[10] A taxpayer may elect to defer payment of tax attributable to property deemed sold.[11]

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4 Code §877A(a).

5 Code §877A(a)(1). Exceptions to the mark-to-market regime exist for individuals with a net worth of less than $2 million and for certain other taxpayers. These exceptions are not discussed in this article.

6 Code §1(j). The highest ordinary income tax rate is set to revert to 39.6% as of January 1, 2026.

7 Code §1(h)(1).

8 Code §1411.

9 Code §877A(a)(3).

10 Rev. Proc. 2023-34.

11 Code §877A(b).

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The mark-to-market regime does not apply to deferred compensation items,[12] specified tax deferred accounts,[13] and interests in non-grantor trusts of which the individual was a beneficiary on the day before renunciation.[14]

Jack and Diane will be subject to the special expatriation rules in Code §877A. Consequently, they will be deemed to have sold their worldwide assets for fair market value on the day before their renunciation. In addition, their 401k is a deferred compensation item that will be subject to special rules (discussed below).

Taxation of Bona Fide Residents of Puerto Rico (Issue 2)

U.S. citizens who are bona fide residents of Puerto Rico are generally subject to U.S. income tax on their worldwide income.[15] However, bona fide residents of Puerto Rico can exclude Puerto Rican-source gross income from their total gross income.[16] This exclusion applies only to income "derived from sources within Puerto Rico".[17]

If Jack and Diane recognize gains that are Puerto Rican-source gains while they are bona fide residents of Puerto Rico, they can exclude those gains from their U.S. taxable income.

Former U.S. Resident Sourcing Rule (Issue 3)

Special sourcing rules apply to gains from dispositions of certain investment property (for example, stocks, bonds, debt instruments, cryptocurrency, diamonds, gold, etc.) owned prior to

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12 Code §877A(c)(1).

13 Code §877A(c)(2).

14 Code §877A(c)(3).

15 *Cook v. Tait*, 265 U.S. 47, 56 (1924); *Huff v. Commr.*, 135 T.C. 222, 230 (2010); Code §61(a)(3) (gross income includes "all income from whatever source derived", including "[g]ains derived from dealings in property").

16 Code §933 ("The following items shall not be included in gross income and shall be exempt from taxation under this subtitle: * * * In the case of an individual who is a bona fide resident of Puerto Rico * * *, income derived from sources within Puerto Rico * * *").

17 *Id.*

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becoming a bona fide resident of Puerto Rico.[18] Under these special rules, gains from dispositions of the specified property within 10 years after becoming a bona fide resident of Puerto Rico generally are treated as **non**-Puerto Rican-source income.[19]

Jack and Diane have been bona fide residents of Puerto Rico for more than 10 years. Therefore, the special former U.S. resident sourcing rules should not apply to them.

<u>Termination of Residency in Puerto Rico (Issue 4)</u>

An individual must meet the "tax home" requirement to be a bona fide resident of Puerto Rico.[20] An individual's tax home is considered to be located at the individual's regular or principal (if more than one regular) place of business.[21] If the individual has no regular or principal place of business because of the nature of the business, or because the individual is not engaged in carrying on any trade or business within the meaning of Code §162(a), then the individual's tax home is the individual's regular place of abode in a real and substantial sense.[22]

In general, to meet the tax home test the individual must "not have a tax home outside [Puerto Rico] during **any part of the taxable year**."[23] [Emphasis added] However, a special "year of move" rule applies to "an individual who * * * ceases to be a bona fide resident of [Puerto Rico] during a taxable year."[24]

A U.S. citizen who has been a bona fide resident of Puerto Rico for at least two years and who ceases to be a bona fide resident of Puerto Rico during the year, is considered a bona fide resident of Puerto Rico for the portion of the year that he or she has a closer connection to Puerto Rico.[25]

Jack and Diane will be U.S. citizens until they move to Switzerland and renounce their U.S. citizenship. They were bona fide residents of Puerto Rico for at least the two taxable years

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18 Treas. Reg. §1.937-2(f)(1).

19 Treas. Reg. §1.937-2(f)(1)(iii)(B).

20 Treas. Reg. §1.937-1(d).

21 *Id.*

22 *Id.*

23 Treas. Reg. §1.937-1(d)(1).

24 Treas. Reg. §1.937-1(d)(2).

25 Treas. Reg. §1.937-1(f)(2)(ii) and Example 10 of Treas. Reg. §1.937-1(g).

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immediately preceding their year of move. They will cease to have tax homes in Puerto Rico in their year of move, and they will have a closer connection to Puerto Rico in their year of move before ceasing to have a tax home in Puerto Rico.

The exact date that Jack and Diane move their tax home (their principal place(s) of business) to Switzerland and have a closer connection to Switzerland may or may not be easy to determine, depending on the circumstances. However, once they purchase a home in Switzerland and move there, it seems clear that they will at that point have moved their tax home(s) to Switzerland and have a closer connection to Switzerland.

Anecdotally, we have heard that it may be months before an appointment is available with a U.S. embassy to renounce U.S citizenship. If Jack and Diane are living in Switzerland for months before they are able to renounce their U.S. citizenship, it seems clear that the day prior to renunciation (the day that gain is recognized under the mark-to-market regime) they will no longer be bona fide residents of Puerto Rico. It should be noted that to renounce U.S. citizenship, a U.S. citizen must appear in person before a U.S. consular or diplomatic officer in a foreign county.

Source of Gain on Sale of USCo (Issue 5)

Gain from the sale of personal property, other than inventory, is generally sourced to the residence of the seller.[26] Typically, a U.S. citizen individual will not be considered a nonresident for purposes of Code §865(g) unless a foreign income tax of at least 10% is actually paid on the gain.[27] However, this 10% foreign income tax requirement does not apply to bona fide residents of Puerto Rico.[28]

Gain recognized by Jack and Diane on the sale of USCo will be gain on a sale of personal property. Jack and Diane will be bona fide residents of Puerto Rico at the time of the sale. Jack and Diane will elect out of the installment method. Consequently, Jack and Diane will recognize the full amount of the gain at the time of the sale. As long as the sale takes place after 10 years in Puerto Rico and before Jack and Diane cease to be bona fide residents of Puerto Rico, the gain on the sale of USCo should be Puerto Rican-source income and not subject to U.S. tax.

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26 Code §865(a)

27 Code §865(g)(2).

28 Notice 89-40.

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Although the entire gain should escape U.S. tax, a 5% Puerto Rican tax would apply to the portion of gain attributable to appreciation of the assets before moving to Puerto Rico. This 5% Puerto Rican tax applies when the appreciated assets are sold more than 10 years after moving to Puerto Rico but before 2036.[29]

Early Triggering Gain Recognition (Issue 6)

Sale: The simplest approach for Jack and Diane to recognize gain on their assets is for them to sell the assets at fair market value in a bona fide sale to unrelated parties. If a sale of an asset to an unrelated party is not feasible, a contribution of the asset to a U.S. corporation or to a foreign corporation may trigger gain.

U.S. Corporation: Code §351 generally provides for nonrecognition of gain or loss on transfers of property to a corporation in exchange for stock of that corporation if the transferor (or transferors) is in control of the corporation immediately following the transfer. However, if a taxpayer contributes property to a corporation in exchange for nonqualified preferred stock, the nonqualified preferred stock will be treated as boot and generate gain.[30] Nonqualified preferred stock is debt-like preferred stock that is treated as taxable consideration for purposes of Code §351.[31]

Foreign Corporation: Code §367(a) generally requires gains to be recognized on contributions of property to foreign corporations. Therefore, if Jack and Diane were to contribute property to a foreign corporation, gain would generally be recognized on the transfer. However, a transfer of a U.S. corporation or a U.S. partnership to a foreign corporations can cause the foreign corporation to be treated as a U.S. corporation under the anti-inversion rules.[32] A contribution to a foreign corporation that is treated as a U.S. corporation generally would not trigger gain recognition.[33] Therefore, Jack and Diane may not want to attempt to trigger gain on USCo or US LLC by transferring the shares or membership interests in these entities to a foreign corporation.

29 Section 2022.02(a) of the Puerto Rico Incentives Tax Code [Act No. 60 of July 1, 2019, as amended].

30 Code §351(b).

31 Code §351(g).

32 Code §7874(b).

33 Code §351(a).

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Source of Gains on Puerto Rican Home and U.S. Equities (Issues 7 & 8)

Gains on sales of real estate are sourced to the location of the real estate.[34] Jack and Diane's Puerto Rican home is located in Puerto Rico. Therefore, gain on sale of the Puerto Rican home should be Puerto Rican-source income.[35]

As described above, gain from the sale of personal property, other than inventory, is generally sourced to the residence of the seller.[36] The U.S. equities are personal property. Consequently, gain recognized on the U.S. equities while Jack and Diane are bona fide residents of Puerto Rico should be Puerto Rican-source income.

Jack and Diane are considered residents of Puerto Rico for sourcing purposes only while their tax homes are in Puerto Rico.[37] If Jack and Diane were to delay the sale of the U.S. equities until after they moved to Switzerland but before they renounced their U.S. citizenship, they likely would have moved their tax homes to Switzerland before the sale. Gain on a sale of the U.S. equities with a tax home in Switzerland (or a closer connection to Switzerland) could not be excluded from their U.S. taxable income. Therefore, Jack and Diane should not delay the sale (or other gain recognition) of the U.S. equities until after they move to Switzerland.

As discussed above under Issue 6, a 5% Puerto Rican tax will apply to pre-residency appreciation.

Early Triggering of Gain on Puerto Rican Home (Issue 9)

It may make sense for Jack and Diane to trigger gain on their Puerto Rican home prior to listing it for sale. The act of listing their Puerto Rican home for sale may be a factor in determining whether Jack and Diane have moved their tax home outside of Puerto Rico[38] or whether they

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34 Code §862(a)(5).

35 Gain on the sale of their Puerto Rican home may result in Puerto Rican income tax. However, it may be possible to avoid Puerto Rican income tax by transferring the home to a Puerto Rican limited liability company and selling the interest in the limited liability company (rather than directly selling the home).

36 Code §865(a).

37 Treas. Reg. §1.937-1(d) and Code §865(g).

38 Treas. Reg. §1.937-1(d).

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have a closer connection to Switzerland, as compared to Puerto Rico.[39] If Jack and Diane have moved their tax home outside of Puerto Rico or if they have a closer connection to Switzerland, they would no longer be bona fide residents of Puerto Rico. Thus, Jack and Diane should consider triggering gain on their Puerto Rican home prior to listing it for sale.

Gain on U.S. Real Estate Sold by US LLC (Issue 10)

A partnership is not taxed at the partnership level.[40] Instead, the responsibility for the payment of taxes passes through to the partners, who pay the tax liability in proportion to each partner's share.[41]

Income of the partnership that could affect the tax liability of a partner must be separately stated.[42] The character of any income passed through to a partner is determined as if the income were realized directly from the same source as it was realized by the partnership.[43] Thus, the general rule is that the source of the income is determined at the partnership level.

A special sourcing rule applies to sales of personal property by a partnership,[44] but that special rule would not apply to US LLC selling its U.S. real estate. As described above, gains on sales of real estate are sourced to the location of the real estate.[45] Because the real estate owned by US LLC is located in the United States, if US LLC were to sell its U.S. real estate, the gain on the sale would be U.S.-source income. Because the gain would not be Puerto Rican-source income, it could not be excluded from Jack and Diane's U.S. taxable income.

Gain on Sale of US LLC (Issue 11)

Gain on the sale of a partnership interest is gain on the sale of personal property. As described above, gain from the sale of personal property, other than inventory, is generally sourced to the

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39 Treas. Reg. §1.937-1(e).

40 Code §701.

41 Code §702(a).

42 *Id.*

43 Code §702(b).

44 Code §865(i)(5).

45 Code §861(a)(5).

residence of the seller.[46] If Jack and Diane sell their interest in US LLC while they are bona fide residents of Puerto Rico, the general rule is that the gain will be Puerto Rican-source income.[47]

As indicated, US LLC owns U.S. real estate. If a nonresident alien or a foreign corporation sells an interest in a partnership where the partnership owns U.S. real estate, a special rule applies to look through the partnership and to treat a proportionate amount of the sale of the partnership interest as a sale of the U.S. real estate.[48] Jack and Diane are not nonresident aliens or foreign corporations. Therefore, this special rule does not apply to them.

Another special rule applies where a nonresident alien or a foreign corporation sells an interest in a partnership which is engaged in a U.S. trade or business.[49] Again, because Jack and Diane are not nonresident aliens or foreign corporations, this special rule also does not apply to them.

A bona fide resident of Puerto Rico is generally treated as a nonresident for purposes of sourcing under Code §865.[50] Code §865(e)(2)(A) contains a special rule for gains attributable to a U.S. office or fixed place of business of a nonresident. Although a U.S. office or fixed place of business of US LLC would likely be attributed to Jack and Diane for this purpose,[51] gain recognized by Jack and Diane on a sale of the partnership interest would not be the type of income regularly earned by the U.S. office or fixed place of business.[52] Therefore, gain recognized by Jack and Diane should not be attributable to a U.S. office or fixed place of business and should not be U.S.-source income under the special rule in Code §865(e).

In general, the sale of a partnership interest is treated as a sale of a capital asset and results in capital gain or loss.[53] There is an exception that requires taxpayers to report the sale of a

[46] Code §865(a)

[47] *Id.*

[48] Code §897(g).

[49] Code §864(c)(8).

[50] Code §865(g).

[51] Code §865(e)(3) and 864(c)(5).

[52] Code §864(c)(5)(B) and *Grecian Magnesite Mining v. Commr.*, 926 F.3d 819 (D.C. Cir. 2019), *aff'g* 149 T.C. 63 (2017)

[53] Code §741. In Rev. Rul. 99-6, Situation 2, a partnership terminated when one person purchased all of the ownership interests of a partnership. The IRS ruled

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partnership interest as resulting in ordinary income or loss if the partnership holds unrealized receivables or inventory items.[54] In *Rawat v. Commr.*,[55] the Tax Court held that the partnership "aggregate" rule[56] in Code §751 (which recharacterizes gain as ordinary income) requires the selling partner to be treated as selling an interest in the partnership assets for sourcing purposes.[57]

However, the D.C Circuit recently reversed the Tax Court,[58] holding that Code §751 merely changes the character of the income from capital gain to ordinary income and does not affect the source of that income. Under *Golsen v. Commr.*,[59] the Tax Court follows the law as stated by the Court of Appeals in the circuit to which the case is appealable. Taxpayers resident in Puerto Rico appeal Tax Court cases to the First Circuit. It remains to be seen whether the Tax Court will reverse its own precedent and follow the holding in the D.C. Circuit or whether the Tax Court will follow its precedent for cases appealable to other circuits.

To simplify our analysis, we have assumed that US LLC has no unrealized receivables or inventory items. Under this assumption, Jack and Diane should not be treated as having sold any of the assets of US LLC for sourcing purposes. However, in a real-world situation, it would be necessary

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that the purchaser and the sellers were treated in different ways. The purchaser was treated as having purchased assets (after the partnership was deemed liquidated), and the sellers were treated as having sold partnership interests. Rev. Rul. 99-6, Situation 2 should have no impact on the analysis in this article because Jack and Diane (the sellers) will be treated as having sold partnership interests.

54 Code §751.

55 T.C. Memo. 2023-14.

56 As opposed to the "entity" rule.

57 See also *Glade Creek Partners, LLC v. Commr.*, T.C. Memo. 2023-82 ("There is an exception that requires taxpayers to report the sale of a partnership interest as resulting in ordinary income or loss if the partnership holds inventory. § 751(a)(2); Treas. Reg. § 1.751-1(a)(2). In such a case, the partner is treated as selling an interest in the partnership assets. Rawat v. Commissioner, T.C. Memo. 2023-14".).

58 *Rawat v. Commr.*, 134 AFTR 2d 2024-XXXX, (CA Dist Col), 07/23/2024.

59 54 T.C. 742 (1970), *affd.* 445 F.2d 985 (10th Cir. 1971).

to determine what portion, if any, of the assets of US LLC were unrealized receivables or inventory items.[60]

Code §937(b) and Treas. Reg. §1.937-2 provide special rules to determine whether income is from sources within a U.S. possession (such as Puerto Rico). Treas. Reg. §1.937-2(c)(1) provides in part:

> * * * [I]ncome from sources within [Puerto Rico] will not include any item of income determined under the rules of sections 861 through 865 and the regulations under those provisions to be—
>
> (i) From sources within the United States; or
>
> (ii) Effectively connected with the conduct of a trade or business within the United States.

As described above, the general rule is that gain on the sale of US LLC is likely Puerto Rican-source income and no exceptions to the general rule apply. Thus, Treas. Reg. §1.937-2(c)(1)(i) should not be of concern.

Treas. Reg. §1.937-2(c)(1)(ii) applies to income effectively connected with a U.S. trade or business. In general, only U.S. source income is effectively connected with a U.S. trade or business.[61] As described above, gain recognized by Jack and Diane on a sale of their partnership interests in US LLC should not be U.S. source income. Consequently, such gain should not be effectively connected with a U.S. trade or business.

As discussed above under Issue 6, a 5% Puerto Rican tax will apply to pre-residency appreciation.

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60 Note that depreciation recapture may be an inventory item. Code §751(d). As such, depreciation recapture with respect to U.S. real estate may be treated as U.S. source income. Code §865(c).

61 Code §864(c)(4)(A). Code §864(c)(4)(B) contains three situations where foreign-source income is effectively connected with a U.S. trade or business. None of those exceptions apply to gain recognized by Jack and Diane on the disposition of US LLC.

Treatment of Jack's 401k (Issues 12 & 13)

Jack's 401k is not subject to the mark-to-market regime because it is a deferred compensation item.[62] Eligible deferred compensation items are subject to a flat 30% tax at the time of distribution.[63] Other deferred compensation items ("ineligible deferred compensation items") are treated as being distributed on the day before renouncing.[64]

An eligible deferred compensation item generally means a deferred compensation item where the individual provides a Form W-8CE, *Notice of Expatriation and Waiver of Treaty Benefits*, to the 401k administrator within 30 days of renunciation.[65] The individual must also make an irrevocable election on Form 8854, *Initial and Annual Expatriation Information Statement*, to waive any right to claim any withholding reduction under any treaty with respect to the item.[66] The individual must also annually file Form 8854 to certify that no distributions have been received from his or her eligible deferred compensation item(s) or to report the distributions received.[67]

If Jack wants to avoid being taxed as if he received a distribution of his entire 401k on the day before he renounces his U.S. citizenship, he should provide Form W-8CE to his 401k administrator

62 Code §877A(d)(4).

63 Code §877A(d)(1)(A) and Notice 2009-85, §5.C. ("30 percent withholding tax that cannot be reduced or eliminated by treaty."). IRS notices do not comply with the notice-and-comment requirements of the Administrative Procedure Act ("APA"). In the recent case of *Mann Construction, Inc. v. U.S.*, 27 F.4th 1138 (6th Cir. 2022), Notice 2007-83 was set aside because it did not comply with such requirements. The 6th Circuit held that Notice 2007-83 was a legislative rule (which is subject to the notice-and-comment requirements) and not an interpretive rule (which is not subject to the notice-and-comment requirements). We have not performed any analysis to determine whether Notice 2009-85 is a legislative rule or an interpretive rule. Taxpayers may not need to follow all of the rules specified in Notice 2009-85. However, to the extent Notice 2009-85 is based on statutes or final regulations, those rules would need to be followed.

64 Code §877A(d)(2)(A) and Notice 2009-85, §5.

65 Notice 2009-85, §5.B.(2) and §8.D.

66 Notice 2009-85, §8.C.

67 *Id.*

within 30 days of his renunciation, and he should file Form 8854 electing to waive any treaty claim.

U.S. Tax on Interest Income (Issue 14)

After Jack and Diane renounce their U.S. citizenship, they will be nonresident aliens ("NRAs"). In general, foreign individuals who derive fixed and determinable annual and periodical income from U.S. sources – items such as dividends, royalties, interest, and compensation – are subject to a 30% tax on the gross amount of such income.[68]

The tax is imposed on the gross amount paid and no reduction in the tax base is allowed for any deductible expenses. The tax is generally collected by the person in the U.S. that makes the payment.[69]

Tax treaties often reduce the 30% rate of tax, and the U.S. has an income tax treaty with Switzerland (the "Treaty"). However, Jack and Diane will not qualify for treaty relief because they will be taxed in Switzerland under the special "forfait" tax regime. To qualify for benefits under the Treaty, Jack and Diane must be considered residents of Switzerland.[70] Jack and Diane will not be considered residents of Switzerland because they will elect to not be subject to the generally imposed income taxes in Switzerland.[71]

Although Jack and Diane may not be able to rely on the Treaty to avoid U.S. tax on the interest income, it may be possible to structure the promissory note to qualify for the portfolio interest exception.[72] To meet this exception, the promissory note would need to be in registered form[73] and Jack and Diane would need to provide W-8BEN, *Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)*, to the borrower.[74]

68 Code §871(a).

69 Code §§1441 and 1442.

70 Article 4 of the Treaty.

71 Article 4, paragraph 5 of the Treaty.

72 Code §871(h).

73 Code §871(h)(2)(B)(i).

74 Code §871(h)(2)(B)(ii).

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U.S. Tax on Consulting Income (Issue 15)

Jack and Diane will perform consulting services for USCo after they sell USCo and move to Switzerland.[75] They will perform all of the services while they are located in Switzerland. Jack and Diane will be NRAs. As described above foreign individuals who derive fixed and determinable annual and periodical income from U.S. sources are subject to a 30% tax on the gross amount of such income.[76]

Personal services income is sourced to where the services are performed, without regard to the location of the payor, the residence of the taxpayer, the place of contracting, or the place of payment.[77] Because Jack and Diane will perform all of the consulting services from Switzerland, all of the income will be foreign-source income. None of the income will be U.S. source income. Because, the U.S. 30% withholding tax only applies to U.S. source income, the withholding tax should not apply to the consulting income received by Jack and Diane.

After renouncing their U.S. citizenship, Jack and Diane should each provide Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*, to USCo. By signing Form W-8BEN, Jack and Diane will be certifying that they are not U.S. persons and that the income is not effectively connected with a U.S. trade or business.

Post-Renunciation Gifts & Bequests (Issue 16)

In 2008, Congress enacted Code §2801, which imposes a tax on the fair market value of gifts and bequests received by a U.S. citizen or resident from a covered expatriate.[78] The taxable amount

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75 The hypothetical facts provide that Jack and Diane will earn consulting income and that Jack and Diane will be taxed in Switzerland under the forfait regime. This fact pattern may not be entirely realistic because taxpayers may not qualify for the Swiss forfait regime if they earn services income.

76 Code §871(a).

77 Code §§861(a)(3), 862(a)(3); Treas. Reg. §1.861-4(a); *Francisco v. Commr.*, 119 T.C. 317 (2002); *Dillin v. Commr.*, 56 T.C. 228, 244 (1971).

78 A covered expatriate is generally an individual that was subject to the mark-to-market regime under Code §877A. Code §877A(g)(1). Jack and Diane will be covered expatriates after they renounce their U.S. citizenship.

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is reduced by the annual gift tax exclusion (currently $18,000).[79] The tax rate is the highest rate specified in Code §2001(c) (currently 40%).[80]

The U.S. citizen or resident receiving the gift or bequest is liable for payment of the tax.[81] The amount of the tax under Code §2801 can be reduced by foreign gift or estate taxes imposed.[82]

Notice 2009-85 provides that satisfaction of the reporting and tax obligations under Code §2801 is deferred, pending the issuance of separate guidance by the IRS. In 2015, the IRS issued proposed regulations under Code §2801.[83] However, those regulations have not yet been finalized.

If Jack and Diane make taxable gifts or bequests to their U.S.-citizen children after they have renounced their U.S. citizenship those gifts or bequests will be subject to the 40% tax. Even though the obligation to report and pay the tax has been deferred, it has not been waived. The tax imposed under Code §2801 will be reported on Form 708 (which does not yet exist). The preamble to the 2015 proposed regulations states:

> The IRS intends to issue Form 708 * * *. The IRS will provide the due date for filing * * * and for payment of the * * * tax liability in the final regulations. * * * U.S. recipients will be given a reasonable period of time after the date the final regulations are published * * * to file the Form 708 and to pay the section 2801 tax on covered gifts and covered bequests received on or after June 17, 2008, and before the date of publication of the final regulations in the Federal Register. Interest will not accrue on the section 2801 tax liability for any taxable years until the due date for payment, as specified in the final regulations, has passed.

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79 Code §2801(c), Code §2503(b), and Rev. Proc. 2023-34.

80 Code §2801(a)(1).

81 Code §2801(b).

82 Code §2801(d).

83 REG-112997-10; 80 FR 54447.

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Pre-Renunciation Gifts & Bequests (Issue 17)

The U.S. imposes an estate tax on the taxable estate of U.S. citizens.[84] The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death.[85] The taxable estate generally equals the worldwide gross estate less certain allowable deductions, including a marital deduction for certain bequests to the surviving spouse of the decedent and a deduction for certain bequests to charities.[86]

U.S. gift and estate taxes are unified such that a single graduated rate schedule and exemption apply to an individual's cumulative taxable gifts and bequests. A unified credit of $5,389,800 (for 2024) is available to U.S. citizens with respect to taxable transfers by gift or at death. This credit effectively exempts a total of $13.61 million (for 2024)[87] in cumulative taxable transfers from the gift tax or the estate tax.

Jack and Diane are currently U.S. citizens. If they were to now gift assets to their U.S.-citizen children, they could utilize their gift/estate tax exemptions. Pre-renunciation gifts below the exemption amount would allow their children to avoid the Code §2801 tax as well as for Jack and Diane to avoid U.S. gift or estate tax.

U.S. Estate & Gift Tax (Issue 18)

After Jack and Diane renounce their U.S. citizenship, they will only be subject to U.S. gift and estate tax on U.S.-situs property.[88] However, their estate tax exemption will be reduced to $60,000.[89]

A discussion of the U.S. estate and gift tax rules for non-U.S. citizens is beyond the scope of this article. It is important to note, however, that shares of stock of U.S. corporations are deemed to

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84 Code §2001.

85 Code §2031, *et seq*.

86 *Id*.

87 The basic exclusion amount is indexed for inflation. Code §2010(c)(3)(B).

88 Code §2101, *et seq* and Code §2501, *et seq*.

89 Code §2101(b) (a credit of $13,000 which effectively exempts a total of $60,000).

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be U.S.-situated assets.[90] Thus, if Jack or Diane passes away owning U.S. equities, those equities would generally be subject to U.S. estate tax.[91]

Form 8854 (Issue 19)

Individuals subject to the mark-to-market regime under Code §877A must file Form 8854, *Initial and Annual Expatriation Information Statement*.[92] The penalty for failing to file Form 8854 is $10,000.[93]

Jack and Diane should each file Form 8854 for the year they renounce their U.S. citizenship.

CONCLUSION

Jack and Diane have many things to think about. If Jack and Diane were not 10-year residents of Puerto Rico and expatriated, they would owe U.S. exit tax on roughly $114,000,000[94] of deemed gain under the mark-to-market regime. This would result in a federal tax bill in the range of $25-$40 million ($114,000,000 * 20%-40.8%). However, because they are in the unique position of being 10+ year residents of Puerto Rico with Act 60 benefits, they have some truly unique tax planning opportunities available to them to almost fully eliminate their federal tax bill, in the event they decide to expatriate.

The focus of this discussion has been on the U.S. tax rules related to Jack and Diane's potential renunciation of their U.S. citizenship. However, before deciding to renounce, Jack and Diane should have extensive discussions with an immigration attorney.

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90 Code §2104(a).

91 The U.S. does have an estate tax treaty with Switzerland. We have not analyzed whether Jack and Diane may qualify for benefits under this treaty or what those benefits may be.

92 Code §6039G(a).

93 Code §6039G(c).

94 $117,000,000 less the 401k amount of $3,000,000.

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About Tom Duffy, C.P.A., P.A. & P.C.

Tom Duffy C.P.A., P.A. & P.C. is a Greater Chicago-based firm that specializes in international taxation with a particular focus on U.S. possessions. In addition, the firm is one of the few CPA firms in the country that specializes in representing residents of Puerto Rico during IRS examinations, specifically those taxpayers granted tax incentives under Puerto Rico's Act 60 (formerly Act 20/22).

Our foreign clients rely on our knowledge and expertise in complying with their U.S. tax obligations. Tom Duffy has over fifteen years of experience in international tax planning and associated U.S. tax return preparation. The firm services clients in the United States, its possessions, and throughout the world. Tom Duffy is a member in good standing with the American Institute of CPAs and the Puerto Rico Society of CPAs. He is licensed to practice in Florida, Illinois, and Puerto Rico.

For more information and tax-related articles on Puerto Rico's Act 60 program, please visit us at www.tomduffycpa.com

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