



Errors in IRS Publication 1321 Regarding the Allocation and Apportionment of Charitable Contributions for Residents of Puerto Rico

Facts

Bob is a U.S. citizen and bona fide resident of Puerto Rico for the entire year. This year Bob earned \$24,000 from Puerto Rico sources and \$96,000 from U.S. sources. All of the income earned was compensation for services. Bob itemizes deductions, and included in the itemized deductions are \$5,000 of charitable deductions (cash contributions) to a U.S. charity.¹

IRS Publication 1321 indicates that Bob can only deduct \$4,000 of the \$5,000 on Schedule A. This is computed as $\$5,000 \times (96,000 / 120,000)$.

Issue

Is IRS Publication 1321 wrong? In other words, can Bob deduct the full \$5,000 on Schedule A?

Conclusion

Yes, IRS Publication 1321 is wrong. Bob can deduct the full \$5,000 on Schedule A.

Discussion

Treas. Reg. §1.937-2(b)² provides that unless an exception applies, the principles of Code §§861 through 865 and the regulations under those provisions are applied in determining the gross and the taxable income from sources within and without the relevant possession. In discussing the allocation and apportionment of expenses under Treas. Reg. §1.861-8, the Tax Court recently stated in *Aptargroup, Inc. v. Commr.*:³

¹ These facts are loosely based on the example at the bottom of Page 2 of IRS Publication 1321 (last updated October 2021). <https://www.irs.gov/pub/irs-pdf/p1321.pdf>.

² All section references are to the Internal Revenue Code of 1986, as amended (the “Code”) and the regulations promulgated thereunder.

³ 158 T.C. No. 4 (2022).



In general, expenses are allocated and apportioned on the basis of the factual relationship of the expense to gross income. Expenses are allocated to the class of gross income to which they definitely relate. Some expenses are not definitely related to a class of gross income or are related to all gross income and thus must be ratably allocated to all gross income. Next, if necessary, expenses are apportioned between the statutory and residual groupings. [footnotes and citations omitted]

Thus, under Treas. Reg. §1.861-8 expenses are first allocated to a class of gross income. Then expenses are apportioned between the statutory and residual groupings within that class of gross income.

Bob only earns income from services. Therefore, the only relevant class of gross income should be “compensation for services.”⁴

The gross income that can be excluded from Bob’s income under Code §933 is the statutory grouping, and all other income is the residual grouping.⁵ Only Bob’s Puerto Rican-source income can be excluded from income under Code §933. Therefore, \$24,000 of Bob’s gross income (the Puerto Rico-source gross income) is in the statutory grouping. In addition, \$96,000 of Bob’s gross income (the US-source gross income) is in the residual grouping.

Treas. Reg. §1.861-8(e)(12)(i) provides in full:

The deduction for charitable contributions that is allowed under sections 170, 873(b)(2), and 882(c)(1)(B) is definitely related and allocable to all of the taxpayer's gross income. The deduction allocated under this paragraph (e)(12)(i)

⁴ Code §61(a)(1).

⁵ Treas. Reg. §1.861-8(a)(4) (“* * * the term ‘statutory grouping of gross income’ or ‘statutory grouping’ means the gross income from a specific source or activity which must first be determined in order to arrive at ‘taxable income’ from which specific source or activity under an operative section. (See paragraph (f)(1) of this section.) Gross income from other sources or activities is referred to as the ‘residual grouping of gross income’ or ‘residual grouping.’ In some instances, where the operative section so requires, the statutory grouping or the residual grouping may include, or consist entirely of, excluded income. * * *”). It is arguable that the statutory grouping and the residual grouping could be reversed, or that the US-source income and the Puerto Rican-source income could both be considered statutory groupings. However, the result should be the same in this example regardless of how the two types of income are labeled.



shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources in the United States in each grouping.

A review of the statute and regulations did not reveal any exceptions to the rule in Treas. Reg. §1.861-8(e)(12)(i) for bona fide residents of Puerto Rico.

The apportionment for charitable contributions is based on “relative amounts.” That is, the deduction is apportioned “on the basis of the relative amounts of gross income from sources in the United States in each grouping.”

None of the gross income in the statutory grouping is US-source income. In addition, all of the gross income in the residual grouping is US-source income. In calculating the amount apportioned to the statutory grouping, the formula would be $\$5,000 \times (0 / 100)$. Thus, none of the charitable deductions would be apportioned to the statutory grouping of gross income.

In contrast, in calculating the amount apportioned to the residual grouping, the formula would be $\$5,000 \times (100 / 100)$. Thus, all of the charitable deductions would be apportioned to the residual grouping of gross income.

This would mean that all \$5,000 of the charitable contribution should be apportioned to the US-source income (the residual grouping). In other words, all \$5,000 of the charitable contribution should be allowed as a deduction on Schedule A.

This interpretation is consistent with the instructions to Schedule K-2 (“Charitable contribution deductions are apportioned solely to U.S. source gross income.”) and with Schedule K-2 itself, which only allows an input for charitable contributions being allocated or apportioned against US-source income.

An older version of Treas. Reg. §1.861-8 provided for the apportionment of charitable contributions between the statutory and residual groupings using a ratable apportionment on the basis of gross income (similar to the approach in IRS Publication 1321). However, in 2004, the regulation was changed “to ensure that a taxpayer is not discouraged from making a charitable contribution.”⁶

⁶ Treasury Decision 9143.



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IRS Publication 1321 is incorrect in only allowing a deduction of \$4,000 on Schedule A.

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